

Implications of Proposed CRD IV Changes for AT1 Investors



Scope
Ratings

On 23 November, the European Commission presented a package of reforms intended to further strengthen the resilience of banks and to ensure that banks can support the economy. Some of the proposed changes should be positive for AT1 investors while others would be less so. On the positive side, we highlight the softening of Pillar 2 capital add-ons and the prioritisation of AT1 coupons. The proposals, however, would also increase the hurdle for meeting the combined buffer requirement, notably by including MREL requirements. Overall, we view favourably the greater transparency and clarity provided.

The proposals would entail amendments to the Capital Requirements Regulation (CRR), the Capital Requirements Directive (CRD), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR). The European Parliament and Council are currently considering the legislative proposals. If adopted, changes to CRD and BRRD would then need to be transposed into national laws.

The positive

Softening of Pillar 2 capital add-ons

The proposals clarify the conditions for setting additional own funds requirements stemming from CRD and emphasises the institution-specific nature of these add-ons. There is a clear distinction between Pillar 2 requirements and Pillar 2 guidance. The former are mandatory requirements to address risks not covered or sufficiently covered by Pillar 1 and buffer capital requirements. Meanwhile, capital guidance are competent authorities' expectations for capital in excess of Pillar 1, Pillar 2 and buffer requirements to address forward-looking concerns revealed by supervisory stress tests. Pillar 2 add-ons, however, should not be used to deal with macro-prudential risks; there are other dedicated tools (capital buffers) for this.

Consequently, CET1 requirements are coming down

European banks have started to disclose their requirements for 2017 stemming from the supervisory review and evaluation process (SREP). As seen from the disclosures, the CET1 requirement for 2017 will be meaningfully lower than in 2016; in some cases by as much as 200bps (Figure 1). These CET1 levels include a Pillar 1 minimum of 4.5%, a Pillar 2 requirement and the phasing-in of the capital conservation and systemic buffers. Within the EU, it appears that Pillar 2 requirements for large banks will be around the 1.5%–2% level. None of the banks have disclosed their Pillar 2 guidance which is not relevant for assessing the MDA trigger level.

Figure 1: 2016 vs 2017 CET1 requirements for three EU G-SIBs

	BNP Paribas 2016	BNP Paribas 2017	ING Group 2016	ING Group 2017	Banco Santander 2016	Banco Santander 2017
Pillar 1	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Pillar 2	4.4%	1.3%	4.4%	1.8%	4.4%	1.5%
Capital conservation buffer	0.6%	1.3%	0.6%	1.3%	0.6%	1.3%
Systemic buffer	0.5%	1.0%	0.8%	1.5%	0.3%	0.5%
Total	10.0%	8.0%	10.3%	9.0%	9.8%	7.8%

Source: Company data, Scope Ratings

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Prioritisation of AT1 coupons

The proposals clarify that if a bank does not meet the combined buffer requirement, it should not distribute more than the MDA in dividends, variable remuneration or discretionary pension benefits, and coupons on AT1 securities. Further, coupons on AT1 securities should be made before dividends and employee compensation. This provision (new Article 141(3)) is a clear positive for AT1 investors as they would have priority of payment claims. However, if the amount of MDA is limited, AT1 investors could still face a partial loss.

The negative

Hurdle for meeting the combined buffer requirement rises

A bank is considered to be in breach of the combined buffer requirement if it does not have own funds and eligible liabilities in an amount and of the quality needed to meet at the same time each of the following requirements:

- A CET1 capital ratio of 4.5%,
- A Tier 1 capital ratio of 6%,
- A total capital ratio of 8%,
- Pillar 2 requirements,
- Combined buffers, and
- MREL requirements.

To date, AT1 investors have primarily focused on banks' CET1 capital positions. Starting next year, this will no longer be sufficient; total capital requirements are just as important. Further, MREL requirements will also become relevant.

We have highlighted in the past that while a bank might meet its 'strict' CET1 requirement and not be in breach of the MDA trigger level, supervisors would likely be concerned if a bank did not meet all of its various regulatory requirements – be they total capital, leverage or liquidity. The above proposals confirm our earlier thoughts.

Pillar 2 requirements would no longer only have to be met with CET1 capital

At least 75% of the additional own funds requirement should be met with Tier 1 capital. Further, at least 75% of this Tier 1 capital should be CET1 capital; i.e. 56% of Pillar 2 requirements must be met with CET1 capital. This would be similar to the approach taken by the Bank of England. While this would reduce banks' CET1 requirements, this does not significantly alter their overall requirements due to the clarification of the combined buffer requirement as detailed above.

Clarification that MREL requirements are as important as capital requirements

To ensure that there will be no double-counting of CET1 capital towards both the combined buffer and MREL requirements, Article 141a proposes a stacking order with the combined buffer sitting on top of MREL.

