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Bank+InsuranceHybridCapital Briefing

Long duration, no-grow Commerz AT1 shows favourable dynamics of supply-starved euros

Unseasonably low September supply has only served to boost the prospects of those banks ready to approach the euro market with carefully crafted capital trades, with investors continuing to see value in the sector as crisis measures and low yields persist. *Neil Day* reports, with insights from market participants including Crédit Agricole CIB's financial institutions team.

The success of a €500m no-grow perpetual non-call nine and a half year Additional Tier 1 (AT1) for Commerzbank on Tuesday — coming just three months after its last, debut euro AT1 but achieving almost five times oversubscription flat to fair value — underlined the favourable dynamics banks are encountering when issuing subordinated debt in the post-summer euro market.

After Intesa Sanpaolo showed the euro bank capital market to be open for business with an upsized €1.5bn dual-tranche AT1 on 25 August, a thin primary market has meant that those issuers who did follow in its wake achieved more favourable results than might otherwise have been expected.

According to Vincent Hoarau, head of FIG syndicate at Crédit Agricole CIB (CACIB), euro financial institutions supply is around 45% lower than the amount issued in the same post-summer period last year.

"The first week of September was the lightest we have seen in FIG primary for years," he said, "and appetite for FI bonds denominated in euro is much more pronounced due to the imbalance in the demand-supply dynamic."

From returning issuers such as Bank of Ireland and Commerzbank in AT1, to credits such as Banca Monte dei Paschi di Siena in Tier 2, banks have achieved multiple-times oversubscribed order books and pricing close to or through fair value — particularly when limiting issue sizes and offering duration.

The low volumes so far this month comes on top of a preceding lack of issuance over the summer and accompanying tightening: from 22 July to 24 August, the

Inside:

euro FIG market was completely bereft of supply. This was in spite of conditions remaining favourable, which had prompted some DCM bankers to suggest issuers accelerate any issuance plans, even if they were ultimately disappointed.

"Probably the most important thing is that — even if the Covid-19 situation has not improved — we didn't really get any unanticipated bad news," said André Bonnal, FIG syndicate at CACIB. "So the overall market has held strong throughout the entire summer, with new highs in equities, and strong tightening across the whole capital structure — some AT1 are in more than 150bp, while Tier 2 are 20bp-50bp tighter — or 70bp for Italy — and senior are 20bp-30bp tighter, too.

"A second factor is the fact that after the Q2 results, it was clear to every analyst around that banks substantially utilised the TLTRO in June, and that this would strongly limit supply from financials, and that, if anything, there would hence be more of a focus on capital trades."

Indeed, of post-summer euro FIG supply (excluding covered bonds), around half has been in either AT1 or Tier 2, matching issuance of senior preferred and senior non-preferred (SNP).

After BNP Paribas launched the first post-summer euro FIG deal on 24 August, a €1bn eight year non-call seven SNP, Intesa Sanpaolo the next day attracted some €6.6bn of orders to its €1.5bn dual tranche AT1, the first in euros since a €500m RBI deal on 22 July.

But in spite of the successful market reopening, the habitual September flood of issuance failed to materialise, with banks under no pressure to come to market.

"You had some issuers — those who see more risk on the horizon — eyeing the first window that was available, and they came as early as possible at the end of August," said Bonnal, "whereas others have been more relaxed. TLTRO has taken care of funding, so issuers aren't focused on covered or senior preferred, and they anticipate being given more time on the MREL/TLAC front, so aren't necessarily looking at that, either.

"For banks wishing to raise AT1 — for example, to optimise their Pillar 2R needs, as has been the case for some of the recent issuers — subordinated debt is also proving to be where there is a very strong bid from the investor community."

Euro issuance has also been undermined by better economics being available in the US dollar market for higher beta projects. Barclays and Credit Suisse issued AT1 after euros had closed for the summer, and the post-summer tone has been constructive, according to Fadi Attia, managing director, US dollar syndicate, at CACIB, with September potentially turning into a record month for issuance.

"Subordinated paper has in general performed well," he said. "Investors have been net buyers of Yankee bank Tier 2 and AT1 in secondary over the past four weeks."

