EU banking package brings new risks for AT1 investors

The fundamental assessment of Additional Tier 1 (AT1) securities has generally become more straightforward as banks' capital requirements are now largely known and transitional arrangements are coming to an end. There has been a renewed focus on call risk, meanwhile, as the wave of AT1s issued in 2014 approach their first call dates. Fundamentals should again come to the fore with the pending adoption of the EU's risk-reduction package, which contains measures influencing a bank's ability to make payments on AT1 securities.

AT1 issuance has been strong since the start of the year, with issuance propelled by the market rally during the first quarter that rendered such issuance more economic for issuers, and by likely pre-refinancing of securities that have call dates later this year. Barclays and UniCredit successfully issued despite economic and political uncertainties.

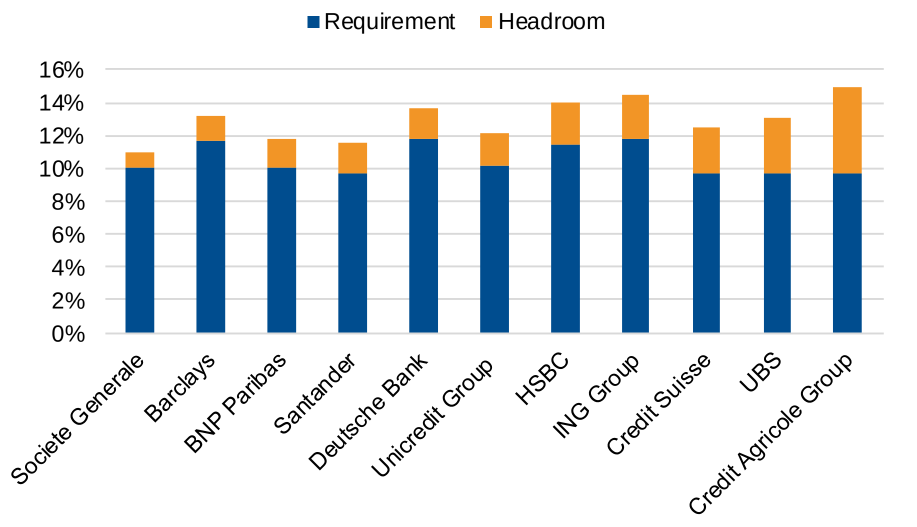
We reiterate the view that investors need to be comfortable with long-term fundamentals, as it is not a given that AT1 securities will be called on their first call dates – as demonstrated when Santander opted not to exercise the call of an AT1 security at the first call date in March – and subsequent call dates may be many years later. In addition to regulatory approval, banks are considering the economics of call decisions.

Better clarity on capital requirements

As far as capital requirements are concerned, the level at which the Maximum Distributable Amount (MDA) needs to be calculated has become more evident. The various capital buffers (i.e. capital conservation and systemic) are now largely phased in and Pillar 2 requirements have generally been stable. Compared to last year, more banks now have positive countercyclical buffers, although they remain relatively minor (well below 0.5% except for UK and Nordic banks).

Consequently, banks' capital buffers above the MDA trigger have steadily decreased. Comparing YE 2018 CET1 capital positions to estimated 2019 MDA-relevant CET1 requirements, the buffer averages around 3%, down from about 6% two years ago. Buffers are likely to stabilise around these levels rather than returning to the higher levels of the past.

Figure 1: Headroom to MDA-relevant CET1 requirements



Note: YE 2018 CET1 vs. estimated 2019 requirements.
Source: Banks, Scope Ratings

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EU bank risk-reduction package raises new concerns

AT1 investors should note that the EU risk-reduction package contains measures that may limit a bank's ability to make payments on AT1 securities. The amendments to the CRR/CRD and BRRD that the EU Council and Parliament agreed on 15 February aim to reduce risks in the EU banking sector and will implement reforms agreed at international level. The texts are currently undergoing legal linguistic revision. The EU Council and Parliament will be called on to adopt the proposed regulations at first reading.

