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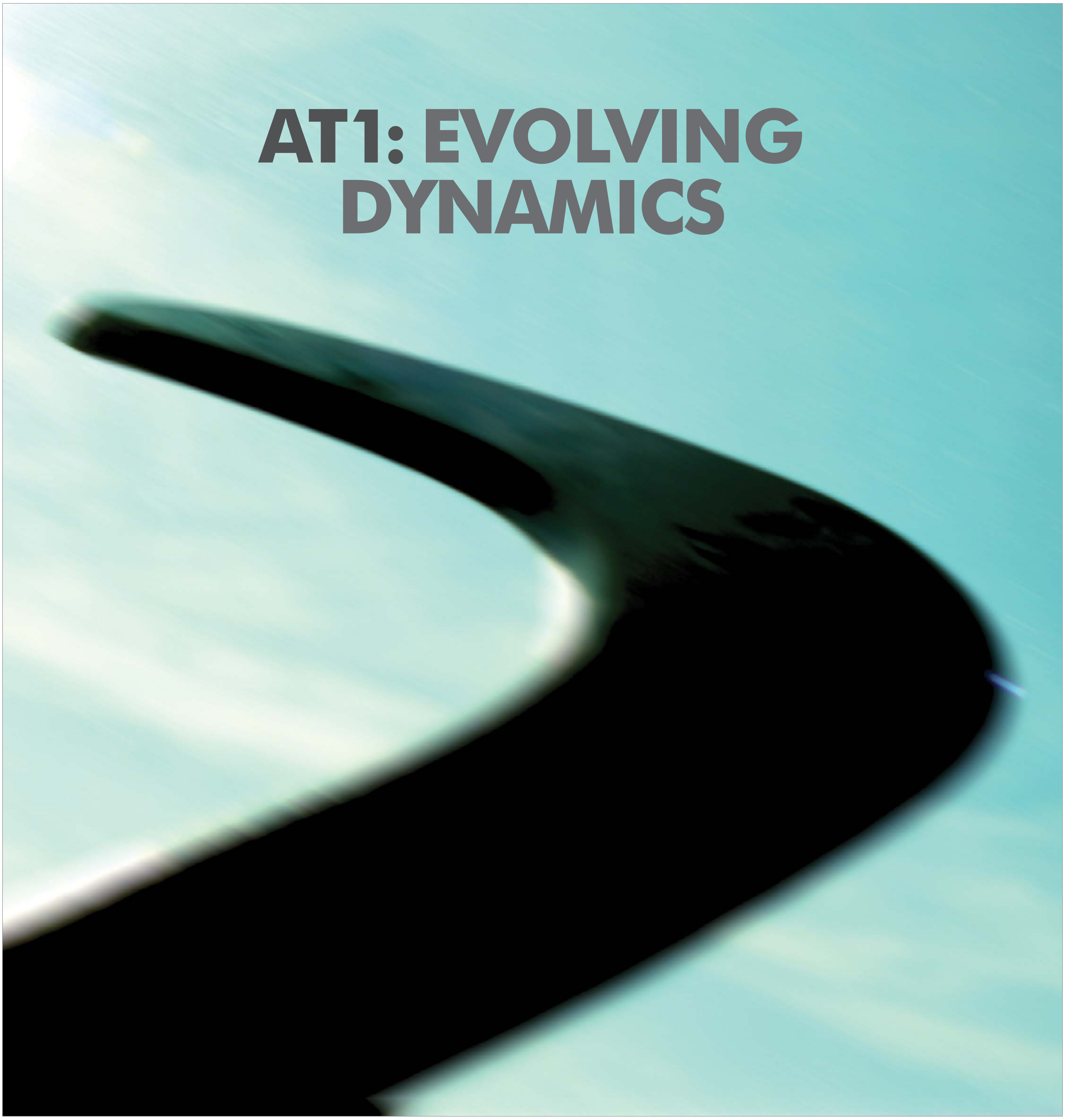


AT1: EVOLVING DYNAMICS

3Q 2018

AT1
Evolving dynamics

Rising yields, volatility and risk premia combined with developments in regulation are posing challenges and questions for issuers and investors alike — just as the first wave of AT1 calls arrives. Crédit Agricole CIB and Bank+Insurance Hybrid Capital brought together the different sides of the market to share their views on how pricing and capital stacks should develop.

Neil Day, Bank+Insurance Hybrid Capital (BIHC): AT1 valuations have moved significantly since issuers like Nordea and Belfius priced euro-denominated AT1s at record reset levels in November 2017 and January 2018, respectively. What are the major differences between the situation back then and today's environment? How do you cope with the negative mark-to-market?

Marc Stacey, BlueBay: The repricing has less to do with the banks themselves — they continue to be well capitalised and asset quality continues to improve. In essence, the repricing has been mainly driven by macro/political factors and a repricing of risk premiums generally. So the value prospect today makes the investment proposition even more compelling.

Over the last 10 years banks have continued to streamline the types of business they are involved in and have increased capital levels. Prior to the crisis common equity made up roughly 6% of banks' risk-weighted assets and today that number is closer to 14.8% on average — in absolute terms over EUR600bn of equity has been added onto banks' balance sheets. We didn't lose nearly that number during the financial crisis, so in essence we've actually added onto banks' balance sheets a buffer that could almost withstand the financial crisis again — I am not suggesting that if we had a repeat of the global financial crisis certain banks wouldn't find themselves in trouble, but it does give you a sense of how much safer banks are today than they've been before.

Given this fundamental trajectory I think AT1 looks particularly compelling, especially when compared to Lower Tier 2, for example. Perhaps the biggest risk differential between AT1 and Lower Tier 2 is the prospect of a non-coupon payment of the AT1, and in some cases one would have to have AT1 coupons missed 60% of the time just to break even with the Lower Tier 2 valuation. So by that metric AT1 looks extremely cheap versus Lower Tier 2.

