Bank+InsuranceHybridCapital Briefing

Euro Tier 2s fly on back of renewed rally, as optimism feeds fear of missing out

With investors drawing comfort from positive headlines on the health and economic fronts, and supply easing, the recovery in credit markets kicked on last week, allowing Commerzbank, Crédit Agricole and Swiss Re to garner big books and tight pricing for euro Tier 2s, all jointly led by Crédit Agricole CIB. *Neil Day* reports, with insights from CASA and Swiss Re funding heads.

Credit markets moved another leg tighter last week on the back of optimism around pandemic and economic prospects, allowing banks and insurers to tighten subordinated trades sharply from IPTs and print at levels well inside what had been possible a week earlier.

After treading water the previous week, subordinated indices tightened anew to break levels last seen a month ago and set new pandemic era tights *(see graph over)*. Credit markets moved hand in hand with equity markets, where banks outperformed.

In the euro market, Commerzbank, Crédit Agricole and Swiss Re were able to price Tier 2 issues inside fair value, with order books multiple times oversubscribed *(see below and over for further details)*. André Bonnal, FIG syndicate at Crédit Agricole CIB (CACIB) — joint bookrunner on the three trades — said the markets were much stronger than just a week earlier.

"Investors are clearly choosing to focus on the positive headlines," he said. "i.e. the health situation being much better, lockdowns being lifted, prospects of vaccines sooner than later, and the implications this has for the economic recovery. Plus we had the European Commission's proposal for a €750bn stimulus package last week.

"Clearly the market feels that it can disregard potential new trade tensions between the US and China and Hong Kong becoming another geopolitical hotspot, while investors are instead ready to put cash to work in the credit market."

Although supply across fixed income asset classes continued to tick over, the recent wave of corporate issuance eased, further supporting the rally in financial institutions paper, according to Vincent Hoarau, head of FIG syndicate at CACIB.

Inside:

"Corporate supply has not disappeared, but the flows are less intense than they were a couple of weeks ago," he said. "This relative decrease in supply is also supporting the FIG space, where likewise we are not seeing a deluge of supply — the regulators have made it clear to banks that they will do what is necessary to ensure that they can manage their funding and balance sheets without facing any pressures. Flexibility is the new rule."

Spreads have nevertheless recovered to levels that make it harder for issuers to justify staying away from the market.

"Funding officials need to realise that at this particular moment in time there is probably more downside risk then upside risk in terms of spread," said Bonnal. "Are they willing to take the risk that spreads could go, say, 20bp tighter? Or risk that they go 75bp wider?"

Smaller and second tier peripheral names could be next to approach the euro primary market, according to Hoarau, as well as national champions who have not yet tested the recovering market.

Similar dynamics have been at play in the US market, where Macquarie Bank on Wednesday sold a $750m (€675m) 10 year Tier 2 at 295bp over mid-swaps, some 55bp inside IPTs, and Bank of Nova Scotia issued a $1.25bn perpetual non-call five Additional Tier 1 (AT1) with a coupon of 4.9%, inside initial talk of the 5.25% area. Likewise, Phoenix Group slashed pricing on a $500m 11.25 non-call 6.25 Tier 2 by 62.5bp on the back of an 11 times subscribed book.

"US dollar market sentiment has been gathering further steam over the past week, as investors price in more upside on the health front and the phased economic reopening," said Fadi Attia, managing director, US dollar FIG, at CACIB. "Yankee bank secondary paper has been particularly well bid as of late — scarcity of supply has been a key driver around this dynamic, and while there have been plenty of new issues from US players, it has been limited from European bank names.

"Subordinated deals are increasingly are gathering attention," he added, "as investors look to pick up relative value."

Swiss Re in 'compelling' €800m

Swiss Re generated the biggest order book in the European market, its €800m 32 year non-call 12 Tier 2 being around 10 times oversubscribed on Wednesday. The deal is only the second subordinated insurance euro benchmark this year, after Allianz on 15 May reopened the sector with a €1bn 30 year non-call 10 Tier 2 that attracted some €2bn of orders.

Priced at 228bp over mid-swaps, Allianz's deal had tightened to around 205bp over by the time Swiss Re approached the market, while Swiss Re's own paper had recovered strongly from mid-March highs, its 2050 non-call 2030s tightening from around 400bp over to be bid at around 249bp when the new issue hit the market.

