Daiwa Capital Markets

Market Dynamics of Loss Absorbing Senior Debt

Current Trends on Senior MREL/TLAC Debt in Europe

- As a relatively new asset class, the dynamics of senior MREL/TLAC eligible debt in both primary and secondary markets are still evolving.
- Given the similar purpose of the instruments, senior HoldCo/SNP and T2 spreads should converge over time, particularly in risk-off periods.

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Primary Markets

As a relatively new asset class, the dynamics of senior MREL/TLAC eligible debt in both primary and secondary markets are still evolving. The instrument has significantly re-shaped European G-SIBs debt structure, whilst the impact on non-G-SIBs is largely yet to emerge.

In the Senior Preferred (SP) / OpCo space, we continue to expect the net supply of new debt to be negative again in 2019 driven by the building-up of MREL/TLAC buffers by several players, the new round of TLTRO announced by the ECB, and simple deleverage. The latter was the rationale given by Deutsche Bank in its 1Q19 results, when it announced a 50% decline on its SP issuance plan to €3-4bn for 2019 due to 'balance sheet optimization'.

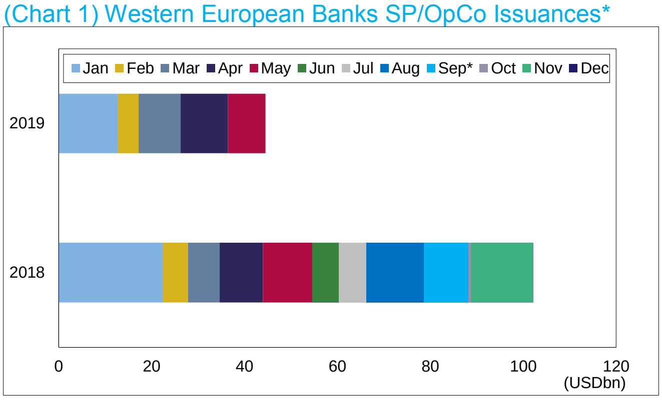
The aggregate supply of Senior Non Preferred (SNP) / HoldCo debt is also expected to decline in 2019 vs 2018, as larger issuers in the UK, Switzerland and France have already reached elevated levels of the required MREL/TLAC buffer. This is the case for BPCE, Credit Agricole, Lloyds, HSBC and RBS for instance. Other names, however, plan to maintain the issuance levels of 2018 (Societe Generale) or even increase placements (BNP Paribas).

In addition, due to increased clarity on requirements, and with the necessary legislation in place, a wider range of SNP/HoldCo issuers is expected to come to the market this year, albeit volumes should be limited. So far in 2019, we have already seen BFCM, Erste, NIBC, Sabadell, and Yorkshire Building Society with inaugural SNPs, whilst the Swedish names are widely expected to issue in the new format this year.

Interestingly, MREL requirements may not always be the direct driver of SNP issuance. The volume of outstanding SNP/HoldCo debt is also relevant for Moody's ratings (higher volume → lower Loss-Given-Default → higher rating), highlighted by a recent 2Y SNP paper issued by Deutsche, which will be of limited use for actual MREL purposes.

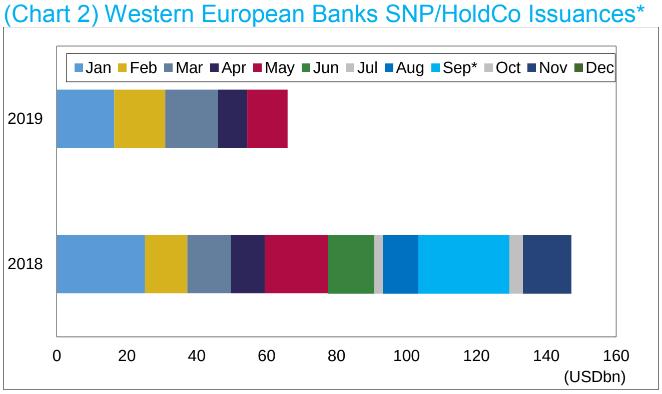
On the regulatory front, we now have approved subordination regimes in place in most jurisdictions in the developed world, providing legal certainty to issuers and investors. Yet key uncertainties persist, particularly in the euro area, in which minimum subordination levels are yet to be decided, as well as full clarity on utilisation of call options on senior MREL debt. BNP Paribas has been the only euro area bank so far to include call options on its SNP papers, whilst other groups are awaiting further clarification from the ECB, or have deemed it uneconomical.