Jenna Collins, BlueCrest: Even though I totally agree banks look great and I love their credit quality, one has to look at this on a relative basis. We have a situation where rates have been going up in the US, and a two year Treasury — zero risk, basically — trades at 2.7%. This starts to look interesting to people. And that has a cascading effect on other assets.

We still really like top tier, national champion names in AT1 as long as they are priced with a good new issue premium — for example, some of the more recent ones, including Credit Suisse 7.5% and 7.25%. But it's tricky for the second tier banks when zero risk-ish assets become attractive — second tier assets don't then look as cheap anymore.

Neel Shah, Crédit Agricole CIB (CACIB): The market pricing of AT1s overstretched in Q4 last year and at the beginning of this year. Investors we speak to compare the AT1s within the financial space, but with high yield as well, and AT1s are trading 100bp-150bp wide of double-B bonds — they are trading almost like single-B rated bonds in terms of yield. So if you look at the bigger picture beyond the financials universe, they definitely look much more attractive. And we have heard recently about defaults in China and Asian high yield is also underperforming, so we've seen a substantial shift by Asian investors from high yield Asian credits back into AT1s.

Alexandre Birry, S&P Global Ratings: It's true that in terms of fundamentals, banks are better capitalised and balance sheets are more resilient. So I don't think these market developments are driven by banks' credit quality or profitability. Political risk is clearly there, but we saw that last year already, so it is not a new story. The dynamics around interest rates in the US are a more plausible explanation for market conditions.

In addition, while many banks have more or less filled their AT1 buckets, their attention has now increasingly turned to MREL and TLAC instruments. There is probably an expectation in the market that there will be all this supply of new instruments — even if less subordinated — in the next couple of years. And this at a time when the ECB's monetary support is gradually fading.

The roundtable was hosted by Crédit Agricole CIB on 31 August in London, featuring:

Ervin Beke, bank analyst, BlackRock

Olivier Bélorgey, global head of Crédit Agricole group treasury and funding

Alexandre Birry, head of analytics and research, financial institutions, S&P Global Ratings

Michael Benyaya, DCM solutions, Crédit Agricole CIB

Nigel Brady, AT1 trader, Crédit Agricole CIB

Jenna Collins, credit trader, BlueCrest Capital Management

Bernard du Boislouveau, FI DCM, Crédit Agricole CIB

Vincent Hoarau, head of FI syndicate, Crédit Agricole CIB

Sebastiano Pirro, portfolio manager, Algebris Investments

Neel Shah, financial credit desk analyst, Crédit Agricole CIB

Marc Stacey, partner, senior portfolio manager, BlueBay Asset Management

Aarti Vasudeo, senior manager, capital issuance, ratings and debt IR, Lloyds Banking Group

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

So for me, monetary policy and the industry's overall issuance requirements are some of the main elements driving the market changes, rather than bank fundamentals or even political risks.

Ervin Beke, BlackRock: To answer to your question as to what's different to six months ago in AT1s, it's really convexity. It wasn't priced in in January. Now it seems to be more rationally priced and the main driver of developments — apart from all the other macros factors that have been mentioned.

Nigel Brady, CACIB: One of the approaches to pricing that we now use is to look at the current financing core funding rate for AT1s as opposed to where the existing secondary bonds are, because they are clouding the relative value and performance of AT1s — if you are using Nordea or Belfius, for example, they clearly make the AT1 market look much worse this year than it is. If you actually look at the underlying core finance rate, it isn't that much wider than it was at the beginning of the year. It's just that all the bonds that were issued at a tighter level due to this convexity effect are obviously impacted harder.

Vincent Hoarau, CACIB: Coming sub-300, Belfius's reset spread was quite punchy. In January there was a striking imbalance between supply and demand in the AT1 market and clearly there was a sort of frenzy in the air. The market was pricing only good news, everyone was positioned for a goldilocks scenario.

Then we had the first shock, with rates pushed higher in the US by a more hawkish Fed on the risk of an overheated US economy. But the greater catalyst for the correction was Italy and the shock it implied for VAR models, and the spill-over effect across the board. Lastly, the ongoing rhetoric around a trade war simply stimulated the volatility of the equity markets to which AT1 instruments are highly correlated.

As everyone has said, what has changed is the level of volatility driven by macro events, and the reward requested by investors to load mark-to-market risk in the investment book. We have moved from a liquidity-driven market to a macro, fundamental-driven market with a greater AT1-bank equity correlation.

Now, with the intensification of EM risk, idiosyncratic risks are set to return, i.e. more pronounced discrimination and differentiation. And some names are clearly much more exposed than others.

Also bear in mind that AT1 now face the competition of other high yield products which suffered massively throughout H1.

Aarti Vasudeo, Lloyds: 'The call policy is based on an overall capital management perspective'

But the strong appetite for the asset class is intact, providing that valuations make sense.

Day, BIHC: We have the first wave of AT1s coming up to their first call dates. What have issuers' Tier 1 call policies been until now?

Aarti Vasudeo, Lloyds: Generally we look at it in two separate buckets. One is legacy stack Tier 1, and the other is the AT1 instrument. We know the legacy stack is not going to count towards regulatory capital beyond a certain point, so the drivers for calling or not calling such instruments are how they will be treated.

For the AT1 instrument, it is assessed on an economic basis, does it makes sense from a capital stack perspective, how can we optimise the overall capital stack, is there any more bucket filling to be done as RWAs move, etc? So the call policy is based on an overall capital management perspective.

