Bank+InsuranceHybridCapital Briefing

Bank capital emerges from lockdown, but Fed warns even as its support drives market

Bank and insurance hybrid capital issuance is back on the agenda in Europe, largely due to the rapid central bank largesse that has driven a recovery in financial markets. However, the weight of credit market supply has begun to weigh on spreads, which remain vulnerable to Covid-19's lasting impact. *Neil Day* reports, with insights from Crédit Agricole CIB's FI team.

The full suite of bank capital instruments hit the market last week for the first time since the coronavirus struck financial markets, and Tier 2 trades for Allianz and Barclays on Friday showed the market remaining constructive in spite of socio-economic Covid-19 fears and broader supply weighing on sentiment.

Royal Bank of Scotland had the previous Wednesday (6 May) reopened the European market for bank capital with the first such trade since Greece's Piraeus Bank sold a €500m 5.5% 10 year Tier 2 issue at the height of the pre-crisis market. The UK bank's £1bn (€1.13bn) 10.25 year non-call five Tier 2 deal was then last week followed up by a Deutsche Bank €1.25bn 11 year non-call six Tier 2 on Monday and a €675m 7.5% perpetual non-call five Additional Tier 1 for Bank of Ireland Group on Thursday, before the Allianz and Barclays trades. *(See below and over for full details of the new issues.)*

However, following a strong recovery in spreads since the market's wides in mid-March, credit markets experienced a reversal last week on the back of warnings of the long shadow cast by the coronavirus on the health and economic fronts. Dr Anthony Fauci, a leading member of the White House coronavirus taskforce *(pictured)*, warned that a premature relaxation of pandemic prevention measures could lead to "suffering and death", even as a range of countries were reporting encouraging reductions in Covid-19 infection rates. Meanwhile, Fed chair Jerome Powell on Wednesday highlighted that "the scope and speed of the downturn are without modern precedent" and called for more fiscal support given the limits of central bank powers.

(For opinion on the latest ECB developments from CACIB Eurozone economist Louis Harreau, see page 5.)

Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB (CACIB), said the comments brought the disconnect between financial markets and the impact of the crisis on the real economy into stark relief.

"The retracement of the losses in equities and credit has been amazing and mainly driven by the liquidity element and the Fed backstop for the financial markets," he said, noting that global equity markets had rebounded to trade only around 15% lower than their peaks, with the Nasdaq even up year-to-date. "Central banks managed to avoid a very nasty situation in global credit markets and the most recent moves by the Fed and ECB on asset eligibility criteria towards sub-IG instruments have been decisive.

"But the chasm between Wall Street and Main Street is not sustainable. 36.5m people in the US have filed unemployment claims since early March and the unemployment rate is 14.7% — the world-wide economy is on the edge of a horrific collapse and, logically, at some point this could impact the credit market."

Further dampening credit market performance has been a deluge of supply, with a record €65bn of euro corporate bond issuance in April continuing into May, with some €26bn last week alone. Financial institutions issuance was a relatively modest €18.5bn, but the move in spreads no less impressive — the spread on a €1.5bn nine year non-call eight HoldCo Bank of America deal that reopened the euro FIG market on 24 March had more than halved from a re-offer of 365bp to as tight as 160bp before widening again to 190bp last week.

Corporate bonds had to pay higher new issue premiums and were less subscribed as the week progressed and NatWest's and Deutsche Bank's Tier 2 issues ended the week wide of re-offer.

"Last week we really started to see a little weakness on the macro side, with Q1 results also starting to sink in," said André Bonnal, FIG syndicate at CACIB, "and maybe pointing to an end to the

Allianz reopens insurance sub debt with successful €1bn

Allianz launched the first subordinated insurance euro benchmark of the year on Friday, a successful €1bn 30 year non-call 10 Tier 2 that took advantage of a window of opportunity between less propitious days to sate investor appetite for financials.

"Thursday was quite a difficult day," said André Bonnal, FI syndicate at joint bookrunner Crédit Agricole CIB, "but the US closed positively, and when we looked at the market in the morning there were much more positive signs."

