AT1 Bank Securities: Latest Developments Reassure

Since its beginnings in 2013, the AT1 market continues to grow and mature. While there was some market turbulence at the beginning of the year, large European banks have been able to tap the market. Issuers are well aware of where they need to be with their capital positions in order to maintain investor confidence. And on the regulatory front, there are moves to support the asset class.

Capital positions continue to strengthen

During 2Q 2016, most banks strengthened their CET1 capital positions, with several banks achieving more than 25 bps compared to 1Q 2016 (Appendix I). In addition to earnings retention, banks continue to closely manage their RWAs. Capital build was also supported by asset disposals, particularly for those banks in the midst of restructuring programs.

Ongoing Pillar 2 discussions likely to be supportive

Over the last six months there has been continuing news flow about the softening of Pillar 2 measures. We review what has happened and what has actually changed, noting that the process is ongoing.

Positively for AT1 investors, it is clear that the ECB as supervisor will split Pillar 2 into two components – one that is required and one that is considered guidance. This means that on the whole banks next year should have more headroom before breaching combined buffer requirements. Other supportive changes may be forthcoming such as the explicit prioritization of AT1 coupons over dividends and discretionary compensation.

Clarification on specific issues

On 9 March a note titled "*Clarifying aspects of Pillar 2 capital requirements, Pillar 2 capital guidance and automatic restrictions on earnings distribution in the context of the CRR/CRD review*" was sent to the European Commission's Expert Group on Banking, Payments and Insurance (EGBPI) for comment. Comprised of experts appointed by member states, the EGBPI provides advice and expertise in the preparation of draft delegated acts (acts supplementing or amending certain non-essential elements of a basic act).

It is our understanding that the note originated from the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA), one of the Directorates-General and specialised services making up the Commission, with responsibility for initiating and implementing policy in the area of Banking and Finance.

The note identified uncertainties in the interpretation of the rules and use of Pillar 2 measures. With the aim of improving consistency across jurisdictions and certainty for banks and the market, the note clarified specific issues (see below). As well, the note established a basis for a more formal clarification of these issues by the Commission via legislative proposals, if deemed appropriate.

- **The stacking order of capital requirements** to be: Pillar 1 capital requirement, Pillar 2 capital requirement, capital buffers requirement and Pillar 2 capital guidance.
- **The distinction between Pillar 1** capital requirements which are applicable to all banks **and Pillar 2** capital requirements which are bank specific.

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- **The difference between Pillar 2 capital requirements and Pillar 2 capital guidance**. Pillar 2 capital requirements are only for risks not covered or sufficiently covered by Pillar 1 and buffers requirements; duly justified to the banks; must be met at all times and subject to public disclosure. Pillar 2 capital guidance implies an expectation that the bank have additional capital to ensure that capital requirements are met at all times.

- **The maximum distributable amount (MDA) calculation**: Pillar 2 capital requirements should be included in the calculation but not Pillar 2 capital guidance. Further, AT1 instruments should be given priority if distributions have to be limited as a result of the MDA calculation.

Under SREP, Pillar 2 to be split

Subsequently, on 1 July the EBA communicated that the Supervisory Review and Evaluation Process (SREP) decisions for 2016 will be comprised of a Pillar 2 requirement and a Pillar 2 guidance. The results of the EBA/ECB 2016 stress test were an important input for the SREP process which will be finalised by end-2016. While banks are expected to meet Pillar 2 guidance (which sits on top of minimum and additional requirements and buffers) a breach does not result in automatic supervisory action and will not be used to determine the MDA trigger.

Possible modifications to CRR/CRD framework under discussion

Last month, a discussion paper exploring options for a possible clarification of EU rules concerning Pillar 2 own funds requirements was circulated amongst the EGBPI. We note that the mentioned options would support and legislate the clarifications raised in March. The possible modifications to the current CRR/CRD framework under discussion may eventually be approved and adopted by the European Parliament. Key points raised for consideration in the discussion paper include:

- **Supervisory powers**

Exclude capital guidance from the list of supervisory powers in order to avoid confusion regarding the nature of guidance.

- **Additional own funds requirements**

Explicitly clarify under which cases additional capital requirements can be imposed. The materiality of risks is also a consideration. Risks subject to grandfathering provisions or transitional treatment under CRR/CRD should be excluded.

Establish a methodology where supervisors justify their decisions and risks and capital shortfalls are measured. As well, the paper considers whether additional own funds requirements should be met with at least 75% of Tier 1 capital and at least 56.25% of CET1 capital. Currently, Pillar 2 requirements must be met entirely with CET1 capital.

- **Guidance on additional own funds**

Suggests that setting a target level of capital should be in the first place up to the bank. However, competent authorities should review these internal levels and may expect adjustments if warranted.

- **Stacking order of capital requirements**

Where AT1 and Tier 2 capital is insufficient to meet Pillar 1 and 2 requirements, CET1 capital available to meet the combined buffer requirement should be used to meet the shortfall.

- **Restrictions on distributions (MDA)**

To determine whether the combined buffer requirement has been met, CET1 capital needed to meet Pillar 2 capital and MREL requirements should also be considered. The current text refers only to Pillar 1 requirements. While the inclusion of Pillar 2 capital requirements would be line with the supervisory approach taken by the ECB, the inclusion of MREL requirements could potentially raise the MDA trigger level.

- **CET1 instruments**

In order to give preference to AT1 instruments when MDA restrictions are in effect, it could be clarified that in order for an instrument to qualify as CET1 capital, distributions on this instrument are paid after all legal and contractual obligations have been met, including payments on non-CET1 own funds instruments (such as AT1 coupons).