Following initial price thoughts (IPTs) of the 325bp area for Wednesday's trade, guidance was set at the 285bp area on the back of books in excess of €6.25bn, before the spread was fixed at 275bp on the back of more than €7.75bn of demand, pre-reconciliation. The bonds then rallied two points on the break.

The new deal is issued via Swiss Re Finance (UK) plc and guaranteed by Swiss Re Ltd, whereas the 2050 non-call 2030s were issued by Swiss Re Finance (Lux) SA and guaranteed by Swiss Reinsurance Company Ltd, following a change in Swiss tax law at the start of the year that made the new set-up more efficient. Whereas the outstanding comparable is rated A2/A, the new security is rated A3/BBB+.

With around 15bp of the 26bp pick-up between the old and new issues reflecting the curve extension, the remaining 11bp captured any new issue premium as well as the change in issuer/guarantor and related lower rating, noted Bonnal at joint bookrunner CACIB.

"Is that 0bp of new issue premium and 10bp for the credit differential, or 20bp for the differential and minus 10bp of NIP?" he said. "No one can pinpoint that exactly, but regardless, it's clearly an extremely strong result for the issuer.

"The book was really strong, featuring all the major asset managers you want to see in a subordinated euro trade. The re-offer yield of 3.2% at IPTs for the A3/BBB+ security was way too compelling for people to miss out."

Swiss Re's paper also offered an attractive pick-up over the likes of Hannover Re and Munich Re, whose 2039 non-call 2029s and 2049 non-call 2029s were quoted around 187bp and 180bp, respectively, added Bonnal.

See Q&A with Swiss Re head of funding Daniel Bell on page 6 for more.

Two's company for Commerz, CASA

Commerzbank and Crédit Agricole each launched €750m Tier 2 trades into the buoyant tone on Thursday and the market proved more than able to digest them both, with their relatively modest €750m sizes and a perceived lack of competition between the different trades helping them achieve pricing inside fair value.

Commerzbank enjoyed the biggest book of this week's European bank trades — which also included BBVA and Banque Fédérative du Crédit Mutuel with senior preferred and senior non-preferred trades — as the German's €750m 10.5 year non-call 5.5 Tier 2 attracted peak demand of €5.2bn and a final order book above €4.7bn good at re-offer.

Following IPTs of the mid-swaps plus 490bp area for the December 2030 non-call December 2025 issue, guidance was set at 440bp-450bp for a €750m size with orders above €4.25bn, and pricing was ultimately set at 435bp, for a coupon of 4%, on the back of more than €5.2bn of orders, pre-reconciliation.

"They were able to take advantage of a red hot market," said Hoarau at joint bookrunner CACIB. "We had a very positive trend across senior non-preferred and Tier 2 over the week and Commerzbank's outstanding bullet Tier 2s tightened some 50bp in the 48 hours ahead of launch."

Its March 2026s were quoted at 386bp over mid-swaps on the morning of launch and its March 2027s at 395bp. Curve extension worth around 30bp-35bp as well as 15bp to reflect the call feature of the new issue put fair value in the context of 445bp, according to Hoarau, implying a negative new issue premium of some 10bp.

The UK and Ireland took 39% of the paper, France 18%, Germany 10%, Asia 8%, Scandinavia 7%, Italy 5%, and Austria and Switzerland 5%, Spain and Portugal 3%, the Benelux 3%, and others 3%. Funds were allocated 67%, hedge funds 10%, and banks 8%, government/agencies 6%, insurance companies and pension funds 6%, private wealth 2%, and others 1%.

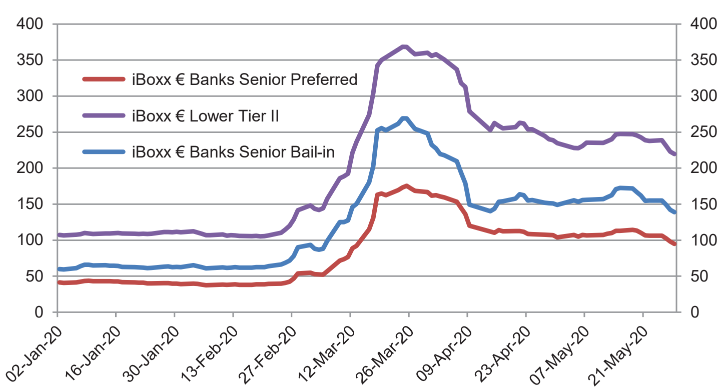
Commerzbank's deal came after it announced results on 13 May and a downgrade from S&P on 23 April, which led to the new issue carrying a rating of Baa3/BB+/BB+. On Tuesday the bank also announced that it had established a €3bn AT1 issuance programme.