The proposals further clarify the consequences when a bank breaches its MREL requirement. If there are insufficient liabilities to comply, any CET1 capital being used to meet the combined buffer requirement would automatically be used to meet MREL requirements. Acknowledging that this could lead to a breach of the combined buffer requirement and hence the calculation of the MDA, the proposal includes a six-month grace period before restrictions on discretionary payments including AT1 coupons kick in. This grace period is available if a bank met its Pillar 1 and Pillar 2 capital requirements but faced a temporary inability to issue new MREL-eligible debt.

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Banks have not yet been informed of their MREL requirements. However, the proposals indicate that, for EU G-SIBs, TLAC requirements would be incorporated into the MREL framework. More specifically, minimum TLAC requirements will be considered Pillar 1 MREL requirements. In addition, resolutions authorities have the discretion to impose a bank-specific supplementary MREL requirement as a Pillar 2 add-on.

The minimum TLAC requirements are as follows:

- By 2019, the higher of 16% of RWAs or 6% of leverage exposure
- By 2022, the higher of 18% of RWAs or 6.75% of leverage exposure

When banks are informed of their MREL requirements, this will be relevant for the MDA trigger level. We point out though that banks will be able to use capital as well as MREL-eligible liabilities to meet MREL requirements.

Other proposals

The basis for calculating MDA

While there had been some market expectations that banks might be able to pay AT1 coupons when in breach of the combined buffer and when a loss has been incurred, the proposals clarify that the MDA calculation should be based on interim profits plus year-end profits not included in CET1 capital since the last distribution of profits. This appears appropriate to us as a bank needs to be in compliance with regulatory requirements before making 'discretionary' payments.

Supervisory approval to reduce, redeem or repurchase

Prior permission must be obtained to reduce, redeem or repurchase CET1 instruments. As well, prior permission is needed to call, redeem or repurchase AT1, Tier 2 and eligible liabilities before their contractual maturity. Permission will be granted if the above instruments would be replaced by own funds or eligible liabilities at a cost that would be sustainable in light of the income capacity of the bank.

Permission will also be granted if the bank can demonstrate that it would still meet requirements by a margin that the competent authority deems necessary; the competent authority will also consult the resolution authority before granting permission. There are provisions for banks to obtain general prior permission subject to a certain time period (no more than a year) and for predetermined amounts.

There appears to be a substantial increase in supervisory oversight regarding calls and redemptions which may limit issuers from calling AT1 securities. We would expect competent authorities to also consider the potential impact on a bank's future funding costs when making such decisions.

Appendix I: CET1 capital positions and headroom to trigger levels

Headroom to MDA trigger level

	2015	2016						
	FYE CET1	Req CET1	1Q16 CET1	Gap %	3Q16 CET1	Gap %	Currency	Gap bn
Barclays	11.4%	7.8%	11.3%	3.5%	11.6%	3.8%	GBP	14.1
BBVA	12.1%	9.8%	11.6%	1.9%	12.3%	2.6%	EUR	48.0
BNP Paribas	11.0%	10.0%	11.1%	1.1%	11.6%	1.6%	EUR	10.1
Credit Agricole Group	13.5%	9.8%	13.7%	4.0%	14.2%	4.5%	EUR	23.2
Credit Agricole SA	10.8%	9.5%	10.8%	1.3%	11.9%	2.4%	EUR	7.2
Danske Bank	14.4%	6.8%	15.0%	8.2%	15.8%	9.0%	DKK	128.6
Deutsche Bank	13.2%	10.8%	12.0%	1.2%	12.6%	1.8%	EUR	7.1
DNB Bank Group	14.3%	13.2%	14.7%	1.2%	15.0%	1.5%	NOK	15.7
DNB Group	14.4%	13.2%	15.2%	1.7%	15.7%	2.5%	NOK	26.1
HSBC	11.9%	7.1%	11.9%	4.8%	13.9%	6.4%	USD	58.2
ING Group	12.9%	10.3%	13.0%	2.8%	13.5%	3.3%	EUR	10.2
Intesa	13.0%	9.5%	12.9%	3.4%	12.8%	3.3%	EUR	9.5
KBC Group	11.4%	10.3%	14.6%	4.4%	15.1%	4.9%	EUR	4.3
Lloyds	12.8%	7.7%	12.9%	5.2%	13.5%	5.8%	GBP	30.0
Nordea Bank	16.5%	10.4%	16.7%	6.3%	17.9%	7.5%	SEK	24.3
Santander	12.5%	9.8%	12.4%	2.6%	12.4%	2.7%	EUR	72.0
Societe Generale	11.4%	9.8%	11.5%	1.8%	11.6%	3.9%	EUR	13.6
Svenska Handelsbanken	21.2%	10.6%	22.7%	12.1%	24.0%	13.4%	SEK	111.4
Swedbank	24.1%	10.7%	23.7%	13.0%	23.8%	13.1%	SEK	96.2

Note: Required CET1 for 2016 is based on disclosed SREP requirement plus any applicable systemic buffers.

