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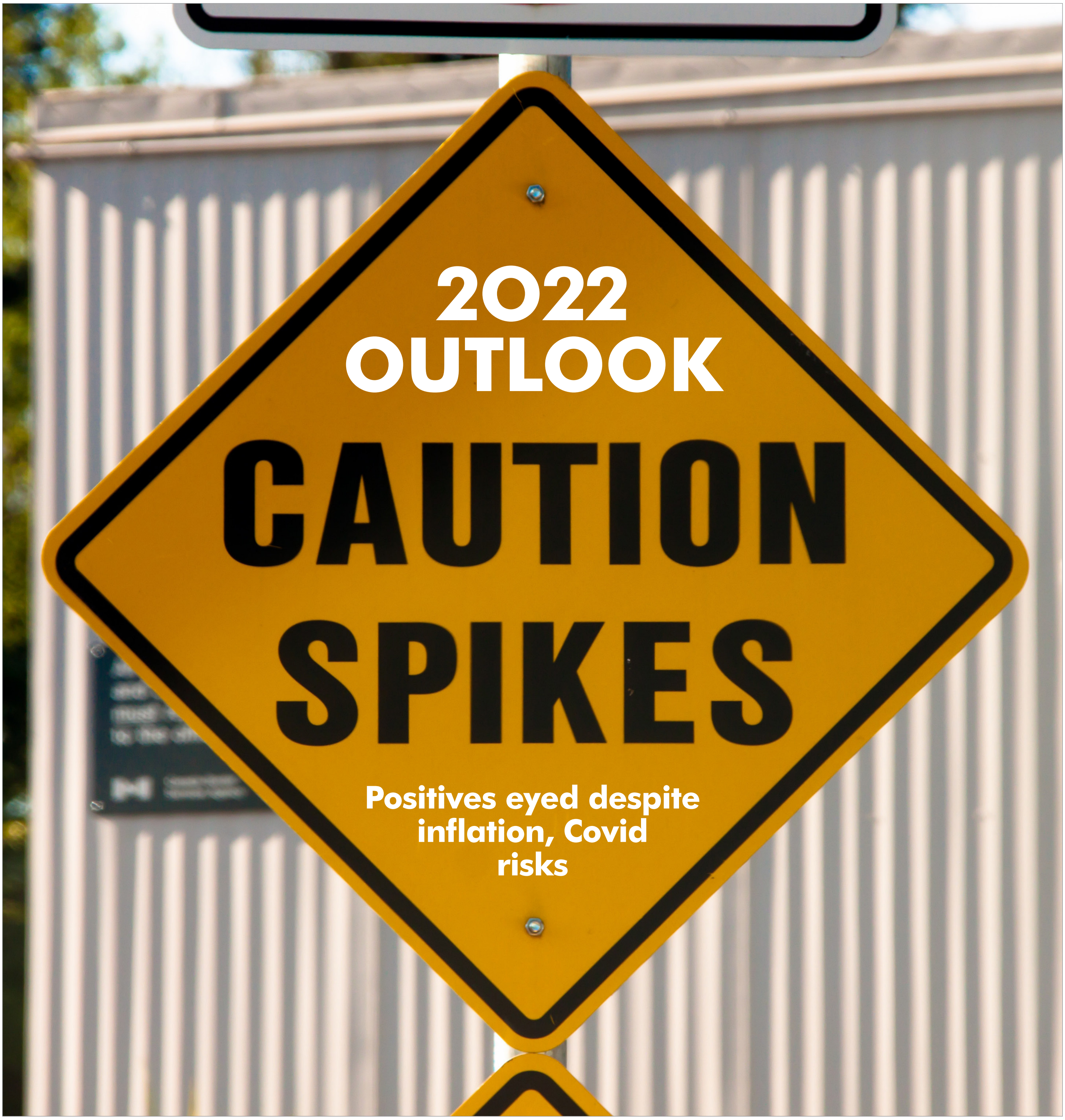


## 2022 OUTLOOK

**Positives eyed despite inflation, Covid risks**

DECEMBER 2021

# 2022
# Positives eyed despite inflation, Covid risks

Main Street and Wall Street may have reconnected at a bullish juncture lately, but amid supply chain struggles, a spike in inflation has fuelled rates volatility and the latest from Fed chair Powell is that tapering may be accelerated. Meanwhile, ECB president Lagarde could on 16 December announce the fate of TLTROs.

Investor, rating agency and Crédit Agricole CIB (CACIB) representatives on 23 November shared their views on the implications of such decisions for bank funding, performance, and asset allocation with *Bank+Insurance Hybrid Capital*. The subsequent emergence of the Omicron Covid-19 variant with a worrying number of protein spike mutations has only further raised the stakes at this critical time, but key takeaways from our roundtable still resonate.

Cécile Bidet, head of FIG DCM, CACIB

Louis Harreau, ECB strategist, CACIB

Matthieu Loriferne, bank credit analyst, PIMCO

Alexandre Birry, chief analytical officer, financial institutions, S&P Global Ratings

Stéphane Herndl, head of fundamental and sustainable analysis, La Banque Postale Asset Management

Marjolaine Marzouk, head of credit sales France, Belgium, Luxembourg, Switzerland, CACIB

Florian Eichert, head of covered bond and SSA research, CACIB

Vincent Hoarau, head of FIG syndicate, CACIB, and moderator

Grégoire Pesquès, CIO credit, Amundi


**Vincent Hoarau, CACIB: What are the implications of the current spike in inflation, and what are the implications for how central banks are likely to be addressing the issue?**

**Louis Harreau, CACIB:** It is relatively clear that the US Federal Reserve is heading towards a tightening of its monetary policy. The Fed has already started the tapering of its QE, and from its recent communication, the central bank might accelerate this, to be ready to hike the rates before the end of next year. So we are expecting a tightening of Fed monetary policy before the end of 2022.

The European Central Bank is in a totally different situation. We are expecting the ECB to reconfirm its very accommodative monetary policy, via two channels in particular: firstly, by an increase of the asset purchase programme — its mainstream QE, if you like; and secondly, by reinforcing its forward guidance — the ECB will reiterate that it intends to keep its rate very low for a prolonged period of time.