(Chart 1) Western European Banks SP/OpCo Issuances*



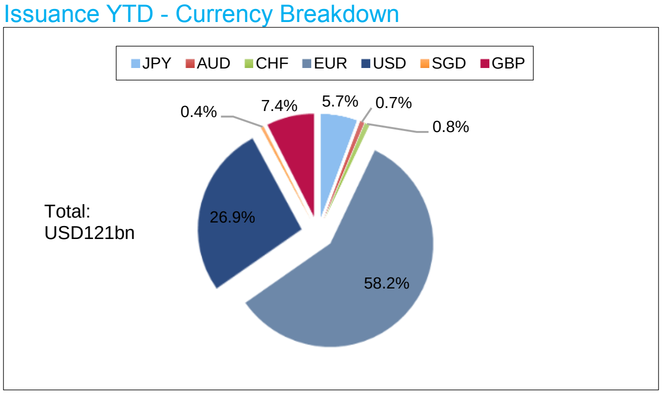
*Excluding JPY Issuances. Source: BondRadar, Daiwa CM Europe. Data as of 21/05/2019

(Chart 2) Western European Banks SNP/HoldCo Issuances*



*Excluding JPY Issuances. Source: BondRadar, Daiwa CM Europe. Data as of 21/05/2019

(Chart 3) Western European Banks Senior Unsecured Issuance YTD - Currency Breakdown



Source: BondRadar. Data as of 30/05/2019

By currency, EUR issuance has dominated the primary markets so far this year, backed by favourable market conditions (see Chart 3). Meanwhile, the JPY market for senior bail-in debt is slowly establishing itself as a reliable alternative funding source for issuers worldwide, met by generally good levels of demand throughout the year. This has been supported by the relaxation of Japanese investors' preferences about issuance formats, who are now willing to buy not just Samurai but also Euroyen and global yen bonds. 1Q19 saw a flurry to the JPY market as a result of the changing rules on risk weighting of TLAC debt holding by domestic banks, with a total volume of JPY1.16trn of Samurais and Euroyens, the highest Q1 figure since 2007.

Senior Bail-in Debt Requirements and Outstanding

The implementation of TLAC and MREL rules has been asymmetrical across Europe, with outstanding and required Senior Bail-in debt varying significantly across banks and jurisdictions.

The implementation of MREL rules and legislation has been particularly slow and inconsistent in the **euro area**, leading to a significant disparity in the levels of Loss Absorption Capacity (LAC), i.e. CET1 + AT1 + Tier 2 + SNP/HoldCo debt, (see Chart 4). The local G-SIBs have largely filled their senior TLAC needs so far with a combination of SP and SNP debt, whilst minimum subordination levels are - frustratingly for credit analysts and investors - yet to be specified and disclosed.

The euro area is the only region not to require full subordination for MREL/TLAC purposes, i.e. banks can use senior preferred papers to comply with minimum TLAC/MREL levels. This, in our view, undermines the whole MREL framework, and blurs the differentiation between SP and SNP debt. The slow definition and implementation of MREL regulations has also meant that several key players are yet to receive their minimum MREL requirement from the ECB. As a result, most euro area non-G-SIBs have only recently started to tap the markets for SNP papers.

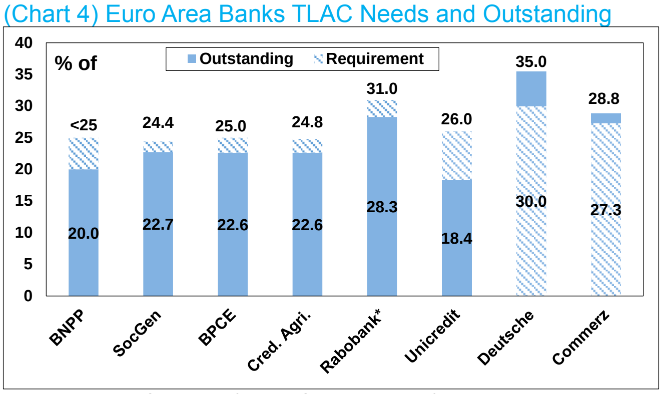
Other key European jurisdictions have made more tangible progress, so that their largest banks are now comfortably close to compliance or already compliant with minimum future requirements.