Crédit Agricole was also able to come inside fair value on its €750m 10 year non-call five Tier 2, a trade that was launched in conjunction with a tender offer for senior preferred debt *(see separate article for more)*.

The distribution profile of the French issuer's trade differed from the German's thanks to its three investment grade ratings (Baa1/BBB+/A-), noted CACIB's Hoarau.

French accounts were allocated 43%, the UK and Ireland 23%, Germany and Austria 9%, the Benelux 8%, Italy 7%, Spain and Portugal 5%, and others 5%. Real money accounts and asset managers took 75%, insurance companies and pension funds 14%, central banks and official institutions 9%, and others 2%. ●

Secondary bank performance



Source: Markit, Crédit Agricole CIB

CASA rebalances in Tier 2-tender combo

Crédit Agricole priced a €750m 10 year non-call five Tier 2 inside fair value on Thursday alongside the launch of a tender for senior preferred debt, taking advantage of the strong market to rebalance its liabilities in the context of surplus liquidity and growing TLAC/MREL needs.

After going out with IPTs of the mid-swaps plus 230bp area and a €750m size for the 10 year non-call five Tier 2, guidance was set at the 200bp area on the back of books above €3.4bn, and the deal was ultimately priced at 190bp on the back of some €2.3bn of demand.

This was inside fair value seen in the context of 195bp-200bp, according to Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB (CACIB), given the issuer's March 2027 and March 2029 bullet Tier 2s were quoted at 185bp and 193bp, bid, respectively — 15bp-20bp tighter than at the start of the week. The pricing was also inside BNP Paribas October 2030 non-call October 2025s quoted at 192bp, and where ING Group had the previous week priced a €1.5bn 11 year non-call six, at 240bp.

Hoarau said the pricing also implied a zero cost to the issuer for the call option, and that a strategy of limiting the deal to below its typical €1bn-plus sizes helped achieve the issuer's target of a sub-200bp spread. The strong demand was supported by the upbeat market tone and investment grade ratings (Baa1/BBB+/A-), he added, as well as the simultaneous tender, with those committing to the European leg of the exercise offered more favourable allocations in the Tier 2.

"Putting the tender together with the Tier 2 boosted the bookbuilding," said Hoarau. "All these factors contributed to a very strong result, clearly helped by market conditions where investor behaviour is driven by the excess of cash combined with the fear of missing out."

The tender offers for some €11bn-equivalent of euro and sterling senior preferred debt and $3.65bn (€3.3bn) of US dollar senior preferred run until this Wednesday (3 June). The US tender for four issues is on an any-and-all basis, while the European tender — for nine euros and two sterling — is capped at €3.5bn, equivalent to just over 30% of the outstanding bonds. The bonds' maturities range from November 2020 to January 2025.


Nadine Fedon, Crédit Agricole

The issuer said the tenders would offer liquidity to investors in the targeted bonds. The tender spreads represented an average premium in the low 20bps, with the outstandings rallying strongly as a result.

"We have tried to calibrate the premia such that the repurchase levels make sense for the issuer, but also remain as attractive as possible for investors, which is made trickier by the volatile market," said Véronique Diet Offner, in charge of liability management for EMEA and corporate hybrid structuring, DCM solutions and advisory, CACIB.

She said the exercise had gotten off to a promising start, with some investors committing to the tender when participating in the Tier 2, but noted that others would hold off until closer to the deadline.

According to Nadine Fedon, head of MLT funding, Crédit Agricole Group, beyond offering investors liquidity, the purposes of the combined exercise for the issuer are twofold. The first is to limit the rise in the group's excess liquidity, or "stable resources position", as Crédit Agricole calculates it.

"Our target is to have a surplus of €100bn," she said, "but we have more than €132bn. This is explained by a rise in medium and long term funding resulting from TLTRO drawings and wholesale funding, and a rise in customer deposits.