That said, the ECB will at the same time have to manage the exit of its extreme monetary accommodation — I'm talking about the pandemic emergency tools. On the one hand, the pandemic emergency purchase programme (PEPP) will indeed have to end sometime in 2022, probably in March, possibly slightly later — it doesn't matter that much; what is clear is that the ECB will exit this specific monetary policy tool.

The other big topic for the ECB is exiting the extremely accommodative TLTRO III. TLTRO III are probably one of the most accommodative monetary policy tools ever implemented. While the ECB was able to provide very favourable liquidity to the banking system during the pandemic to ensure that banks were able to lend to the private economy, they have to be ended when the pandemic recedes, so the ECB will have to manage the exit of TLTRO III. The ECB will not totally remove TLTRO, but what is clear is that in the future they will be less available than what we currently have.

**Hoarau, CACIB: Florian, what are the concrete implications of those changes in monetary policy guidance in the US and in Europe for the market in general, and for the banking sector in particular?**

**Florian Eichert, CACIB:** Before we go into the actual implications, let's just take a quick step back and think about what all of this has done over the past few years, and afterwards we can dive into what the various implications are.

We have negative rates in Europe, very compressed spreads, and a drop in market liquidity because of ECB purchases. We've had reallocations among fixed income investors, either within fixed income into higher risk or longer duration, or altogether out of fixed income, because of all the implications the ECB's policies have had for the market. They've touched on virtually anything and everything, so if you unwind or start to unwind some of these measures, there are naturally a lot of moving parts that could possibly start to be put into motion.

And with banks, it's ultimately the same thing. Rates are exceptionally low and ultimately impact bank profitability. The liquidity measures that have been put in place, as Louis mentioned, have impacted their market funding behaviour and added to the squeeze that we have in the market. So if you unwind these measures, as I said, you get a lot of different moving parts and some of them are really hard to assess and grasp. That's why whenever you have monetary policy and governing council members of the ECB — even some who are a bit more on the central-dovish side — start making hawkish comments, you get quite a bit of uncertainty in the market. Whether that is through EGB spread widening or credit spread widening or swap spreads shooting wider, it all comes back to this very central point that they've impacted markets in so many different ways that it's really tricky to get a proper idea as to what happens once they start unwinding it. That's why they're being so cautious about it and trying to figure out which tool and which instrument to use, which to unwind first, and at what pace — it's such a big issue at the end of the day. It's not just a minor element that they've touched; they've touched on virtually everything.

**Hoarau, CACIB: Matthieu, from your perspective, what are the implications of all these monetary pol-**

**'We are expecting the ECB to reconfirm its very accommodative monetary policy'**
**Louis Harreau, CACIB**

icy changes on the market and the banking sector?

**Matthieu Loriferne, PIMCO:** I agree with much of what has been said so far. There are two important aspects I would focus on. Firstly, the absolute level of yields — in the US, in particular, since this has direct implications for Additional Tier 1s as predominantly a yield product. Both the absolute level of government yields, as well as the volatility of those instruments, will influence the continued demand for AT1.

Secondly, regarding funding, and higher up the capital structure, we go back to central bank intervention. And this is also linked to the point on TLTRO. As we have seen three years ago, it's very difficult for the ECB to disengage altogether; rather, it would have to be a gradual withdrawal of the extraordinary support provided to the system. TLTRO has been phenomenally useful, and has been very complementary to the other ECB policy actions, but it has had also significant implications on the way the banks are funding themselves. It has also had implications in terms of regulatory ratios, like the NSFR, etc.

And so, for those two reasons, the withdrawal has to be gradual.

It is true, though, that unlike three years ago, given the significant excess liquidity that there is in the system at the moment, it will be easier for the banks to cope with such withdrawal. And as such, there should not be a major impact onto funding products as the ECB tapers that particular extraordinary support measure.

Hoarau, CACIB: Alexandre, what's the view of S&P on the change in monetary policy regime and market implications?

**Alexandre Birry, S&P:** Especially looking at the bank side, that can be very interesting.

Let's assume we have inflation that is a bit more persistent — maybe not at this elevated level, but still, more persistent and not just transitory in Europe. For banks, a bit of inflation and steepening of the yield curve can be a good thing, especially in terms of net interest margin. The question mark really is around the scenario underpinning this inflation, and what that means for asset values or banks' asset quality, for instance. If we step back, as a result of the pandemic, the global government debt to GDP level spiked by 19% in 2020, and for corporates this increase in debt to GDP is 15% and households 9%. So clearly, the stock of debt is much higher. We are expecting that, with the economies recovering, that leverage will ease a little bit going into 2022, especially for corporates. But at the moment there is or there seems to be too much money chasing too few goods, so we do see a bit of persistence in inflation.

**There seems to be too much money chasing too few goods**

We have looked at what this means for corporates, as large customers of banks in Europe. Our analysis on what the supply chain disruption and cost inflation pressures mean for global non-financial corporates found that they appear to be taking these in their stride. We analysed 78 global corporate sectors, and companies in 54 of these were finding it either very easy or somewhat easy to pass on costs, so at the moment they are handling the inflation pressures. We do have the question around what increased debt costs combined with salary pressure could mean in 2022, but so far, it's OK. For households, it's a similar picture — it depends on the scenario that's underpinning this inflation. If we have inflation, but we still have low unemployment, healthy housing markets, and household revenues going up, fine, we can deal with that. But if you change some of these variables, the outcome could be very much less favourable for banks' clients.

So in summary, we think a tightening of monetary policy, if done smoothly, can benefit banks by lifting net interest margins from their low levels. But in a more pessimistic scenario, obviously it could also cause volatility in markets, higher impairments, and potentially a slowdown in the economy. However, that's not our base case, more a downside scenario that we are monitoring to see if such risks manifest themselves. As I said, our base case is that inflation will be mostly transitory, what will be left of inflation after that will be manageable.

Hoarau, CACIB: So, optimistic, but cautious. Let's come back to the ECB and the last meeting of the year, which is seen as instrumental for bank funding in 2022, and potentially for credit spreads. Why is it so important?

