

## Stepping in at the Deep End

### Analysing Tier I grandfathering

- In our opinion the decision by issuers to call legacy Tier I instruments will be increasingly driven by economic rationale and a more efficient management of the legacy capital. While we moved to [Overweight on Tier I](#) as an outcome of the latest EBA guidance, we recognise that the decision to call or extend Tier I will be driven by the unique interaction of many different factors which we believe are becoming more economically driven. To this extent it is important to understand the regulatory treatment Tier I instruments will receive over the coming years.
- In this note we review how benchmark European issuers will manage their profile of legacy hybrid capital instruments bearing in mind the guidance on grandfathering and Tier II eligibility as defined by the EBA. This analysis has allowed us to identify specific instruments where the market is not pricing in the likely outcome of the issuer managing their capital structure efficiently. In our analysis we look at the interaction between various types of hybrid capital with regards to grandfathering in an attempt to build a comprehensive overview of how the existing stack of legacy instruments can be managed efficiently and economically.
- In Table 1 we highlight the some key trades we find interesting from our analysis both on the long side and the short side. Given our overweight stance on the sector most of our trades are from the long side.

Table 1: Sample of Tier I trades

ISIN	Issuer	Cpn	First Call	Next Call	Step	Ccy	Amt	Back End	Mid Price	YTD	Year	Buy/Sell
<b>Call date Pre Dec 2011</b>												
US74928P2074	RBS	6.08	18/02/2009	03/10/2013	Yes	USD	1,800	FIXED	20.2 <sup>A</sup>	28.8	2014	Buy*
USU2445QAA68	KBC	4.3156	02/11/2009	02/11/2013	Yes	USD	173	3m+405bp	90.0	22.9	2014	Buy
XS0109138536	LLOYDS	6.059	31/05/2010	31/05/2015	Yes	GBP	250	5y+385	96.5	8.3	2015	Buy
<b>Call Date 31st Dec 2011 - 31st Dec 2013</b>												
XS0149161217	RBS	2.319	30/06/2012	30/12/2013	Yes	EUR	227	3m+210	78.0	39.1	2014	Buy*
XS0156923913*	LLOYDS	2.7	25/02/2013	25/11/2013	Yes	EUR	261	3m+250	93.0	13.7	2014	Buy
US749274AA41	RBS	2.139	01/07/2013	31/12/2013	Yes	USD	846	3m+186.5	80.0	34.0	2014	Buy*
<b>Call Date Post 31st Dec 2013</b>												
XS0231436238	UCGIM	4.028	27/10/2015	27/10/2015	Yes	EUR	280	3m+176bp	94.25	7.0	2015	Sell
FR0010279273	BPCEGP	4.75	01/02/2016	01/02/2016	Yes	EUR	350	3m+135	88.00	10.7	2016	Buy
USF22797FJ25	ACAF	6.637	31/05/2017	31/05/2017	No	USD	890	FIXED	97.55	7.4	2017	Sell
US780097AU54	RBS	7.64	29/09/2017	29/09/2017	Yes	USD	1,013	3m+232	90.00	10.2	2017	Sell – pair
XS0323734961	RBS	7.0916	29/09/2017	29/09/2017	Yes	EUR	471	3m+233	87.00	11.3	2017	Buy – pair
XS0813929782	SOCGEN	6.625	11/06/2018	11/06/2018	No	USD	1,500	5yr+575.4	101.5	6.3	2018	Buy – UT2

Source: Company reports. Bloomberg. \* For investors less comfortable with the RBS split we would recommend must pays over may pays, <sup>A</sup>\$25 par securities. \*\*Many of these securities can be considered illiquid therefore pricing may vary.

- We have chosen to add £2mm LLOYDS £6.059 at 97.5 and £5mm SOCGEN 6.625% \$18P to our model portfolio at 101.5. A summary of open trades can be found on page 62

#### See page 63 for analyst certification and important disclosures.

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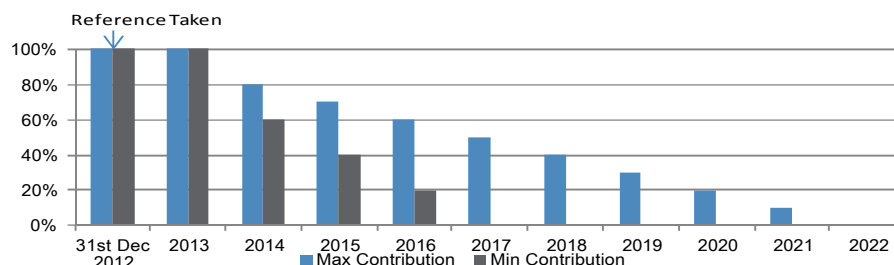
## Executive Summary

**Grandfathering only begins on the 1st Jan 2014 where 80% of the grandfathered items will be consider capital by regulators.**

### Grandfathering begins 1st Jan 2014

CRD IV grandfathering begins on the 1st Jan 2014; from this date only 80% of grandfathered capital instruments will be deemed capital for regulatory purposes (each within their own respective Tier of capital, i.e. Tier I or Tier II). Each subsequent year will reduce the ceiling for grandfathered instruments by 10% until 2022 whereby there will be no further grandfathering for legacy instruments. This schedule is highlighted in Figure 1. We also highlight (min contribution in Figure 1) that regulators in each jurisdiction have the scope to accelerate the grandfathering period, however, in our opinion there will be relatively limited incentives to do this.

Figure 1: CRR grandfathering limits



Source: EC - CRR text

**The 31st of December 2012 is the reference point for CRD IV grandfathering of legacy instruments.**

### Reference point for the grandfathering buckets have been set

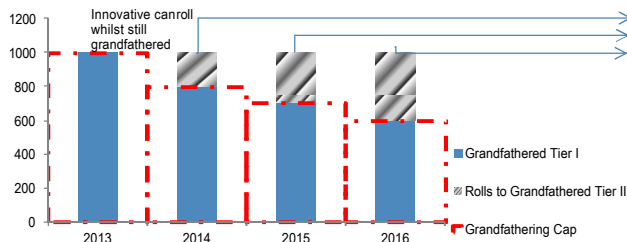
We note the reference point for debt which is to be grandfathered was set as the 31st December 2012. As such FY 2012 account should allow investors to understand the amount of instruments that can be grandfathered in each subsequent year, bearing in mind that CRD IV does not enter into force until 1st January 2014.

### Tier I can be grandfathered as Tier II if certain conditions are met

We note that Tier I instruments that exceed the limits to grandfathering can roll down into the Tier II grandfathering bucket as long as the following conditions are met:

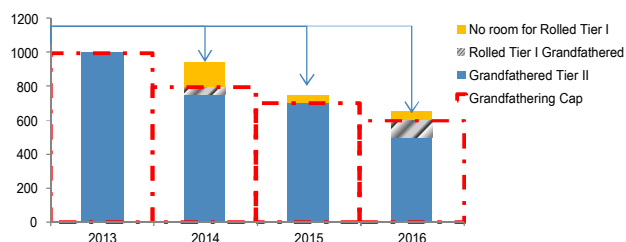
- 1) The Tier I instruments are still eligible for grandfathering (save for being in excess of the grandfathering cap)
- 2) There is room in the Tier II grandfathering buckets for excess Tier I instruments to flow into.

Figure 2: Example Tier I Capital Stack



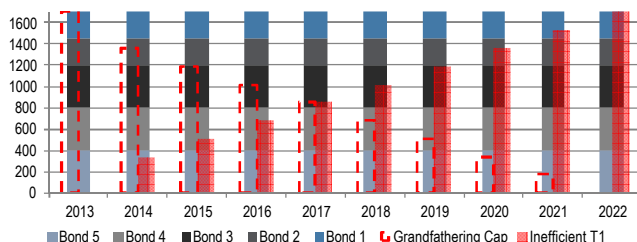
Source: J.P. Morgan.

Figure 3: Example Tier II Capital Stack



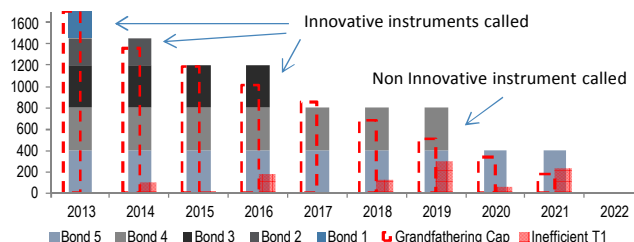
Source: J.P. Morgan.

Figure 4: Evolution of inefficient T1 WITH NO active management of Legacy instruments



Source: J.P. Morgan.

Figure 5: Evolution of inefficient T1 WITH active management of Legacy instruments



Source: J.P. Morgan.

**Grandfathered capital instruments can be managed more efficiently**

### Managing the existing stock of Tier I instruments can make the capital structure more efficient.

We highlight that the grandfathering limits will tend to make a bank capital structure inefficient as time passes. As such, we believe that banks will look to more actively manage their capital structures over the coming 10yrs in order to optimise their capital utilisation. By understanding the grandfathering schedules, we believe we have identified some interesting instruments which could offer investor's potentially greater upside than is currently priced.

## Trade ideas

### LLOYDS 6.059% £15P

**We expect Lloyds 6.059% £15P to be taken out in 2015**

**We find the LLOYDS 6.059% £15P attractive with next call date on the 5th March 2015.** The high back end spread of 5yr + 385bp is likely to incentivize a call at its next call date. We believe instruments will not be able to be reclassified from being an instrument with an incentive to redeem to an instrument without an incentive to redeem and therefore even though this instrument has 5 yearly calls, we believe the instrument would not get Tier II treatment from regulators. Nevertheless, we highlight the back end is greater than Lloyds 5yr sub CDS (225bp) and also greater than their longest LT2 bond at Z+325bp for a callable instrument to 2025-2030. As such, given the must pay nature and the fact this instrument has not been given an opportunity to be LME'd (as it was too low down on the waterfall) we believe this instrument will likely be called (or even in worse case LME'd like the GB0058322420 which was exchanged in Feb 2012). Furthermore, we note that Lloyd is our top pick amongst the UK Banks given its improving margins, successful execution to date of its deleveraging plan and reduced expected impact from the potential ring fencing proposals.

### LLOYDS FRN €FEBP - XS0156923913

We like the LLOYDS FRN €FEBP with back end of €3m Euribor + 250bp. These are "must pay" instruments that we expect to lose Tier I capital treatment as of the 1st Jan 2014 as per *article 486* of the CRR. Furthermore, we believe according to the EBAs Q&A that due to the existence of the quarterly calls we believe that it cannot count as Tier II capital in CRR. We also believe that the EBA might not allow instruments that were issued with an incentive to redeem to be reclassified as an instrument without an incentive to redeem. **We recommend investors buy LLOYDS FRN €FEBP (XS0156923913) at the current cash price of 93 mid, YT2014 at 13.7%, YTP at 6.1%. We believe this represents a low cost option on earlier and expected call.**

Table 2: Lloyds: Preferred Tier I capital instruments

ISIN	Issue Date	Coupon	First Call	Next Call	Step?	Ccy	Amt	Back End	Price	YTD	Year	Type^
<b>Call date Pre Dec 2011</b>												
XS0109138536	14/03/2000	6.059	31/05/2010	31/05/2015	Yes	GBP	250	5y+385bp	96.5	8.3	2015	Must
<b>Call Date 31st Dec 2011 - 31st Dec 2013</b>												
XS0156923913*	25/10/2002	2.7	25/02/2013	25/11/2013	Yes	EUR	261	3m+250bp	93.0	13.7	2014	Must

Source: Company reports. Bloomberg, Must pay - do not offer management discretion to not pay coupon

We add the LLOYDS 6.059% £15P (XS0109138536) to our model portfolio in £2mm at 97.5. Whilst both these instruments are of smaller issue size we believe the 6.059% would be easier to source For a summary of the currently open trades please see the Appendix on page 57.

### RBS 7.64% \$17P versus RBS 7.0916% €17P

These two instruments may receive differing regulatory capital treatment from the regulator

We note that RBS spreads have recently been volatile and whilst our base case is that no split is to occur, we would caution that current pricing does not offer good risk reward opportunities for investors. However, for those investors looking for RBS risk we highlight some of the other opportunities that we would prefer. We currently attribute a 75% chance that RBS continues with business as per the original plan.

We highlight that there are two non innovative instruments which would appear to be very similar in characteristics, i.e. same issue date, same call date and similar back end spreads. However, we highlight importantly, the call period for these instruments is different. The RBS 7.64% \$17P is only callable every 10yrs whilst the RBS 7.0916% €17P is callable every quarter following its first call date and therefore according to the EBA Q&A clarification would not be able to qualify as Tier II capital outside of grandfathering. As such we believe these two instruments offer differing regulatory benefits to RBS. At best the RBS 7.0916% €17P will count as bail-in debt where as the RBS 7.64% \$17P will be able to count towards RBS' Tier II capital stack in its own right, in our opinion. **We therefore believe that there should be a more material pricing discrepancy between this two instruments and would recommend that investors buy the RBS 7.0916% €17P at 88 and Sell the RBS 7.64% \$17P at 89 to take advantage of changing investor perceptions around the utility of capital instruments.**

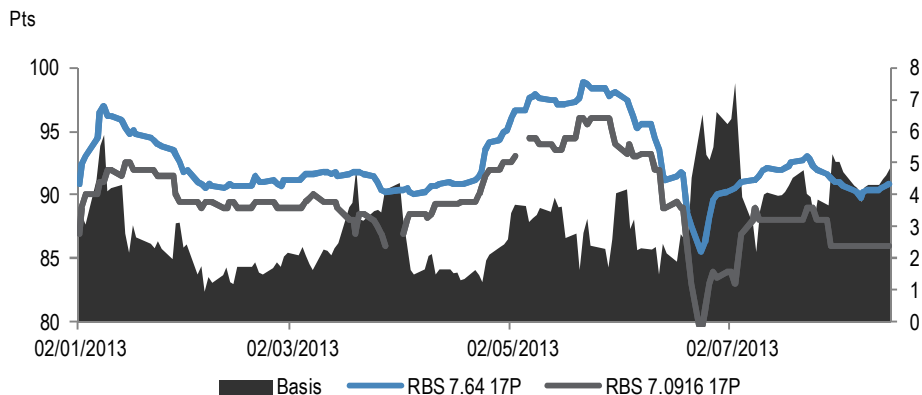
Table 3: RBS: Tier I non step instruments

ISIN	Coupon	First Call	Ccy	Amt Out	Back End	RPC	Call Period	Mid Price	YTC	TYP	Post Call
XS0323734961	7.0916	29/09/2017	EUR	471	3m+233bp	Yes	3 months	87.00	11.3	7.4%	Bail-in
US780097AU54	7.64	29/09/2017	USD	1,013	3m+232bp	Yes	10 years	90.00	10.2	8.1%	LT2

Source: Company reports. Bloomberg,

We remind investors that these bonds were both successfully LME'd in 2009 and RBS at the time stated they would base future calls on an economic basis. In our opinion, this means that RBS is free to treat each instrument on a stand alone basis and therefore is not constrained to treat each issue the same.