"So we have room to manoeuvre in how to deploy this surplus of liquidity."

The group drew some €15bn of TLTRO funding in the first quarter in light of the crisis, reducing the group's pure funding needs.

"As the leading French retail bank, we have really seen the impact of this crisis on liquidity and have had to manage this very actively," said Fedon. "Customers have dramatically reduced the duration of their deposits and therefore we have used the TLTRO drawings to maintain our LCR ratios. TLTROs are also key to funding the state-guaranteed loans the government introduced."

The second purpose of buying back the senior preferred debt while issuing the Tier 2 is to optimise the group's liabilities.

"We are well above current TLAC/MREL requirements, but still building our TLAC/MREL-targeted buffers and the crisis has increased needs on this front due to all our new lending," said Fedon.

As well as the €750m Tier 2, the issuer last week raised ¥122bn (€940m) of senior non-preferred (SNP) and Tier 2 debt and A$290m (€175m) of Tier 2. Combined with a €1.5bn six year non-call five SNP last month, the group has raised some €3.5bn of TLAC debt since the end of March.

"With this Tier 2 issue, Crédit Agricole should be close to its TLAC issuance target for the year of €6bn composed of SNP and Tier 2," said Romain Beillard, DCM FIG origination, CACIB, "but the issuer said recently it could increase this target up to €8bn depending on the capital planning update and impact of the current crisis."

Having announced at the turn of the year a €12bn overall funding programme for 2020, Crédit Agricole has already raised close to €10bn.

"We have also been able to issue at extremely competitive levels throughout the year," said Fedon, "high beta trades at the beginning of January — Tier 2 in dollars, SNP in euros — then around the peak of the crisis a low beta covered bond.

"We have now issued our SNP at mid-swaps plus 125bp in April and this Tier 2 at 190bp — great levels. The sequencing and execution of the trades has been very good, so I'm very pleased with the outcome of the funding programme so far." ●

Demystifying equity and AT1 correlation

Among the fundamental characteristics intuitively attributed to a hybrid instrument, a correlation with related equity performance is one of the most oft-cited. But while a strong correlation with share prices may appear fairly natural and logical, does it really occur? *Szymon Wypiorczyk* in Crédit Agricole CIB's DCM Solutions cautions against jumping to conclusions.

Prior to 2020, correlation based on price indices of bank and insurance equity, and of related subordinated instruments fluctuated significantly throughout 2018 and 2019. The evolution of their dependence was quite random, with correlation remaining relatively weak and no signs of any strong convergence between different instruments and asset classes. We believe that in spite of the many equity characteristics of hybrid instruments, the performance of the hybrid market was mainly driven by fundamental credit metrics and central bank measures, and typical equity KPIs already had a limited impact on subordinated debt. During this period, European financial institutions (FIs) were in at least decent shape, even if their low profitability — primarily provoked by an inhospitable, low interest rate environment — was already a reality. Stable economic growth and the significantly improved or sound asset quality of the majority of institutions allowed subordinated investors to sleep easy.

Over the past few months, we have observed an interesting change in the relationship *(see accompanying charts)*. At the beginning of the year, a substantial increase in correlation could be observed, with a visible and strong convergence across subordinated instruments for both asset classes. We believe that this change was mainly driven by the gradual advance of Covid-19 and particularly accentuated by the World Health Organisation's declaration of a pandemic and following lockdown decisions in major economies. Plummeting global markets provoked a similar reaction in financial institutions' subordinated instruments, but subsequently the situation has changed considerably.

Since late March, we have witnessed a gradual weakening of the correlation for all analysed asset classes. This phenomenon could in part be explained by all the protective measures announced by the European authorities (reduction of capital and liquidity requirements) and their recommendation that basically forced banks to shore up capital with dividend cancellation (on 27 March the European Central Bank asked banks not to pay dividends or buy back shares during the Covid-19 pandemic until at least October 2020, with a similar statement from Eiopa on 2 April), but also by a strong statement from Andrea Enria, chair of the ECB's supervisory board, on 8 April: "ECB has no plans to order banks to suspend coupons on their hybrid debt." Those actions were supposed to help banks and insurers to maintain crucial access to the subordinated markets in an extreme context where equity markets are closed.