The leads announced the mandate for the 30 non-call 10 fixed to floating subordinated issue, with A+/A2 expected ratings, on Friday morning with initial price thoughts (IPTs) of the mid-swaps plus 250bp area. After two hours and 20 minutes, they reported books above €2bn and an hour later set guidance at 230bp+/-2bp, will price in range, and the size at €1bn on the back of books in excess of €2.25bn. After a total of almost four hours, they fixed the spread at 228bp on the back of books above €2.1bn, pre-reconciliation, and the final book was just above €1.8bn.

Fair value was seen in the context of 208bp, according to Bonnal, given that Allianz 2029 non-call 2049s, sold in September 2019, were bid at an i-spread of 204bp and its 2047 non-call 2027s at 192bp. He said the IPTs of the 250bp area took into account the softness of the market evident earlier in the week, notably in the corporate sector *(see main article)*.

"It was crystal clear to us that 250bp was the right number to get the appropriate momentum and attention from investors, which it did," said Bonnal. "At the end of the day, we had a 1.8 times subscribed book and a very safe and successful trade at the end of a busy week in the primary market and ahead of a potentially tricky week ahead. The pipeline in financials has been building, corporates are due to remain extremely busy, so it felt like the right day for us to launch the transaction, even being the Friday of a very primary-heavy week.

"There was of course no doubt that the market would be open to a subordinated trade from an issuer like Allianz, but we clearly wanted to find a window that such a name deserves."

The last subordinated euro benchmark from an insurance company was a €750m debut Restricted Tier 1 for Ageas on 3 December and Bonnal said the lack of subordinated supply among financials in general helped demand for the deal. Investor appetite for the sector had meanwhile already been demonstrated in the sterling market, where Phoenix Group, Legal & General and Pension Insurance Corporation raised an aggregate £1.2bn of Tier 2 from 23 to 30 April. ●

bear market rally. Meanwhile, the corporate market continued to be extremely busy and over the course of the week investors' fatigue started to take its toll on the execution of new issues."

However, he said that financials should remain supported by the excess cash in the market.

"What helped us as well on Allianz is the fact that there hasn't been much issuance from financials overall," said Bonnal. "The financial specialists among portfolio managers had been waiting for supply, so there isn't the same investor fatigue as on the corporate side."

The extent to which the Fed and ECB fuel credit markets via balance sheet growth will remain the fundamental driver for markets until there is greater visibility on the economic impact of the coronavirus and lockdowns, according to Hoarau.

"We have entered a phase of consolidation post-earnings and for the time being investors are simply following the path being shown by central banks," he said. "I expect this to remain the case until we have hard data regarding the shape of the recovery, which will be determined by how economic agents react to the reopening of the economy and how long it takes to get to the new normal. June data will be key and the evolution of the temporary component of unemployment numbers is one of the key metrics to follow.

"Overall, downside risks for markets are very high."

Tentative Tier 2, AT1 reopening

Ahead of the weakening, RBS Group's £1bn 10.25 year non-call five Tier 2 reopener on 6 May attracted some £5.5bn of orders, allowing for pricing to be tightened from initial price thoughts of the Gilts plus 400bp area to 355bp and a coupon of 3.622%.

Deutsche's reopening of the euro sub debt market last Monday with a €1.25bn 11 year non-call six Tier 2 was in conjunction with a tender offer for €2bn across eight senior non-preferred securities maturing from 2021 to 2023. The liability management exercise boosted demand for the paper from investors comfortable with the credit. The German issuer was able to tighten pricing from 625bp over mid-swaps to 600bp over, but the deal underperformed in a weaker secondary market, widening some 25bp.

"The transaction offered a positive signal," said CACIB's Hoarau. "Already last week RBS was active in this space with a £1bn issue showing strong evidence that the market was able to absorb Tier 2 debt, so things continue to move in the right direction."

Barclays followed with a £500m 3.75%

10.5 year non-call 5.5 Tier 2 on Friday, which was priced at Gilts plus 275bp on the back of some £1bn of demand following IPTs of the 300bp area.

The final step in the recovery of the European market for bank capital was that taken by Bank of Ireland Group on Thursday, when it sold the first AT1 since a €1.5bn dual-tranche Intesa Sanpaolo deal on 20 February.

The Irish lender raised €675m in its perpetual non-call five AT1 sale on the back of some €1.4bn of orders, having entered the market at short notice in the morning with its leads already having gathered sufficient indications of interest to cover the deal and gone out with a 7.5% coupon for a €625m size.