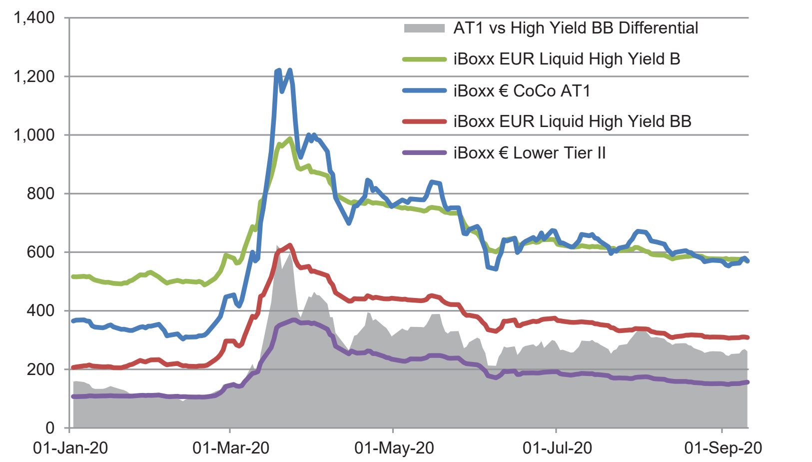
Monetary, fiscal stimuli dominate

Demand continues to be supported by bank capital offering relative value to corporates, including high yield, which have tightened on the direct central bank buying, according to Bonnal.

"But at the same time banks are meant to be part of the solution to this crisis," he said, "and they are a lot better capitalised than they were last time around.

"If you compare Tier 2s we've seen post-summer from Danske and Erste, which are triple-B rated, versus triple-B corporates, at least they are paying almost 200bp in spread."

Secondary market performance



Source: Markit, Crédit Agricole CIB

Central banks' interest rate stances meanwhile contributed to yields falling over the summer, further enhancing the attractions of sub debt.

"The lower for longer mantra pushes investors to dive into duration regardless of the part of the capital structure you look at," said Hoarau. "Intesa and Commerzbank were well received with long-dated tenors, for example, while the stock of AT1s at the long end is almost empty.

"We lost 15bp of outright yield in 10 years during the summer break, which adds to spread performance, with resets mechanically pushed higher to the benefit of investors. Meanwhile, the flattening of the curve is a strong argument for borrowers to consider curve extension."

At the same time, central banks' QE measures continue to support the overall asset class.

"Credit risk has all but vanished with central banks acting as lender of first resort since the Covid-19 crisis erupted," said Hoarau, "so investors are keen on going down the credit curve and the capital structure."

While central banks have spurred and supported the recovery in financial markets since the peak of the crisis in March, government measures — whether moratoria or fiscal stimuli — have increasingly come to the fore.

Filippo Maria Alloatti, senior credit analyst, international, at Federated Hermes, for example, continues to see value in some AT1, even if levels are back to those last seen around the turn of the year, citing government measures as key to current valuations.

"It's a common theme across equity and fixed income markets that the market got ahead of the economic situation," he said, "which typically tends to be the case when these large-scale fiscal stimuli are deployed."

Alloatti said the measures have specifically helped financials and their valuations.

"The expectations for credit losses for banks are coming in somewhat lower than originally feared in February, March," he said. "That's the result of all these moratorium schemes around Europe for mortgages, SMEs and to some extent corporate loans.

"Credit costs for banks this year will probably be higher than they have budgeted for, but, crucially, they will be lower than the EBA estimate from May, which was 280bp-320bp of CET1 drawdown — that was always a worst case scenario, anyway, not taking into account the fiscal stimulus measures."

A potential merger between CaixaBank and Bankia, coming on top of Intesa's acquisition of UBI Banca, has also raised expectations of further consolidation in the European banking industry, which Alloatti said could indirectly have a positive impact on AT1 valuations.

"Banks, especially in Europe, are trading at very depressed levels in the stock market," he said, "and maybe the possibility of some domestic mergers focused on cost savings — rather than revenue synergies, which are always more difficult to achieve — could reignite some interest in the sector. And if there is a more positive predisposition of the equity folks towards banks, that could trigger a move tighter of the AT1s."