Figure 6: RBS 7.64% \$17P versus RBS 7.0916% €17P



Source: J.P. Morgan.

## RBS FRN €JUNP XS0149161217 & RBS FRN \$JULP US749274AA41

We like the RBS FRN €JUNP (XS0149161217) & RBS FRN \$JULP (US749274AA41) which we expect to lose all capital recognition as of the 1st Jan 2014, given the incentive to redeem and quarterly call dates. We think these instruments could benefit from a sooner than anticipated redemption given their high back end relative to where we envisage RBS could issue bail-in debt. We highlight that YTP and YT22 are c7% and c7.5% for these instruments respectively; as such with a YT14 of >50% we like the low cost option this offers investors. We note liquidity in these instruments is likely to be difficult.

**We continue to believe that investors should not consider T1 may pays until after the split of the bank is completely ruled out, expected Oct '13. Before the rule out we would prefer to be long must pay instruments versus may pay instruments.**

## RBS NV trusts

We continue to highlight the increased probability of an LME on the RBS NV trusts. We have written about this before our "Financial Trade Idea Portfolio", [here](#). We note that not only is capital likely to be more efficiently allocated at the group's main operating entity, but the Tier I's at RBS currently only contribute about 80% of their notional outstanding to the groups Tier I capital. This is because RBS has hit the limits from *article 66* in directive 2006/48/EC which states that hybrids cannot contribute more than 50% of reference capital defined in *article 55*. In other words, it has breached the gearing limit.

Furthermore, an analysis of RBS' grandfathering profile suggests that due to the high number of retail non steps its T1 capital efficiency gets materially worse through time as the grandfathering cap decreases yet the capital stock falls only slightly. Furthermore, RBS' Tier II grandfathering buckets are already full and therefore as these Tier I's overflow, they will receive no regulatory capital benefit. **We remind investors that we are taking the broader interpretation of the EBA's Q&A, indeed a similar approach to that which RBS has taken with regards to quarterly calls (As can be seen from their recent CRD IV forecast) meaning that legacy Tier I's cannot be consider Tier II in their own right.** Under these

**RBS NV is breaching the gearing limit for hybrids in their Tier I capital**

circumstances it may be more economical for RBS to take out some of its higher coupon non steps via LME. We highlight that some of the RBS NV trusts have the higher coupons where there is a good size outstanding but alternatively we note that RBS could call entire issues of higher coupon bonds where there is a call date every interest payment date.

**RBS has 3 good reasons to conduct LME on the RBS NV trust preferred instruments**

In summary, RBS is incentivized to take out the RBS NV bonds to:

- 1) Repatriate capital back to the RBS plc
- 2) Reduce the level of inefficient Tier I hybrids due to grandfathering , and
- 3) Improve the efficiency of Tier I on a consolidated basis due to the limits on RBS NV Tier I capital on a solo basis (which then impact RBS on a consolidated basis.

**Table 4: RBS 6.08% P, RBS 5.9% P and RBS 6.25% P**

ISIN	Sub	Issued	Ticker	Coupon	Call date	Maturity	Ccy	Amt	Price*	YTD	Date	YTP
US74928K2087	T1	03/07/2003	RBS	5.9	03/07/2008	Perp	USD	1285	19.8	30.9	2014	7.6
US74928M2044	T1	30/09/2003	RBS	6.25	30/09/2008	Perp	USD	200	20.4	28.9	2014	7.8
US74928P2074**	T1	18/02/2004	RBS	6.08	18/02/2009	Perp	USD	1800	20.2	28.9	2014	7.6

Source: J.P. Morgan. \*\$25 securities, \*\*This bond is already in our model portfolio, see page

## **BACR 6.86% \$32P**

In our opinion, the Barclay's innovative instruments are largely fairly priced given the strong performance of the USD preferred market. However, within the liquid spectrum of innovative category, we would prefer the **BACR 6.86% \$32P**. This is due to the fact we believe it could be subject to further LME if Barclays were to further optimise its capital structure during the grandfathering period. We highlight on page 26, even if Barclays were to call all of its step-up instruments and institutional non steps it would still have excess capital that would not be considered Tier I, as such an LME on some of these longer dated instruments could benefit the institution. We highlight the **BACR 6.86% \$32P** because, even though it is trading at par, we note the hedging instrument is currently in the money for Barclays as such an LME could still be capital accretive whilst successfully managing its Tier I capital stack. We highlight in Table 5 that institutions have continued to carry out LMEs on capital instruments that have traded above par. There are other instruments that could be subject to LME which look more attractive but these have lower outstanding notional amounts and therefore the incremental value achieved by conducting an LME is reduced.

**Most Barclays innovative instruments are fairly priced, however, some of the longer dated instruments have swap gains that could be tapped**



Table 5: Examples of above par LMEs on subordinated debt

Date	ISIN	Ticker	LME Price	Sub
05/03/2012	XS0361244311	ABBEY	104.5	LT2
05/03/2012	XS0041864512	ABBEY	107.5	LT2
05/03/2012	XS0034981661	ABBEY	117.5	LT2
05/03/2012	002927AA9	ABBEY	103	T1
05/03/2012	002920AC0	ABBEY	106	T1
11/06/2012	FR0000487886	SOCGEN	104.5	LT2
11/06/2012	XS0110673950	SOCGEN	106.5	LT2
03/07/2012	XS0148995888	CS	97	LT2
03/07/2012	US22546QAD97	CS	98.578	LT2
03/07/2012	US22541HCC43	CS	103.787	LT2
03/07/2012	XS0336248082	CS	104.25	LT2
03/07/2012	XS0118514446	CS	105.25	LT2
03/07/2012	XS0112553291	CS	105	T1
18/07/2012	XS0148995888	CS	101.25	LT2
18/07/2012	US22546QAD97	CS	109.628	LT2
18/07/2012	XS0336248082	CS	109.75	LT2
18/07/2012	US22541HCC43	CS	111.203	LT2
18/07/2012	XS0118514446	CS	112.25	LT2
18/07/2012	XS0112553291	CS	108.25	T1
10/10/2012	XS0060505228	BBVASM	100	LT2
10/10/2012	XS0137037361	BBVASM	100	LT2

Source: J.P. Morgan.

## ACAFP 6.637% \$17P unattractive

Whilst we continue to believe ACAFP is over leveraged in comparison to its peers and has one of the largest shortfalls for bail-in debt as we highlight in our [YE 2013 Outlook](#)

**Investors are currently pricing high coupon non steps to call, yet do not provide the same benefit to other issuers where it is economical to call non steps**

The ACAFP 6.637% \$17P **non-step** currently trades to call with a yield c.8.0% which would arguably look cheap had it not been for the back end spread of only €3m+123.25bps. This is in contrast to 10yr senior cash Z-spreads c.105bps and subordinated 7yr spreads of c.230bps. In our opinion this would put the cost of bail in debt c165bp and therefore the Tier I non step would make economic bail-in debt. As such, looking at this instrument as a perpetual give a yield of circa 6.4% which in our opinion is expensive given the reduce expectation of seeing a return in principle. **More importantly, we highlight that the ACAFP 6.637% \$17P has 10yr call resets and as such would argue this instrument would make cheap Tier II capital and therefore has an increase probability of being extend. As such, we believe the ACAFP 6.637% \$17P is expensive.**

Table 6: ACAFP T1

ISIN	Sub	Issued	Ticker	Coupon	Call date	Maturity	Ccy	Amt	Price*	YTC	YTP
USF22797FJ25	T1	31/05/2007	ACAFP	6.637	31/05/2017	Perp	USD	890	97.5	7.4	6.4

Source: J.P. Morgan. \*\$25 securities

## BPCE 4.75% €16P

**BPCE has been transparent with its policy towards redeeming capital instruments, we don't expect this to change.**

We highlight the BPCE 4.75% €16P as a relative cheap bond in the BPCE capital structure. This bond contains a step at its first call date and as such according to BPCE's own presentation, they should call this bond. However, due to the low back end of €3m+135bp investors are more skeptical. We note that calling this bond would fall in line with previous French bank behavior and follow previous bank guidance. Given our assumption that instruments that have been classified as having an incentive to redeem cannot be reclassified then these instruments cannot get Tier II capital treatment, not only because of the quarterly calls as clarified by the EBA. In our opinion the total capital of BPCE is too low for BPCE to attempt to cover a

total capital ratio of 17% with subordinated debt alone, therefore we believe it is likely that senior will ultimately be part of the bail-in buffer for BPCE. We highlight the BPCE 2.875% 16-Jan-24 trade circa Z+80bps and therefore the BPCE 4.75% €16P could also be considered expensive bail-in debt. We find 10.7% YTC attractive for the BPCE 4.75% €16P.

Table 7: BPCE: Tier I

ISIN	Coupon	First Call	Step?	Ccy	Amt	Back end	Price	YTC	YT22	YTP
FR0010279273	4.75	01/02/2016	Yes	EUR	350	3m+135	88.00	10.7	6.0	5.5

Source: Company reports. Bloomberg

The upside is skewed in the investors' favour at current cash prices where the downside is limited.

## SOCGEN 6.625% €18P UT2

Given the pricing of Socgen's Tier I instruments, we in fact find its recent UT2 6.625% \$18P instrument more interesting from a valuation point of view. We highlight that the coupon on this instrument are not only **cumulative** but also the **arrears of interest bear interest at 6.625%** also. Furthermore, we note the deferred coupons would be payable following payment on any class of share capital of Socgen. We highlight SOCGEN 6.125% €18 LT2 trade c2.7% whilst the SOCGEN 6.625% \$18 trade c6.2% as per Table 34.

Table 8: SOCGEN: UT2 and comparables

ISIN	Issue Date	Coupon	First Call	Innovative	Ccy	Amt	€ Equiv	Back End	RPC	Price	YTC	Type
XS0383634762	20/08/2008	6.125			EUR	778	778			115.7	2.7	LT2
XS0813929782	11/12/2012	6.625	11/06/2018	No	USD	1500	1135	5yr+575.4	Yes	101.5	6.3	UT2
XS0449487619	04/09/2009	9.375	04/09/2019	Yes	EUR	1000	1000	3m+890.1	Yes	114	6.6	T1

Source: Company reports. Bloomberg

## Ratings event is a short term suppressant which creates an opportunity for investors

We highlight the loss of equity treatment from S&P allows SOCGEN certain rights to vary the terms and conditions of the bonds in a similar way as the Dankse 7.125% which we have previously mentioned in our [2H 2013 outlook](#). In short, as long as Socgen inserts a call pre 1st of Jan 2014 then SOCGEN could potentially call the bonds back at par. To do this, SOCGEN must give between 30-60 days notice to note holders. This means that the ratings event par call is essentially a short term depressant if, like us, the investor believes SOCGEN would not utilize the call itself without offering investors an alternative. In our opinion at current cash prices the downside is limited and the upside is skewed in the investors favour should SOCGEN decide to do nothing. In our opinion, investors should be long SOCGEN UT2 instruments, we believe that the downside is limited by the investor friendly nature of the French banks especially SOCGEN and could even offer upside via an LME which includes a small market premium. However, we view the UT2 instruments as a good method of securing a low cost option that SOCGEN leaves these instruments outstanding. Under these circumstances we would expect significant price appreciation post 1st December 2013 especially given the pricing of the recent AT1 instrument.

We note that if this instrument is not exchange or called back then the instrument should trade with a I degree of certainty to its first call date with little extension risk given the reduced utility the SOCGEN would be receiving for this instrument. We believe this would justify a compression between the SOCGEN LT2 and the UT2.

Comments from KBC management suggest they are thinking about the KBC trust instruments in an opportunistic way.

The AQR and balance sheet review will continue to put pressure on peripheral operating environments.

## KBC Trust step up instruments

In our opinion, the KBC FRN €P could be called or tendered as early as 2014 in order to maximise the existing stock of non-innovative instruments during the grandfathering period. Whilst an alternative to this could be to tender a capped amount of the KBC 8% €13P we believe that the high cash price of this instrument as well as comments from management would deem this as unlikely. Under these circumstances, the average back end spread of the trust instruments is between +300bp and +405bp in comparison to the average senior cash spread (5yr – the longest liquid senior) or even subordinated CDS spread of z+80bp or 265bps respectively, therefore KBC would be incentivised to call these instruments from an economical stand point sooner than the 2023 grandfathering deadline.

## UCGIM 4.028% €15P unattractive

Given our view on the periphery we find the capital structure of UCGIM relatively uninteresting. However, we would highlight the UCGIM 4.028% €15P as bonds which trade at call but could face significant downside if these are not called. We note that UCGIM 7yr cash bonds trade c Z+210bps and 10yr UCGIM senior CDS trades c360bps. Therefore if extended the UCGIM 4.028% €15P would make cheap senior funding and currently these bonds price in little change of extension. In our opinion, this might be justified for an institution which were operating under much sounder financial conditions.

We highlight that in their LME on these bonds in 2012, they stated that future calls shall be considered in the “best interests of the group”. Obviously if financial conditions substantially improve for UCGIM then a call may be more much more likely. Currently we think the bonds offer over 10pts of downside versus only 5pts of upside and therefore view the risk reward characteristics of this bond as undesirable. We would therefore take profits if this hasn’t been done already. We note due to the low amount outstanding many of the UCGIM bonds may be very illiquid.

Table 9: UCGIM: Tier I

ISIN	Issue Date	Cpn	First Call	Step	Ccy	Amt Out	(€) Equiv	Back End	Price	YTC
Call Date Post 31st Dec 2013										
XS0231436238	27/10/2005	4.028	27/10/2015	Yes	EUR	280	280	3m+176bp	94.25	7.0

Source: Company reports. Bloomberg.

## Outstanding Issues

### Call frequency

We believe there are two interpretations of the response the EBA gave to Question 2013\_15.

- 1) **NARROW INTERPRETATION: ONLY applicable to instruments with an incentive to redeem – therefore all other instruments could receive Tier II recognition outside of grandfathering**
- 2) **BROAD INTERPRETATION: Encompassing both instruments with AND without an incentive to redeem. – therefore no instrument with quarterly calls post first call could receive Tier II recognition.**

**The EBA remain ambiguous, we await answers to Questions 2013\_31, 2013\_40 and 2013\_50**

**Institutions such as Lloyds and RBS have taken the broad interpretation as can be seen from their recent CRD IV projections, i.e. they have taken the most conservative stance with regards to capital**

**We are at odds with the EBA's decision given that T1 instruments require regulatory approval before they are called. Furthermore, it is the issuer's call option and therefore we question why the quarterly calls needed to be a point of contention**

A narrow interpretation would try and understand the answer within the context of the question ONLY. We believe the only way the answers could make sense in the context of the question is if we structure the sentence in the following way:

As per Article 489 (4) instruments must meet Article 52 on a **“from the date of the effective maturity”** however ... *“Due to the existence of subsequent quarterly calls, the instrument does not meet fully the criteria of Article 52 and in accordance with the provisions of Article 489 (4) of Regulation (EU) No 575/2013, the instrument described above will be fully disqualified from AT1 after the first call date... “In addition, because in particular of the quarterly call, the instrument would not meet the eligibility criteria for inclusion in fully eligible Tier 2 capital”* as per Article 63.