**Eichert, CACIB:** It is because the ECB will be touching on all those crucial parts that impact banks. They'll be announcing what they plan to do with the PEPP and the APP, and all those net additions to the overall monetary policy portfolios. And they'll be announcing news or not on the on TLTRO side. So it's both on the purchases, as well as on providing banks with liquidity. And it's all been leading up to that moment, in a way, which happens to be in the middle of December when market liquidity is at its poorest, so I can see why there's a bit of

‘If TLTRO is unfavourable, we will see a material increase in covered bonds and senior preferred’
Cécile Bidet, CACIB

a tension building around this. I can say a word or two on the liquidity side in a moment, but let’s just think of the purchases. We have the potential for the PEPP, which has been going at €65-odd billion net per month, to drop away altogether. If you believe some of the statements that were made by governing council members, that is a real possibility, at least. While that doesn’t necessarily mean much for corporate buying or for covered bond buying — because that by now relies to a large extent on redemption reinvestments rather than net additions to the portfolio — it does, of course, have a very, very big impact on EGBs, on SSAs, on supranationals, on European Union purchases, because they have been benefiting the most in absolute terms from these amounts. If you take these away, then clearly there will be volatility that wouldn’t necessarily come directly from within, say, the bank space, but will be imported from the EGB side. Just think of the Italians: they widened by 8bp-9bp the moment governing council member Villeroy made a more hawkish speech. So it’s as critical as it has been made out to be, because it’s touching on all those different elements. And funding, as we said, depends on or is driven by TLTRO terms, so you could get a whole lot more supply from banks. But for the time being the main focus is in terms of spread volatility or possible volatility, and how the market could cope with the ECB no longer buying these €65-odd billion a month in net terms.

**Hoarau, CACIB: Cécile, you’re in touch with issuers all the time — are they all basically waiting for December 16 to finalise a funding plan?**

**Cécile Bidet, CACIB:** Issuers have to have a funding plan in place, of course; they can’t wait for the ECB. But after that, the funding plans will be adapted, depending on the outcome. There are two main themes.

On the one hand, there’s the pure funding or liquidity instruments, covered bonds and senior preferred. There, we can say that both volumes and credit spreads could be impacted: if TLTRO is unfavourable, we will see a material increase in covered bonds and senior preferred, and credit spreads, and if the purchases are reduced, there will be an impact.

On the other hand, anything MREL-related or where the bank needs to meet capital requirements in the broad sense, will not be impacted by the ECB’s decision. The banks need to meet certain volumes for MREL or for capital optimisation, and this depends more on their activity, the evolution of risk-weighted assets or the leverage ratio, rather than the impact on funding cost. But while volumes would not be impacted, credit spreads could be affected because the impact on SSAs, covered bonds, senior preferred could ripple all the way to senior non-preferred, and maybe some opportunistic trades that we could expect normally would not materialise. So we will see two different dynamics between funding/liquidity instruments and those satisfying capital requirements.

But it’s true that a lot of issuers are waiting for the outcome of the ECB meeting, not only for funding, but also in terms of profitability, because it makes a big difference if the new TLTRO has an incentive of, say, 25bp or none — balance sheet dynamics will be materially impacted by that.

**Hoarau, CACIB: We will come back on the different scenarios, but maybe before that, Stéphane, what are your thoughts on the December 16 ECB meeting?**

**Stéphane Herndl, La Banque Postale AM:** I would echo the mix of everything that has been said thus far. It’s difficult for central banks, and especially the ECB, to strike the right balance between taming inflation, making sure that you maintain the boost to the real economy, and at the same time asset prices surging, as we’ve seen, for instance, with house prices in a number of countries, which can be worrisome in the eye of the supervisors. Our take is that, indeed, as was said, it would be a bit chaotic to stop the TLTRO abruptly because of the negative signal it would send to the banks, especially because the TLTRO is there to fund the real economy, the economic agents — the SMEs, the corporates — and we’re still in a very intermediated economy in the EU, unlike in the US. That’s why the ECB is still there, willing to extend, albeit probably with less favourable terms, as was said before.

Just one food for thought: when you look at the latest bank lending survey of the ECB — I think that was back in October — what is striking is that only 12% of the banks surveyed indicated that they would participate in the last TLTRO III auctions. 42% were undecided at the time and 43% did not intend to participate. When you look at these figures, it seems that banks may already have basically made as much use of TLTRO as they can, because they think they will not be able to meet the benchmark rate or because they do not have any eligible assets. That could be a positive signal, saying that even altering the TLTRO conditions would not have a meaningful impact on the programmes. I’m talking here at the Eurozone level, not bank-specific, of course — there are different cases for different institutions.

**Hoarau, CACIB: Let’s go back now into TLTRO and potentially some details. Florian, what would be the trigger for issuers to refocus from TLTRO III to, let’s say, pure market funding? Higher TLTRO III rates? The maturity**

**dropping below one year? A combination of these? What's your best guess?**

**Eichert, CACIB:** At the end of the day, it depends a bit on what banks have done with the money. If you have banks that have taken the liquidity and redeposited it at the ECB at deposit rate minus 50bp, clearly it's all about the ultimate rate that they can get. The moment that carry and that profitability boost to their income bottom line goes away, they'll repay that amount. I think Louis had a piece out on this, where if the TLTRO were to go back to the deposit rate, rather than deposit minus, then the ECB would get a very high triple-digit billion number, if not all the way up to a trillion of liquidity dumped back onto its courtyard, just because of that profitability element no longer being there. There's no point in holding money at the deposit facility if there's no actual benefit from it. Banks are overly liquid, they don't need to have that as a precautionary amount; it's purely there for profitability purposes. And if the ECB were to get that amount of money back, I'm sure there would be the odd bond floating around that has just become freed up as far as collateral is concerned, and if that happens at a time the ECB is already going at a lower asset purchase pace, I'm not sure how well the market would deal with it at that point in time.

On the pure funding side, at the end of the day, it's a matter of costs, so it's a question of whether you beat the net lending benchmark? If you do, then it's 50bp cheaper funding for you. And then it still makes sense to hold on to the TLTRO, and not yet go full-on aggressive on market refinancing. If you're not meeting that benchmark, then market funding via covered bonds, or even senior preferred already at this point is the more economically beneficial choice for funding officials. You're terming out your funding and the steepness between TLTRO funding and longer dated market funding is not really meaningful — you can walk into a CFO's office and propose a market trade without getting fired, which wasn't the case a year ago. So it's all about the terms. If the ECB were to continue at depo minus, all those profitability trades would be maintained for however long that depo minus is extended; if they go full-on hawkish and, say, the minus 1% runs out in June — even if they introduce new TLTROs at depo flat or something between depo and MRO — you'll see what Cécile said earlier, that issuance will pick up again. I don't think it's really started in a more meaningful way, and it might not be a big bang, but rather a more gradual shift back towards market funding, and we'll only see net issuance on let's say the covered bond side, for example, turn positive in 2023 rather than next year. But you'll get a gradual normalisation, and the pace of that normalisation really depends on the ECB. As Cécile said, there are essentially two funding plans in the drawers at the moment, and the one is a very gradual pick-up in issuance, while the other is a good bit more in terms of pace.