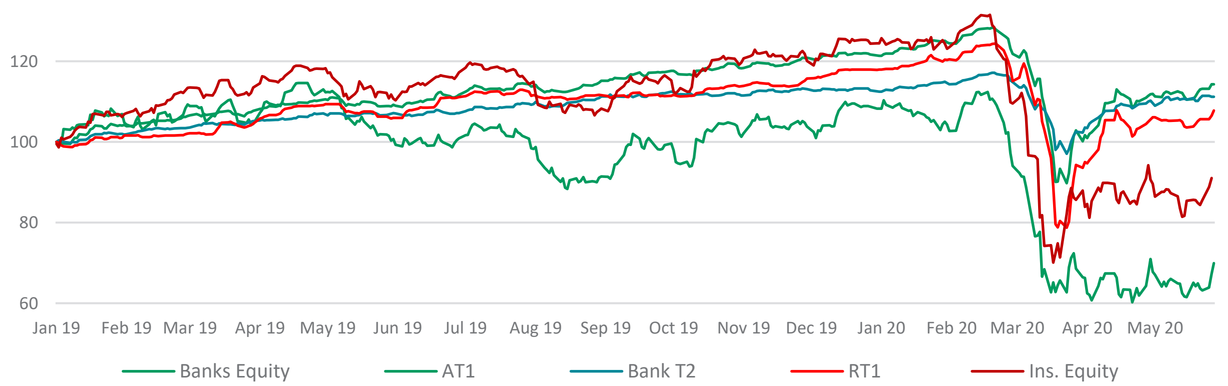
Today, this strategy seems to be working. All the capital relief measures and especially the dividend cancellation recommendation mechanistically improved FIs' credit metrics that again seem to be a major factor for the subordinated market. Consequently, we have seen a dichotomy in equity and fixed income interests.

An interesting observation is the very similar behaviour of AT1s and RT1s — their correlation with the respective share prices came out very similarly, showing that these instruments are perceived very similarly by investors.

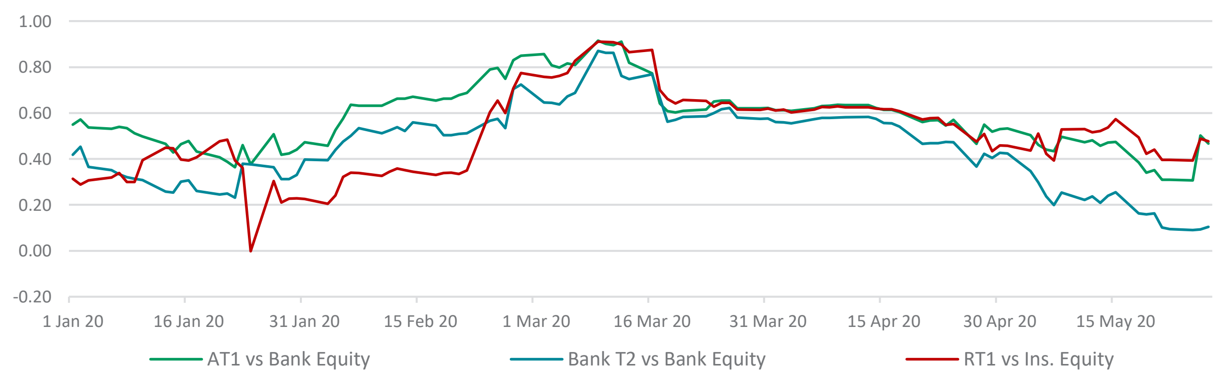
Another interesting point is an even more important decrease of bank Tier 2 and equity dependence in recent weeks. The ECB's statement on AT1 coupons may have been perceived as very strong and reassuring for the interests of AT1 investors, but at the same time the statement has implicitly reduced Tier 2 bonds' risk and incited an outperformance of Tier 2. Such favorable conditions allowed Commerzbank and Crédit Agricole to execute very successful Tier 2 transactions last week *(see related articles)*.