In **Switzerland,** both Credit Suisse and UBS are well positioned to comply with current and future requirements (see Chart 5). That said, recent proposals related to internal TLAC increased further their future total requirement, yet the long implementation period until 2024 provides a comfortable timeframe for compliance. Both banks also plan for an additional management buffer above the minimum requirement, so that Credit Suisse targets a total volume of outstanding HoldCo debt of USD55bn, and UBS USD48bn.

In the **UK**, the seven largest banks are well positioned overall to comply with future requirements (see Chart 6). RBS, Barclays and Santander UK still have marginal incremental HoldCo debt issuance needs until 2022, but these fit comfortably within the banks' normal funding plans. The UK banks have largely stayed out of primary markets in 1Q19, as they were prepared for significant market disruption due to the Brexit negotiations. Yet, as the negotiations dragged along, and the risk of no deal diminished, British banks felt more comfortable to come to the markets more recently, despite the continued Brexit premium on their spreads.

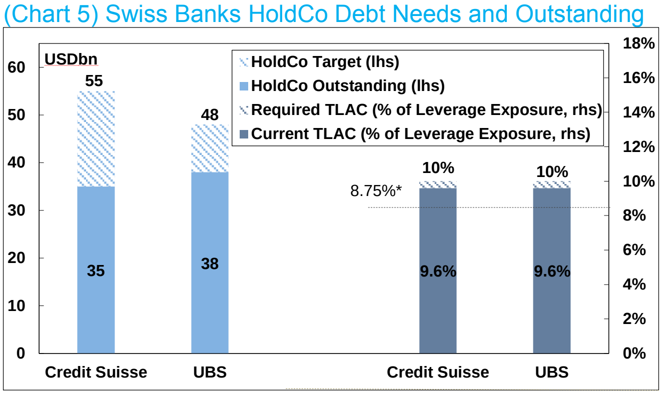
Swedish banks are yet to issue SNP paper, partly due to the ongoing money laundering issues, which has significantly widened the spreads of Swedbank for instance. Meanwhile, **Danish** banks are much more advanced in the building up of their SNP buffer (Chart 7). That said, banks in these jurisdictions will fill their SNP needs through normal refinancing of maturing senior preferred debt, which comfortably surpass minimum MREL requirements by 2022.

(Chart 4) Euro Area Banks TLAC Needs and Outstanding



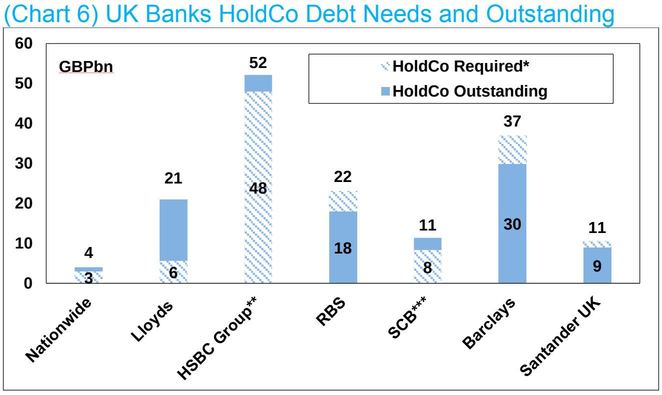
*Data as of end-1Q19. *As of YE18. Source: Banks' financial statements.*

(Chart 5) Swiss Banks HoldCo Debt Needs and Outstanding



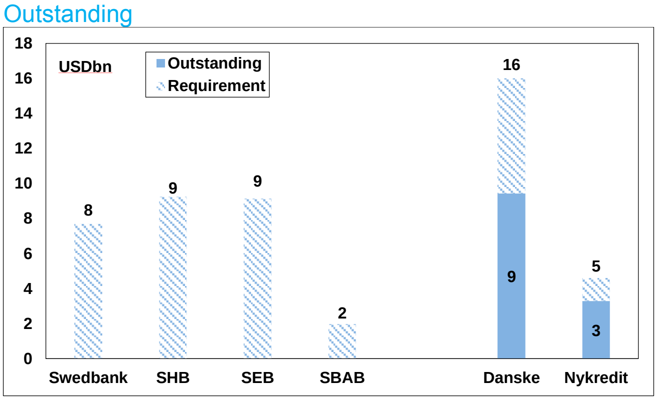
*Data as of end-1Q19. *New requirement from 2022 allowing for 125bps rebate. Source: Banks' financial statements.*

(Chart 6) UK Banks HoldCo Debt Needs and Outstanding



*Data as of end-1Q19. *Assuming constant capital ratios and requirements. **Final requirement yet to be established. ***As of YE18. Source: Banks' financial statements*

(Chart 7) Danish and Swedish Banks TLAC Needs and Outstanding



Data as of end-1Q19. Source: Banks' financial statements.