**'There are essentially two funding plans in the drawers at the moment'**
**Florian Eichert, CACIB**

If I then sort of close the circle and go back to spread valuations, a large reason why we are as tight as we are, both in covered bonds in absolute spread terms versus swaps, but also senior preferred to covered bonds, is the lack of supply. The ECB has never bought senior preferred through any of its purchase programmes, so it's all about liquidity and lack of supply. The moment you take that back, you could have movement in covered space, which ultimately could even push senior preferred wider, totally delinked from whatever is happening on the APP and PEPP, and the volatility from the EGB space that I mentioned earlier. We had the situation previously where the ECB stepped back from buying covered bonds in the same size, they lowered primary market orders from 50% at some point all the way down to 5%, and at the time that we moved into the next calendar year with a lower CBPP3 order number and start-of-the-year funding activity, the covered bond space became a pretty volatile market — not by AT1 investor standards, but by covered bond standards. If even German Pfandbriefe move 20bp wider, you can see the knock-on effects that has on other markets and other segments. So it's to a large extent dependent upon the cost element. NSFR plays a role for some that are tight in NSFR — they will focus more on the June date and at what point does the biggest TLTRO drop below one year residual time to maturity. But the bigger element is really the cost and the pricing, and whether it is below depo or not.

**Hoarau, CACIB: So potentially a less boring year ahead of us. Let's move on to specifically the bank funding profile now. Cécile, how do you see the different parts of the capital structure evolving in 2022 from a gross issuance standpoint, but also from a regulatory standpoint?**

**Bidet, CACIB:** It all depends. I'm not going to go back over the arguments discussed by Florian, but assuming that the ECB is still going to be relatively accommodative in the next year and TLTRO, we think that covered bonds could pick up for European banks by 25% — as Florian says, it's going to be gradual increase. June 2022 is the key date for a number of banks for NSFR, for leverage ratio, depending on whether or not the central bank exemptions carry on, and for the bonus minus 1%. Some banks are already not meeting the lending targets, so they don't benefit from that, and we've seen already — I'm not going to name names, but you know which banks they are — that they've started accessing the market and refinancing their TLTRO because profitability-wise it's not interesting, and they didn't need it for liquidity. So again, a gradual increase in the first part of the year for the banks who did not meet the lending target, and definitely in the second part of the year, because the minus 1% will have disappeared, the NSFR advantage will drop from 100% to 50% for the big drawdown that was in June.

Senior preferred/OpCo will also benefit from these increased liquidity needs. We've already started seeing that on the PP market: it's a product that had completely disappeared over the past year, and it's gradually coming back, with banks showing an interest. So we expect senior preferred/OpCo issuance to increase, albeit more modestly, probably in the 5% area.

For senior non-preferred/HoldCo, it's a bit of a mix and match. The risk-weighted asset inflation that could have been expected due to the pandemic has not materialised — I was one of the Cassandras predicting a deterioration of NPLs, but it didn't materialise; banks are doing extremely well. So, unfortunately for me, no more massive volumes of SNP. But there will be a little bit of risk-weighted asset inflation that will also drive some increase in senior non-preferred. Some banks were running very large Tier 2 buffers and are refinancing those maturing Tier 2s with senior non-preferred or HoldCo, so we are seeing banks changing their capital structure in that respect. Banks have very high CET1 ratios, so they are trying to optimise, meaning not having extra buffers in AT1 and Tier 2 at the moment. So for SNP, we will also probably seen an increase of around 5%. Tier 2 is the only asset class where we foresee a decrease, of minus 10%. Capital situations are optimised and some banks are running down the Tier 2 buffer a bit, and AT1 should also be flat.

So to sum up: a massive increase in covered bonds, everything else relatively flat to positive, except for Tier 2, which should see a bit of a decrease.

That's all about structures, but it's important to note that ESG will be something that will go further in all asset classes — we can come back to that later.

**Hoarau, CACIB: Yes, indeed. Matthieu, would you echo Cécile's view? How do you see things evolving across the bank capital structure in terms of volumes?**

**Loriferne, PIMCO:** If we start at the very bottom of the cap stack, I agree with Cécile. Clearly there is at the moment a meaningful surplus of excess capital across Europe, more than 500bp — that's a lot more than pre-crisis. And there has been a build-up of AT1 and Tier 2, including the changes in regulation — like the P2R add-on, for example. This is now largely behind us, so for Tier 1 it should be largely about refinancing, assuming banks call at the first call date. Tier 2 should indeed come down, as banks realise that there is no point in carrying excess Tier 2 for the purpose of MREL — senior non-preferred/HoldCo is perfectly acceptable for all stakeholders, and so they should focus on that. Regarding MREL, we are still in building mode for several banks, particularly on the continent, so that should see a continued increase. The UK is largely done, which probably stands out positively versus the rest of Europe from a supply standpoint. And when it comes to the pure funding instruments — preferred, covered bonds — as everybody has said, this will depend largely on what the ECB does, either in December, or in March, actually.