"The new deal was effectively 'reverse enquired' by investors and the lead managers, making it a virtually riskless transaction for the borrower and the arrangers in terms of investor demand," said TwentyFour Asset Management CEO Mark Holman, "a sensible way to operate with the most sensitive part of a bank's capital structure in these times."

The transaction was launched in a tight window, between Bank of Ireland announcing results on Monday (11 May) and the last day of the first call window for its €750m 7.375% AT1, tomorrow (Tuesday), when the new issue settles. The bank announced that the deal would contribute to refinancing its only outstanding AT1, which was launched in 2015.

The Irish bank is the first to both issue and call AT1 since the pandemic struck financial markets in March, with others having either not called outstanding issues or gone ahead with calls without needing to refinance during the crisis.

The 792bp reset spread on its new issue is almost 100bp higher than that of the outstanding, 696bp. However, whereas the new €675m AT1 is issued at the group level, the outstanding €750m was at the OpCo level and hence subject to haircuts when calculating group level capital, taking its regulatory value down to €611m. According to CACIB analysis, this means that the cost per euro of regulatory value of the old AT1 is 8.1% post reset, significantly higher than the new bond's 7.5% coupon.

Bank of Ireland also incorporated a six month anytime par call feature into its transaction.

With Bank of Ireland's position and the execution of its trade considered something of a special case, expectations for further AT1 issue remain subdued and likely limited to other issuers approaching first call dates, according to Neel Shah, financial credit analyst at CACIB.

"Funding levels for AT1 issuance remains elevated for issuers given the macro uncertainty and we expect this to remain the case in the near term," he said. "With iBoxx US dollar AT1 spreads at around 675bp and euro AT1 spreads at around 775bp, we do not expect banks to be in a rush to issue at these wide levels."

A €750m 6.375% Lloyds AT1 is also in its call window, ending on 28 May, while RBS has a $2bn 7.5% AT1 with a month-long call window opening on 11 June.

The lack of new AT1 supply — further exacerbated by capital relief initiatives from regulators — has contributed to a lack of trading in outstanding AT1 following the initial dramatic falls and rebound, according to CACIB AT1 trader Nigel Brady.

"Overall trading volumes have fallen off a cliff," he said, estimating them at 15%-25% of pre-crisis levels.

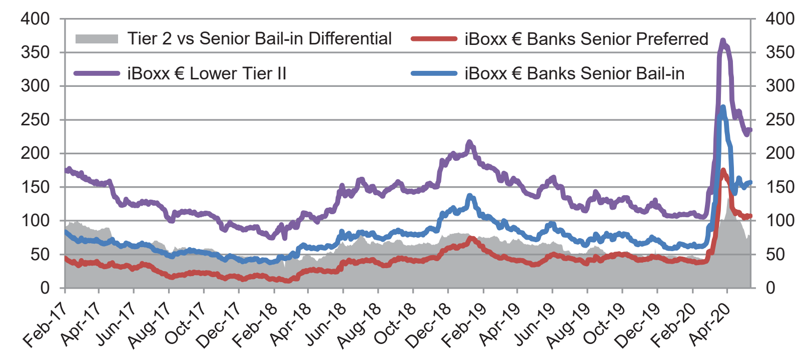
However, he said that supply/demand dynamics remain favourable.

"I would be fairly confident that if a deal came, more so in dollars, it would do very well and start a virtuous circle," said Brady, citing the success of preference share issuance by US banks, such as a recent 5.25% Bank of New York Mellon trade. "That gives you a benchmark as to where European names could come."

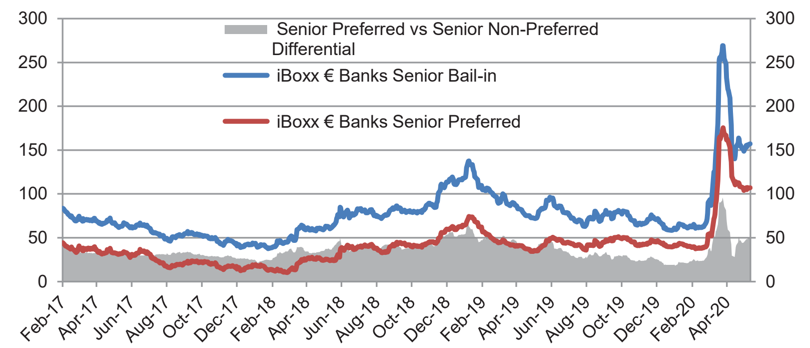
According to Brady, peripheral credits have underperformed core European credits in the recovery after several printed AT1 at the market's tights early this year, and Hoarau said he expects increasing discrimination among credits as the fallout of the crisis becomes clearer and ratings come under pressure.