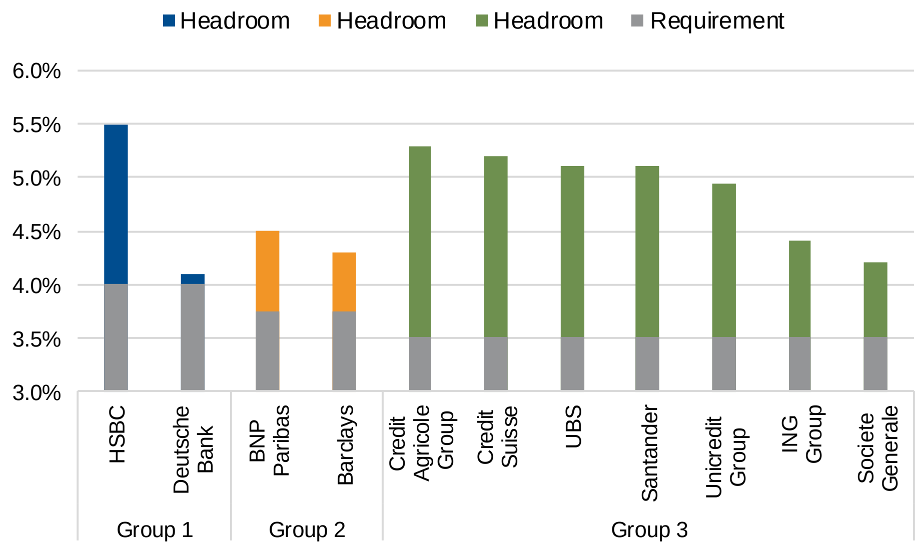
Leverage ratio-related MDA (L-MDA)

Global systemically important institutions (G-SIIs) will be subject to a leverage ratio buffer requirement equal to 50% of their respective G-SII buffer, which must be met with Tier 1 capital from 2022. For other systemically important institutions (O-SIIs), the EC will consider whether it would also be appropriate to subject them to a similar leverage ratio buffer requirement.

A bank that fails to meet the leverage ratio buffer requirement must calculate the leverage ratio-related MDA (L-MDA). As with breaches of the MDA related to risk-weighted capital requirements, a bank cannot pay dividends, bonuses and coupons on AT1 securities before calculating the L-MDA. Depending on the magnitude of the breach, the amount of distributable profits will be limited to 0%, 20%, 40% or 60%.

Our initial analysis indicates that major European AT1 issuers would not have problems meeting the additional leverage ratio buffer requirement, although the headroom to the requirement varies bank by bank.

Figure 2: YE 2018 Basel III leverage ratio vs. expected leverage ratio requirement



Note: The minimum leverage ratio requirement is 3%. In addition, for Group 1, Group 2 and Group 3 banks, the additional leverage ratio buffer is 1%, 0.75% and 0.5%, respectively.
Source: Banks, Scope Ratings

MREL-related MDA (M-MDA)

When a bank breaches its MREL requirement, the resolution authority has the power to prohibit distributions in excess of the MREL-related MDA (M-MDA), including payments on AT1 securities. After a grace period of nine months, the resolution authority would exercise this power unless two of the following conditions are met:

(i) the failure is due to a serious disturbance to the functioning of financial markets;

(ii) the disturbance results in increased price volatility or costs of MREL instruments and a full or partial closure of markets which prevents issuance;

(iii) the market is also closed for several other banks;

(iv) the disturbance prevents issuance in enough volume to remedy the failure;

(v) exercising the power on distributions would lead to negative spill-over effects which could undermine financial stability.

The additional M-MDA is unlikely to represent a major hurdle for large systemic banks as they mostly meet expected requirements already and have market access to non-preferred senior and subordinated debt. The M-MDA is less rigid than the other MDA limits on CET1 and leverage ratios.

However, the additional M-MDA requirement could make it more difficult for small and medium-sized banks to access AT1 funding as they may already be struggling to build-up MREL debt. The EU deadline for non-TLAC banks is January 2024, providing more time to meet requirements.