Constructive, not 100% convinced

The persistence of the technicals supporting the market has meant that credit spreads have remained relatively immune from equity market moves, notably the recent Nadaq fall, partly due to their endogenous nature. When Commerzbank issued its AT1 on Tuesday, for example, the deal succeeded in spite of an inauspicious stock market backdrop.

"There was a bit of concern when it was breaking, because equities were deeply in the red, but it never really traded down much below re-offer," said William Rabicano, director, credit trading, at CACIB. "The credit market is very low beta at the moment — or at least much lower beta versus macro markets than it was a couple of months ago. We'll

Filippo Maria Alloatti, Federated Hermes: Expectations for credit losses for banks are coming in somewhat lower than originally feared

have days where equities are up 1%-2% or down 1%-2%, and credit in general doesn't react much.

"I can't really see that changing in the short term, either."

However, while flows and fundamentals are supportive of spreads, Rabicano and others caution that there are widespread expectations of the market moving a leg wider before year-end, while investors' conviction in today's levels is far from unanimous.

"Despite many investors being cash rich, they remain cautious and selective at current valuations in order to protect performance that has been pretty good so far year to date," said Marjolaine Marzouk, head of credit sales France Belgium Luxembourg Switzerland, at CACIB. "In spite of the credit market's relative resilience, investors have in mind risks factors like the macro 'real economy' catch-up and the potential volatility linked to US elections.

"In the context of limited supply and the erosion of new issue premiums, orders book can drop significantly from IPTs."

In spite of the uncertainty around the real economy impact of the crisis, CACIB's Hoarau is on balance constructive on the outlook for credit spreads going into year-end.

On the negative side, he cites the potential for a meltdown in equities — with the Nasdaq 100, for example, still almost 60% up on its crisis lows — and the potential for unemployment to stabilise at much higher levels than expected, with crisis measures currently masking the ultimate outcome.

"And the ingredients are all there for an unexpected inflation spike," he added, "now that we have monetary and budgetary QE in place, while debt levels are reaching new records every day. This would be fatal for debt instruments."

However, on the positive side, he acknowledges that such measures may pay off in terms of the recovery.

"Globally, we continue to believe that in the medium term, the capacity of bad news to hit the market will continue to be limited," said Hoarau. "And we have not fully exploited the stock of good news, with serious headlines around vaccination being at the top of the list."

Meanwhile, as the market moves on from the initial phases of the crisis, issues familiar and specific to the bank capital market could return to the fore. For example, although AT1 coupons have proven reliable amid the crisis, Alloatti said the risk to them is something to bear in mind going forward.

"The authorities were quite forthcoming in saying that they did not want to add a detrimental reaction to any AT1 coupon cancellation to their already long list of worries," he said, "and I detect very little willingness from any bank to save on the AT1 coupons.

"However, people tend to forget that back in the day AT1 coupons were always grouped together with dividends and bonuses, so this is something that could still be an issue in the next couple of years, particularly as the market grows and broadens."

Rare SCOR €300m takes scarcity to extreme

SCOR encountered overwhelming demand for its first euro subordinated transaction since 2016 on Thursday, a €300m 31 year non-call 10.5 Tier 2 that underlined the dynamics across the hybrid space.

With the French reinsurer's last issue in the euro capital markets having been back in May 2016, and its issuance size limited to its €300m needs, the transaction represented the overall lack of euro financial institutions issuance in extremis, according to André Bonnal, FIG syndicate at joint bookrunner CACIB. He noted that SCOR's last capital trade was a tap of its inaugural $625m (€507m) Restricted Tier 1, which it first sold in March 2018.

"The mainstream continental European investor base doesn't buy US dollar RT1, even from a name like SCOR, and they haven't done anything in euro for over four years," said Bonnal. "All the outstandings of SCOR are small and if you look at the call schedule of the issuer, there is nothing significant coming before 2026.

"So when they come with a €300m 31 non-call 11, you know it's a one-time only offer."

Insurance subordinated debt tightened over the summer alongside bank hybrids and the wider credit market. A Crédit Agricole Assurances €1bn 10 year bullet Tier 2 that was one of the last pre-summer trades on 7 July, for example, had tightened from 220bp to 190bp by last week.