"After the recent rally in AT1, the pricing approach needs to discount a much

Tier 2 versus senior performance



Senior non-preferred versus senior preferred performance



Source: Markit, Crédit Agricole CIB

more prudent view that investors will take in light of increased macro event risks but also idiosyncratic risks," he said. "Investors are moving up in quality and focusing on stronger balance sheets."

A slew of senior non-preferred issues launched in mid-April also underperformed, hitting the market ahead of a previous bout of weakness, leaving spreads versus senior preferred paper at differentials — around 70bp in some core jurisdictions, versus 25bp pre-crisis *(see chart)* — where supply from core European issuers is unlikely to materialise, according to Hoarau.

The performance of SNP is in contrast to senior preferred issuance, which has enjoyed a mini renaissance. Svenska Handelsbanken opened the sector on 6 April and achieved the then lowest crisis era new issue premium by a bank, 15bp, on the back of €8.25bn of demand for a €1.25bn five year trade at 135bp over, while SEB underlined the continued buoyancy of senior preferred last Monday with a €1bn three year priced at 68bp over, with the shorter-dated deal coming some 5bp inside its curve.

Supply dynamics are expected to be reinforced by an easing of MREL requirements. Already in Denmark the authorities have fast-tracked the implementation of BRRD II, which limits the amount of MREL subordination required, and extended the deadline to 2024. Alpesh Varsani, director, DCM solutions and advisory at CACIB, said that although MREL requirements across the EU are expected to be largely unchanged, non-GSIBs could effectively expect to see similar measures to those in Denmark, leading to a somewhat more important role for senior preferred than previously anticipated and a reduced level of overall funding needs given the possibility of a longer compliance period than previously anticipated. ●