The strong appetite for the asset class is intact

Olivier Bélorgey, Crédit Agricole: We have systematically exercised our call when the instrument has no more regulatory value or when, for example, the instrument had a step-up. For example, in November 2015 we exercised a call on a legacy Tier 1 bond that had a step-up — complying, in a sense, with the original deal that was made with investors, because when these instruments with step-ups were originated clearly the implicit intention was to call the instrument.

Beyond that, last year we launched a liability management exercise for a perpetual deal without any step-up, proposing to investors to buy back the bond at 95, bearing in mind that the original deal with investors was that it could be perpetual. We noted when launching this liability management exercise that our policy is first of all to maintain a medium and long term relationship with investors, so in a sense to be investor-friendly. That doesn't meant that we will call a bond if it's clearly to the detriment of the bank, but we want to have a combined approach between this medium to long term relationship with investors and, of course, our own interest.

Stacey, BlueBay: It is important for investors to understand what the economics behind the call or the non-call are. Take AT1 as an example: I think that the decision of whether or not to call that bond should be based on significantly more than just the market conditions prevailing at the moment of the call and the reset spread. If a bank issued a bond at, say, mid swaps plus 500bp and since then profitability has improved at the bank and the capital position is stronger, but because of exogenous market conditions external to the bank — call it Turkish lira volatility or Italian political turmoil — risk premia generally have risen and the reset spread to issue a new bond today is wider than the reset spread of mid swaps plus 500bp; it would be very difficult for investors to understand why that bonds wouldn't be called given the improvement in the bank's metrics since it was issued. As a result, issuers should think more holistically about their entire curve and capital structure, including the cost of equity, instead of just a particular bond and its respective reset spread at one point in time.

Collins, BlueCrest: I'm an investor and I don't find it hard to understand their position — they're going to do what they need to do for themselves, right?

Stacey, BlueBay: Absolutely. But what is that? Is it not calling that bond? Let's say on that day they can only issue at mid-swaps plus 550bp.

Collins, BlueCrest: So for them it doesn't make sense.

Stacey, BlueBay: Doesn't it? Longer term it actually raises their cost of capital, because as soon as they don't call that bond, then as an investor I sit back and I think, OK, so if at mid swaps plus 500bp they don't call the bond, that's got to be the floor now for where their AT1 bonds should trade and I'll need a premium over and above that if they want to issue another AT1 bond.

Collins, BlueCrest: For now, and then it'll change when market spread/yield levels trade tighter again.

Day, BIHC: What flexibility do banks have from a regulatory perspective on making such decisions whether or not to call? Can you issue an AT1 now because the level is lower than one you might want to call next year? Bearing in mind that your cost of funding might go up permanently if you don't call a bond. Does that go against the spirit of the instrument?

Bélorgey, Crédit Agricole: AT1 remains a very expensive instrument, compared, for example, to Tier 2. If you have much more than the 1.5% bucket, which is the optimum, it costs you a lot of money. So issuing when spreads are low and having an AT1 stack of 2%, for example, would be costly. I don't think that banks generally speaking are ready to carry two times this type of instrument.

Take our issuance strategy, for example. Timing-wise, we issued the highest beta instruments in our 2018 funding plan — Tier 2 for Crédit Agricole SA and Crédit Agricole Assurances — right at the beginning of the year given that market conditions were wonderful — spreads were in a sense too low. Nevertheless, we haven't yet issued an AT1 ahead of our next call, in September 2019, partly because we don't know what market conditions will be then — perhaps they will be just as good — and also considering the cost of the double carry.

Day, BIHC: Would the regulator question you if you called an AT1 without having a replacement strategy even if you are still above the 1.5% level?

Vasudeo, Lloyds: The regulatory approval takes three to four months ahead of any call and any market notice. So banks will start thinking well in advance about when they should refinance — if they do need to refinance at all — and have a discussion with the regulator.

Pirro, Algebris: That would kill the economic argument, though, because it would mean that you basically have to prefinance your issue before you actually call it — then it would be economic 100% of the time, because you would have double the capital.

Vasudeo, Lloyds: There will definitely be some carry cost, but the question is how much you can you minimise that, taking into account the regulatory requirements and the bank's appetite to take carry cost.

Pirro, Algebris: But the regulator will not stop you from issuing more capital, because that's your decision.

Vasudeo, Lloyds: No it wouldn't, but it can stop you from calling a bond before you have actually issued a bond to ensure capital ratios do not go below certain levels.

Pirro, Algebris: But you have to issue beforehand, that's the point.

Bélorgey, Crédit Agricole: No, I don't think so. For example, many banks don't have 1.5% of AT1. This means that, at least temporarily, you can weaken your capital structure a little bit, at least by perhaps calling one issue.

Pirro, Algebris: My experience on this is that it depends a lot on where you are. In the UK, for example, no one has less than 1.5% and you are not allowed to go down. What we aren't clear about is Europe, which is much bigger and much more diversified. As you say, there are circumstances where it is conceivable, but my hunch would be that you are not allowed to go down. You shouldn't necessarily look at the worst, because institutions still have to strengthen. You have to look at the best, and my thinking is that Europe will follow the UK. Best practice has always come from the UK. The system is transparent and clean, and from the perspective I would assume that is the way it will work in Europe, too.

Sebastiano Pirro, Algebris: 'You have to look at the best, and my thinking is that Europe will follow the UK'

Stacey, BlueBay: Correct me if I'm wrong, but when I've had the opportunity to speak to any regulators, I've gotten the sense that they don't want to be micromanaging banks. Where possible they'd like banks to be able manage their own capital, and as long as it doesn't impact solvency or profitability materially then the decision to call a bond is really at their discretion, and they would only restrict the issuer if it really effected the capital or profitability of the bank.