Relative Valuation

Recent Trends

The pricing dynamics of senior MREL/TLAC eligible debt are also still evolving. Based on fundamentals, overall credit quality, and capital buffers (CET1 + AT1 + Tier 2) in particular, should drive absolute senior spread levels, but this has not always been the case in practice, as relative supply considerations have also been a key source of pricing differentials across the different debt layers.

European banks' credit spreads have tightened significantly since the beginning of the year (see Chart 8), particularly for lower-ranked paper, against the backdrop of the US Fed's halt to monetary policy tightening and the signal from the ECB that tightening was off the table in 2019. Spreads of euro area banks have also been supported by the central bank's continued commitment to support its problematic banking sector, with confirmation from the ECB of a new round of TLTROs, which accompanied signals that it would consider a tiered system on deposits placed at the central bank. This tightening reversed somewhat in recent weeks, driven by the re-escalation of global geopolitical tensions, some negative political noise coming from Italy, and, for UK banks, continued Brexit and political uncertainty.

The tight conditions in the EUR market have pushed investors to chase higher yields and duration, leading to strong demand levels for long dated papers ranked below senior preferred, and to low new issuer premia. American, Canadian and Australian banks, which are fairly infrequent EUR issuers, have also taken advantage of the favourable conditions to tap the EUR markets in recent weeks.

Relative Dynamics – OpCo/SP vs HoldCo/SNP vs Tier 2

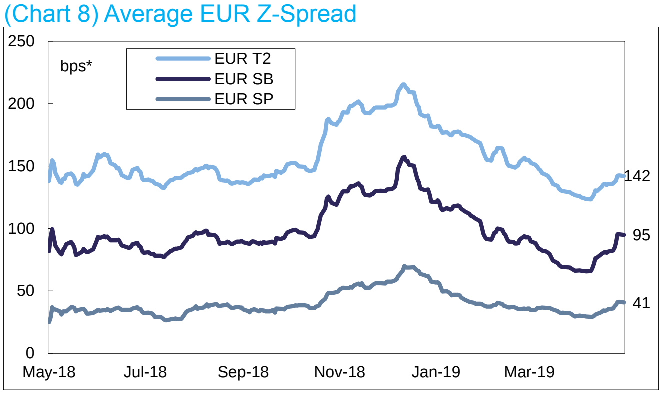
Based on fundamentals, HoldCo/SNP debt should price closer to Tier 2 than to OpCo/SP debt.

First, OpCo/SP debt benefit from vast LAC buffers, comfortably higher than the biggest losses observed in the recent financial crisis, particularly in jurisdictions with stricter TLAC/MREL requirements, such as the UK and Switzerland. RBS reported the largest corporate loss in the UK history in 2008, totalling GBP24bn, requiring a GBP45bn bailout by the UK government, whilst the bank's total losses accumulated in the 2008-2017 period amounted to GBP58bn. The latter is the exact amount the bank has today in LAC. UBS reported the biggest loss in the Swiss corporate history in 2008 (CHF20bn), today it has a LAC of USD88bn. Its peer, Credit Suisse (CHF8bn loss in 2008) has a LAC of CHF86bn. Deutsche Bank, which booked a EUR4bn loss in 2008, and an accumulated loss of EUR9bn in the 2015-2017 period, reported a LAC of EUR123bn at end-1Q19. Lehman Brothers' losses were estimated to be in the order of USD46bn to USD63bn, that is significantly below the LAC of the largest European institutions currently. In that context, an unprecedented level of losses would need to be registered for the OpCo/SP debt of the largest financial institutions in Europe to incur any loss.

Second, any loss at this level would also significantly destabilise the European, if not global financial system, likely resulting in a government intervention. As a result, Moody's applies a one notch upgrade on SP/OpCo debt based on implied government support.