Given the following questions 2013\_31 and 2013\_40, we highlight the ambiguous nature of this response. Nevertheless, in our view reading the answer within the context of the question misses the point of what it appears the EBA and regulator is trying to achieve. In our opinion, it appears that the legacy instruments are being purposely forced out of bank capital structures, as such we consider the second interpretation. We note that either by issuer decision or regulatory guidance most of the new callable capital instruments have had 5 year call dates. We highlight that this avoids the potential pitfall of being ineligible under CRD IV due to the technical specifications developed by the EBA, though this could always be circumnavigated by the use of regulatory calls. We believe this could serve to orientate investors for what the EBA is trying to achieve.

We highlight that for issuers to redeem capital instruments they must obtain regulator permission in first instance, as such we question why one would make quarterly calls something that would disqualify an instrument from capital recognition. We believe there is an underlying desire to clean up the capital structures of banks and therefore the sentence above (beginning “In addition...”) was separated by an entirely different paragraph of writing to allow it to stand alone. As such we believe this would not only apply to instruments with an incentive to redeem but all instruments outside of grandfathering. I.e. removing quarterly calls from a CRD IV environment.

We think about this not only in the context of regulator's achieving a higher quality cleaner capital structure but also in the context of newly issued capital instruments. If we look at the recent CRD IV compliant instruments such as the SCOGEN 6.625% UT2, 8.25% AT1 or BBVA 9% AT1, we note that all of the call dates have been on a 5 yearly basis. Thus we believe the future issuance design highlights what a CRD IV compliant instrument should look like and we do not believe this includes quarterly calls.

*Although we acknowledge that both views could be taken, our base case is that regulators are attempting to reduce the number of legacy instruments outstanding and as such think that the presence of quarterly calls would make a legacy instrument non compliant with CRD IV capital. In the case, studies that follow our assumptions follow this line of thinking and therefore instruments which are grandfathered would lose full capital treatment by the 1st Jan 2022.*

#### **Can instruments that have been issued as innovative be reclassified?**

This has specific ramifications for instruments that do not have quarterly calls but do were originally issued as an innovative instrument (i.e. with an incentive to redeem). A question has been posed to the EBA (2013\_50) which addresses this point and asks for clarification whether this statement was made within the context of grandfathering or more broadly. In our opinion, the EBA seems as though it would

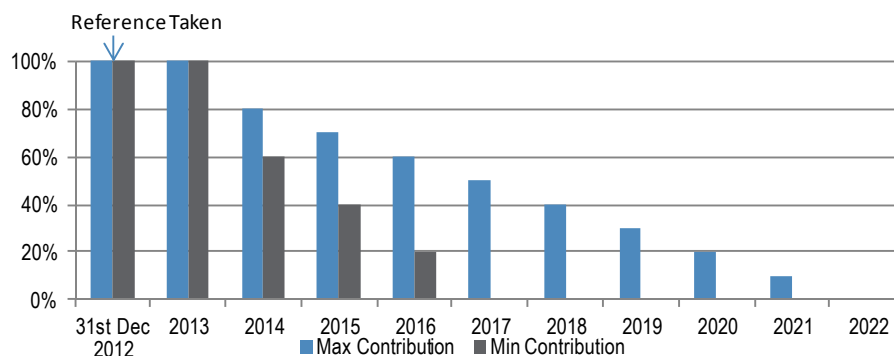
like to remove these legacy instruments from bank capital structures (oddly) and therefore our base case would be that an instrument issued as an innovative instrument will not be able to reclassified as an instrument without an incentive to redeem and therefore will not be eligible to qualify as Tier II in its own right outside of grandfathering. In other words we believe that the characteristic of having an incentive to call is "locked-in" at issue. **This would mean that any instruments originally issued with an incentive to redeem would lose all capital treatment (both Tier I and Tier II) when they exited grandfathering. We note this also means that the removal of calls from an innovative instrument would not help it to gain CRD IV capital recognition. (We do not expect the removal of calls to be a wide spread practice across the banking industry).**

## CRD IV/CRR Grandfathering

**CRD IV grandfathering begins on the 1st Jan 2014 and lasts until 31st Dec 2021**

The limits for Grandfathering are laid out in Article 486 of the CRR. These limits are the same for both Tier I and Tier II instruments and last from a period of 1st Jan 2014 to 31st December 2021. This period is effectively only 8 years long because; whilst the Basel III implementation was delayed, the grandfathering of legacy instruments was not. As such the grandfathering period remained intact with issuers effectively receiving 100% over 2013 before falling to (60 to) 80% in 2014, (40 to) 70% in 2015 and so on. The CRR grandfathering limits are highlighted in Figure 7.

Figure 7: CRR grandfathering limits



Source: EC - CRR text

We note that CRR gives regulators some discretion with regards to how quickly they phase out the legacy instruments. This is highlighted in Figure 7 by the Max contribution (slowest phase out) and Min contribution (fastest phase out). In our opinion, most regulators will be pragmatic and chose the slowest phase out for legacy instruments.

### Grandfathering reference

We highlight that the grandfathering limits are based specifically upon the outstanding stock of ineligible (for CRD IV) instruments as of 31st Dec 2012 (adjusted for excess of Basel II limits and innovative instruments callable between 31st Dec 2011 and 1st Jan 2014). See equation below (JPM simplification) and Figure 8 for an illustration<sup>1</sup>.

*AT1 Grandfathering Reference = Nominal Amount of outstanding instruments\* on 31st Dec 2012*

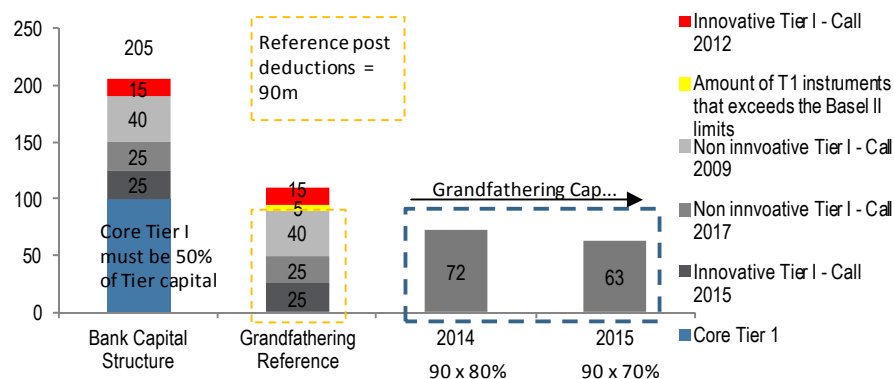
*LESS: Amount exceeding limits specified in national*

Put another way, the reference point for grandfathering is locked to the 31st Dec 2012 and each percentage cap in the following years will be a percentage of this reference point. As such for each institution using data from the FY 2012 annual report, we can understand the maximum cap that will be applied to their legacy instruments. In Figure 8 we have given an example for the calculation method and the following grandfathering caps for an example bank. We note that most banks will

<sup>1</sup> \*instruments that require grandfathering ^as per point (a) of article 66(1) and Article 66(1a), we highlight there are no limits for AT1 and T2 in CRD IV.

not be required to deduct amounts for exceeding the Basel II limits given that it would have been inefficient to operate with a stock of Tier I instruments that exceeded 50% of total Tier I capital and many institutions have also tender Tier I capital in favour of core capital generation. We also note that the number of instruments outstanding that had a call date in 2012 are relatively limited. As such this simplifies the Grandfathering reference to those instruments that were outstanding on 31st Dec 2012.

Figure 8: CRR grandfathering calculation



Source: EC - CRR text

## Interaction between Non Innovative and Innovative Instruments and the Grandfathering limits

Once innovative instruments reach their first call date post 2014 they drop out of the grandfathering buckets

We highlight as we have mentioned before in our [“Financial Trade Idea Portfolio: No Bail-in, No Capital Recognition”](#) 18th Feb 2013, that banks should be thinking about actively managing their outstanding legacy instruments in order to maximise the utilisation of the outstanding stock underneath the grandfathering limits. To this extent we highlight a few points:

- 1) Outstanding non-innovative Tier I instruments will benefit from the full grandfathering period subject to the grandfathering cap.
- 2) Outstanding innovative Tier I instruments with a first call in before **31st Dec 2011** benefit from the full grandfathering period subject to the grandfathering cap.
- 3) Outstanding innovative Tier I instruments with a first call in between **31st Dec 2011 and 1st Jan 2013** will effectively lose Tier I capital treatment as of the **1st of Jan 2014**
- 4) Outstanding innovative Tier I instruments with a first call post **1st Jan 2013** will lose Tier I capital treatment as of their first call

These points are important to consider when thinking about the economic incentives for the issuer when they are managing their outstanding stock of legacy instruments. In Table 10 we give an example of each bond that falls within these categories and highlight the regulatory treatment that the instrument will receive through time.



Table 10: Grandfathering of Tier I instruments, example bonds

Type	ISIN	Coupon	First Call	Date of 100% capital treatment loss*
1) Outstanding <u>non-innovative</u> instruments will benefit from the full grandfathering period subject to the grandfathering cap.	XS0205935470	5.500	31/12/2009	1st Jan 2022
2) Outstanding <u>innovative</u> instruments with a first call in before <b>31st Dec 2011</b> benefit from the full grandfathering period subject to the grandfathering cap.	USU2445QAA68	4.3231	02/11/2009	1st Jan 2022
3) Outstanding <u>innovative</u> instruments with a first call in between <b>31st Dec 2011</b> and <b>1st Jan 2013</b> will effectively lose capital treatment as of the <b>1st of Jan 2014</b>	XS0179207583	5.419	10/11/2013	1st Jan 2014
4) Outstanding <u>innovative</u> instruments with a first call post <b>1st Jan 2013</b> will lose capital treatment as of their first call	FR0010638338	7.781	02/07/2018	2nd July 2018

Source: J.P. Morgan.\* Assuming 1 bond capital structure

Given that the innovative instruments can no longer benefit from any potential grandfathering post their first call date, it is likely that these instruments will be taken out first in favour of leaving the non innovative instruments outstanding so that they can benefit from the prolonged grandfathering.

## Rolling from Tier I Grandfathering into Tier II Grandfathering

If a Tier I instrument is still eligible for grandfathering but is exceeding the Tier I grandfathering limits, it can roll down into Tier II grandfathering as long as there is free space in the Tier II grandfathering bucket

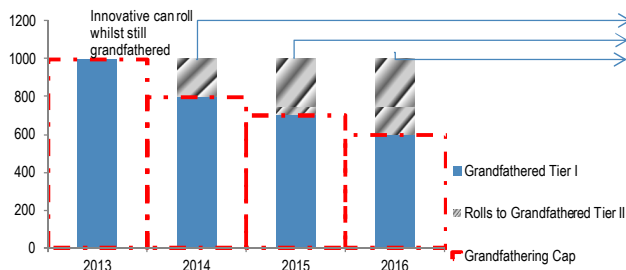
On the 26th July 2013 the EBA published an update to its final draft Regulatory Technical Standards (RTS) on own funds. We highlight that within this update the EBA clarified that:

*“...Additional Tier 1 instruments grandfathered according to the transitional provisions...are allowed to be included **within the limits** for grandfathered instruments for **lower tiers of capital**. This nevertheless cannot alter the limits for grandfathered instruments for lower tiers, therefore any inclusion in the grandfathering limits of the lower tier should only be possible if there is sufficient allowance in that lower tier.”*

Our understanding is that this clarification essentially means that Tier I instruments **that are still eligible for grandfathering** (as per *article 484*) **but that exceed the grandfathering cap** will be allowed to flow into the Tier II grandfathering bucket **only if there is sufficient room below the cap for these instruments** to be grandfathered within the Tier II grandfathering limit. We try to demonstrate this interaction in Figure 9 & Figure 10. In our opinion, this will mean that investors must consider the inter play between Tier I grandfathering and Tier II grandfathering when considering the issuers intentions for Tier I instruments without an incentive to redeem (or that stepped before 31st Dec 2011) as these instruments will be available to benefit from the full period of grandfathering either as a Tier I instrument or a Tier II instrument.



Figure 9: Example Tier I Capital Stack



Source: J.P. Morgan.

Figure 10: Example Tier II Capital Stack



Source: J.P. Morgan.

We highlight that issuers will still be incentivized to call innovative instruments as soon as they reach their first call date because these innovative instruments lose the ability to be grandfathered post their first call date (if after 1st Jan 2013) and therefore will not have the ability to sit within the Tier II grandfathering limit. This was clarified by the EBA Q&A where the EBA stated that due to *article 484 (5)* of the CRR.

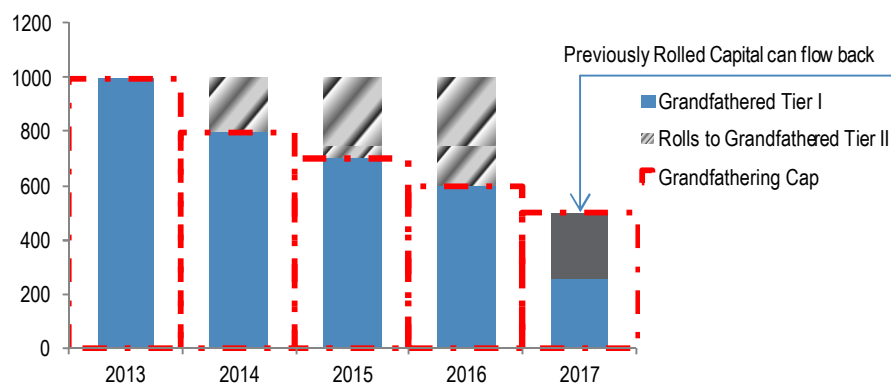
**Tier I instruments can roll back into Tier I grandfathering if free space has been created by the redemption of a capital instrument, for example**

It is also worth highlighting that if “headroom” is subsequently created within the Tier I grandfathering limit (by perhaps the call of an innovative instrument) then the “rolled” Tier I is able to flow back into the Tier I grandfathering bucket. We highlight this in Figure 11 as a continuation of Figure 10. The EBA stated:

*“... as these are excess instruments of the higher tier, it should be possible for those instruments to be later reclassified to a higher tier of capital”*

In our opinion, this provides incentives for issuers to manage their capital stacks efficiently to maximise the level of grandfathering that can be achieved. Ultimately the majority legacy capital instruments are likely to lose capital treatment as they stand by 1st Jan 2022 at the latest; however, we believe their are more optimal ways to manage the capital stack prior to this date.

Figure 11: Example Tier I capital that had previously rolled to Tier II flowing back to Tier I



Source: J.P. Morgan.