Regulators don't want to be micromanaging banks

Bélorgey, Crédit Agricole: I cannot speak on behalf of my peers, of course, but I can perhaps give you some thoughts. We generate CET1 each quarter and banks in general probably generate in a quarter or semester enough CET1 to call one AT1 issue. If in your capital planning you tell the ECB that you will call the instrument but that you have no increase in RWA and so on and that due to the increase in CET1 your Tier 1 ratio remains the same, I don't think there is any reason you couldn't call the bond, and without being obliged to prefund.

Beke, BlackRock: But as a funding manager, if you are managing a bank that has an optimised capital structure — i.e. you've filled your buckets, you don't have excess capital — would you want to refinance an AT1 before calling it? Or would you wait?

Bélorgey, Crédit Agricole: To be honest, if you prefinance one, two, three months ahead of course you sleep better. Any later,

Jenna Collins, BlueCrest: 'It's not clear what different factors are considered'

and, depending on market conditions, you may have to accept a little more weight on your shoulders. So I would prefer to prefinance — but I think I could sleep all the same even if I didn't.

Beke, BlackRock: Aarti mentioned that the whole call discussion with the regulator starts three or four months beforehand — would it be the same with the ECB?

Bélorgey, Crédit Agricole: I cannot answer that because we do not yet have that kind of discussion with the ECB. What I know is that when I have to call an instrument I have to send the ECB my capital planning each time. So when we announced the call of the Tier 2 CoCo for September three months ago we had to tell the ECB we wanted to call that instrument and explain our capital planning for the next three years.

Brady, CACIB: If financing spreads were considerably wider in the three to four months before the call date of, say, the 2019s, would you then look at say a similar liability-management type option for the AT1s as for the legacy Tier 1s?

Vasudeo, Lloyds: From an issuer perspective, we assess how to best optimise the capital stack, and how to reduce the coupon cost or the spread for the bank overall, because most banks will manage their book on a spread basis. So if the reset spread is higher than what you can actually issue right now, then banks would look at refinancing. Obviously execution certainty and other external factors are considered.

Hoarau, CACIB: But we had a good example this year with KBC. It was a very good idea to look at refinancing some of its outstanding debt despite the added cost of carry. They managed to issue perpetual non-call 2025 in April with a reset spread well below the 400 mark. This would not be possible in the current spread complex.

Pirro, Algebris: Would regulators and issuers consider the potential repercussions on other parts of the capital structure as part of the call/non-call decision?

Vasudeo, Lloyds: Yes, absolutely. Calling or not calling a bond will also have implications on other parts of the capital stack and funding stack, too, so that's taken into consideration while discussing this internally.

Collins, BlueCrest: If I can make one point — which kind of goes back to Marc's original point — which is that what's missing is transparency on exactly how economic decisions are made. It's not clear what different factors are considered.

Issuers have Pillar 3 and other disclosures that are required by the regulators. But it would be good if issuers could just be much clearer about what the economic factors are for AT1 — capital attribution, spread level, swapped spread level — and disclose them in quarterly or semi-annually, maybe with the fixed income conference calls, in an addendum or something. Certain AT1s and other instruments have foreign exchange costs embedded, for example a sterling or euro-denominated bank that issues in dollars. If there is a big currency move, the issuer might find it doesn't make sense to call depending on the details on how it was hedged and accounted for but a euro-denominated bond might be called.

It shouldn't be a guessing game and the fact that there are these ongoing questions about what is going to happen is a concern. It takes a lot of time to keep asking issuers over and over how they make their economic decisions. It would take less time for everyone if disclosure was made on a semi-annual or annual basis.

Issuers are thinking about this in completely the wrong way

Vasudeo, Lloyds: It's bond-specific.

Collins, BlueCrest: You could do a line for each bond — based on current levels, this is what the economics look like to us, the issuer.

Day, BIHC: What if an issuer plans to refinance calling a 5% bond next year by issuing a bond at 7% in a month's time? Arguably that's not economic on a one-for-one basis, but does that 2% a year significantly affect the profitability of the bank? Will the regulator say it is against the spirit of the instrument?

Vasudeo, Lloyds: From an issuer perspective, economics of the call and the impact on profitability are primarily considered.

Stacey, BlueBay: I think issuers are thinking about this in completely the wrong way.

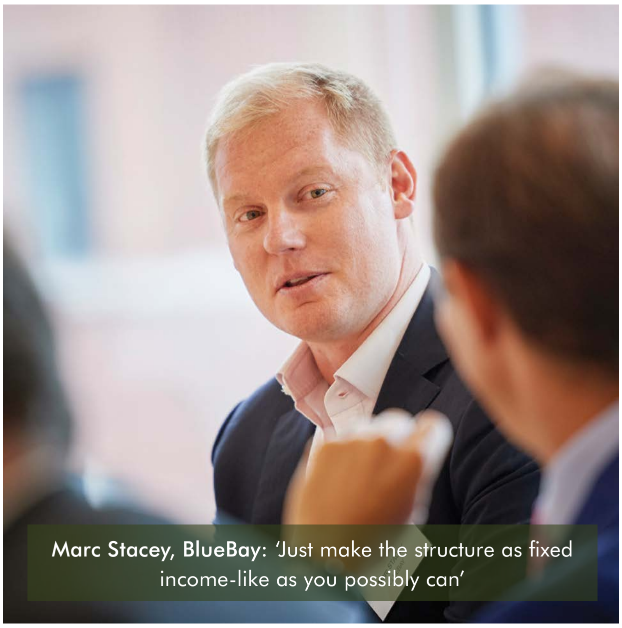
You say it's expensive Lower Tier 2, but the way I look at it is, it's extremely cheap equity for you. It's actually a gift from the regulator, in that you can fill a bucket with this cheaper capital which helps with both leverage and your total capital calculation. The alternative to AT1 for you would be common equity, which would be more expensive. So if I were an issuer I would think, well, my going concern capital bucket should just be made up of equity, with AT1 in my gone concern bucket. Essentially AT1 and the old Tier 1 have the same risks in terms of a bail in, and if we think about where Tier 1 traded back in 2007, it got to 69bp. Rightly or wrongly, AT1 has been predominantly sold to credit investors. So if I'm an issuer, I should be thinking, how do I make my AT1 as fixed income-like, as credit-like as I possibly can so it trades like the old Tier 1 of the past? I wouldn't be trying to game features in the terms like conversion to equity versus permanent write-down because I'm not getting paid for equity conversion at the time — just make the structure as fixed income-like as you possibly can, where the seniority of AT1 versus equity is unambiguously clear so it trades tighter in spread, like the gone concern capital it is. And eventually AT1 then makes it into IG and high yield credit indices — because, by the way, when you look at Banco Popular, it didn't matter whether you were in the equity, AT1, Lower Tier 2, and if they'd had any senior non-preferred that would have been haircut as well — so either Lower Tier 2 or senior non-preferred shouldn't be part of IG and high yield indices, or AT1 should, as the regulator treats them in the same way once a bank has been deemed failing or likely to fail. For issuers, the game-plan here should be to try to get AT1 as tight as possible, treat AT1 like credit not equity, in which case it will become an even cheaper source of capital and as a consequence improve profitability at the bank.