European subordinated financials issuance since the pandemic hit capital markets

Issue Date	Issuer	Currency	Format	Rating (M/S/F)	Size (m)	Coupon	Tenor	Current I+ Bid	Reoffer Spread (MS)	Perf.	IPT	NIP	Books
24-Mar	Bank of America Corp	EUR	HoldCo	A2/A-/A+	1500	3.6%	9NC8	190	365	-175	380a	60	5000
25-Mar	Lloyds Bank Group plc	EUR	HoldCo	A3/BBB+/A+	1500	3.5%	6NC5	220	375	-155	400a	55	8750
25-Mar	Goldman Sachs Group	EUR	HoldCo	A3/BBB+/A	2000	3.4%	5y	195	355	-160	365a	50	6250
26-Mar	Barclays plc	EUR	HoldCo	Baa2/BBB/A *-	2000	3.4%	5NC4	248	370	-122	410a	35	8250
26-Mar	NatWest Markets	EUR	OpCo	Baa2/A-/A+	1000	2.8%	5y	235	300	-65	340a	65	5300
26-Mar	Credit Suisse	EUR	HoldCo	Baa2/BBB+/A-	2000	3.3%	6NC5	207	350	-143	390a	35	12000
2-Apr	Lloyds Bank	EUR	OpCo	A1/A/A+	1000	2.4%	6y	197	270	-73	300a	50	3250
6-Apr	Svenska Handelsbanken	EUR	SP	Aa2/AA-/AA+ *-	1250	1.0%	5y	81	135	-54	175a	15	8250
14-Apr	Crédit Agricole SA	EUR	SNP	Baa1/A-/A+	1500	1.0%	6NC5	167	125	42	155a	13	5000
14-Apr	BNP Paribas	EUR	SNP	Baa1/A-/A+ *-	1250	1.1%	9NC8	169	135	34	175a	10	5300
14-Apr	UBS AG London	EUR	OpCo	Aa3/A+/AA-	2000	0.8%	3y	78	110	-32	145a	3	7000
15-Apr	Société Générale	EUR	SNP	Baa2/BBB+/A *-	750	1.1%	6NC5	191	150	41	175a	17	1450
20-Apr	BPCE	EUR	SP	A1/A+/A+ *-	1500	0.6%	5y	104	95	9	125a	9	3100
23-Apr	Phoenix Group	GBP	T2	-/-/BBB	500	5.6%	11y	G+500	G+540	-40	G+585	50	3400
24-Apr	Swedbank AB	EUR	SP	Aa3/A+/AA-	1000	0.8%	5y	94	98	-4	130/135	-5	3500
24-Apr	Wells Fargo & Co	EUR	HoldCo	A2/A-/A+	1500	1.3%	5NC4	192	160	32	200	20	4000
24-Apr	Wells Fargo & Co	EUR	HoldCo	A2/A-/A+	1500	1.7%	10NC9	218	185	33	225	20	4500
24-Apr	Legal & General Group	GBP	T2	A3/BBB+/-	500	4.5%	30.5NC10.5	G+434	G+425	9	G+475	15	4750
28-Apr	Crédit Mutuel Arkéa	EUR	SP	Aa3/-/A	750	0.9%	7y	119	112	7	135/140	5	1600
28-Apr	Citigroup Inc	EUR	HoldCo	A3/BBB+/A	1750	1.3%	6.2NC5.2	185	160	25	185	10	3700
29-Apr	Banco Santander	EUR	SNP	Baa1/A-/A-	1500	1.4%	5.7	200	170	30	200a	12.5	4750
29-Apr	Rabobank	EUR	SNP	A3/A-/AA- *-	1000	0.9%	8NC7	122	110	12	135a	7	1700
30-Apr	Pension Insurance Corp	GBP	T2	-/-/BBB+	300	4.6%	11y	G+434	435		485a	0	3500
5-May	Helaba	EUR	SP	Aa3/A/AA-	1500	0.4%	5y	87	80	7	100a	12.5	2200
5-May	OP Corporate Bank	EUR	SP	Aa3/AA-/-	1000	0.5%	5.2y	92	85	6	105a	10	1500
5-May	Danske Bank A/S	EUR	SP	A3/A/A+	1000	0.6%	5y	119	103	16	125/130	8	1800
5-May	QBE Insurance	USD	AT1	Baa2/BBB-/-	500	5.9%	PNC5	533	5.875%/551	-18	6.5% a	12.5	4000
6-May	Erste Group	EUR	SP	A2/A/A	750	0.9%	7y	107	115	-8	145a	5	2200
6-May	SBAB Bank AB	EUR	SP	A1/A/-	500	0.5%	5y (Green)	79	90	-11	115/120	0	2250
6-May	Nordea Bank	EUR	SP	Aa3/AA-/AA *-	1250	0.5%	7y	86	85	1	110a	7	2000
6-May	RBS	GBP	T2	Baa3/BB+/BBB+	1000	3.6%	10.25NC5	G+364	G+355	9	G+400a	12.5	5500
11-May	Credit Suisse	EUR	OpCo	A1/A+/A	1500	FRN	2y	DM+95	95	0	E+115a	5	2100
11-May	Credit Suisse	EUR	OpCo	A1/A+/A	500	0.5%	5y (Green)	84	80	4	115a	0	2800
11-May	SEB	EUR	SP	Aa2/A+/AA *-	1000	0.3%	3y	65	68	-3	95a	-5	2000
11-May	Deutsche Bank AG	EUR	T2	Ba2/BB+/BB+	1250	5.6%	11NC6	644	600	44	625a	30	2200
14-May	Bank of Ireland	EUR	AT1	Ba2/-/-	625	7.5%	PNC5.5	770	7.500%/792	-22	7.5%#	-	1400
15-May	Allianz SE	EUR	T2	A2/A+/-	1000	2.1%	30NC10	-	228	-	250a	20	1850
15-May	Barclays plc	GBP	T2	Baa3/BB+/BBB+	500	3.8%	10.5NC5.5	-	G+275	-	G+300a	22.5	1000

Source: Crédit Agricole CIB

ECB tools effective, but Eurozone differences must be addressed

The ECB's comprehensive and diversified response to the Covid-19 crisis has proven effective in providing relief in the sovereign, corporate and banking spheres, and the central bank appears ready to act further, says Crédit Agricole CIB Eurozone economist Louis Harreau. However, both the German constitutional court PSPP ruling and differing impact of the crisis across the EU pose challenges for the Eurozone.