SCOR's IPTs were set at the 205bp over mid-swaps area for the €300m no-grow September 2051 non-call March 2031 deal, rated A by S&P.

"We were very quickly able to demonstrate that the book was multiple times oversubscribed, with €2bn of very high quality demand, and from there we were able to substantially tighten pricing," said Bonnal.

Guidance was set at the 170bp area, plus or minus 5bp, and with the book peaking at some €3bn, the deal was ultimately priced at 160bp on the back of €2.4bn of orders good at re-offer.

Bonnal said the re-offer spread was flat to SCOR's outstanding 2048 non-call 2028, implying a negative new issue premium of some 15bp, taking into account the curve extension. The deal had tightened 2bp by the next day.

"With this successful placement, SCOR continues to benefit from exceptional market conditions in a low yield environment," said Denis Kessler, chairman and CEO of SCOR. "The success of today's euro placement enables us to further secure attractive long-term financing to support the future organic growth of the group.

"The notes were oversubscribed by nine times, which confirms the very high level of confidence placed in the group by the credit market." ●

Dual-tranche Intesa impresser

Intesa Sanpaolo's new issue on 25 August was the Italian bank's second €1.5bn dual-tranche AT1 of the year, after it sold the first ever dual tranche euro AT1 on 20 February, split into perpetual non-call five and non-call 10 tranches. Like that trade, the AT1 reopener was upsized from €1.25bn to €1.5bn, on the back of some €6.6bn aggregate of demand.

Following initial price thoughts of the 6% area for the perpetual non-call seven and a half and 6.5% area for the perpetual non-call 11, rated Ba3/BB-/B+/BB (low), the coupons were set at 5.5% and 5.875%, respectively, on the back of a combined €6.5bn of demand. With the order book rising slightly to €6.6bn, two €750m tranches were priced.

According to Bonnal at joint bookrunner CACIB, the pricing implied new issue premiums of between zero and an eighth, but more notably inside where BBVA and Santander were trading.

"There is a very positive vibe around Intesa following the merger announcement with UBI Banca," he said, "and that helped them print inside the Spanish national champions, which they had never done before. It's even more of an achievement for them to do so when coming back in the midst of Covid-19 for another €1.5bn after the dual-trancher in February — and going as long as non-call 11, to boot.

"It's impressive how far they have come in the past couple of years."

The choice to again split its transaction into two tranches was down to Intesa seeking to maintain a smooth call schedule, said Bonnal, and notably crystallised a bid for long duration sub debt.

"When you aim for duration in AT1, it's never a straightforward aspect," he said, "so prior to the trade, it was not necessarily a given that the longer tranche would have a much better following than the shorter bond, but that's exactly what happened."

As well as being tightened an eighth more than the non-call seven and a half, the longer tranche attracted €3.6bn of demand and the shorter €3bn. Bonnal attrib-

utes part of the stronger demand for the non-call 11 to the lack of alternatives.

"Looking at a perp non-call seven or similar offering in the context of 5.5% or 6%, you have names like Santander, BBVA, Bank of Ireland or AIB, so if Intesa had been tightened too much, from an investor perspective there are alternatives," he said. "But there have only been four euro benchmark AT1s longer than non-call eight, three in 2017 and then Intesa's from January, so there isn't really any alternative for investors.

"And the new Intesa perp non-call 11 looked very interesting versus their outstanding perp non-call 10 because of the difference in reset and coupon."

Intesa's January trade carries a 4.125% coupon, while its reset is 180bp lower.

The longer tranche also outperformed the shorter, such that amid last week's weaker tone the non-call 11 was trading roughly flat to the non-call seven and a half.

"This clearly shows that there is less credit curve in the AT1 market than one would think," said Bonnal, "and that there is a strong bid for duration."

Like several other issuers to have raised subordinated debt during the development of the coronavirus crisis, Intesa was seeking to optimise its Pillar 2R AT1 bucket, while sending a strong signal of pro-active and prudent capital management.

Sophisticated UK asset managers were more heavily involved in the non-call 11, according to Bonnal, while high profile mainstream continental Europe buy-side accounts were strongly involved in the non-call seven and a half.