Looking at it on a bond by bond basis makes no sense at all, because as soon as you don't call a bond, against Lloyds I'd have, OK, you didn't call a bond at 400bp over, that's the floor for your spreads.

Bélorgey, Crédit Agricole: If you can tell me how many basis points I save if I call a bond — even if it is from a pure economic, short term maths perspective non-economic for me — I will give you more clarity on what is economic for me in a broader sense. But you don't give me that information.

Beke, BlackRock: If the regulator does not necessarily allow non-economic calls, then as an investor I will price you based on the assumption you will act in a purely economic way. Once the regulator allows them, then I will start giving credit to guys who actually have a strong policy and will call instruments, in which case I will price them to a shorter end date.

Bélorgey, Crédit Agricole: Again, we've not yet had that kind of discussion with the regulator, but my personal feeling is that I would be totally confident in being able to explain to the ECB that I am calling an instrument because my economic approach is the pure difference between the new issue spread and the reset spread and the impact on my future issuances. I think this is totally rational, and if the difference between the two spreads is reasonable, my feeling is that the ECB could accept this argument. Of course, if the difference is, let's say, 200bp, it would be hard for me to convince them that investors' attitude towards this is worth so much. So there would an area where I wouldn't expect the ECB to intervene, an area where the ECB would challenge the issuer a lot, and perhaps a grey area where it is not clear how they would react.



Marc Stacey, BlueBay: 'Just make the structure as fixed income-like as you possibly can'

Day, BIHC: Alexandre, does any of this affect your angle?

Birry, S&P: If I can start with the obvious: not calling is not an event of default. It's perfectly permissible under the terms of the instruments.

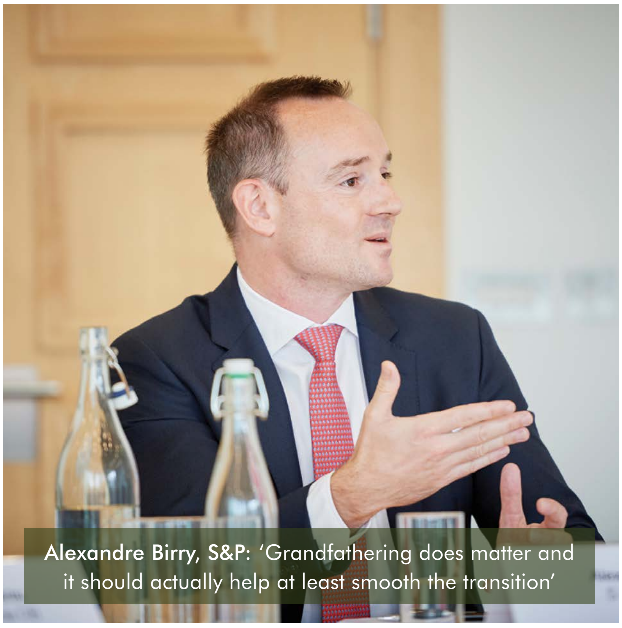
> **Some issuers may be erring on the side of caution**

For us, permanence is a key element of our criteria for granting equity content to an instrument. We may grant equity content to an instrument with call features, but on the premise that the issuer has full flexibility not to call the instrument, whether it's for economic reasons or others.

What we now see happening is a normal reflection by issuers willing to exert their discretion — after consultation with their supervisors. Issuers' readiness not to call has been more prevalent in other parts of the world and other industries, but it is now being tested in Europe.

Obviously, if not calling instruments led to a material and persistent deterioration in the overall cost of funding of an issuer, then we might not grant equity content to these instruments. It's a hard call to make, and at the moment we haven't seen that happen in practice. But some issuers may be erring on the side of caution — at least for now.

Day, BIHC: How could do you manage any FX volatility arising from hedging swaps for AT1 and how might that affect the call strategy?



Alexandre Birry, S&P: 'Grandfathering does matter and it should actually help at least smooth the transition'

Vasudeo, Lloyds: We definitely want to be a multi-currency issuer, across our capital stack and debt stack, and this is definitely a consideration for us. It is embedded in our planning in terms of impacts of calls, maturities and issuances, specifically because the UK AT1s are all equity accounted, which create volatility given the way they are accounted. So it is definitely high on our list of considerations.

It's basically a timing mismatch, because it just doesn't go through P&L, and you just get the hit at a later date, so that is considered when we plan for the next four or five years — we are conscious that there will be a call coming up, that if that bond is called then there will be certain impact on the P&L.