Even if the correlation between subordinated instruments and equity can be perceived as a quasi-paradigm, we need to be careful before jumping to conclusions about its relevance. We consider that, in today's opaque and extremely complex regulatory context, other, less straightforward factors weigh on the performance of the subordinated market, even if our perception may be biased by its behavior during the crisis. ●

Bank and Insurance Subordinated Instruments and Equity: price evolution (since January 2019)



Bank and Insurance Subordinated Instruments and Equity: correlation coefficient (since January 2020)



Source: Crédit Agricole CIB

Key takeaways:

- A substantial rise in the correlation at the beginning of the year — the correlation coefficient reaching the range of 0.85-0.95 for all analysed asset classes
- A gradual decrease of correlation since the Covid-19 outbreak — particularly by Bank Tier 2 (a drop from 0.80 to ~0.1)
- AT1 and RT1 instruments exhibit a very similar behavior in terms of correlation evolution in 2020

The correlation presented above has been calculated based on the following indices:

- Europe Banks Stoxx Index SX7P — as a proxy for European Banks Equity market
- STOXX Europe 600 Insurance Price EUR — as a proxy for European Insurance Companies Equity market
- Barclays Europe CoCo Tier 1 I31415EU Index — as a proxy for AT1 market
- Barclays Tier 2 Index — as a proxy for Tier 2 market
- RT1 CACIB Index — in-house based on selected European RT1 instruments

The evolution of correlation presented on the second of the charts is based on 30 days correlation

Swiss Re €800m Tier 2 timing 'vindicated' by demand, spread

Swiss Re became only the second insurer this year to sell a subordinated euro benchmark when it issued an €800m 32 year non-call 12 Tier 2 on Wednesday. Daniel Bell, head of funding at Swiss Re, discusses the issuer's approach, which paid off as it drew more than €7.75bn of demand and achieved pricing arguably inside fair value.

What is the rationale for the new subordinated issue?
The new issue was part of our regular funding plan off our debt issuance programme aimed at supporting business growth. The notes will count as regulatory and rating agency capital and so supplement the group's target capital structure in a low rate environment.

Why has there been the change in issuer/guarantor and what are the implications of that?
Changes to Swiss corporate tax laws effective 1 January 2020 make issuance at Swiss Re Ltd level (via its finance subsidiary Swiss Re Finance (UK) plc) more efficient, and more likely going forward, enabling more flexible use of proceeds throughout the group.

How have your key credit metrics been affected by the Covid-19 crisis and how do you expect these to evolve?
Covid-19 has certainly had an impact on the industry, but our capital position under the Swiss Solvency Test regime remains strong, with a peer-leading group solvency ratio as of 31 March 2020 comfortably above 200%.

How, if at all, has the Covid-19 crisis affected your issuance strategy?
We typically have a funding plan to complete each year to support areas of the business where we see growth opportunities. Covid-19 impacted our timing, but not our issuance strategy, as such.

Why did you feel this was the right time to approach the market?
We are fairly regular users of the March-June market window. To us, this was really the first time since the onset of Covid-19 where we felt some reasonable stability in the market, with better news on the virus and economies reopening. For that reason, issuing sooner just wasn't feasible.

We do see some potential macro risks on the horizon, with escalating tensions between the US and China, the situation in Hong Kong, and the US election in November. So, all in all, I think now was a good time to issue and the strong performance on the day of both the market and this transaction vindicated our view.

Daniel Bell, Swiss Re

How satisfied are you with the outcome?
We were very satisfied with the outcome. We obviously chose a day with a supportive backdrop, but we also knew we had a good story to tell.

How did the level of demand and pricing compare with your hopes and expectations?
We have a very good relationship with our investors and it was evidenced here with the who's who of the fixed income market again demonstrating their strong support for Swiss Re. Over 380 line items in the book also shows that support runs very deep. We had large books for our euro and US dollar transactions last year, so we were expecting a good response, but of course the backdrop was very different then. There was reasonable demand for other insurance transactions in the past few weeks but, in the current environment, to have a book in excess of €7.5bn even after significantly revising pricing was a pleasant surprise. On pricing, we felt our secondary levels prior to this transaction were wide of where fair value should be for us and so we were not particularly surprised that we were able to tighten as we did.

Your MSCI rating was included in the announcements around the trade — why did you flag this?
This was not a labelled bond, but we are aware that ESG credentials are a key factor for many investors. Swiss Re has been at the forefront of managing its business in a sustainable way on both sides of the balance sheet and we wanted to remind investors of that.

Is there anything else about the transaction you would like to highlight?
The only thing I would add is that I thought our syndicate of banks worked very well together and properly challenged each other to ensure we got a very strong outcome with this transaction. ●

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