The UK and Ireland were allocated 35% of the shorter tranche, France 17%, Asia 8%, Nordics 8%, Italy 8%, Germany and Austria 7%, the Benelux 6%, Switzerland 5%, and others 6%, while fund managers took 75%, insurance companies and pension funds 13%, banks and private banks 11%, and others 1%. On the longer tranche, the UK and Ireland were allocated 61%, France 8%, Germany and Austria 7%, Asia 5%, Italy 4%, Nordics 3%, Switzerland 3%, and others 9%.

Commerzbank tailored for success

Commerzbank opted to take advantage of the bid for duration when it approached the market on Wednesday for its second euro AT1, a €500m no-grow perpetual non-call nine and a half, only three months after its first. On 8 June, the German bank debuted in AT1 in euros with a €1.25bn 6.125% perpetual non-call six that attracted over €9.5bn of demand, pre-reconciliation.

The latest issue was again launched off a €3bn AT1 issuance programme Commerzbank established in May, which the bank said enables it to make use of the regulatory changes whereby the instrument can now be used to meet capital requirements to a greater extent. The new bond reduces Commerzbank's CET1 requirement (MDA threshold) by 27bp to 9.82% pro forma as at the end of June 2020, it said.

"We were surprised to see Commerzbank coming back to the primary market for AT1s so quickly after their former issue back in June," said Jérémie Boudinet, fund manager, La Française Asset Management. "Yet we view this as a positive and opportunistic move to increase their capital buffer against requirements, which is positive for AT1 bondholders in the end."

The books were opened with IPTs of the 7% area for the €500m no-grow perpetual non-call nine and a half deal, rated Ba2/BB-. After around an hour and a half orders had passed €1.5bn, and after a little over two hours guidance was revised to 6.5%-6.625%, will price in range, with orders above €2.8bn. The deal was ultimately priced at 6.5% on the back of more than €2.4bn of orders good at re-offer, comprising 190 accounts.

The €500m no-grow size was key to the deal's success, alongside the long duration, according to Hoarau at joint bookrunner CACIB.

"In today's market, and particularly the AT1 market, size matters as much as anything else," he said.

"The issuer felt that at the end of the summer period the market was sufficiently hot to welcome such a trade," he added, "as long as it came with very specific parameters — such as the duration and size — and consensual pricing, and they were rewarded with a positive outcome."

The pricing was deemed flat to fair value, with Intesa's dual-tranche AT1 having shown there to be very little credit curve between the five and 10 year parts of the curve, and Commerzbank's outstanding AT1 trading at around par, making relative value calculations straightforward.

Alloatti at Federated Hermes saw value in the new Commerzbank AT1 even if it came roughly flat to outstandings.

"There is a camp that thinks the bank is a value trap," he said, "but we are in the camp that is positive on the bank, already owning its AT1 and some legacy instruments.

"The bond has performed relatively well," added Alloatti.

The UK and Ireland again led the way, noted Hoarau, being allocated 41%, with France on 17%, Asia 11%, Austria and Switzerland 9%, Germany 7%, Iberia 6%, Nordics 3%, the Benelux 2%, Italy 1%, and others 3%. Funds took 69%, banks 10%, insurance companies and pension funds 10%, hedge funds 9%, and others 2%.

Bank of Ireland also made a relatively swift return to AT1, issuing a €300m perpetual non-call five and a half on 26 August, the day after Intesa's dual-tranche reopener. The new issue was priced at 6% on the back of some €1.5bn of orders, following IPTs of the 6.5% area. In mid-May the Irish bank had launched the first AT1 since February, a €675m perpetual non-call five deal.

"Bank of Ireland coming back four months later with another AT1 and achieving a strong result tells you just how receptive the market is," said CACIB's Bonnal.

And Austria's Bawag completed the post-summer AT1 line-up in euros, issuing a €175m 5.125% perpetual non-call five and a half on 1 September.

Danske 'an attractive proposition'

Danske Bank launched the first euro Tier 2 of the post-summer restart, a €500m no-grow 10 non-call five on 26 August that attracted more than €2.5bn of orders from 168 investors to achieve pricing through fair value.

George Kalbin, director, FI syndicate, at joint bookrunner CACIB, said that like the post-summer AT1 issuers, the Danish bank was keen to take advantage of the overall scarcity of euro financial institutions supply, with the relative performance of Tier 2 a further consideration.