## Managing Legacy Tier I instruments

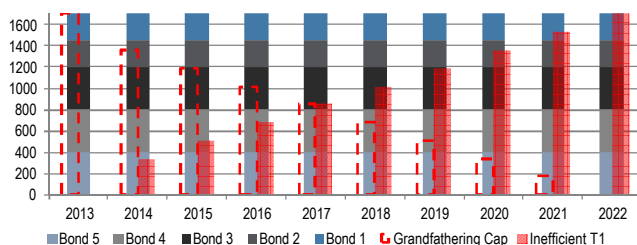
In order to highlight how banks can actively and efficiently managed their outstanding legacy instruments in order to receive the maximum benefit from grandfathering without paying interest on an inefficient capital instrument, we will use an example of a bank with 5 legacy T1 instruments highlighted in Table 11. In Figure 12 we observe the amount of inefficient legacy instruments that would exist if the issuer did nothing with their legacy instruments. Conversely in Figure 13 we highlight that the bank benefits from the grandfathering for a long period of time whilst leaving significantly less inefficient T1 legacy instruments outstanding which in this case would constituted expense bail in debt (given that the cheapest form of bail in debt would be a senior bond issue).

Table 11: Outstanding Tier I stock of Example Bank

No.	Type	Amt	1st Call	Comment	Next best usage
1	Innovative	250	2014	Loses full capital treatment in 2014	Bail-in Debt
2	Innovative	250	2015	Loses full capital treatment in 2015	Bail-in Debt
3	Innovative	400	2017	Loses full capital treatment in 2017	Bail-in Debt
4	Non Innovative	400	2015	Loses full capital treatment in at the end of the grandfathering period i.e. 2022	Bail-in Debt
5	Non Innovative	400	2019	Loses full capital treatment in at the end of the grandfathering period i.e. 2022	Bail-in Debt
		1700			

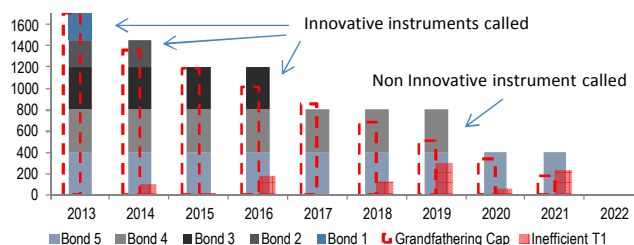
Source: J.P. Morgan.\*Assuming no space in Tier II grandfathering bucket

Figure 12: Evolution of inefficient T1 WITH NO active management of Legacy instruments



Source: J.P. Morgan.

Figure 13: Evolution of inefficient T1 WITH active management of Legacy instruments



Source: J.P. Morgan.

This example analysis is supportive for innovative Tier I instruments as issuers look to replace expensive debt with cheaper forms of debt whilst gaining the maximum benefit from the grandfathering period. However, it also highlights that non innovative instruments could be called earlier than the 31st December 2021 that signals the end of the grandfathering period. In the following section we conduct an extensive analysis on the Tier I capital structures of a number of banks that have been heavily involved in the Tier I space in order to determine which bonds are likely to remain outstanding for the entire grandfathering period and which bonds could see earlier redemption.

## The Opportunity Cost of Doing Nothing

**Leaving hybrid capital instruments outstanding becomes economically expensive for issuers versus replacing with other instruments**

As we mentioned in our [upgrade of Tier I](#) the utility of capital instruments post the EBA's clarification has been reduced. In this section we highlight the opportunity cost that issuers would potentially face if they chose not to manage their outstanding stock of capital instruments. In order to quantify this opportunity cost we will use SOCGEN as an example and we will highlight ways in which SOCGEN might seek to meet its funding and capital requirements in a CRD IV world.

In Table 12 we highlight the annual expect cost to the bank for keeping the Tier I instruments outstanding. We then carry on to understand the cost to the bank if it were to replicate the capital treatment it was receiving, instead using new issuance of AT1 instruments and other bail-in instruments as an alternative to leaving the Tier I instruments outstanding.

### Other Bail-in instruments

We note that banks do not necessary have to choose between senior and LT2 debt in order to meet the bail-in requirements that are likely to be given the banking institutions. We could envisage some of the more sophisticated institutions issuing "bail-in debt" that would be more subordinated than senior debt but less subordinated than LT2 debt. We note that the RRD currently envisages the scope for subordinated debt that is not Tier II or Additional Tier I to be eligible to count towards the bail-in buffer. As such, issuers may look to avoid contaminating their senior debt issuance, not by issuing LT2 debt which has a 5yr minimum maturity requirement, but by issuing specific "bail-in debt" which would have a higher attachment point in the capital structure than the LT2 debt. We would proxy this instrument as having a cost somewhere between senior debt costs and subordinated debt costs.

Table 12: SOCGEN: Example Opportunity Cost of leaving capital outstanding

			2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
ISIN	Backend	Call	€ Amt									
XS0179207583	3m+195	2013	420	420	420	420	420	420	420	420	420	420
FR0010136382	3m+153	2015	728	728	728	728	728	728	728	728	728	728
XS0454569863*	FIXED	2015	754	754	754	754	754	754	754	754	754	754
Priv Placement	3m+677	2016	339	339	339	339	339	339	339	339	339	339
USF8586CAA02	3m+175	2017	609	609	609	609	609	609	609	609	609	609
US83367TAB52	3m+175	2017	47	47	47	47	47	47	47	47	47	47
XS0336598064	3m+335	2017	468	468	468	468	468	468	468	468	468	468
XS0369350813*	3m+340	2018	586	586	586	586	586	586	586	586	586	586
XS0373447969	3m+370	2018	100	100	100	100	100	100	100	100	100	100
XS0449487619	3m+890.1	2019	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Tier I outstanding			5,052	5,052	5,052	5,052	5,052	5,052	5,052	5,052	5,052	5,052
Eligible for Gr.Fthing			5,052	4,631	4,631	3,903	3,564	2,440	2,340	1,340	1,340	1,340
Grandfathering Cap			5,847	4,677	4,093	3,508	2,923	2,339	1,754	1,169	585	0
T1	Eligible		5,052	4,631**	4,093	3,508	2,923	2,339	1,754	1,169	585	0
Bail-in Debt	Excess		0	374	959	1,544	2,128	2,713	3,298	3,882	4,467	5,052
Annual Cost			374	362	363	356	363	359	353	384	393	400
Reference Data			Yield	Swap	Spread	Tenor						
Cost of New T1			8.25%	1.90%	6.35%	5yr						
Cost of Sub			6.50%	2.00%	4.50%	10yr						
Cost of Senior			4.67%	1.87%	2.80%	9yr						
Alternatives												
Exp Annual Cost	AT1		418	383	338	289	241	193	145	96	48	0
	Sub		0	26	64	102	140	179	217	255	294	332
	Senior		0	19	47	76	104	132	161	189	217	246
Route 1: Sub issue	Cost		418	409	401	392	382	372	362	352	342	332
	Saving		-42	-46	-37	-34	-17	-11	-7	34	53	69
Route 2: Sen issue	Cost		418	402	385	365	345	325	305	286	266	246
	Saving		-42	-39	-20	-7	19	35	49	100	129	155
50% Sub/50% Sen	An. Cost		0	21	55	88	121	155	188	221	255	288
Route 3:	Cost		418	406	393	378	363	348	334	319	304	289
	Saving		-42	-43	-28	-21	1	12	21	67	91	112

Source: J.P. Morgan.\*Non Step instruments, \*\* innovative instruments lose all capital recognition at first call date

We note that initially due to the high level of grandfathering and the high cost of AT1 issuance, it is not logical to call the legacy instruments in favour of fresh issuance. However, as we highlight in the bottom half of Table 12, depending on whether the bail-in debt is chosen to be Senior or subordinated debt or an instrument that line in between these liability classes, it can actually be economic to issue AT1 instruments and senior/sub instruments instead of leaving the legacy instruments outstanding.

If we repeat the exercise but this time assume that SOCGEN calls each of its innovative instruments at the first call date (i.e. creating room in the grandfathering bucket) we notice that because these innovative instruments carry a low back end spread, it makes the overall average cost increase. This in turn makes it more efficient to replicate the capital structure using new AT1 instruments and bail-in instruments. This exercise is repeated in the Appendix which also contains the forward rate and interest rate assumptions used for the annual coupon cost calculations.

## Points of Clarification

### Call frequency

Innovative instruments with quarterly calls cannot count as Tier II capital in their own right according to the latest EBA response to Q 2013\_15

We highlight the EBA Question 2013\_15 stated:

*In addition, because in particular of the quarterly call, the instrument would not meet the eligibility criteria for inclusion in fully eligible Tier 2 capital*

We believe there are two possible interpretations for this:

#### 3) **NARROW INTERPRETATION: ONLY applicable to instruments with an incentive to redeem**

We understand that question 2013\_15 was not exactly answered clearly and often led to more questions from market participants. However, a narrow interpretation would try and understand the answer within the context of the question ONLY. In which case we must ask our selves what does “In addition...” refer to. We believe the only way the answers could make sense in the context of the question is if we structure the sentence in the following way:

As per Article 489 (4) instruments must meet Article 52 on a “**from the date of the effective maturity**” however ... “*Due to the existence of subsequent quarterly calls, the instrument does not meet fully the criteria of Article 52 and in accordance with the provisions of Article 489 (4) of Regulation (EU) No 575/2013, the instrument described above will be fully disqualified from AT1 after the first call date...*” **“In addition, because in particular of the quarterly call, the instrument would not meet the eligibility criteria for inclusion in fully eligible Tier 2 capital”** as per Article 63.

The reason why the quarterly calls would make the instrument ineligible for Tier II capital treatment in this instance is because Article 490 (4) which governs the grandfathering of Tier II items with incentives to redeem states that **from the date of effective maturity** it must meet article 63. This would not be the case given the quarterly calls for this instrument which had an incentive to redeem which could either be governed by Article 489 (Tier I items with an incentive to redeem) or Article 490 (Tier II items with an incentive to redeem)

Given the following questions 2013\_31 and 2013\_40, we highlight the ambiguous nature of this response. Nevertheless, in our view reading the answer within the context of the question in our view misses the point of what it appears the EBA and regulator is trying to achieve. In our opinion, it appears that the legacy instruments are being purposely forced out of bank capital structures, as such we consider the second interpretation.

#### 4) **BROAD INTERPRETATION: Encompassing both instruments with AND without and incentive to redeem.**

Our starting point for this interpretation is newly issued capital instruments and the structure these instruments have. We highlight that either by issuer decision or regulatory guidance most of the new callable capital instruments have had 5 year call dates. We highlight that this avoids the potential pitfall of being ineligible under CRD IV due to the technical specifications developed by the EBA, though this could always be circumnavigated by the use of regulatory calls. We believe this could serve to orientate investors for what the EBA is trying to achieve.

Institutions such as Lloyds and RBS have taken the broad interpretation as can be seen from their recent CRD IV projections, i.e. they have taken the most conservative stance with regards to capital

**Most of the capital instruments issued that are CRD IV compliant seem to have 5yrlly call dates**

We highlight that for issuers to redeem capital instruments they must obtain regulator permission in first instance, as such we question why one would make quarterly calls something that would disqualify an instrument from capital recognition. We believe there is an underlying desire to clean up the capital structures of banks and therefore the sentence above (beginning "In addition...") was separated in by an entirely separate paragraph of writing to allow it to stand alone. As such we believe this would not only apply to instruments with an incentive to redeem but all instruments outside of grandfathering, i.e. ridding CRD IV instruments of quarterly calls.

We think about this not only in the context of regulators achieving a higher quality cleaner capital structure but also in the context of newly issued capital instruments. If we look at the recent CRD IV compliant instruments, such as the SCOGEN 6.625% or BBVA 9% AT1, we note that all of the call dates have been on a 5 yearly basis.

**Although we acknowledge that both views could be taken, our base case is that regulators are attempting to reduce the number of legacy instruments outstanding and as such think that the presence of quarterly calls would make a legacy instrument non compliant with CRD IV capital. In the case studies that follow our assumptions, we follow this line of thinking and therefore instruments which are grandfathered would lose full capital treatment by the 1st Jan 2022.**

### **Can instruments that have been issued as innovative be reclassified?**

**Even if quarterly calls are removed by the issuer, if an instrument cannot be reclassified then it is unlikely to get regulatory capital treatment outside of grandfathering**

The EBA Q&A Question 2013\_15 the EBA stated:

***"The fact that the instrument is not called does not mean that the instrument may be reclassified as an instrument without an incentive to redeem"***

We believe this to be ambiguous given that it was said in response to a question regarding the grandfathering implications of an innovative Tier I instrument. This has specific ramifications for instruments that do not have quarterly calls but were originally issued as a innovative instrument (i.e. with an incentive to redeem). A question has been posed to the EBA which addresses this point and ask for clarification whether this statement was made within the context of grandfathering or more broadly. In our opinion, the EBA seems as though it would like to remove these legacy instruments from bank capital structures (oddly) and therefore our base case would be that an instrument issued as an innovative instrument will not be able to reclassified as an instrument without and incentive to redeem and therefore will not be eligible to qualify as Tier II in its own right outside of grandfathering. In other words, we believe that the characteristic of having an incentive to call is "locked-in" at issue. **This would meet that any instruments originally issued with an incentive to redeem would lose all capital treatment (both Tier I and Tier II) when they exited grandfathering. We note this also means that the removal of calls from an innovative instrument would not help it to gain CRD IV capital recognition.**

## Case Studies

What follows is the capital structure break down for a number of institutions (mainly the historical issuers of T1 instruments) including how the Tier I capital instruments interact with the grandfathering schedules of both their tier I but also with Tier II instruments. For each institution we aim to show how the bank could optimise its Tier I capital treatment and also highlight some potential trade ideas based on the optimisation of bank capital structure. Immediately below we highlight the main assumptions that were used when constructing the optimisation profile of the bank's grandfathering schedule. We begin with the issuers that took advantage of the hybrid capital market the most, the UK Banks.

### Assumptions

For all our case studies we have used the same set of assumptions (unless stated otherwise) when deriving the grandfathering schedule for each institution. We list these below:

#### **All Step-up bonds are called at their first call date**

Due to the market expectation and institutional investor base that invest in step-up hybrid instruments, we have assumed that all step up instruments that have not yet reached their first call date will be called and thereby will reduce the amount of Tier I instruments outstanding for the relevant institution leaving the rest of the instruments in the Tier I grandfathering bucket.

#### **Non step instruments (unless high coupon) remain outstanding past first call**

In order to work out the efficiency of the grandfathering buckets, we have assumed that non-step, like for many issuers, remain outstanding post first call date. The few places where we have strayed from this assumption is for Tier I non steps which carry an excessively high coupon, under these circumstances we have assumed a call at first call date and have highlighted where we have made this assumption.

#### **Grandfathering based on notional amounts rather than regulatory amounts**

This point is yet to be defined and we understand discussion are still on going with regulators, as such we have had to make the assumption that it refers to either the notional amounts of capital or the regulator amounts. In our analysis, we have used the notional amounts given that the regulatory amount changes through time depending on hedge instrument valuations and amortization and therefore we believe this would over complicate the grandfathering schedules. We note that for Tier I instruments without an associated hedging instruments would have similar regulatory values as notional values.