**For SNP/HoldCo, it's a bit of a mix and match**

**'Clearly there is at the moment a meaningful surplus of excess capital across Europe'**

**Matthieu Loriferne, PIMCO**

**Hoarau, CACIB: So to wrap up: technicals are definitely supportive for high beta products, Tier 1, Tier 2; less so for, let's say, pure funding instrument.**

**We have discussed TLTROs, but we have not discussed deposit balances. Together with TLTROs, they are potentially the other driver of banks' funding. We all know that they have been surging massively since the start of the pandemic. Florian, for 2022, how do you see things evolving in terms of lending growth versus deposit growth? Could this be an additional driver for higher wholesale funding needs?**

**Eichert, CACIB:** It is clearly a driver for wholesale funding needs — it's the most natural, historically relevant one, after all. It's just that we've been so distracted by all this ECB liquidity over the past years, that this has almost been pushed to the background. But if you just look at ECB euro area data, for example, there's more than one trillion euros of excess deposit growth over lending growth since the start of 2020, which is a very, very meaningful amount that comes on top of the TLTRO liquidity balances we've discussed. So clearly, unless you have more pronounced needs for term funding — because of ALM constraints or because you are very large in, say, mortgage lending — and you need tenors longer than short term deposits or ECB three year money, then you've not really needed wholesale funding. And that's what we've seen in wholesale markets for senior preferred and covered. So yes, if there is a shift in that balance, then

**'Some of these excess household deposits will be gradually used for consumption'**
**Alexandre Birry, S&P**

that would naturally lead to more and more market funding. And on the mortgage side, it would clearly lead to more covered bond funding. We've seen one of the Dutch issuers, Rabobank, today do a €1.5bn 10 year: they've always said that they use this instrument to finance their long term lending growth on the mortgage side, so clearly it is having an impact. On the corporate, unsecured lending side, a lot also depends on how effectively the recovery fund is rolled out in some of these jurisdictions, because there's a co-financing element to a lot of these projects that will involve banks, too. So it's the most traditional sort of need for banks to finance if lending growth outpaces deposit growth. The more recent data already shows that in some countries private sector deposits are falling. But, we've been through I don't know how many waves of the pandemic now and some countries are going back into lockdown — the lovely city I'm sitting in even has a higher infection number than the UK, which is a first, as far as I can recall. So of course things will depend a lot on what happens on the pandemic side: the more people are stuck at home and can't go out and spend, the more deposit balances will stay elevated. Fingers crossed that will eventually normalise, and clearly that will add to banks' needs to refinance. We'll have the TLTROs that will ultimately drop down in terms of tenor, plus that really exceptional period with deposits far outpacing lending growth will also ultimately have to reverse.

**Hoarau, CACIB: What's S&P's view on lending growth versus deposit growth?**

**Birry, S&P:** I'm slightly less optimistic that the deposit and lending dynamic will drive wholesale funding. For me, probably the bigger driver of delta for wholesale funding will remain whatever happens with monetary policy and the removal of TLTRO. Florian's right about the magnitude of deposit growth — between the beginning of 2020 and September 2021, they grew around €900bn on the household side and €600bn on the corporate side, so some €1.5bn gross, and netting it off against lending growth, Florian's one trillion number makes complete sense. But I'm not expecting any shift to result in a surge in the wholesale funding. Rather, what we expect is that some of these excess household deposits will be gradually used for consumption again, which would probably depress lending a bit in terms of consumer finance or activities like that, for instance, because households can use their savings instead of taking short term loans. For the banks, these excess deposits don't necessarily need to be replaced by other sources of funding, because they can instead run off some of their liquidity on the other side of the balance sheet. Maybe a question mark is on the continued growth in some housing markets: can they continue to be so bullish? Because that can support a healthy covered bond market. Otherwise, in terms of the lending versus deposits dynamic, probably slightly less positive, at least in the short term. Corporates also still hold lots of cash on their balance sheets — again, a kind of hedge against future rate rises, with many of them trying to tap the market to benefit from the low rates achievable. But that means that, like households, they also have the ability to run down some of the cash they have, or to use it for M&A and other uses. If you look at maturities of corporates, we don't see any big concentration in the near term. If anything, they've been using these markets to lengthen the maturity profile. We looked at S&P-rated corporate bonds in Europe and 2022 redemptions are basically on a par with 2023, and there are more redemptions in 2024, 2025 and 2026. Leverage is relatively high, so I don't think there's much more appetite necessarily to take on more debt.

So as I said, the bigger delta for wholesale funding needs for banks probably will be more TLTRO and whatever happens with monetary policy, rather than the dynamic between lending and deposit growth.

**Herndl, LBP AM:** I am on Alexandre's side, simply because when our corporate analysts and I have meet with corporates for credit updates, the corporates are not signalling that they need to materially increase their funding needs, be it for capex or just working capital. These corporates indeed typically have overall strong liquidity profiles as of today, and we do not expect any growth to be substantial. Hence, this in itself would not materially change banks' funding needs.

So we come back to the variables we've previously discussed. Cécile mentioned quite clearly that there is, on the one hand, regulatory-driven supply that will come, predominantly MREL instruments, and on the other hand, pure funding instruments, where we are back to the question about TLTRO and the future conditions. In the end it boils down to the relative cost of the pure funding instruments, senior preferred, senior OpCo, or covered bonds versus TLTRO conditions and the benchmark rate that you need to attain.

**Hoarau, CACIB: Let's now discuss the market capacity aspect. We have lived with net negative supply and squeezed valuations for quite some time — Mathieu, how do you expect investors to react if funding needs normalise again and issuance turns net positive?**

**Loriferne, PIMCO:** A lot of literature has been published on the relationship between supply volumes and performance, but in my view, it is not very robust — quite the contrary. Away from specific reasons such as regulatory change, for example, it is probably fairer to say that when markets are strong, supply is high, and when markets are less supportive, there is less supply. So if next year we see an increase in supply driven by either regulatory changes or the withdrawal of central bank support, then I would expect the areas of the market most affected to be most at risk of being repriced wider, so that indeed the market can digest this extra supply.

**Hoarau, CACIB: Stéphane, what about you?**

**Herndl, LBP AM:** I think of it in a slightly different way. It really depends on just why net issuance would turn positive for the banks. It's not the scenario I outlined before, but let's assume we indeed see strong loan growth. If issuance turns net positive for this reason, then we are talking about a strong economic rebound, and that in itself is something that is credit positive for the banks — it would signal that asset quality is probably going to be strong, and maybe there would be maturity transformation because of steepening. All this would be positive for margins. So overall, you could argue that this is positive for the banks, and the positive fundamentals would probably or arguably compensate for the technicals, if I can put it like that. Conversely, if, as Matthieu said, there is net positive supply because of a reversal or a change in the currently accommodative stance of the of the ECB, then maybe this is a situation that would be a bit more difficult for the banks, and that could have an impact on pricing. So I would really link it to the very reason net issuance turns positive.