Clearly some instruments on the market do not tick all the boxes

Bélorgey, Crédit Agricole: In terms of interest rates, we have always hedged our issuances, so our call policy — at least for the pure mathematical economic part — is based on spreads, not absolute rates. And for the issuances we have made in dollars, we also have hedged the issuance, meaning that we didn't want to have P&L volatility — because the instrument is equity accounted, so if you do not hedge, you have P&L volatility coming from the other elements of the balance sheet — so we have hedged that. Doing so increases the sensitivity of your CET1 to forex moves a little bit. But it's already, each quarter, integrated in our CET1 ratios. So because we have hedged the forex risk of these instruments, we have a little more volatility in our CET1, but it's only some basis points in fact, so it's not really an issue for us. And at the end of the day, because it doesn't go through the P&L, for us forex risk won't impact our call policy. So what you need to know is that our call policy — at least the purely economic part of the equation — is only based on the spread.

Stacey, BlueBay: That's key as an investor, the investment decision should be simple for credit investors: you buy a bond, you get paid a coupon, you get par at the end. If we're starting to have to analyse what the bank did on its FX swap and having to implement that into our analysis, then there needs to be a much bigger premium for what we charge for your bonds. It's as simple as that.

Collins, BlueCrest: Or you could provide very clear information.

Stacey, BlueBay: Sure, but you need to have the information to be able to price it.

Day, BIHC: What are the most recent developments in terms of AT1 eligibility criteria in CRR2? How could this affect the outstanding stock of AT1?

Michael Benyaya, CACIB: The new draft for CRR2 and CRD5 proposes to include new eligibility criteria for both AT1 and Tier 2, notably in terms of set-off and bail-in acknowledgement.

In terms of set-off, there may be a need to include a formal contractual set-off waiver in the documentation. We need to see the final form of the text to see if it's really going to be necessary or not — it's unclear at this stage.

In terms of bail-in acknowledgement, this will be necessary for bonds issued under non-EU law, so maybe New York law and potentially English law post-Brexit. It may be necessary to change the documentation of some AT1 and Tier 2 instruments to introduce this bail-in acknowledgement. I'm not a lawyer, but I don't think it's a major change for investors, because it was already part of the instrument that it be subject to bail-in, so if it were to happen it would be only a kind of cosmetic change — it will not change the underlying risk of the instrument. But clearly some instruments on the market do not tick all the boxes, so here and there some action is necessary from particular issuers.

It is also worth bearing in mind that the new draft foresees some grandfathering provisions. Currently it's six years from 2019, so until 2025. If that's ultimately confirmed it will help ensure a smooth transition towards the new criteria.

Day, BIHC: Alexandre, have you been looking at this issue?

Birry, S&P: It is relevant for us because regulatory classification as AT1 is a necessary though not sufficient condition for us to give equity content to instruments. So for instance if an AT1 instrument meets our other criteria to be included in capital then we also look at the regulatory classification and if it's 100% AT1, perfect, that's the last condition and we can include the instrument in our analysis of capital for a bank. We therefore follow the grandfathering rules, and if there is, for example, pro rata treatment that reduces acknowledgement as AT1 over the life of an instrument, we would also follow this trend. That would be the approach we would take, so therefore grandfathering does matter and it should actually help at least smooth the transition.

Day, BIHC: Could grandfathering introduce a de facto final maturity on perpetual AT1 instruments and therefore discredit their perpetuity feature?

Benyaya, CACIB: It's difficult to give a final view until we see the text that has been voted by the parliament. But if some instruments are clearly identified as non-compliant with the new regulation you could question the perpetuity. However, this does not necessarily mean they will be called at the end of the grandfathering period — there are some other factors that can come into play, like rating agencies' model eligibility, for example. So yes, you could question the perpetuity of some instruments, but again you have to be careful, and there are some factors affecting the entire capital structure that can come into play.

Day, BIHC: Do you see trigger levels for AT1 evolving?

Stacey, BlueBay: If you think about all the restructurings that we've had in the sector, they've all been executed with CET1 ratios above 7%, right? So you can argue that even at 7% the trigger is too low. This goes back to my point that AT1 is gone concern capital. I mean, does a bank want to turn off a coupon to recapitalise itself? No, it makes no sense. There's a big German bank that could save EUR300m-EUR350m if it turned off a coupon — but it would do nothing to recapitalise the bank, and yet it would reprice not only its capital structure, but other core European banks' capital structures. So I think it's almost dawning on the regulators more and more that actually this is gone concern capital and common equity is going concern capital.

Vasudeo, Lloyds: I agree. For UK banks the 7% trigger is a requirement. It has little meaning given the regulatory framework has evolved so much. When AT1 was introduced, it probably made sense, but given the fact that now there is a need to bolt on the MREL stack on top of capital, the AT1 trigger is irrelevant. In reality everything will go down at one point.

The regulators know very well that low trigger is gone concern capital

Shah, CACIB: I think the regulators know very well that low trigger is gone concern capital. If you were really serious about it being going concern, it would probably have to be a 10% principal trigger level. But at this moment in time they are focused on building the total capital of banks as opposed to the trigger levels. I can envisage it changing, but it's going to be 10 years down the line when banks are in a different situation in respect of their total capital structure.

But whether 5.125% or 7%, it's too low. We have been discussing call features and previously we were talking about coupon risk; principal risk was never at any point really a concern for AT1 investors because it's so out of the money.

Pirro, Algebris: The whole point of this was to have a prefunded rights issue on the balance sheet and not have to take any decision, right? So the regulator understood it was weak, and it could not actually force something to convert into shares early.

But now it is clear that a number makes no sense, because the numerator might change — as it did — but the denominator of the capital ratio is changing, too. And that number is completely arbitrary, decided by the G20 at a roundtable. Your capital ratio can fall substantially — such as in the UK, where mortgage risk weights are going up a lot — but the risk of that issuer is not changing.