#### **For optimization banks will seek to first take out most expensive non steps or bonds with gains to be made via LME for steps and non steps.**

When configuring a possible option for a bank to optimise its Tier I capital structure, we have assumed that banks would look at taking out high coupon instruments where the opportunity cost of leaving these instruments outstanding is the largest. We notice that high coupon non steps such as the ACAFP 9.75% \$14P already trade to first call even though the instruments are non steps (which have previously been left outstanding). We also look at those instruments that issuers could conduct LME on to recognise upfront gains especially in institutional deals where the uptake expectations are highest.

In the table below, we remind investors of previous language that has been used with various European Issuers when they have carried out Liability Management Exercises in the past.

**Table 13: Historical: Summary of issuer language used during LMEs**

Issuer	Subordination included in LME	Language used with LME	
BAWAG	Tier I	Future Calls based on Economic Rationale	
BBVA	Tier I	Future Calls based on Economic Rationale	
BFASM	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale	
BPIM	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale	
CXGD	Upper Tier II, Tier I	Future Calls based on Economic Rationale	
DEXGRP	Tier I	Future Calls based on Economic Rationale	
ERSTBK	Lower Tier II, Tier I	Future Calls based on Economic Rationale	
HSHN	Lower Tier II	Future Calls based on Economic Rationale	
INTNED	Lower Tier II, Tier I	Future Calls based on Economic Rationale	
JYBC	Tier I	Future Calls based on Economic Rationale	
LLOYDS	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale	
RBS	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale	
RZB	Tier I	Future Calls based on Economic Rationale	
SANTAN	Lower Tier II	Future Calls based on Economic Rationale	We note even a small €4.8m UT2 issue was not called
UBIIM	Tier I	Future Calls based on Economic Rationale	
NWIDE	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale	
BESPL	Upper Tier II, Tier I	Other (options to meet minimum CT1)	
UCGIM	Upper Tier II, Tier I	Other (Best interests of the Group)	
ABN	Lower Tier II	No Economic Based language used	
ACAFP	Upper Tier II, Tier I	No Economic Based language used	
BACR	Tier I	No Economic Based language used	
BCPPL	Lower Tier II, Tier I	No Economic Based language used	Issuer unlikely to have the financial flexibility to call
BFCM	Tier I	No Economic Based language used	
BNP	Lower Tier II, Tier I	No Economic Based language used	
BPCEGP	Tier I	No Economic Based language used	
CMZB*	Tier I	No Economic Based language used	
ISPIIM	Tier I	No Economic Based language used	
SOCGEN	Tier I	No Economic Based language used	

Source: J.P. Morgan. NB. Language is only applicable to those bonds where LME was targeted and successfully reduced.



## BARCLAYS

Barclays currently has 15 Tier I instruments comprised of 4 retail non steps all of which have been extended, 4 institutional non steps that have yet to reach their first call date and 7 step up (innovative) Tier I instruments which have yet to reach their first call date. The Tier I instruments for Barclays are summarised in Table 14. We highlight that Barclays has called all of its innovative capital instruments to date and we continue to expect this to be the case. Out of more **liquid innovative instruments** we prefer the **BACR 6.86% \$32P** which, although trading at par, we believe could still be subject to early LME as a method of unlocking the swap gains whilst managing its grandfathered Tier I stack. Amongst the more **liquid non innovative instruments**, we prefer the lower cash priced **BACR 4.75% €20P** and also the **BACR 6% £17P** which we believe offer a lower cost optional on a potential capital markets transaction to bridge the gap to new AT1 instruments in comparison to other non innovative Barclays' instruments.

Table 14: Barclays: Tier I capital instruments

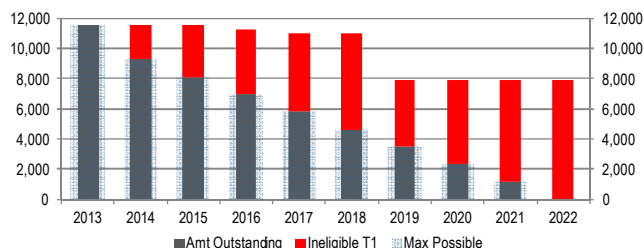
ISIN	Issue Date	Coupon	First Call	Innovative	Ccy	Amt	£ Equiv	Back End	RPC	Price	YTD	Year
Call date Pre Dec 2011												
US06739F3901	25/04/2006	6.625	15/09/2011	No	USD	750	488	Fixed		97.5	7.0	2022
							<b>488</b>					
Call Date 31st Dec 2011 - 31st Dec 2013												
US06739H7769	13/09/2007	7.1	15/12/2012	No	USD	1,375	895	Fixed		99.7	7.1	2022
US06739H5110	07/12/2007	7.75	15/03/2013	No	USD	1,150	749	Fixed		100.0	7.7	2022
US06739H3628	11/04/2008	8.125	15/06/2013	No	USD	2,650	1,725	Fixed		101.1	8.0	2022
							<b>3,369</b>					
Call Date Post 31st Dec 2013												
XS0205937336	08/12/2004	4.875	15/12/2014	No	EUR	1,000	859	3m+105		81.3	24.2	2014
XS0269453139*	28/09/2006	5.926	15/12/2016	Yes	USD	533	347	3m+175		102.3	5.2	2016
<b>XS022208539</b>	<b>22/06/2005</b>	<b>6</b>	<b>15/12/2017</b>	<b>No</b>	<b>GBP</b>	<b>750</b>	<b>750</b>	<b>3m+142</b>		<b>89.5</b>	<b>5.6</b>	<b>2022</b>
XS0322792010*	25/09/2007	7.434	15/12/2017	Yes	USD	347	226	3m+317		108.5	5.2	2017
XS0397801357*	27/11/2008	14	15/06/2019	Yes	GBP	3,000	3,000	3m+1340	Yes	133.5	6.8	2019
XS0305103482*	12/06/2007	6.3688	15/12/2019	Yes	GBP	95	95	3m+170		91.0	8.5	2019
<b>XS0214398199</b>	<b>15/03/2005</b>	<b>4.75</b>	<b>15/03/2020</b>	<b>No</b>	<b>EUR</b>	<b>1,400</b>	<b>1,203</b>	<b>3m+71</b>		<b>77.5</b>	<b>9.7</b>	<b>2020</b>
<b>XS0155141830*</b>	<b>25/09/2002</b>	<b>6.86</b>	<b>15/06/2032</b>	<b>Yes</b>	<b>USD</b>	<b>681</b>	<b>443</b>	<b>6m+173</b>		<b>99.0</b>	<b>7.0</b>	<b>2032</b>
XS0150052388*	04/07/2002	6	15/06/2032	Yes	GBP	91	91	6m+89		91.0	7.4	2032
US06738C8284	08/06/2005	6.278	15/12/2034	No	USD	1,000	651	3m+155		92.1	7.1	2034
XS0248675364*	31/03/2006	5.3304	15/12/2036	Yes	GBP	81	81	3m+198.5		83.0	7.3	2036
							<b>7,746</b>					
<b>Total</b>							<b>11,603</b>					

Source: Company reports. Bloomberg, Excluded ABSA pref shares c£338m assumed non compliant with CRD IV for Tier II, \*assumed hedged instrument.

### A Brief note on hedged instruments

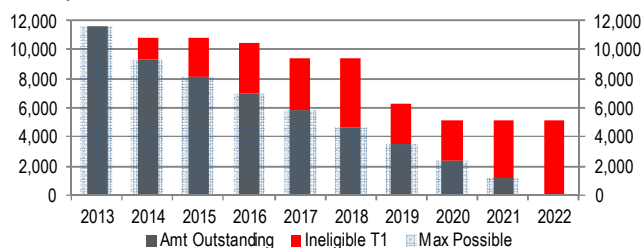
We highlight that many of Barclay's instruments have been hedged and as such will offer a different regulatory capital value when compared to its notional amount outstanding. This is because the regulator requests that Barclay's deducts the mark to market of the hedging instrument from the regulatory value because the payments on the interest rate swaps are not subordinated. Therefore the balance is deducted regardless of the value of whether the FV hedge is positive or negative. The unwind of these hedging instruments would have to be taken accounting when considering any early optimisation of the Tier I stack (this instrument have been highlighted with an "\*" in Table 14.

Figure 14: Barclays: Tier I capital recognition assuming only call of innovative instruments



Source: Company reports and J.P. Morgan estimates.

Figure 15: Barclays: Assuming capital management with the call of non-steps at first call date



Source: Company reports and J.P. Morgan estimates.

## Trades Ideas for Barclay's capital structure

### Innovative (step) instruments - BACR 6.86% \$32P

In our opinion, the Barclay's innovative instruments are largely fairly priced given the strong performance of the USD preferred market. However, within the liquid spectrum of innovative category, we would prefer the **BACR 6.86% \$32P**. This is due to the fact we believe it could be subject to further LME if Barclays were to further optimise its capital structure during the grandfathering period. We highlight in Figure 14 & Figure 15 that even if Barclays were to call all of its step-up instruments and institutional non steps, it would still have excess capital that would not be considered Tier I, as such an LME on some of these instruments could benefit the institution. We highlight the **BACR 6.86% \$32P** because, even though it is trading at par, we note the hedging instrument is currently in the money for Barclays as such an LME could still be capital accretive whilst successfully managing its Tier I capital stack. We highlight in Table 15 that institution have continued to carry out LMEs on capital instruments that have traded above par. There are other instruments that could be subject to LME which look more attractive but these have lower outstanding notional amounts and therefore the incremental value achieved by conducting an LME is reduced.

The approx mtm gain on the IR swap for this instrument is c10pts.

Table 15: Examples of above par LMEs on subordinated debt

Date	ISIN	Ticker	LME Price	Sub
05/03/2012	XS0361244311	ABBEY	104.5	LT2
05/03/2012	XS0041864512	ABBEY	107.5	LT2
05/03/2012	XS0034981661	ABBEY	117.5	LT2
05/03/2012	002927AA9	ABBEY	103	T1
05/03/2012	002920AC0	ABBEY	106	T1
11/06/2012	FR0000487886	SOCGEN	104.5	LT2
11/06/2012	XS0110673950	SOCGEN	106.5	LT2
03/07/2012	XS0148995888	CS	97	LT2
03/07/2012	US22546QAD97	CS	98.578	LT2
03/07/2012	US22541HCC43	CS	103.787	LT2
03/07/2012	XS0336248082	CS	104.25	LT2
03/07/2012	XS0118514446	CS	105.25	LT2
03/07/2012	XS0112553291	CS	105	T1
18/07/2012	XS0148995888	CS	101.25	LT2
18/07/2012	US22546QAD97	CS	109.628	LT2
18/07/2012	XS0336248082	CS	109.75	LT2
18/07/2012	US22541HCC43	CS	111.203	LT2
18/07/2012	XS0118514446	CS	112.25	LT2
18/07/2012	XS0112553291	CS	108.25	T1
10/10/2012	XS0060505228	BBVASM	100	LT2
10/10/2012	XS0137037361	BBVASM	100	LT2

Source: J.P. Morgan.

**Non Step institutional Tier I instruments can provide a good bridge to the new style AT1 instruments that Barclays plans to issue by Jun 2014**

**Given the requirement for a fully loaded 7% trigger for UK AT1, we expect Barclays AT1 issues will wait until 2014 when FY profits can help boost their fully loaded CET1 ratio.**

### Institutional (non-step) - BACR 4.75% €20P

For the institutional non step instruments which represent a similar proportion of Barclay's balance sheet we believe a call would be extremely generous of Barclay's given some of the back end spreads which are as low as £3m libor + 71bps. We note that this is still relatively cheap bail-in (PLAC) debt and arguable cheap long dated funding therefore its future will have to be carefully weighed up. In our opinion, the issuance requirement of c£2bn AT1 instruments prior to June 2014 could help play an important role in the decision making process for the institutional non-steps given the benefits of a captive investor base when pricing a new instrument. We note the new AT1 instruments in the UK are expected to have a trigger of 7% fully loaded CET1. We highlight in Figure 15 that taking out the non step instruments would also aid the efficiency of Barclay's Tier I grandfathering bucket.

We expect there to be a lot of investor pressure on Barclays to do the right thing with regards to its institutional non steps, however, we cannot ignore the economics of the decision. As such our base case scenario would be some form of liability management which would likely be investor friendly and offer investors a chance to exit their current investment in exchange of either cash or more likely a new AT1 instrument with a 7% Fully loaded Basel 3 trigger (as per the PRAs recommended structure). **We expect that any LME transaction would likely target more than one non innovative institutional deal and therefore we would prefer the BACR 4.75% €20P and also the BACR 6% £17P which offer better risk reward profiles in the downside scenarios but are also likely to appreciate upon any announcement concerning the shorter dated non innovative instruments. We note that below par transactions would be capital accretive for Barclays.**

### Optimisation

We highlight in Figure 14 the level of Tier I that becomes ineligible if Barclays maintains its track record of calling innovative instruments however fails to call the non innovative instruments. Whilst we note that we expect innovative instruments to be called given Barclays statement:

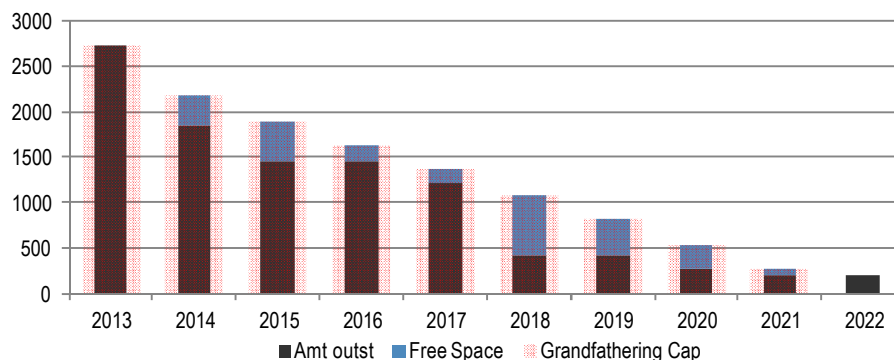
*“Our expectation is that ineligible Additional Tier 1 capital, which qualifies for grandfathering under the transitional relief, **will be replaced with eligible capital over time**”*

We highlight that the longer dated “step” instruments could potentially face early LME in order to improve the efficiency of the Tier I capital stack especially given the relatively high back end spreads in comparison to some of the other instruments and sub par cash prices. We note that Barclays currently believes that its AT1 instruments would be eligible in their own right as Tier II instruments as highlighted in their Pillar III report (and updated in 1H 2013). In our opinion this point is yet to be clarified by the EBA following its statement:

*“In addition, **because in particular of the quarterly call**, the instrument would not meet the eligibility criteria for inclusion in fully eligible Tier 2 capital.”*

When responding to a question regarding an innovative instrument which was not called after its first call date (concurrent with the step). As we highlight above, if the existence of quarterly calls is the reason for an instrument not being eligible as Tier II capital in CRD IV then by the same reasoning the non innovative instruments that fall out of grandfathering should also not meet the criteria to be eligible Tier II capital. Furthermore, we highlight there is little room in their Tier II grandfathering (Figure 16) bucket to excess Tier I instruments to roll down into. This would mean, in our opinion, that their excess Tier I instruments would be considered bail-in debt (PLAC)/funding at best.