Other amendments may bring some relief

Meanwhile, included in the EU bank risk-reduction package are two measures which may be positive for AT1 issuers – distributable items and Pillar 2 requirements.

The agreed text would allow for the distribution of items eligible under CRR/CRD, including profits which are non-distributable pursuant to national legislation or the bank's by-laws, and non-distributable reserves in accordance with national law or the bank's statutes. Some banks, including those in France and the UK, have successfully sought shareholder approval to reclassify reserves, bolstering available distributable items. Meanwhile, this change would be particularly useful for banks in countries like Germany where such discretion has not been possible.

More flexibility in meeting Pillar 2 requirements

Pillar 2 requirements can potentially be met with a mix of CET1, AT1 and Tier 2 capital instead of just CET1. Under this rule, only 75% of the Pillar 2 requirement must be met with Tier 1 capital and 75% of Tier 1 capital must be CET1 capital (i.e. at least 56% of the Pillar 2 requirement needs to be funded with CET1). Supervisors, however, can request that Pillar 2 requirements be met with a higher proportion of CET1 or Tier 1 capital if necessary.

Whether the ECB will utilise this flexibility for banks under its supervision is not altogether clear. Currently, issuers in Denmark and the UK have a component of Pillar 2 requirements that is not met with CET1 capital. We note, however, that total Pillar 2 requirements (CET1 and non-CET1 components) for these issuers tend to be much higher than for euro-area banks and are generally above 3%.

Figure 3: Selected new issues

Issuer	Amount	Coupon %	Issue date	Next call date	Reset spread %	Reference swap	Conversion type	Trigger %
UBS GROUP FUNDING AG	USD 2.5bn	7	31/01/2019	31/01/2024	4.344	USSW5	Permanent write down	7
BANCO SANTANDER SA	USD 1.2bn	7.5	08/02/2019	08/02/2024	4.989	USSW5	Equity conversion	5.125
SVENSKA HANDELSBANKEN	USD 500m	6.25	22/02/2019	01/03/2024	3.89	H15T5Y	Equity conversion	5.125
ING GROEP NV	USD 1.25bn	6.75	26/02/2019	16/04/2024	4.264	USSW5	Equity conversion	7
CREDIT AGRICOLE SA	USD 1.25bn	6.875	27/02/2019	23/09/2024	4.319	USSW5	Temporary write down	5.125
KBC GROEP NV	EUR 500m	4.75	05/03/2019	05/03/2024	4.689	EUSA5	Permanent write down	5.125
UNICREDIT SPA	EUR 1.0bn	7.5	19/03/2019	03/06/2026	7.334	EUAMDB05	Temporary write down	5.125
BNP PARIBAS	USD 1.5bn	6.625	25/03/2019	25/03/2024	4.149	USSW5	Temporary write down	5.125
NORDEA BANK ABP	USD 1.0bn	6.625	26/03/2019	26/03/2026	4.11	H15T5Y	Temporary write down	5.125
BARCLAYS PLC	USD 2.0bn	8	27/03/2019	06/15/2024	5.672	H15T5Y	Equity conversion	7
BBVA	EUR 1.0bn	6	29/03/2019	29/03/2024	6.039	EUSA5	Equity conversion	5.125

Source: Scope Ratings

Appendix:

Headroom to MDA relevant CET1 requirements

		2019	3Q 2018	4Q 2018			
	Basis	Requirement	3Q18 CET1	4Q18 CET1	Gap %	Currency	Gap bn
Barclays	Transitional	11.7%	13.2%	13.2%	1.5%	GBP	7.5
BBVA	Transitional	9.3%	11.6%	11.6%	2.3%	EUR	10.9
BNP Paribas	Transitional	10.0%	11.8%	11.8%	1.8%	EUR	17.0
Credit Agricole Group	Transitional	9.7%	14.9%	15.0%	5.3%	EUR	34.2
Credit Agricole SA	Transitional	8.5%	11.5%	11.5%	3.0%	EUR	11.2
Credit Suisse Group	Transitional	9.7%	12.8%	12.5%	2.9%	CHF	9.4
Danske Bank	Transitional	11.2%	16.4%	17.0%	5.8%	DKK	56.7
Deutsche Bank	Transitional	11.8%	14.0%	13.6%	1.7%	EUR	10.2
DNB Group	Transitional	14.0%	16.5%	16.4%	2.4%	NOK	30.2
HSBC	Transitional	11.4%	14.3%	14.0%	2.6%	USD	32.4
ING Group	Transitional	11.8%	14.0%	14.5%	2.7%	EUR	12.7
Intesa	Transitional	9.0%	13.5%	13.5%	4.5%	EUR	14.7
KBC Group	Transitional	10.6%	16.0%	16.0%	5.4%	EUR	5.8
Lloyds	Transitional	13.1%	14.6%	14.6%	1.5%	GBP	9.6
Nordea Bank	Fully loaded	11.1%	20.3%	15.5%	4.4%	EUR	6.8
Rabobank Group	Transitional	11.8%	16.0%	16.0%	4.3%	EUR	11.3
RBS Group	Transitional	10.7%	16.7%	16.2%	5.5%	GBP	11.5
Santander	Transitional	9.7%	11.3%	11.5%	1.8%	EUR	16.7
Societe Generale	Transitional	10.0%	11.2%	11.0%	1.1%	EUR	8.7
Svenska Handelsbanken	Fully loaded	11.5%	21.7%	16.8%	5.3%	SEK	37.4
Swedbank	Fully loaded	11.6%	24.3%	16.3%	4.7%	SEK	29.8
UBS Group	Transitional	9.7%	13.5%	13.1%	3.4%	CHF	10.4

Notes: Nordea is not expected to receive its SREP from the ECB until 1Q 2020. For Nordea, Handelsbanken, Swedbank, DNB and Danske, Pillar 2 requirements are excluded from 2019 MDA-relevant CET1 requirements.
Source: Banks, Scope Ratings

Headroom to writedown/conversion trigger

			2017	2018	
	Basis	Trigger	YE CET1	YE CET1	Gap %
Barclays	Fully loaded	7.00%	13.3%	12.8%	5.8%
BBVA	Transitional	5.125%	11.7%	11.6%	6.5%
BNP Paribas	Transitional	5.125%	11.9%	11.8%	6.7%
Credit Agricole Group	Transitional	7.00%	14.8%	15.0%	8.0%
Credit Agricole SA	Transitional	5.125%	11.7%	11.5%	6.4%
Credit Suisse Group	Transitional	7.00%	13.4%	12.5%	5.5%
Danske Bank	Transitional	7.00%	17.6%	17.0%	10.0%
Deutsche Bank	Transitional	5.125%	14.8%	13.6%	8.4%
DNB Group	Transitional	5.125%	16.4%	16.4%	11.3%
HSBC	Fully loaded	7.00%	14.5%	13.9%	6.9%
ING Group	Transitional	7.00%	14.7%	14.5%	7.5%
Intesa	Transitional	5.125%	13.3%	13.5%	8.3%
KBC Group	Transitional	5.125%	16.5%	16.0%	10.8%
Lloyds	Fully loaded	7.00%	14.1%	14.3%	7.3%
Nordea Bank	Fully loaded	8.00%	19.5%	15.5%	7.5%
Rabobank Group	Transitional	7.00%	15.8%	16.0%	9.0%
RBS Group	Fully loaded	7.00%	15.9%	16.2%	9.2%
Santander	Transitional	5.125%	12.3%	11.5%	6.3%
Societe Generale	Transitional	5.125%	11.6%	11.0%	5.9%
Svenska Handelsbanken	Fully loaded	8.00%	22.7%	16.8%	8.8%
Swedbank	Fully loaded	8.00%	26.1%	16.3%	8.3%
UBS Group	Transitional	7.00%	14.9%	13.1%	6.1%

Source: Banks, Scope Ratings

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