"We saw Tier 2 lag the tightening in the subordinated space a bit over the course of the summer, with AT1s having outperformed the overall market, and senior non-preferred having compressed very tightly versus senior preferred," he said. "In early August, we nevertheless saw Tier 2 start to catch up and then prove an attractive proposition for a number of issuers as they started to perform.

"Investors had meanwhile built up cash during the dry spell and were ready to be put this to work. Danske therefore saw the opportunity to go out with a €500m no-grow deal that suited its limited requirements, and being the first out of the starting blocks and capping the size clearly helped them from the outset."

Following IPTs of mid-swaps plus 220bp-225bp for the 10 non-call five deal, rated BBB/BBB+, guidance was set at the 195bp area on the back of just over €2.25bn of demand. The Tier 2 was ultimately priced at 190bp on the back of the €2.5bn-plus pre-reconciliation book.

With Danske's 1.375% 2030 non-call 2025s trading in the context of 187bp on an i-spread basis, fair value was put in the low 190s over, meaning that its latest Tier 2 was priced with a negative new issue premium.

"Danske is going through a transition, and has recently seen some positive results and outperformed its Danish peers," said Kalbin. "However, it still trades at elevated spreads versus a lot of the Nordic names, and from a relative value and absolute standpoint, it looks very attractive to a lot of investors.

"They managed to use this new issue as something of an exercise to reprice their curve and showcase that they are still considered a top quality name."

Nordics accounts were allocated 30% of the bonds, the UK and Ireland 24%, Germany, Austria and Switzerland 19%, France 10%, the Benelux 10%, Asia 3%, southern Europe 3%, and others 1%. Asset managers took 70%, central banks and official institutions 12%, insurance companies and pension funds 10%, banks and private banks 5%, and corporates 3%.

Tier 2 opportunities seized

Erste was the next bank to enter the Tier 2 market, selling a €500m 11 non-call six on 1 September on the back of one of the most oversubscribed books of the new season.

After IPTs of the 245bp area for the €500m no-grow September 2031 non-call June 2026 deal, rated Baa2/BBB+/BBB+, the deal was priced at 210bp over on the back of some €3.4bn of demand. The pricing was at around 5bp through fair value.

"Everyone likes this name," said Bonnal at CACIB. "It's the national champion of Austria and trades at a much higher spread than where, for example, a French or a Dutch credit would, and on that basis it was always going to be a success."

Higher beta credits then seized the opportunity to tap the accommodative market, with Banca Monte dei Paschi di Sienna (MPS) raising €300m of triple-C rated Tier 2 on 3 September, followed by two of its compatriots. Banca MPS's trade satisfied a condition of an ECB decision on 2 September allowing it to hive off non-performing exposures.

The 10 non-call five transaction, rated Caa1/CCC+ was priced at 8.5% on the back of IPTs of the 9% area and a €1bn order book.

"It's a very high coupon," said Bonnal, "but you are talking triple-C paper, and the fact is they were able to very successfully do a trade.

"It's also an M&A story," he added, "with investors potentially betting it will get bought by another Italian bank now that its plan has been approved."

Four days later, on 7 September, Banco BPM entered a clear and quiet market — with the US closed for Labor Day — with a €500m no-grow 10 non-call five Tier 2, rated B1/BB. Following IPTs of the 5.125% area, the deal was priced at 5% on the back of over €700m of demand from more than 90 accounts.

Hoarau at joint bookrunner CACIB said this outcome was impressive, particularly given that it is the fourth high beta issue from BPM in the past 12 months, including prior Tier 2, senior non-preferred and AT1 issuance — the latter a €400m deal in January.

"The trade was driven by sophisticated accounts aware of the ins and outs of BPM but also the wider Italian banking sector," he added.

Domestic accounts took 48% of the paper, the UK and Ireland 31%, France 10%, and Switzerland 6%. Asset managers were allocated 63%, banks and private banks 24%, and hedge funds 11%.