Figure 16: Barclays: Tier II grandfathering amortisation schedule



Source: J.P. Morgan estimates, Company data.

Table 16: Barclays: Tier II instruments eligible for grandfathering

ISIN	Issue Date	Coupon	Call Date	Innovative	Ccy	Amt	£ Equiv
XS0187033864	04/03/2004	4.5	04/03/2014	Y	EUR	1,000	863
XS0223265462	29/06/2005	6.14	29/06/2015	Y	GBP	265	265
XS0120327571	27/11/2000	6.875	27/11/2015	Y	GBP	135	135
XS0145875190	19/04/2002	6.375	19/04/2017	Y	GBP	133	133
ZAG000101221	21/11/2012	7.075	21/11/2017	?	ZAR	1,805	119
XS0334370565	07/12/2007	6.75	16/01/2018	Y	GBP	500	500
US06739HAA59	25/04/2008	7.7	25/04/2018	Y	USD	99	64
ZAG000101239	21/11/2012	7.175	21/11/2018	?	ZAR	2,007	133
ZAG000101254	21/11/2012	8.295	21/11/2018	?	ZAR	1,188	79
XS0350187430	29/02/2008	8.25	15/12/2018	N	GBP	140	140
XS0118932366	24/10/2000	7.125	24/10/2020	Y	GBP	158	158
XS0071252919	27/11/1996	9.25	27/11/2021	Y	GBP	75	75
XS0145875513	19/04/2002	6.125	19/04/2027	Y	GBP	196	196
							<b>2861</b>

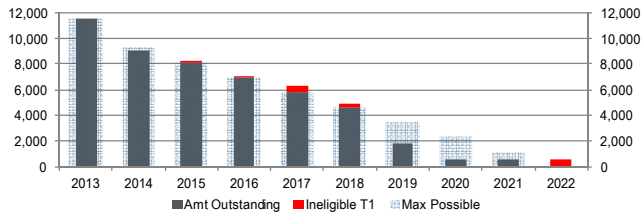
Source: J.P. Morgan estimates, Company data. \* Excludes reg callables, and extendibles

## Blue sky thinking

For illustration purposes we show how Barclays can manage its Tier I grandfathering stack

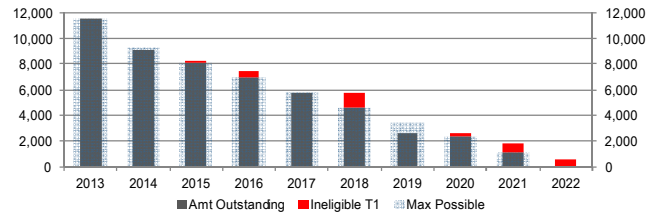
We highlight there are many different aspects with regards to the decision making process that determines the future for bank capital instruments. Given that Barclays is our first case study, we highlight in Figure 17, Figure 18, Table 17 & Table 18 some potential blue sky outcomes for some of the non-step instruments if the bank had a sole motivating factor to maximize the efficiency of its Tier I grandfathering stock. We note that this is more for illustrational purposes only given that the utility of retail prefs that the company has previously alluded to. We note however, this was before the recent updates from the EBA. We would highlight that the retail prefs have a relatively high coupon and as such the market currently trades them around par given the ability for these instruments to be called every 3 months. As such, it seems unlikely there is any significant capital appreciation to be gained from holding the retail prefs of Barclays.

Figure 17: Barclays: Assuming capital management based upon the economics of the interest expense



Source: Company reports and J.P. Morgan estimates.

Figure 18: Barclays: Assuming capital management based upon kind treatment of institutional investors then by interest expense



Source: Company reports and J.P. Morgan estimates.

Table 17: Barclays: Assuming capital management based upon the economics of the interest expense

Grand-fathering Cap %	Year	Grand-fathering Cap Amt	Coupon of Called Bond	Coupon of Called Bond	Amt Outstanding post calls	Eligible T1	Ineligible T1 Post Calls
			Called Amt	Called Amt			
100%	2013	11,603	0	0	11,603	11,603	0
80%	2014	9,282	0	2,474	9,129	9,129	-153
70%	2015	8,122	0	895	8,234	8,122	112
60%	2016	6,962	347	488	7,399	6,962	437
50%	2017	5,801	226	1,401	5,772	5,772	-29
40%	2018	4,641	0		5,772	4,641	1,131
30%	2019	3,481	3095		2,677	2,677	-804
20%	2020	2,321	0		2,677	2,321	357
10%	2021	1,160	0	859	1,818	1,160	658
0%	2022	0	0	1,203	615	0	615

Source: J.P. Morgan estimates. €m

Table 18: Barclays: Assuming capital management based upon kind treatment of institutional investors then by interest expense

Grand-fathering Cap %	Year	Grand-fathering Cap Amt	Coupon of Called Bond	Coupon of Called Bond	Amt Outstanding post calls	Eligible T1	Ineligible T1 Post Calls
			Called Amt	Called Amt			
100%	2013	11,603	0	0	11,603	11,603	0
80%	2014	9,282	0	2,584	9,019	9,019	-264
70%	2015	8,122	0	749	8,270	8,122	148
60%	2016	6,962	347	895	7,028	6,962	66
50%	2017	5,801	226	488	6,314	5,801	512
40%	2018	4,641	0	1,401	4,913	4,641	272
30%	2019	3,481	3095		1,818	1,818	-1,663
20%	2020	2,321	0	1,203	615	615	-1,705
10%	2021	1,160	0		615	615	-545
0%	2022	0	0		615	0	615

Source: J.P. Morgan estimates. €m

## LLOYDS

### Lloyds is currently our top pick UK bank

Lloyds currently has 30 Tier I instruments outstanding comprised of 9 non steps the majority of which are yet to reach their first call date. The Tier I instruments for Lloyds are summarised in Table 19. We highlight that Lloyds was prevented from calling many of its Tier I instruments by the European Commission for a period of 2yrs in 2009. Since then the UK regulator has taken a strict stance with regards to capital conservation and as such some instruments have faced an exchange into a LT2 instrument instead of a call. We highlight many of the Tier I instruments were targeted in the 2009 exchange into ECNs and Lloyds used economic call based language with regards to the future decisions on its subordinated capital instruments. **We highlight that we expect Lloyds to act more favourably to those issues that, whilst included in the LME in 2009 did not get a chance to take part because they were too far down the waterfall.**

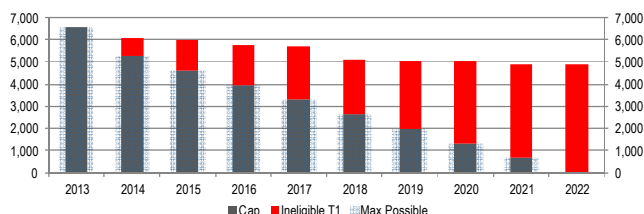
Table 19: Lloyds: Tier I capital instruments

ISIN	Issue Date	Coupon	First Call	Step?	Ccy	Amt	£ Equiv	Back End	RPC	Price	YTD	Year	Type^
Call date Pre Dec 2011													
XS0156372343*	22/10/2002	6.9	22/11/2007	No	USD	343	224	FIXED	Yes	99.2	7.1	2022	Must
XS0165483164	21/03/2003	6.85	23/03/2009	No	USD	1,000	653	FIXED	Yes	95.8	7.6	2022	Must
<b>XS0109138536</b>	<b>14/03/2000</b>	<b>6.059</b>	<b>31/05/2010</b>	<b>Yes</b>	<b>GBP</b>	<b>250</b>	<b>250</b>	<b>5y+385bp</b>		<b>96.5</b>	<b>8.9</b>	<b>2015</b>	<b>Must</b>
GB0058322420	09/12/1999	3.075	09/12/2011	Yes	EUR	183	159	3m+287bp		80.5			Must
							1,286						
Call Date 31st Dec 2011 - 31st Dec 2013													
<b>XS0156923913*</b>	<b>25/10/2002</b>	<b>2.7</b>	<b>25/02/2013</b>	<b>Yes</b>	<b>EUR</b>	<b>261</b>	Excluded	<b>3m+250bp</b>		<b>90.0</b>	<b>26.1</b>	2014	<b>Must</b>
XS0406095637	19/01/2009	7.875	29/11/2013	No	EUR	173	150	FIXED		99.8	8.0	2022	May
XS0406095041	19/01/2009	7.875	29/11/2013	No	USD	424	277	FIXED		100.0	7.9	2022	May
							423						
Call Date Post 31st Dec 2013													
<b>USG43648AA57</b>	<b>24/06/2004</b>	<b>6.071</b>	<b>30/06/2014</b>	<b>Yes</b>	<b>USD</b>	<b>750</b>	<b>489</b>	<b>3m+190bp</b>		<b>96.8</b>	<b>10.3</b>	<b>2014</b>	<b>Must</b>
XS0107228024	07/02/2000	7.834	07/02/2015	Yes	GBP	5	5	5y+350bp					May
XS0408828803	19/01/2009	6.0884	12/05/2015	No	GBP	11	11	3m+131bp		69.7	7.8	2022	May
USG5533WAB30*	19/01/2009	5.92	01/10/2015	Yes	USD	213	139	3m+129.5bp		86.7	14.2	2015	May
XS0255242769	23/05/2006	4.939	23/05/2016	Yes	EUR	39	34	3m+173bp		80.4	15.0	2016	May
XS0125681345*	28/02/2001	7.286	31/05/2016	Yes	GBP	150	150	5y+364bp		99.4	7.9	2016	Must
US539439AA71*	13/11/2006	6.267	14/11/2016	No	USD	398	260	3m+103.5bp					May
XS0218638236*	12/05/2005	4.385	12/05/2017	Yes	EUR	88	76	3m+168bp		70.0	15.7	2017	May
XS0353590366	19/03/2008	9.54	19/03/2018	Yes	GBP	14	14	3m+675bp		105.0	12.5	2018	May
XS0139175821	28/11/2001	6.461	30/11/2018	Yes	GBP	600	600	5y+285bp		94.9	7.7	2018	Must
XS0408620135*	21/01/2009	13	22/01/2019	Yes	GBP	9	9	5y+140bp					May
XS0408623311*	21/01/2009	13	22/01/2019	Yes	EUR	46	40	FIXED		142.2	4.4	2019	May
XS0408826427	19/01/2009	6.3673	17/06/2019	No	GBP	3	3	3m+136bp					May
XS0109139344	14/03/2000	7.754	31/05/2021	Yes	GBP	150	150	5y+420bp		101.0	7.7	2021	Must
GB00B3KSB568	19/01/2009	6.475	15/09/2024	No	GBP	56	56	FIXED					May
US539473AE82*	16/12/2009	12	16/12/2024	Yes	USD	2,000	1,305	3m+1175.6bp	Yes	133.7	7.6	2024	May
XS0125686229*	28/02/2001	7.281	31/05/2026	Yes	GBP	150	150	5y+409.5		99.0	7.6	2026	Must
XS0408620721*	21/01/2009	13	21/01/2029	Yes	GBP	591	591	5y+1340bp		150.5	7.5	2029	May
GB0058327924	09/12/1999	7.881	09/12/2031	Yes	GBP	245	245	5y+440bp		100.0	8.0	2031	Must
GB00B3KSB238	19/01/2009	9.75	n/a	No	GBP	56	56	FIXED					May
GB00B3KS9W93	15/04/2009	9.25	n/a	No	GBP	300	300	FIXED					May
GB00B3KSBH82*	19/01/2009	6.413	19/01/2035	n/a	USD	375	245	3m+149.5bp					May
GB00B3KSBK12*	21/11/2008	6.657	21/11/2037	n/a	USD	4.5	3.0	3m+127bp					May
							4,930						
<b>Total</b>							<b>6,599</b>						

Source: Company reports. Bloomberg, \* ACSM, ^May pays—payable at managements discretion, Must pay - do not offer management discretion to not pay coupon. Excluded means notional not included in the grandfathering reference.

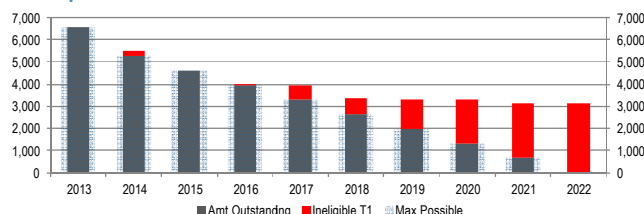


Figure 19: Lloyds: Tier I capital recognition assuming only call of innovative instruments



Source: Company reports and J.P. Morgan estimates.

Figure 20: Lloyds: Assuming capital management with the call of non-steps at first call date



Source: Company reports and J.P. Morgan estimates.

## Trades Ideas for Lloyds' capital structure

### LLOYDS 6.059% £P

We find the LLOYDS 6.059% £P attractive with next call date on the 5th March 2015. The high back end spread of 5yr + 385bp is likely to incentivize a call at its next call date. In our opinion, as we mention above, we believe instruments will not be able to reclassified from being an instrument with an incentive to redeem to an instrument without an incentive to redeem and therefore even though this instrument has 5 yearly calls, we believe the instrument would not get Tier II treatment from regulators. Nevertheless, we highlight the back end is greater than Lloyds 5yr sub CDS (225bp) and also greater than their longest LT2 bond at Z+325bp for a callable instrument to 2025-2030. As such given the must pay nature and the fact this instrument has not been given an opportunity to be LME'd (as it was too low down on the waterfall), we believe this instrument will likely be called (or even in worse case LME'd like the GB0058322420 which was exchanged in Feb 2012).