Because the system is moving so much, it doesn't make any sense to change the trigger now. Any number would be as arbitrary as the precedent. The understanding is that the trigger is irrelevant, and we all understand that.

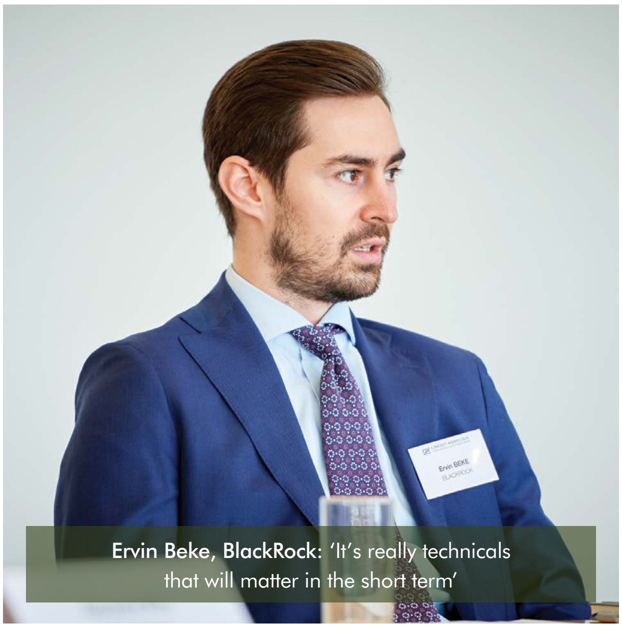

Olivier Bélorgey, Crédit Agricole: 'We could show investors that we believe in our institution'

Day, BIHC: The trigger features were nevertheless discussed when the market was developing, for example when CASA used a dual trigger.

Bélorgey, Crédit Agricole: When we issued with this dual trigger, it was in order to demonstrate our strength. We were not forced to include the high trigger, 7%, at the group level, but did so in order to be compliant with best practices that had been established by the UK. And we could show investors that we believe in our institution and want to build such high capital ratios that we have no concern about issuing with a high trigger. We also wanted to introduce the dual trigger to better explain the structure of the group, how capital circulates between the regional banks and Crédit Agricole SA as the issuer.

But I totally agree with what has been said. Today 7% is for many institutions — at least for our institution — below the Pillar 2R requirement.

Day, BIHC: What are the implications of the abolition of Dutch tax deductibility of AT1s?



Ervin Beke, BlackRock: 'It's really technicals that will matter in the short term'

Birry, S&P: My main question is, will other countries follow suit and if so, when? The news came out at the end of June and it was clearly stated that the European Commission pushed for this change, on state aid grounds. It is therefore possible that other countries may have to follow suit. At the same time, we all know how complex it is for a country to change its tax legislation, and even more so to harmonise that at a European level. So indeed everyone is wondering what it means outside the Netherlands.

If this was adopted more broadly, for European banks, it would represent another hit to be absorbed by the P&L at a time when profitability is still sub-par. To put it into perspective, the Dutch initiative is expected to bring an additional EUR150m of tax revenues into the coffers of the Kingdom of the Netherlands. It's another pain point for ROEs, but manageable when spread across the country's main banks and insurance companies.

Everyone is wondering what it means outside the Netherlands

Beke, BlackRock: I think the question is not the validity of the instrument, but rather how issuers would think about the economy of tax calls. Would they call a high cash price bond to get a gain through re-issuing it at a lower spread? That's a risk for their bonds. But for the sector it doesn't really matter.

Hoarau, CACIB: In terms of market reaction, I remember when the news came out you saw AT1 from ABN, Rabo and ING take a dive, but they recovered fairly rapidly as soon as issuers made a formal statement that they would not approach the market on the back of this news in an opportunistic manner and exercise the tax call. So at the end of the day it was a non-event in that respect.

Collins, BlueCrest: When I spoke to issuers they kind of groaned, they issued their statements, then they said: "Ugh! This is another cost for us." That was the main takeaway I got.

Vasudeo, Lloyds: Yes, agreed. From an issuer perspective, it's not welcome. We are closely following it. We haven't heard anything in the UK specifically on this.

Bélorgey, Crédit Agricole: I don't know if this is an issue that is the same across the different jurisdictions, because from what I know, the origin of this ruling in the Netherlands comes from the fact that there was a difference between the taxation of banks and insurance companies on the one hand, and corporates on the other — which is not the case in France. So, for the moment in France we don't think there is a reason to be concerned by that development.

Benyaya, CACIB: It's true that in many countries there is no specific rule for the treatment of AT1 coupons, and in that context it would be difficult for the Commission to pinpoint specific issues in those countries. In some other countries — I'm thinking the UK and Germany — there has been a specific ruling for the AT1 coupons, so there could be an issue there. But elsewhere I don't see any spillover effect.

Day, BIHC: How do you see the use of AT1 and Tier 2 in the capital structure evolving going forward?

Benyaya, CACIB: I will again refer to the CRR2 because there are many elements in that draft that are of interest. Under some regulatory metrics, like large exposures and also what we call the standardized outlier test, there is a restriction in the use of Tier 2 capital, so some issuers have questions about the use of Tier 2 and the need to maintain a significant buffer of Tier 2 capital.

Vasudeo, Lloyds: There will be limited use for Tier 2. It has an impact on pricing in the capital stack. Ticking the regulatory box is one of the main things from an issuer's perspective. But I think increasingly Tier 2 will lose more and more of its value.

Shah, CACIB: The UK regulator is much stricter in terms of leverage ratios than in continental Europe. I don't think the leverage ratio can remain at 3% in continental Europe, so AT1 as an instrument will be more important going forwards, and banks will have to issue more than the minimum 1.5%.