- **Disclosure of capital requirements**

Obligatory disclosure of Pillar 2 capital requirements but not Pillar 2 guidance. Currently, supervisors can ask banks to disclose their requirements but it is not required.

Appendix I: CET1 capital positions and headroom to trigger levels

Headroom to MDA trigger level

	2015	2016						
	FYE CET1	Req CET1	1Q16 CET1	Gap %	2Q16 CET1	Gap %	Currency	Gap bn
Barclays	11.4%	7.8%	11.3%	3.5%	11.6%	3.8%	GBP	13.8
BBVA	12.1%	9.8%	11.6%	1.9%	12.0%	2.3%	EUR	9.0
BNP Paribas	11.0%	10.0%	11.1%	1.1%	11.2%	1.2%	EUR	7.6
Credit Agricole Group	13.5%	9.8%	13.7%	4.0%	14.0%	4.3%	EUR	22.0
Credit Agricole SA	10.8%	9.5%	10.8%	1.3%	11.1%	1.6%	EUR	5.0
Danske Bank	14.4%	6.8%	15.0%	8.2%	15.8%	9.0%	DKK	71.8
Deutsche Bank	13.2%	10.8%	12.0%	1.3%	12.2%	1.5%	EUR	5.8
DNB Bank Group	14.3%	13.5%	14.7%	1.2%	14.5%	1.0%	NOK	10.7
DNB Group	14.4%	13.5%	15.2%	1.7%	15.2%	1.7%	NOK	18.2
HSBC	11.9%	7.1%	11.9%	4.8%	12.1%	5.0%	USD	54.5
ING Group	12.9%	10.3%	13.0%	2.8%	13.2%	3.0%	EUR	9.4
Intesa	13.0%	9.5%	12.9%	3.4%	12.7%	3.2%	EUR	9.1
KBC Group	11.4%	10.3%	14.6%	4.4%	14.9%	4.7%	EUR	4.1
Lloyds	12.8%	7.7%	12.9%	5.2%	13.1%	5.4%	GBP	12.0
Nordea Bank	16.5%	10.4%	16.7%	6.3%	16.8%	6.4%	SEK	9.2
Santander	12.5%	9.8%	12.4%	2.6%	12.3%	2.6%	EUR	15.1
Societe Generale	11.4%	9.8%	11.5%	1.8%	11.5%	1.8%	EUR	6.2
Svenska Handelsbanken	21.2%	10.6%	22.7%	12.1%	23.0%	12.4%	SEK	58.8
Swedbank	24.1%	10.7%	23.7%	13.0%	23.0%	12.3%	SEK	50.7

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			
	Trigger level	FYE CET1	Gap %	1Q16 CET1	Gap %	2Q16 CET1	Gap %	Currency	Gap bn
Barclays	7.00%	11.4%	4.4%	11.3%	4.3%	11.6%	4.6%	GBP	16.8
BBVA	5.13%	12.1%	7.0%	11.6%	6.5%	12.0%	6.9%	EUR	27.3
BNP Paribas	5.13%	11.0%	5.9%	11.1%	6.0%	11.2%	6.1%	EUR	38.5
Credit Agricole Group	7.00%	13.5%	6.5%	14.6%	0.0%	14.0%	7.0%	EUR	36.3
Credit Agricole SA	5.13%	10.8%	5.7%	10.8%	5.7%	11.1%	6.0%	EUR	18.6
Credit Suisse	7.00%	14.2%	7.2%	13.5%	6.5%	14.1%	7.1%	CHF	19.6
Danske Bank	7.00%	16.1%	9.1%	15.0%	8.0%	15.8%	8.8%	DKK	70.4
Deutsche Bank	5.13%	13.2%	8.1%	12.0%	6.9%	12.2%	7.1%	EUR	28.5
DNB Bank Group	5.13%	14.3%	9.2%	14.7%	9.6%	14.5%	9.4%	NOK	99.3
DNB Group	5.13%	14.4%	9.3%	15.2%	10.1%	15.2%	10.1%	NOK	107.7
HSBC	7.00%	11.9%	4.9%	11.9%	4.9%	12.1%	5.1%	USD	55.2
ING Group	7.00%	12.9%	5.9%	13.0%	6.0%	13.2%	6.2%	EUR	19.8
Intesa	5.13%	13.0%	7.9%	12.9%	7.8%	12.7%	7.5%	EUR	21.6
KBC Group	5.13%	14.9%	9.8%	14.6%	9.5%	14.9%	9.8%	EUR	8.6
Lloyds	7.00%	12.8%	5.8%	12.9%	5.2%	13.1%	5.4%	GBP	12.0
Nordea Bank	8.00%	16.5%	8.5%	16.7%	8.7%	16.8%	8.8%	SEK	12.6
Santander	5.13%	12.5%	7.4%	12.4%	7.2%	12.3%	7.2%	EUR	42.2
Societe Generale	5.13%	11.4%	6.3%	11.5%	6.4%	11.5%	6.4%	EUR	22.6
Svenska Handelsbanken	8.00%	21.2%	13.2%	22.7%	14.7%	23.0%	15.0%	SEK	71.1
Swedbank	8.00%	24.1%	16.1%	23.7%	15.7%	23.0%	15.0%	SEK	61.8
UBS	7.00%	19.0%	12.0%	16.9%	9.9%	17.1%	10.1%	CHF	21.9

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] Senior unsecured debt rating eligible for TLAC/MREL as applicable.
Source: Scope Ratings.

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