### LLOYDS FRN €FEBP - XS0156923913

We like the LLOYDS FRN €FEBP with back end of €3m Euribor + 250bp. These are "must pay" instruments that we expect to lose Tier I capital treatment as of the 1st Jan 2014 as per *article 486* of the CRR. Furthermore, we believe according to the EBAs Q&A, that due to the existence of the quarterly calls we believe that it cannot count as Tier II capital in CRR either. We also believe that the EBA might not allow instruments that were issued with an incentive to redeem to be reclassified as an instrument without an incentive to redeem. **We recommend investors buy LLOYDS FRN €FEBP (XS0156923913) at the current cash price of 93 mid, YT2014 at 13.7% and YTP at 6.1%. We believe this represents a low cost option on earlier and expected call.**

We note the illiquidity of the Tier I instruments

Table 20: Lloyds: Preferred Tier I capital instruments

												Type <sup>A</sup>
ISIN	Issue Date	Coupon	First Call	Next Call	Step?	Ccy	Amt	Back End	Price	YTD	Year	
<b>Call date Pre Dec 2011</b>												
XS0109138536	14/03/2000	6.059	31/05/2010	31/05/2015	Yes	GBP	250	5y+385bp	96.5	8.3	2015	Must
<b>Call Date 31st Dec 2011 - 31st Dec 2013</b>												
XS0156923913*	25/10/2002	2.7	25/02/2013	25/11/2013	Yes	EUR	261	3m+250bp	93.0	13.7	2014	Must

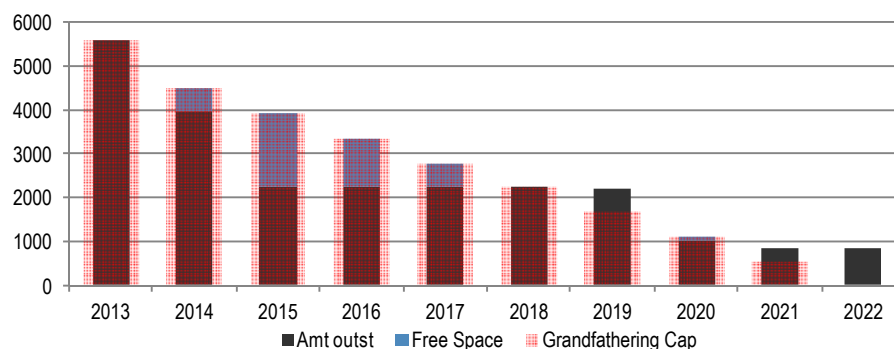
Source: Company reports. Bloomberg, Must pay - do not offer management discretion to not pay coupon

## Optimisation

The inefficiency in Lloyds' Tier I grandfathering buckets is caused by the presence of many long dated callable instruments. The means even if we were to assume an opportunistic call of all of the non steps that allow for a call, the grandfathering buckets would still remain in-efficient.

In Figure 20 we highlight that calling non-step instruments could improve the efficiency of the grandfathering however, we note as per Figure 21 that Lloyds would have about £1bn of space in their Tier II grandfathering bucket in 2015. As such, Lloyds should benefit from around £1bn of Tier I instruments being grandfathered as Tier II instruments. This would mitigate any incentives for Lloyds to retire some Tier I instruments earlier than expected. However, by 2018 this "free space" will have decreased thus suggesting some of the higher coupon Tier Is would have the incentive to be extinguished by 2018 e.g. the 7.875% 13P.

Figure 21: Lloyds: Tier II best case grandfathering amortisation schedule



Source: J.P. Morgan estimates, Company data. \* assuming instruments called at first call date and instruments past first call called in 2014.



## RBS

**RBS is currently waiting the outcome of a review by Rothchilds on whether the privatization can be accelerated. This is expected by the end of September with the government to take its decision in October**

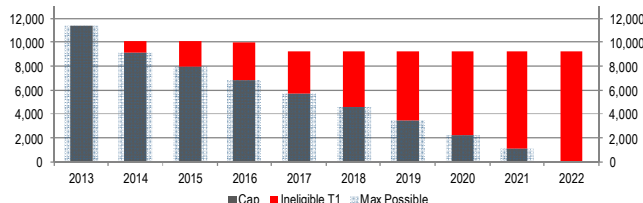
RBS has 33 Tier I capital instruments which are predominantly made up of non steps issued as fixed USD retail prefs. RBS, like Lloyds, faced an EC enforced ban on paying coupons and calling subordinated instruments for a period of 2yrs from April 2010. Due to the high number of non steps, the call of step instruments does not aid the efficiency of the Tier I grandfathering as highlighted in Figure 22. However, we note that the non steps that fall out of the Tier I grandfathering bucket will be eligible as Tier II capital as long as there is space in the Tier II grandfathering bucket. Unfortunately upon closer inspection RBS has no room in its Tier II grandfathering bucket for the over flow of legacy Tier I instruments, as such there could be incentives for early redemption some of the Tier I instruments.

Table 21: RBS: Tier I capital instruments

ISIN	Issue Date	Coupon	First Call	Innovative	Ccy	Amt Out	£ Equiv	Back End	RPC	Type^A	
Call date Pre Dec 2011											
US6385398820	08/04/1997	7.76304	09/04/2002	No	USD	246	160	FIXED	Yes	Must Pay	
US7800978790	08/02/1999	7.25	31/03/2004	No	USD	242	158	FIXED		Must Pay	
US7800978048	26/03/1997	7.65	31/03/2007	No	USD	156	102	FIXED		Must Pay	
XS0159056208	05/12/2002	6.8	31/03/2008	No	USD	486	317	FIXED		May Pay	
74928K208	03/07/2003	5.9	03/07/2008	No	USD	1,285	838	FIXED		May Pay	
74928M204	30/09/2003	6.25	30/09/2008	No	USD	200	131	FIXED		May Pay	
74928P207	18/02/2004	6.08	18/02/2009	No	USD	1,800	1,175	FIXED		May Pay	
US7800977883	23/06/2003	5.75	30/09/2009	No	USD	751	490	FIXED		Must Pay	
US7800977966	26/08/2004	6.4	30/09/2009	No	USD	578	377	FIXED		May Pay	
XS0205935470	29/11/2004	5.5	31/12/2009	No	EUR	1,250	1,084	FIXED		May Pay	
US780097AE13	06/03/2000	9.118	31/03/2010	No	USD	65	42	FIXED		Must Pay	
DE000A0E6C37	28/06/2005	5.25	30/06/2010	No	EUR	785	681	FIXED		May Pay	
US7800977701	19/05/2005	6.35	30/06/2010	No	USD	553	361	FIXED		May Pay	
US7800977628	09/11/2005	6.25	31/12/2010	No	USD	247	161	FIXED		May Pay	
XS0121856859	14/12/2000	7.387	31/12/2010	No	GBP	15	15	FIXED	Must Pay		
US7800977545	25/05/2006	6.75	30/06/2011	No	USD	516	337	FIXED	May Pay		
US7800977479	27/12/2006	6.125	30/12/2011	No	USD	254	166	FIXED	May Pay		
							6,595				
Call Date 31st Dec 2011 - 31st Dec 2013											
US7800977396	28/06/2007	6.6	30/06/2012	No	USD	661	427	FIXED	3m+210bp	May Pay	
XS0149161217	10/06/2002	2.319	30/06/2012	Yes	EUR	227	Excluded	3m+210bp		May Pay	
XS0323839042	04/10/2007	2.84038	05/10/2012	No	GBP	54	54	3m+233bp		May Pay	
US7800977131	27/09/2007	7.25	31/12/2012	No	USD	1,281	827	FIXED		May Pay	
US749274AA41	21/05/2003	2.139	01/07/2013	Yes	USD	846	546	3m+186.5bp		May Pay	
							1,853				
Call Date Post 31st Dec 2013											
US74927FAA93	24/08/2004	1.0756	30/09/2014	Yes	USD	276	178	3m+ 180bp	Yes	May Pay	
US74927QAA58	24/08/2004	5.512	30/09/2014	Yes	USD	950	613	3m+184bp		May Pay	
XS0237530497	12/12/2005	4.243	12/01/2016	Yes	EUR	166	143	3m+169bp		May Pay	
XS0277453774	08/12/2006	5.6457	08/06/2017	Yes	GBP	93	93	3m+169bp		May Pay	
XS0323734961	04/10/2007	7.0916	29/09/2017	No	EUR	471	405	3m+233bp		May Pay	
US780097AU54	04/10/2007	7.64	29/09/2017	No	USD	1,013	654	3m+232bp		May Pay	
CA780097AT83*	04/10/2007	6.666	05/10/2017	Yes	CAD	321	201	3m+276bp		May Pay	
US780097AS09*	04/10/2007	6.99	05/10/2017	Yes	USD	564	364	3m+267bp		May Pay	
US780097AH44	20/08/2001	7.648	30/09/2031	No	USD	762	491	3m+250bp		Must Pay	
US74927PAA75	10/12/2003	6.425	03/01/2034	Yes	USD	394	254	3m+194.2bp		May Pay	
GB0006227051	16/09/1991	9	n/a	No	GBP	140	140	FIXED		Must Pay	
							3,536				
Total							11,915				

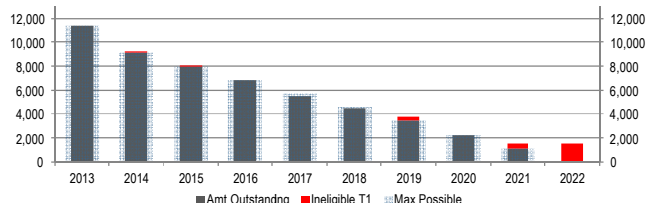
Source: Company reports. Bloomberg, \* ACSM ^May pays—payable at managements discretion, Must pay - do not offer management discretion to not pay coupon. Excluded means notional not included in the grandfathering reference.

Figure 22: RBS: Tier I capital recognition assuming only call of innovative instruments



Source: Company reports and J.P. Morgan estimates. adj for RBS NV limits 80% of T1

Figure 23: RBS: Assuming capital management with the call of non-steps at first call date (highest coupon first)



Source: Company reports and J.P. Morgan estimates. adj for RBS NV limits 80% of T1

Table 22: RBS: Assuming capital management with the call of non-steps at first call date (highest coupon first)

Grand-fathering Cap %	Year	Grand-fathering Cap Amt	Coupon of Called Bond	Called Amt	Coupon of Called Bond	Amt Outstanding post calls	Eligible T1	Ineligible T1 Post Calls
			Steps	Steps	Non Step			
100%	2013	11,421	0			11,421	11,421	0
80%	2014	9,137	1331	871	9.118/7.76304/7.65/7.25/7.0916	9,219	9,137	82
70%	2015	7,994	0.0	1,135	7.25/6.8	8,083	7,994	89
60%	2016	6,852	141	1,128	6.75/6.6/6.4	6,814	6,814	-38
50%	2017	5,710	651	617	6.35/6.25/6.25	5,547	5,547	-163
40%	2018	4,568	0	1,088	6.125/6.08	4,458	4,458	-110
30%	2019	3,426	0	660	5.9	3,798	3,426	372
20%	2020	2,284	0	1,544	5.75/5.5	2,254	2,254	-30
10%	2021	1,142	0	667	5.25	1,588	1,142	446
0%	2022	0	0	54	FRN	1,533	0	1,533

Source: J.P. Morgan estimates. €m

## Trades Ideas for RBS' capital structure

We note that RBS spreads have recently been volatile and whilst our base case is that no split is to occur, we would caution that current pricing does not offer good risk reward opportunities for investors. However, for those investors looking for RBS risk, we highlight some of the opportunities we would prefer.

### The RBS 7.64% \$17P versus RBS 7.0916% €17P

We highlight that there are two non innovative instruments which would appear to be very similar in characteristics, i.e. same issue date, same call date and similar back end spreads. However, we highlight importantly, the call period for these instruments is different. The RBS 7.64% \$17P is only callable every 10yrs from our understanding of the prospectus, quoted below:

*We may redeem the Series U preference shares, at our option, in whole (but not in part) on the first redemption date, or any quarterly dividend payment date falling on or around any tenth anniversary thereafter, upon not less than 30 nor more than 60 days' written notice, at a redemption price of \$100,000 per Series U preference share plus the dividends otherwise payable for the then-current dividend period accrued to but excluding the redemption date*

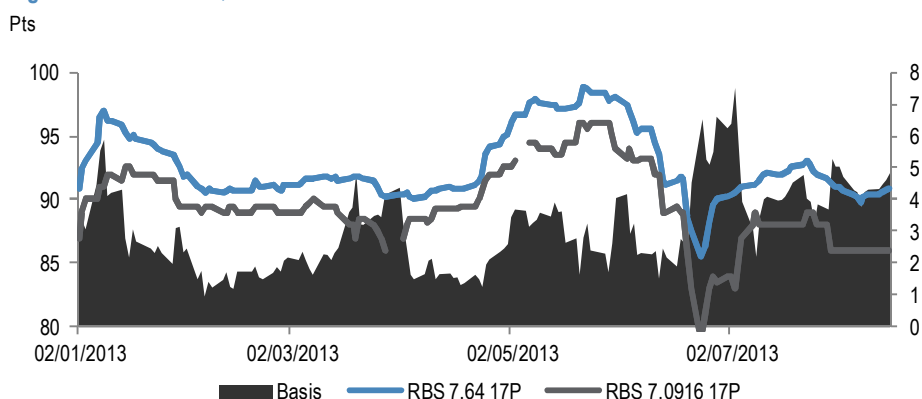
Conversely the RBS 7.0916% €17P is callable every quarter following its first call date and therefore according to the EBA Q&A clarification would not be able to qualify as Tier II capital outside of grandfathering. As such we believe these two instruments are offer differing regulatory benefits to RBS. At best, the RBS 7.0916% €17P will count as bail-in debt where as the RBS 7.64% \$17P will be able to count towards RBS' Tier II capital stack in its own right, in our opinion. We therefore believe that there should be a more material pricing discrepancy between this two instruments and would recommend that investors buy the RBS 7.0916% €17P and Sell the RBS 7.64% \$17P to take advantage of changing investor perceptions around the utility of capital instruments.

Table 23: RBS: Tier I non step instruments

ISIN	Coupon	First Call	Ccy	Amt Out	Back End	RPC	Call Period	Price	YTC	TYP	Post Call
XS0323734961	7.0916	29/09/2017	EUR	471	3m+233bp	Yes	3 months	87.00	11.2%	7.4%	Bail-in
US780097AU54	7.64	29/09/2017	USD	1,013	3m+232bp	Yes	10 years	90.00	10.2%	8.1%	LT2

Source: Company reports, Bloomberg,

Figure 24: RBS 7.64% \$17P versus RBS 7.0916% €17P



Source: J.P. Morgan.

#### RBS FRN €JUNP - XS0149161217 & RBS FRN \$JULP - US749274AA41

We like the RBS FRN €JUNP & RBS FRN \$JULP which we expect to lose all capital recognition as of the 1st Jan 2014 given the incentive to redeem and quarterly call dates. We think these instruments could benefit from a sooner than anticipated redemption given their high back end relative to where we envisage RBS could issue bail-in debt. We highlight that YTP and YT22 are c7% and c7.5% for these instruments respectively; as such with a YT14 of >50% we like the low cost option this offers investors. We note liquidity in these instruments is likely to be difficult.

**We continue to believe that investors should not consider T1 may pays until after the split of the bank is completely ruled out, expected Oct '13. Before the rule out we would prefer to be long must pay instruments versus may pay instruments.**

#### RBS NV trusts

We continue to highlight the increased probability of an LME on the RBS NV trusts. We have written about this before our "Financial Trade Idea Portfolio", [here](#). We note that not only is capital likely to be more efficiently allocated at the group main operating entity, but the Tier I's at RBS currently only contribute about 80% of their notional outstanding to the groups Tier I capital. This is because since 2012 the reduction in core capital as mean the RBS has high the limits from *article 66* in directive 2006/48/EC which states that hybrids cannot contribute more than 50% of reference capital defined in *article 55*. We highlight this in Figure 22.