**Hoarau, CACIB: Marjolaine, you cover a broad range of investors — based on what you're hearing, what's your take on market absorption and capacity in the event that net issuance turns positive?**

**'In the end it boils down to the relative cost'**

**Stéphane Herndl**
**La Banque Postale AM**

**Marjolaine Marzouk, CACIB:** Talking to investors — and as has been highlighted by the previous speakers — it's pretty hard to say, first of all, if net issuance will turn positive. As discussed, purely on the funding side, it will depend on the ECB meeting and the TLTRO update to see what the mix will be for banks in terms of allocation between market funding and the TLTRO.

Investors have been concerned about squeezed valuations for quite some time, as you mentioned, and many of them are waiting for a repricing to add risk. There is a lot of uncertainty at present — on growth, inflation, and also with this latest Covid wave — but the overall tone on credit remains fairly optimistic. Investors are not really suffering significant outflows, they continue to collect cash, and net cash balances show that there is money available to be put to work at the right entry point. In particular, insurers — who have largely been on the sidelines for quite some time — seem to be awaiting larger spreads and higher yields to reposition on the market. Investors are all highlighting banks' improved fundamentals, their good CET1 ratios, which are on average 16% for European banks, and also their pretty good asset quality.

**We will see a material increase in covered bonds and senior**

Investors remain cautious in the face of all the inflationary pressures, but not complacent, as central banks try to balance inflation and growth. As they are publishing their outlooks for 2022, two main risks that investors are highlighting are the growth aspect, with the new wave of the Covid, and also stagflation risk, if central banks are too behind the curve or too aggressive too quickly, even if they are trying to communicate that they will be very accommodative. So investors are being very careful with respect to valuations, looking at relative value. The recent larger new issue premiums on the primary market have generated increasing appetite, but clearly investors remain selective, and we have seen some reallocation.

**Hoarau, CACIB: Indeed, clearly the environment is changing. Grégoire, will this affect asset allocation across sectors, across currencies? How are you going to position yourself next year, towards duration, for example, being more aggressive or more defensive?**

**Grégoire Pesquès, Amundi:** We all have been quite long sub debt and I believe there is a consensus that this has worked quite well. Nevertheless, it is indeed the case that over the last three to four months some investors — not just in sub debt, but overall in the credit market — were adopting a more cautious stance ahead of year-end and following good performance. Fundamentals are for sure extremely good — even Deutsche Bank has been upgraded this year. We have good balance sheets, which enables consolidation, much in the second tier, and this will continue. Rates are increasing, you also have good growth, and if you are a bank, I think you should be pretty happy — what more can you ask for?

The only question mark here is to what extent central banks will be gradual or not, and consequently how volatile rates will be and how that will affect not only sub debt but the overall market. We have seen a big change in light of what has happened recently and I think central banks are now forced to be gradual, they are forced to work hand in hand with governments, for good or for bad. So I expect them to be gradual and slightly behind the curve on purpose, meaning that rates and curves in particular are going to be largely more volatile, particularly in the US but probably less so in Europe.

How does this translate into positioning? Fundamentals are good, a bit more volatility, valuations are tighter, so obviously you are going to run a more cautious position, but I still remain quite confident. And I see little alternative. So it will be all about not running a lot of beta in your portfolio, but being positioned more on sub segments and how you are going to allocate not only AT1 versus Tier 2, and so on, but also within AT1, between dollars and euros. Year-to-date performance is relatively similar between euros and dollars, but recently there has been an outperformance of the dollar market. And it's fair to say that when we reach this level of valuations, the technicals are getting more and more important. Marjolaine was discussing the various sectors, with yield buyers on the one hand, and spread buyers on the other: some yield buyers have been on the sidelines for a very long period of time — are they going to kick in, and when? It's very important in respect of pension funds and insurance for the Tier 2 segment. Asian investors are also key for the dollar segment of the market.

On our side, I am taking a good barbell position, where you have short-dated or short to medium maturities with not too low resets, so high to medium resets — I think this is something that will provide value. You will have volatility, but I'm very happy to hold this risk. On the other hand, a strong conviction on selected high beta names in Tier 2. I will tend to avoid medium maturity, low convexity, expensive names where I don't see a lot of upside.

**'The only question mark here is to what extent central banks will be gradual or not'**
**Grégoire Pesquès, Amundi**

It will be interesting to see how the AT1 asset class develops. It has been an asset class of its own for some time and we have been through massive volatility, but there have still been new investors coming in over the past year or two and adding AT1 in their asset allocation. They did so cautiously, but based on what has happened, they are getting more and more confident on the asset class. They started slowly, with small tickets, but they have drawn confidence from how nicely the regulator has treated AT1 during the crisis, providing a lot of flexibility. Maybe it's a hope or a wish on my part, but I expect that we will start to see them putting it on the same level as emerging markets or high yield as a yield or type of income solution in their portfolios. So I think that, more medium term, the technicals are also quite positive for the asset class to in fact continue to attract investors and for this asset class to compete with EM, with high yield, or other high yield solutions.

**Hoarau, CACIB: Matthieu, do you have the same type of optimistic view as Grégoire? How will you act in 2022 in respect of what we have discussed?**

**Loriferne, PIMCO:** What we can say is that over the past two years, and especially compared to previous times when markets and the whole banking system came under stress, AT1 has this time around fared very well.

There nevertheless remains a question mark over the sector.

If you look at fundamentals, capital positions, distance to coupon-skip or MDA, everything is in good shape, while there is a lot more clarity on the regulatory framework and a lot less volatility than in prior episodes. We have some concerns around inflation and the strength of the recovery, but even here the direction of travel is overall positive. So it's a good environment for banks.

In spite of all this, the AT1 market has not managed to find a new equilibrium from a spread standpoint. Every time we seem to touch the tights, the market seems to be uneasy about it, and so will tend to be repriced wider. So the big question for me is whether or not, based on the above positive factors hopefully persisting, we can at least establish a more sustainable, less volatile trading pattern for the asset class, which in turn should attract more investors. And then there will be the question whether or not AT1 can trade sustainably inside high yield in Europe, as happened in the US a few years ago.

Regarding senior debt and Tier 2 in particular, these are very much spread products, and will hence probably just mimic what the rest of the investment grade credit market does.

**Hoarau, CACIB: Marjolaine, what are your takeaways from what investors have been telling you on asset allocation going forward in this environment?**

**Marzouk, CACIB:** As I was saying before, we saw investors getting more cautious in the context of the recent spread widening and inflationary tensions. We can witness two trends: further reducing duration, and improving the credit quality

## 'I would expect investors to come back in the lower part of the capital structure for strong names'

**Marjolaine Marzouk, CACIB**

of their investments. These are the flows we are seeing from long-only funds — I'm not talking about total return funds, or insurance mandates, which have pretty much been on the sidelines, as I was saying before.