Two days later, Credito Emiliano made it a hat-trick of Italian Tier 2s, issuing a €200m 10.25 non-call five with a coupon of 3.5% on the back of some €260m of demand. ●

REGULATORY UPDATE

EBA Q&A on Par Calls, Set-Off Waiver and eligibility, Scrip Dividends and CET1

On 4 September, the European Banking Authority (EBA) released three final Q&As of significant importance concerning the areas of (i) par call features in Own Funds and Eligible Liabilities, (ii) set-off waiver conditions and eligibility implications, and (iii) scrip dividends and CET1 deduction. Here, CACIB's DCM Solutions team highlight the key takeaways in order of importance (high to low, from the point of view of the debt investor/funding officer):

1. **Par call feature:** The EBA finds the par call feature in line with applicable regulations, as the CRR2 requires that the first call option be at least five years from the settlement date of an AT1 issue and it does not prescribe the frequency of subsequent call options. The CRR also does not prescribe the format and timing of interest resets, other than that incentives to redeem must be avoided. The par call feature must satisfy Art. 52 (1) CRR2, paragraphs (g) to (k) ((g) no incentive to redeem, (h) option only in issuer's hands, (i) reference to Art. 77;78 CRR on reg. approval, (j) no indication of reimbursement of instruments in the documentation, (k) no hints from bank that regulatory approval to a call would be forthcoming). The practices around the marketing and call exercises of this novel feature will be subject to increased scrutiny from regulators. The par call feature does not constitute "exceptional" grounds as per Art. 31 (2) RTS on Own Funds to apply "fast track" regulatory approval for redemption. Deduction of AT1 bond from AT1 Own Funds once the regulatory approval for the call has been granted. The EBA then clarifies that par call features on Tier 2 and Eligible Liabilities instruments are in line with applicable regulations, under the same set of conditions as for AT1 instruments.

2. **Set-Off and OF/EL eligibility:** The EBA confirms that the absence of a set-off waiver condition in the documentation of a bond does not disqualify it per se from treatment as an Own Fund or Eligible Liability item. However, the EBA underlines that *"the **effective absence** of set-off or netting arrangements that would undermine their capacity to absorb losses in resolution"* must be demonstrated. **In CACIB's view, particular attention must be given as to how high the EBA will set the bar for evidencing the "effective absence" of set-off/netting arrangements as 100% demonstration of effective absence of set-off may be very difficult to prove in reality** (or rather, it may be difficult to find a reputable law firm providing a legal opinion ascertaining absolute absence of set-off rights under all possible circumstances). Hence, the stricter the criteria for proof of absence of effective set-off, the higher the probability of failing the test and having the corresponding instrument disqualified as OF/EL. However, it is likely that a compromise be found ensuring strict criteria for the proof of absence of set-off, without putting material parts of the OF/EL segments of EU banks at risk of disqualification. In the meanwhile, this matter may become a priority regulatory point of debate again in the coming months and years.

    - **Brief theoretical illustration of potential set-off issues (one possible constellation among many):** Bank A issues SNP bond to Investor B; Investor B has a loan from Bank A; so Investor B has both an asset and liability in terms of exposure to Bank A; let it be assumed that the loan has been granted from a different legal entity than the issuing entity of the SNP bond within Bank A; further the loan has a different rank and is under different governing law and place of jurisdiction than the SNP bond => can the asset and liability of Investor B be set-off against each other? On the basis of which law/jurisprudence? What if the law governing the loan from Bank A to Investor B allows offset irrespective of contractual conditions, whereas the law governing the SNP bond of Bank A and bought by Investor B respects contractual agreements and therefore prohibits set-off?

3. **Scrip dividends and CET1 deduction:** Normally, foreseeable dividends must be deducted from interim/year-end results prior to inclusion in CET1 based on objective criteria — either explicit dividend policy or past dividend pay-out ratios. Where banks offer to shareholders the optionality of receiving the dividend in shares (scrip) or cash, the portion paid in shares does not need to be deducted from CET1, as CET1 is not reduced. The portion paid in shares may be determined prospectively on the basis of past shareholder behaviour.

For exact regulatory and legal references to the text of the EBA Q&As, or in the event of any questions or comments, please contact us:

Cécile Bidet, Michael Benyaya, Doncho Donchev, DCM Solutions, Crédit Agricole CIB: dcmsolutions@ca-cib.com

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