What is your view on the latest ECB moves and what are the next steps you expect from it?

The ECB has gradually implemented a comprehensive and diversified response: (1) it significantly stepped up its purchase programmes, by adding €120bn to its QE programme and by creating the €750bn PEPP; (2) it dramatically entered the commercial paper market, hence avoiding a prolonged and destructive freeze of the short term funding market for corporates; and, more importantly, (3) it improved banks' funding conditions by easing the TLTRO conditions in several significant ways.

In increasing its purchase programmes, the ECB is aiming first and foremost to ensure that sovereign spreads do not widen too much, which would trigger financial fragmentation and a tightening of monetary conditions. However, because of the programmes' size and flexibility, the ECB can act discretionarily on any dysfunctional market segment — corporate bonds, commercial paper, covered bonds — and improve funding conditions for all big corporates.

Easing the TLTROs (rate as low as -1%, easing of collateral rules) will ensure that banks are able to grant credit to all economic actors, starting with SMEs and households.

These tools have proven to be effective so far: in spite of the economic developments, sovereign spreads have remained at manageable levels; banks have been able to face the astonishing increase in credit demand without tightening credit conditions; and, in spite of risk aversion, corporate spreads have come down from the peak of the crisis.

The ECB will continue to adapt to market and credit conditions. An extension of the PEPP seems to be a given: at the current pace, the ECB will have emptied the €750bn by the end of summer. On other aspects, the flexibility built into the purchase programmes should allow the ECB to adapt to most foreseeable market developments.

If the crisis were to be deeper and the recovery slower than expected, the ECB would reinforce its structural tools: increase monthly purchases in the QE programme and possibly ease TLTRO III conditions further, for example, extending the very favourable period with rates as low as -1% for the whole length of the operations.

What are the implications of the German constitutional court ruling?

The German constitutional court is more a threat to the EU's architecture than to the ECB's monetary policy. Of course, the court called into question the proportionality of the PSPP — a monetary policy tool — but the heart of its decision is rather that the European Court of Justice (ECJ) has not properly analysed the programme and that German institutions (government and parliament) have not exerted enough control over the ECB.

Following the ruling, several European institutions (the ECB, ECJ and European Commission) have rallied and the German government has adopted a constructive tone, which gives us hope that a solution will be found — before the end of the three month period — on the monetary policy side. The challenge, however, will be to make sure that, within this solution, the supremacy of EU law over national courts is guaranteed, which is the only way to ensure that European decisions (whether from the ECB or another body) apply uniformly to the EU as a whole.

On the operational side, however, there is a risk that the ruling — following the December 2018 ECJ ruling — could set limits for what the ECB can to: by highlighting the importance of the limits of QE in avoiding monetary financing, both courts imply that these limits (capital key repartition and 33% ISIN limit) cannot be removed, which could become a concern if the Eurozone needs a more proactive ECB.

Should we expect another Eurozone sovereign debt crisis?

The current crisis will significantly increase public debt in all Eurozone countries, and, worse, according to the latest economic data, the pandemic will increase divergence among countries: the strongest countries (Germany, Netherlands) will better withstand the pandemic and are likely to have a stronger recovery than the weakest countries.

Against this backdrop, the ECB has proven that it is ready to ensure favourable conditions for all Eurozone countries; the ECB is ready to compress spreads to ensure that there is no financial fragmentation in the Eurozone.

Nevertheless, the size of the shock, the dramatic deterioration of public finances and the economic divergences require more than monetary policy interventions. During the sovereign debt crisis, the Eurozone added several limited tools (ESFS, ESM, SSM, SRM) to the ECB's support (OMT, VLTROs), which was enough to calm down the crisis, at a very elevated economic cost; this time, we think, the Eurozone cannot avoid providing a more comprehensive response — including a sort of debt mutualisation and fiscal transfers — or those responses will not be enough, no matter how the ECB is involved. ●

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