This is quite a reversal of the trends and strategies we were seeing in the previous months this year where everyone was playing the high beta call, long high yield, corporate hybrids, AT1s — on both FIG and corporates, investors were really focused on the sub part of the capital structure. The sweet spot for many large asset managers was around seven, eight years, but at the moment the focus is more on five, five-and-a-half years. So we saw some selling on the asset classes I mentioned.

It's not that investors are too negative; rather, it's profit-taking, with the repricing we discussed just before. And we also saw selling on the corporate sector, high beta, like real estate, where we had seen large supply. Turning back to banks, some trends we had seen were a focus on peripherals and also US names, but investors tend to be taking profits on those names as well and to be less active in the new trades. In the primary market, they have refocussed on core euro names. A very good example of that is the recent large triple-tranche senior preferred deal from Allianz, where we saw much larger tickets than before, despite it being pretty tight. We saw two types of credit players being very active in the three and five year maturities: short-dated credit funds, slightly longer than money market, with very large assets under management; and more traditional credit funds, who have been the most active in recent weeks.

As Grégoire was saying, I think this move is pretty temporary, it's more that investors sitting on good performance this year are being conservative in light of the approaching year-end and all the uncertainty with the ECB policy and so on. But, again, fundamentals are pretty strong, and so I would expect investors to come back in the lower part of the capital structure for strong names. They are also very selective about entry levels, so some repricing could be expected, and that's something investors are looking at very closely on every new trade.

## What would be the implications of new restrictions?

One last point on insurance flows, because they can be very large players as well, with a lot of cash. From our recent discussions, they have in mind an entry point around 1%, thinking about an IG rating and 10-12 year maturity for the French investor base. Some accounts had created some longer pockets, 20 years, when yields were getting lower, but at the moment they are telling me that they are refocusing on shorter maturities, so not too much longer than 10, 12, maximum 15 years.

To finish on asset allocation, ESG remains an increasing focus for all types of investors. Regarding banks, investors are waiting for them to communicate more precisely on the components of their exposure, so that's something that could be an increasingly important topic.

**Hoarau, CACIB: Alexandre, what are the risk factors for the new year, at least from the rating agencies standpoint?**

**Birry, S&P:** I'd highlight five risks — three macro and two non-traditional.

The first macro one is supply chain constraints and inflation, i.e. the risk that there is a rise in inflationary expectations and wage pressures that would require the ECB to bring forward their cycle of tightening, and what that would mean. What does a Eurozone with rates in positive territory mean for market turbulence or financing conditions? That's risk number one.

Number two is the accumulated corporate and government debt, and its possible fragility in the face of policy normalisation. Just to take one figure: among European non-financial corporates, 30% of speculative grade companies are rated B minus or lower by S&P, i.e. the companies that we really classify as vulnerable. What are the consequences of such debt levels, especially if some of the variables change a little?

And the third macro risk is around the vaccine and vaccine-resistant COVID strains, if that slows the economic recovery. Thinking about community transmission rates, what would be the implications of new restrictions, a decline in vaccine efficacy, or growing mistrust of vaccines when boosters are being rolled out?

So these are the three macro risks. I'd call the other two non-traditional — not emerging risks, because they have passed that stage.

The first one is the transition to net zero. Even after COP26, the EU's "Fit for 55" programme, targeting a 55% cut in carbon emissions by 2030 (compared with 1990) is still the most ambitious regional plan. What does that mean for certain industries in the non-financial corporate sectors? Think of autos, steel, cement, all that.

And the second non-traditional risk, especially for banks, is around the digitalization of markets. I'm including central bank digital currencies (CBDCs) and the emergence of the decentralised finance (DeFi) ecosystem. How the authorities calibrate regulations and initiatives around CBDCs can also determine how this emerging digi-

## 'We could not have this discussion without incorporating the ESG element'

**Vincent Hoarau, CACIB**

tal ecosystem will either complement or disrupt the banking system.

**Hoarau, CACIB: Grégoire, even if you are fairly optimistic towards next year, have you identified any particular risk factors ahead?**

**Pesquès, Amundi:** The first concern that we perhaps all share is a big policy mistake, for example, a sudden need for the Fed to move more quickly than expected. That could jeopardise the coordination with government policies that I mentioned. This would have knock-on effects on all asset classes — equities, emerging markets, and so on. In such an eventuality, sub debt would also suffer, but I would prefer to be in sub debt than equity or EM — so in relative terms, sub debt would still be a good call.

The second risk, in my personal opinion, is regulation. Regulation can always surprise — sometimes on the positive side, sometimes on the negative side. But we could see something there — the probability is low, but it's always something that is pending.

**Hoarau, CACIB: Clearly we could not have this discussion without incorporating the ESG element, which several of you have already mentioned during the conversation, so let's wrap up the session by tackling this. What are you expecting in respect of ESG looking into next year? What role will ESG play in the evolution of the issuance? Will it even impact the perception of the credit quality of issuers?**

**Bidet, CACIB:** We've just had another record year in terms of green, social and sustainable (GSS) bond supply, more than €700bn-equivalent across all sectors. For banks, GSS represented almost 25% of issuance this year, up from 10% last year, and the same positive trends will continue. This is driven by the ongoing growth of assets managed according to ESG criteria and new commitments being made by investors.

Is credit quality going to be impacted? In some cases we are seeing investors pushing back even on conventional bonds if they do not validate the ESG strategy of the banks, so I think yes, this will impact pricing to some extent — the greenium is up for discussion. And banks have much to navigate on this front. Regulations are being developed, the green taxonomy will be finalised in 2022, the Green Bond Standard, and we have the social taxonomy also coming during the course of 2022. Climate risk is the new thing that's going to be incorporated into stress tests. It's taking up more and more airspace. So is it going to impact credit quality, because we're going to see this turn into capital requirements? Possibly. I think at the beginning, it's going to be relatively subtle.

## SLBs are an indication of the overall strategy of a bank

What is definitely very important is disclosure. We've seen a massive acceleration of banks joining the Net Zero Alliance in the last 12 months and there will be more in 2022, 2023. But the big hurdle is the Green Asset Ratio, and also the Green Investment Ratio for asset managers. We are going to go from banks saying, I'm the greenest of the green, to publishing green asset ratios of 7.5%. So they're going to face this type of problem in pushing their strategy.