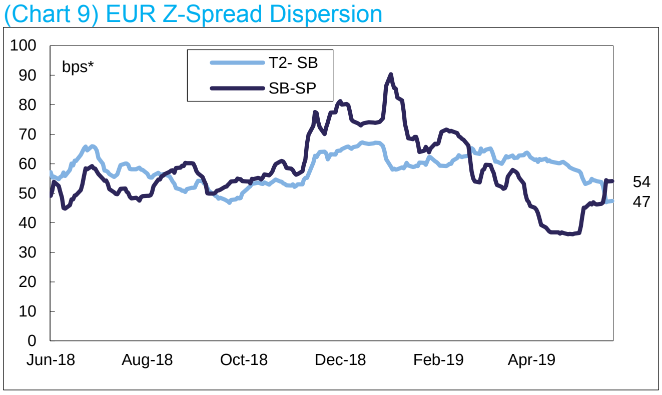
Further, in the euro area, after 8% of a bank's Total Own Funds and Liabilities (TOFL) have been bailed out, the bank would have access to the single resolution fund (total volume of €25bn as of July 2018), albeit capped at 5% of the resolving bank's total liabilities. There's no such fund in the UK or Switzerland, although UK banks would, in theory, be allowed state support after 8% of

(Chart 8) Average EUR Z-Spread



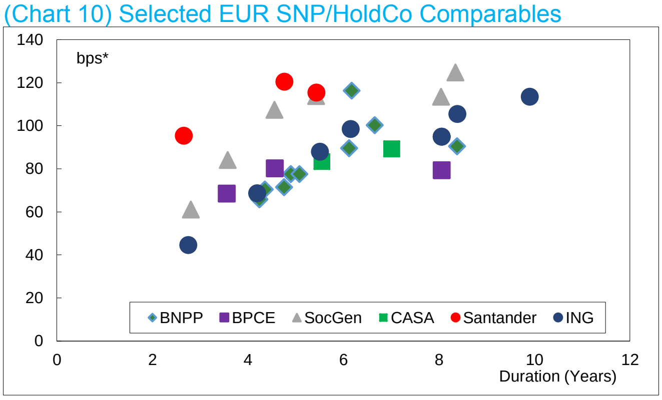
*Data as of 27/05/2019. * Mid Z Spread to maturity/call. SP= Senior Preferred, Senior OpCo. SB= Senior Bail-in (senior HoldCo, SNP). Source: Bloomberg.*

(Chart 9) EUR Z-Spread Dispersion



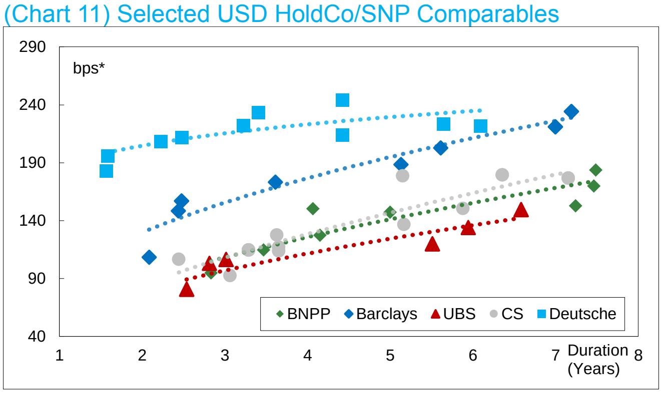
*Data as of 27/05/2019. *Mid Z Spread to maturity/call. Source: Daiwa CM Europe, Bloomberg.*

(Chart 10) Selected EUR SNP/HoldCo Comparables



Data as of 22/05/2019. *Mid Z Spread to maturity/call. SP= Senior Preferred; SB=Senior Bail-in. Source: Bloomberg.

(Chart 11) Selected USD HoldCo/SNP Comparables



Data as of 22/05/2019. *Mid Z Spread to maturity/call. SP= Senior Preferred; SB=Senior Bail-in. Source: Bloomberg