Source: Company data, Scope Ratings

Headroom to writedown/conversion trigger

		2015		1Q 16		2Q 16		3Q 16	
	Trigger level	FYE CET1	Gap %	1Q16 CET1	Gap %	2Q16 CET1	Gap %	3Q16 CET1	Gap %
Barclays	7.00%	11.4%	4.4%	11.3%	4.3%	11.6%	4.6%	11.6%	4.6%
BBVA	5.13%	12.1%	7.0%	11.6%	6.5%	12.0%	6.9%	12.3%	7.2%
BNP Paribas	5.13%	11.0%	5.9%	11.1%	6.0%	11.2%	6.1%	11.6%	6.5%
Credit Agricole Group	7.00%	13.5%	6.5%	13.7%	6.7%	14.0%	7.0%	14.2%	7.2%
Credit Agricole SA	5.13%	10.8%	5.7%	10.8%	5.7%	11.1%	6.0%	11.9%	6.8%
Credit Suisse	7.00%	14.2%	7.2%	13.5%	6.5%	14.1%	7.1%	14.0%	7.0%
Danske Bank	7.00%	16.1%	9.1%	15.0%	8.0%	15.8%	8.8%	15.8%	8.8%
Deutsche Bank	5.13%	13.2%	8.1%	12.0%	6.9%	12.2%	7.1%	12.6%	7.5%
DNB Bank Group	5.13%	14.3%	9.2%	14.7%	9.6%	14.5%	9.4%	15.0%	9.9%
DNB Group	5.13%	14.4%	9.3%	15.2%	10.1%	15.2%	10.1%	15.7%	10.6%
HSBC	7.00%	11.9%	4.9%	11.9%	4.9%	12.1%	5.1%	13.9%	6.9%
ING Group	7.00%	12.9%	5.9%	13.0%	6.0%	13.2%	6.2%	13.5%	6.5%
Intesa	5.13%	13.0%	7.9%	12.9%	7.8%	12.7%	7.5%	12.8%	7.7%
KBC Group	5.13%	14.9%	9.8%	14.6%	9.5%	14.9%	9.8%	15.1%	10.0%
Lloyds	7.00%	12.8%	5.8%	12.9%	5.2%	13.1%	5.4%	13.5%	6.5%
Nordea Bank	8.00%	16.5%	8.5%	16.7%	8.7%	16.8%	8.8%	17.9%	9.9%
Santander	5.13%	12.5%	7.4%	12.4%	7.2%	12.3%	7.2%	12.4%	7.3%
Societe Generale	5.13%	11.4%	6.3%	11.5%	6.4%	11.5%	6.4%	11.6%	6.5%
Svenska Handelsbanken	8.00%	21.2%	13.2%	22.7%	14.7%	23.0%	15.0%	24.0%	16.0%
Swedbank	8.00%	24.1%	16.1%	23.7%	15.7%	23.0%	15.0%	23.8%	15.8%
UBS	7.00%	19.0%	12.0%	16.9%	9.9%	17.1%	10.1%	16.9%	9.9%

Source: Company data, Scope Ratings

Appendix II: Summary of rated AT1 securities

Issuer	Trigger	Type of Loss Absorption	Senior unsecured debt rating ¹	Minimum Notching	Additional Notching	Rating on Capital Instrument
Barclays plc	7% fully loaded	Full conversion	A	4	2	BB
BBVA	5.125% (issuer and group)	Full conversion	A	4	1	BB+
BNP Paribas	5.125%	Temporary writedown	A+	4	0	BBB
Credit Agricole	7% (CA group) or 5.125% (CASA)	Temporary writedown	A+	4	1	BBB-
Credit Suisse GAG	5.125% (CET1+ higher trigger)	Permanent writedown	A	4	0	BBB-
Credit Suisse GAG	7%	Full conversion	A	4	1	BB+
Danske Bank	7% (issuer and group)	Temporary writedown	A-	4	1	BB
Deutsche Bank	5.125%	Temporary writedown	BBB+	4	2	B+
DNB Bank	5.125% (bank, bank group, group)	Temporary writedown	A+	4	1	BBB-
HSBC Holdings	7% fully loaded	Full conversion	AA-	4	1	BBB
ING Group	7%	Full conversion	A	4	0	BBB-
Intesa	5.125% (issuer and group)	Temporary writedown	A-	4	0	BB+
KBC Group	5.125%	Temporary writedown	A	4	0	BBB-
Lloyds Banking Group	7% fully loaded	Full conversion	A	4	1	BB+
Nordea	5.125% bank, 8% group	Temporary writedown	A+	4	1	BBB-
Santander	5.125% (issuer and group)	Full conversion	A+	4	1	BBB-
Societe Generale	5.125%	Temporary writedown	A	4	0	BBB-
Svenska Handelsbanken	5.125% issuer, 8% group	Temporary writedown	A	4	1	BB+
Swedbank	5.125% bank, 8% group	Full conversion	A-	4	1	BB
UBS GAG	5.125% (CET1+ higher trigger)	Permanent writedown	A	4	0	BBB-
UBS GAG	7% (CET1 + higher trigger)	Permanent writedown	A	4	0	BBB-

Note: ¹ Rating of senior unsecured debt eligible for TLAC/MREL as applicable.
Source: Scope Ratings.



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