A last point on the ESG market is sustainability-linked bonds, which are a characteristic of the corporate market. With green bonds, although you may be supporting one billion in green assets, who cares when you have one trillion in balance sheet? Whereas SLBs are an indication of the overall strategy of a bank. Because they are disqualified by the EBA for MREL at the moment, we've hardly seen SLBs in the bank space at a time when MREL was a big driver for issuance. But if senior preferred re-emerges or if the EBA position on that evolves, I hope it's something that we are going to see, maybe not that early in 2022, but towards the end of the year and in 2023.

**Hoarau, CACIB: Stéphane, sustainability is part of your mandate at La Banque Postale AM. What's your view on the topic, how do you see 2022 in the context of green, ESG, this growing asset class?**

**Herndl, LBP AM:** It's very clear that green and social bonds will continue to be a very important tool for funding for banks, not least because there is very strong demand from buy and hold investors — they have mandates and need to chase assets to be able to fill their portfolios. Some banks still have assets that could qualify for green instruments and ultimately this is a cost-benefit exercise for the issuers, deciding whether they issue green funding or standard funding.

Going back to Cécile's point on sustainability-linked bonds, these are a very interesting development. Because they are excluded under bank regulation, as she said, we have not seen much. But we could argue that these are simpler instruments to understand, and you can also issue much more than for green bonds, which need to have the eligible assets. At the same time, it makes investors' lives a bit more complicated because then you have green instruments, social instruments, and SLB instruments, so we are not going in the direction of standardisation, which is what the market really needs. It will be interesting to see how this develops.

Another trend that is in the making is the credit or fixed income sphere heading in the same direction that the equity community took a few years before us, meaning no longer just looking at the instruments when judging whether or not ESG criteria are met, but really looking at the ESG characteristics of the issuers themselves. This is becoming a much more important element in our investment decisions. And it's no longer just looking at particular controversies or big material factors, it's really taking into consideration ESG as a whole. In this respect, within the E, the S and the G, it's really the E that is taking centre stage now, just because regulation is pushing hard there with climate stress tests. This morning we had a new publication from the ECB on environmental and climate risk for banks, and we see that they're really trying to push the banks to take this risk into consideration.

One last point: I'm not really in favour of the green supporting factor, because it creates arbitrage for the banks to invest in green assets. I think it was Andrea Enria at the SSM who said publicly in November 2019 that we have yet to see whether green really contributes to better performance of assets through the cycle than non-green assets. However, I would be in favour of a brown factor, increasing the capital charge on those assets that will be exposed to transition risk. That would probably be a good tool for banks to manage their exit strategy from fossil fuels exposures. Still, it may take a long time for this to be taken into consideration.

**Loriferne, PIMCO:** Generally green financing should be a huge growth opportunity for global financial institutions, particularly European, who tend to be leading the efforts in terms of supporting the green transition and who are certainly quite advanced in terms of integrating those variables into their business plans and emission strategies. It's estimated that between now and 2050 around two trillion euros of incremental capital a year needs to be provided to accompany the green transition — an eye-watering amount of money, and climate policies need to be much more ambitious to support this shift. One could argue that from that perspective COP26 was slightly disappointing, and you would like to see the financial institutions globally stepping up their efforts to provide that financing.

While it helps and is welcomed if well designed, it doesn't have to be structured as a use of proceeds or sustainability-linked bond, but I agree that there has to be a push in terms of transparency and disclosure. It's quite striking that after all these years of discussions about ESG and green financing, we still don't have clear communication from most of the banks and regulators about how to report exposure to various industries, green or brown financing, carbon emissions, transition plans, etc. The industry as a whole needs to very quickly come up with a standardised reporting format for all these issues so that the market can indeed continue to support those issuance plans and ultimately provide the financing that is required to the green revolution — a similar effort to the Enhanced Disclosure Task Force in the wake of the Great Financial Crisis and building here on the recommendations of the Task Force on Climate-Related Financial Disclosures.

**I will be wary of issuers abusing green frameworks**

I will be also wary of issuers sometimes abusing green frameworks just to issue on more attractive terms. I expect all investors will be mindful of how credible a story the green or SDG issuance framework offers, and I expect scrutiny to increase going forward. Because we are still in the early stages and growing very fast, there has to be greater coordination between regulators and the issuance community here, too, so that we end up with a transparent, unified reporting framework and there is no misunderstanding. In the wake of the financial crisis we had a landmark report on reporting standards, and it would seem to make sense to follow in the footsteps of that in respect of sustainability.

My final point is on the issuing vehicle. There has been a lot of debate this year in particular about whether there should be green capital. Our position is lukewarm at best on that. It's very difficult, based on the regulatory framework we currently have to reconcile the characteristics required of a capital instrument, be it Tier 1 or Tier 2, with a non-Basel compliant financial penalty or step-up, step-down, etc. So it seems to me that at this stage, at least, trying to reconfigure capital instruments to meet the green label involves unnecessary complexity, whereas we have already plenty of available funding vehicles — such as senior preferred, non-preferred, covered bonds — that are perfectly suitable for meeting the green aspirations of a financial institution.

**Hoarau, CACIB: Alexandre, maybe you could conclude the discussion with the view of S&P on ESG looking into 2022?**

**Birry, S&P:** The way I look at it is threefold, and echoes some of Matthieu's topics.

The first aspect is the volumes of financing needed. It's a great growth opportunity — if we look at the number from the Intergovernmental Panel on Climate Change, they were quoting 3.5 trillion US dollars of annual investment needed to limit warming to 1.5 degrees by 2050 compared to pre-industrial levels, so certainly huge numbers.

The second angle for me is the credit quality of issuers. If we look at climate or other ESG factors, clearly there will be winners and losers in the corporate sector, for instance, and even greater differentiation between the winners and losers when compared with banks, which are more diversified and have longer term income streams.

And the third angle for me is the nature of the instruments being issued. We'll see more instruments aligned with the Green Bond Principle and the Social Bond Principles. But as Cécile said, we will need more data, more disclosure, and there will be more scrutiny to avoid green or ESG-washing, so we probably need benchmark assessments, too, to ascertain some of these promises. ●

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