Vasudeo, Lloyds: Absolutely. In the UK we assess the volume of AT1 that we issue against the leverage ratio and minimum capital requirements, too, so on an RWA metric and the leverage metric. It could be a binding constraint based on the business model of the bank.

Bélorgey, Crédit Agricole: It is efficient to have at least 2% of Tier 2. Beyond that, the efficiency of Tier 2 in different constraints is indeed declining as Michael described. So everything being equal, the incentive to issue Tier 2 is lower.

I also agree that we have to assess what kind of other benefits we can have. With TLAC, if you only take CET1 plus AT1 it leaves still a lot of space for Tier 2 and senior non-preferred or HoldCo. I'm not sure that the optimum amount of Tier 2 is 2% with the remaining requirement comprising senior non-preferred or HoldCo, because in that case I'm not sure the thickness of the Tier 2 layer would be sufficient to justify an interesting price — at least for the issuer — for senior non-preferred or HoldCo. So my guess is that, everything being equal, the efficiency of Tier 2 will diminish, but 2% will probably not be the optimum in terms of building the capital structure. More than 2% could be more efficient because if you have, for example, 3% of Tier 2 it helps to lower the price for senior non-preferred or HoldCo debt. But, once again, we will build this together — it also depends on how investors price it.

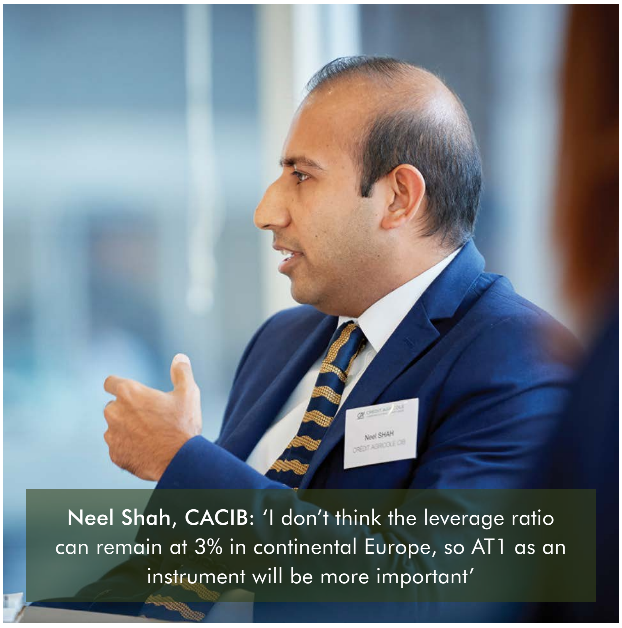
Regarding the single lending limit, the fact that CRR2 intends to remove Tier 2 from counting towards this is not good news for European banks, because it will lower the capacity of European banks to support their biggest clients in their corporate acquisition deals. It is something that we have to lobby against.

Day, BIHC: To conclude — and to an extent come full circle to our discussion of how the market moved in the first part of the year — what can we take away from the US dollar-denominated AT1s Barclays and BNP printed right in the middle of the summer, firstly regarding how liquidity and market depth in the euro and dollar markets compare, but also generally about the outlook for the market?

Hoarau, CACIB: BNP and Barclays got something like $20bn of demand in 48 hours right in the middle of the summer. The US dollar market has proved to be extremely cost-efficient for issuers for some quite time now. Obviously fund inflows and outflows are definitely playing in favour of the US dollar market. We are also pretty well advanced in terms of the interest rate hike cycle in the US, and people feel very comfortable with that. In Europe, I have the feeling that obviously there is a risk of contagion surrounding the acceleration of the quantitative tapering. And obviously the US dollar market by definition is much more resistant to any type of negative news or noise that we can have out of Southern Europe, for instance.

So bringing everything together, you have a US dollar market that seems to be much more liquid and efficient than the euro market, and also there is much less uncertainty with regard to pricing dynamics in the US dollar market, with more regular new issues — in the euro market we haven't seen anything since April this year in terms of benchmark AT1, and distortions in the secondary market are also much higher.

Pirro, Algebris: Take one of the recent issues, the Credit Suisse 7.5%. Coincidentally that is the exact same coupon and was at the exact same spread as a bond they issued five years earlier.



Neel Shah, CACIB: 'I don't think the leverage ratio can remain at 3% in continental Europe, so AT1 as an instrument will be more important'

In the meantime, Credit Suisse has raised capital twice, has 25% less leverage, and it's acknowledged that the capital framework is much more transparent. It is difficult to say, this is cheap, this is expensive. But what I can say is that we came out of the financial crisis and five years ago I can tell you it was definitely riskier than it is today. From that perspective, the market looks cheap, so these bonds have relatively high spreads in the reset and look good.

So I actually think the market is quite good now, it's quite viable. We will see what the euro market looks like, because we are very unlikely to see EUR10bn books on a euro new issue.

At the same time, despite the mark-to-market performance and the peak to trough valuations that you can say have been pretty extreme, liquidity has — unlike what happened in the past — remained pretty resilient and it has been relatively easy to sell and buy. You can see this by how dedicated funds that invest in this space have had material outflows and we haven't heard anything about where these bonds have gone, so that means that the market is in a good shape.

Liquidity has — unlike what happened in the past — remained pretty resilient

Valuations were stretched in January and now I think we are finding a level where they are good. I'm positive. I think it's a good investment over time and fundamentally it's improving. The story hasn't changed. Mark-to-market is disappointing, but equally last year was exceptional.

Beke, BlackRock: The only thing I could add to Sebastiano's point is that, yes, fundamentals look good, valuations look interesting, so it's really technicals that will matter in the short term. If you look at AT1s versus the last year, you have to say they look good value. But technically they have outperformed this year, so you might find better spots to take risk in the short term. But overall the outlook for the more medium term is positive for AT1s. ●

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