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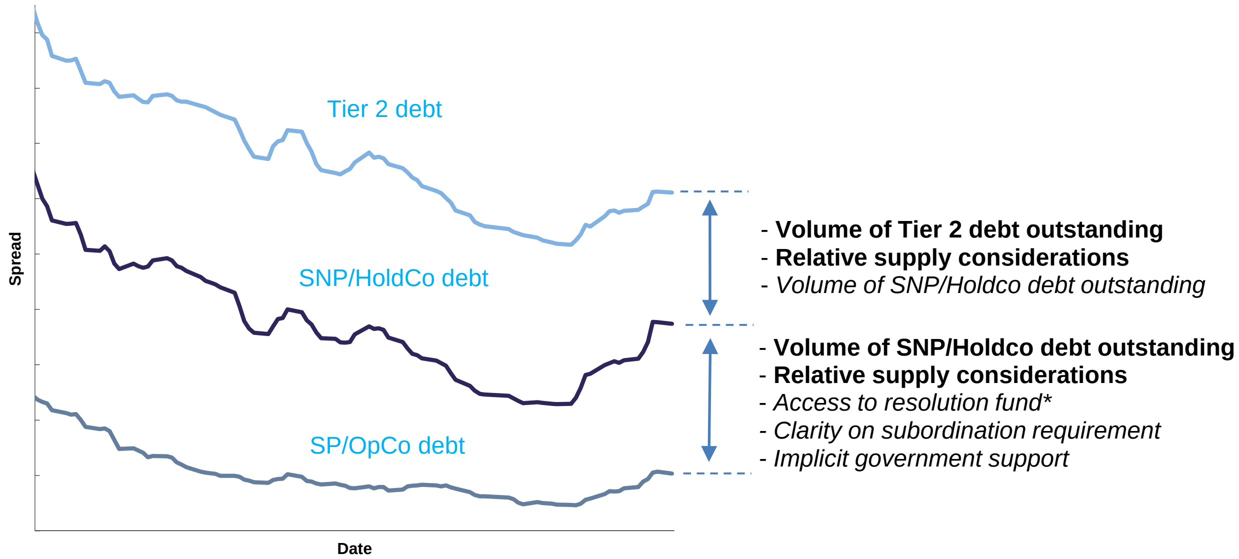
TOFL has been bailed in. Finally, the supply of OpCo/SP bonds may also become scarce, with some banks such as Credit Suisse and BNP Paribas no longer planning to make public placements in such formats for the foreseeable future for instance, further supporting the tightening of SP/OpCo spreads.

HoldCo/SNP paper on the other hand were specifically designed to absorb losses in case of resolution, and with European regulators inclined to bail in as much debt as possible if needed, the differentiation between HoldCo/SNP paper and Tier 2 is somewhat blurred. Given the similar purpose of the instruments, senior HoldCo/SNP and T2 spreads should converge over time, particularly in risk-off periods. This is observed in Chart 9, with SNP/HoldCo spreads trading closer to T2 in risk-off periods, whilst reverting to halfway between SP/OpCo and T2 in risk-on periods. The net supply of T2 debt is also expected to be negative in 2019, driven by the optimization of banks' capital structure, leading technicals to also work in favour of T2 vs SNP/HoldCo debt this year.

(Chart 12) MREL/TLAC Debt Dynamics



Applicable to euro area banks only, after 8% of total own funds and liabilities (TOFL) have been bailed out.

(Table 1) Selected Western European Banks 2019 Senior Unsecured Issuance Plans

	SP/OpCo	SNP/HoldCo
Nordea	€20-25bn in CB + SP + SNP	€10bn from 2018 to 2021
Crédit Agricole	€11-12bn in CB + SP	€5-6bn in SNP + T2
BPCE	€9-11bn	€3-4bn
BNP Paribas	€15bn	€14bn
SocGen	€6-8bn in CB + SP	€6-7bn
Commerzbank	€10bn across the capital stack	
Deutsche Bank	€3-4bn	€9-11bn
Banco Santander	€3-5bn	Nil
Intesa	No issuance in 1H19 due to adverse market conditions	
Unicredit	€2.5bn	€3.2bn
Rabobank	€10 – 12bn in CB + SP + SNP, including €3-5bn SNP	
Banco Santander	€3-5bn	Nil
BBVA Europe	Dependent on balance sheet evolution	€2.5-3.5bn
UBS	Focus on further optimization of debt structure, OpCo issuance possible	
Credit Suisse	Nil	CHF5-7bn
Lloyds	£2bn from the non-ring fenced entity	£5bn annually
HSBC Group	Issuance into local markets from certain subsidiaries	Low/mid-teens USDbn per year
RBS	£3-5bn from Natwest Markets Plc	£4-6bn annually until 2022, £3-5bn target for 2019
Barclays	Potential issuance from non-ring fenced entity	c.£8bn in HoldCo, T2 and AT1

Source: Banks' financial statements and presentations. CB = Covered Bonds; SP = Senior Preferred; SNP = Senior Non Preferred; OpCo = Senior debt issued by the operating entity. HoldCo = Senior unsecured debt issued by the holding entity. T2= Tier 2; AT1 = Additional Tier 1

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