**RBS NV is breaching the gearing limit for hybrids in their Tier I capital**

Furthermore, an analysis of RBS' grandfathering profile suggests that due to the high number of retail non steps, its T1 capital efficiency gets materially worse through time as the grandfathering cap decreases yet the capital stock falls only slightly. Furthermore, although the non steps would be eligible to flow into the Tier II grandfathering buckets, we highlight in Figure 25 below that RBS' Tier II grandfathering buckets are already full and therefore as these Tier I's overflow, they will receive no regulatory capital benefit. **We remind investors that we are taking the broader interpretation of the EBA's Q&A, indeed a similar approach to that which RBS has taken with regards to quarterly calls (As can be seen from their recent CRD IV forecast) meaning that legacy Tier I's cannot be consider Tier II in their own right.** Under these circumstances it may be more economical for RBS to take out some of its higher coupon non steps via LME. We highlight that some of the RBS NV trusts have the higher coupons where there is a good size outstanding but alternatively we note that RBS could call entire issues of higher coupon bonds where there is a call date every interest payment date. We highlight in Figure 23 above the grandfathering profile if RBS were to do this. Obviously this would remove the flexibility of having perpetual bail-in debt in the capital structure however, for the RBS NV trust it seems a more optimal solution to the capital problem.

Table 24: RBS NV: Calculation of Tier I

	FY 2011	FY 2012	1H 2013
<b>Tier 1</b>			
Ordinary shareholders' equity	2483	1799	2484
Non-controlling interests	1		
Adjustments for:			
- Goodwill and other intangible assets - continuing	-10	-4	-3
- Unrealised losses on available-for-sale (AFS) debt securities	2840	2492	1791
- Unrealised gains on AFS equities	-90	-19	-3
- Other regulatory adjustments	-871	-442	-369
Core Tier 1 capital	<b>4353</b>	<b>3826</b>	<b>3900</b>
50% of T1 limit	2177	1913	1950
Tier I Trust Preferred	2566	2470	2503
Less deductions from Tier 1 capital	-915	-1757	-1535
<i>o.w. Material holdings (JPM Est)</i>	-526	-1200	-982
<i>o.w. Inefficient Tier I securities (JPM Est)</i>	-390	-557	-553
<b>Total Tier 1 capital</b>	<b>6004</b>	<b>4539</b>	<b>4868</b>

Source: J.P. Morgan estimates, Company data.

In summary, RBS is incentivized to take out the RBS NV bonds to:

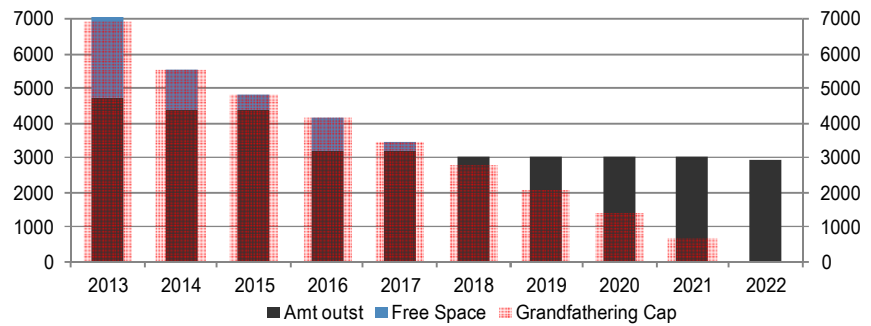
- 1) Repatriate capital back to the RBS plc
- 2) Reduce the level of inefficient Tier I hybrids due to grandfathering , and
- 3) Improve the efficiency of Tier I on a consolidated basis due to the limits on RBS NV Tier I capital on a solo basis (which then impact RBS on a consolidated basis.

Table 25: RBS 6.08% P, RBS 5.9% P and RBS 6.25% P

ISIN	Sub	Issued	Ticker	Coupon	Call date	Maturity	Price*	YT14	Ccy	Amt
US74928K2087	T1	03/07/2003	RBS	5.9	03/07/2008	Perp	19.8	30.9	USD	1285
US74928M2044	T1	30/09/2003	RBS	6.25	30/09/2008	Perp	20.4	28.9	USD	200
US74928P2074	T1	18/02/2004	RBS	6.08	18/02/2009	Perp	20.2	28.9	USD	1800

Source: J.P. Morgan. \*\$25 securities

Figure 25: RBS: Tier II best case grandfathering amortisation schedule



Source: J.P. Morgan estimates, Company data. \* assuming instruments called at first call date, instrument past the first call are assumed to be left outstanding given their low back end. Adjusted for RBS NV LME in 2013

## BNP

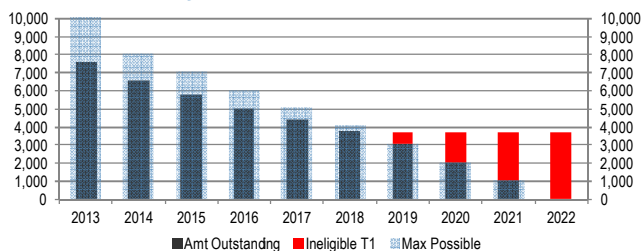
BNP have maintained a relatively simple policy of calling its step instruments and extending its retail prefs. We highlight that BNP also redeemed the Tier I loans that Fortis bank had connected with Ageas as part of the old Fortis entity, these were non steps. As one of the top tier French Banks, BNP Tier I debt trades with relative little discount for the callable feature and as such there is relatively little upside in the shorted dated callable instruments although we view this risk as the cheapest part of the BNP capital structure offering better risk reward than its senior debt for example.

Table 26: BNP: Tier I capital instruments

ISIN	Issue Date	Coupon	First Call	Innovative	Ccy	Amt	€ Equiv	Back End	RPC	Price	YTD	Year
Call date Pre Dec 2011												
FR0010239319	17/10/2005	4.875	17/10/2011	No	EUR	1000	1000	FIXED		90.7	6.3	2022
FR0010239368	17/10/2005	6.25	17/10/2011	No	USD	400	302	FIXED		98.2	6.6	2022
							1,302					
Call Date 31st Dec 2011 - 31st Dec 2013												
FR0010477125	06/06/2007	6.5	06/06/2012	No	USD	600	452	FIXED		98.3	6.8	2022
FR0010661314	11/09/2008	8.667	11/09/2013	Yes	EUR	650	650	3m+405	CALLED			
XS0160850227	16/01/2003	5.868	16/01/2013	Yes	EUR	700	700	3m+248	CALLED			
Fortis Banque	27/08/2008	8.25	27/08/2013	No	USD	750	565	FIXED	CALLED			
Fortis Banque	02/06/2008	8	02/06/2013	No	EUR	625	625	FIXED	CALLED			
							2,993					
Call Date Post 31st Dec 2013												
BE0119806116	27/10/2004	4.625	27/10/2014	Yes	EUR	1000	1000	3m+170		99.5	5.5	2014
US05565AAA16	29/06/2005	5.186	29/06/2015	Yes	USD	1070	807	3m+168	Yes	99.0	6.0	2015
FR0010306738	12/04/2006	4.73	12/04/2016	Yes	EUR	557	557	3m+169	Yes	99.5	5.4	2015
FR0010306787	19/04/2006	5.945	19/04/2016	No	GBP	450	521	3m+113	Yes	97.1	7.5	2016
FR0010348557	13/07/2006	5.954	13/07/2016	Yes	GBP	163	189	3m+181	Yes	100.0	6.5	2016
FR0010456764	13/04/2007	5.019	13/04/2017	Yes	EUR	638	638	3m+172	Yes	99.5	5.3	2017
FR0010533026	23/10/2007	7.436	23/10/2017	No	GBP	200	232	3m+185	Yes	100.5	7.6	2017
FR0010638338	30/06/2008	7.781	02/07/2018	Yes	EUR	500	500	3m+375	Yes	110.0	5.5	2018
FR0010662023	18/09/2008	7.57	18/09/2018	Yes	EUR	100	100	3m+392.5				2018
FR0010821108	29/12/2009	7.028	29/12/2019	Yes	EUR	20	20	3m+475				2019
FR0010821116	29/12/2009	3.968	29/12/2019	Yes	EUR	3	3	3m+475				2019
FR0010821132	30/12/2009	4.024	30/12/2019	Yes	USD	70	53	3m+475				2019
FR0010821124	30/12/2009	7.384	30/12/2019	Yes	USD	1	0	3m+475				2019
FR0010348565	13/07/2006	5.45	13/07/2026	Yes	EUR	150	150	3m+192				2026
US05565AAB98	25/06/2007	7.195	25/06/2037	No	USD	1100	829	3m+129	Yes	99.0	7.3	2037
							5,599					
Other												
RPN							241					
							241					
Total							10,134					

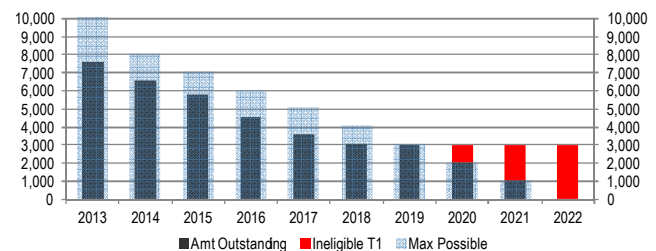
Source: Company reports. Bloomberg

Figure 26: BNP: Tier I amortisation profile assuming first calls on step instruments only



Source: Company reports and J.P. Morgan estimates.

Figure 27: BNP: Tier I amortisation profile assuming first calls of both step and non-step (institutional) .



Source: Company reports and J.P. Morgan estimates.

We highlight that BNP's grandfathering schedule for Tier I instruments is actually relatively efficient (Table 28 & Figure 26) given the spaced out intervals of good size step up instruments. We believe the reputation of the French banks will remain intact with BNP continuing to call its step instruments. We also believe that due to the institutional nature of some of its non steps (such as the BNP 5.945% £16P and BNP 7.436% £17P) that BNP is also likely to call these instruments regardless of the economics of the decision. We highlight in Figure 27 (Table 27) that this would indeed make BNPs Tier I grandfathering stack more efficient than merely calling the step instruments. We have not assumed an early call of the retail non steps although from Figure 27 we can see that it would be more efficient to take these out from 2020 onwards.

Looking at the price of both the steps and the non steps, it appears there is little further value to be gained from assuming a more certain call with some of the non step up instruments traded within 60bps of the equivalent step up instruments. Whilst this relationship is tight, we believe it is also probably justified.

Table 27: BNP: Assuming capital management based on first calls coming due being made both step and non step

Grand-fathering Cap %	Year	Grand-fathering Cap Amt	Called Amt	Coupon of Called Bond	Called Amt	Coupon of Called Bond	Amt Outstanding post calls	Eligible T1	Ineligible T1 Post Calls
			<i>Steps</i>	<i>Steps</i>	<i>Non Step</i>	<i>Non Step</i>			
100%	2013	10,134	2540	8.667/5.868/8.25/8			7,590	7,590	-2,537
80%	2014	8,108	1000	4.625			6,590	6,590	-1,511
70%	2015	7,094	807	5.186			5,789	5,789	-1,300
60%	2016	6,081	746	4.73/5.954	521	5.945	4,513	4,513	-1,563
50%	2017	5,067	638	5.019	232	7.436	3,640	3,640	-1,423
40%	2018	4,054	600	7.781/7.57			3,040	3,040	-1,010
30%	2019	3,040	76	7.028/3.968/4.024/7.384			2,964	2,964	-74
20%	2020	2,027	0				2,964	2,025	939
10%	2021	1,013	0				2,964	1,013	1,952
0%	2022	0	0				2,964	0	2,964

Source: J.P. Morgan estimates. €m

Table 28: BNP: Assuming capital management based on call of steps

Grand-fathering Cap %	Year	Grand-fathering Cap Amt	Called Amt	Coupon of Called Bond	Called Amt	Coupon of Called Bond	Amt Outstanding post calls	Eligible T1	Ineligible T1 Post Calls
			<i>Steps</i>	<i>Steps</i>	<i>Non Step</i>	<i>Non Step</i>			
100%	2013	4,624	2540	8.667/5.868/8.25/8			7,590	7,590	-2,537
80%	2014	3,699	1000	4.625			6,590	6,590	-1,511
70%	2015	3,237	807	5.186			5,789	5,789	-1,300
60%	2016	2,774	746	4.73/5.954			5,041	5,041	-1,035
50%	2017	2,312	638	5.019			4,403	4,403	-661
40%	2018	1,850	600	7.781/7.57			3,803	3,803	-248
30%	2019	1,387	76	7.028/3.968/4.024/7.384			3,726	3,038	688
20%	2020	925	0				3,726	2,025	1,701
10%	2021	462	0				3,726	1,013	2,714
0%	2022	0	0				3,726	0	3,726

Source: J.P. Morgan estimates. €m

## ACAFP

Much like BNP, ACAFP has taken a relatively simply stance of calling all of its step up instruments and extending its retail non steps. Many of ACAFP's Tier I instruments contain regulatory par calls (RPCs), however to date these have not been utilized. The remainder of ACAFP's Tier Is that have not passed their first call date are mainly step up instruments however there are four non step instruments. The non step instruments are more interesting due to the relative difference in coupon between the two more liquid issues.

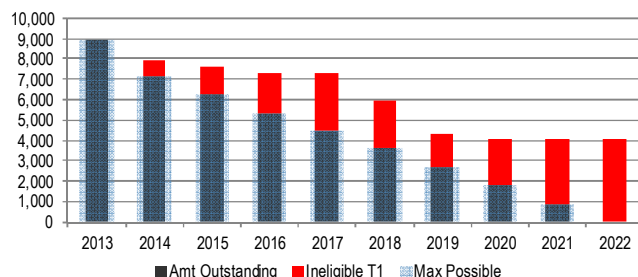
Table 29: ACAFP: Tier I capital instruments

ISIN	Issue Date	Coupon	First Call	Step?	Ccy	Amt Out	GBP Equiv	Back End	RPC	Yield to	Year
Call date Pre Dec 2011											
XS0161441000	30/01/2003	7	30/01/2009	No	USD	1500	1126	FIXED	Yes	7.4	2022
XS0173838847	08/08/2003	7	30/07/2009	No	USD	550	413	FIXED	Yes	7.5	2022
NL0000113868	19/12/2003	6	30/07/2009	No	EUR	550	550	FIXED	Yes	6.8	2022
							2,089				
Call Date 31st Dec 2011 - 31st Dec 2013											
FR0010533554	19/10/2007	7.375	19/10/2012	No	USD	500	375	FIXED	Yes		
Newedge	01/12/2008	8.60	01/12/2013	No	USD	103	77	3m+650bp			
							453				
Call Date Post 31st Dec 2013											
FR0010772244	26/06/2009	9.75	26/12/2014	No	USD	1350	1013	FIXED	Yes	4.6	2016
FR0010161026	04/02/2005	1.916	04/02/2015	No	EUR	371	371	CMS			
FR0010248641	09/11/2005	4.13	09/11/2015	Yes	EUR	329	329	3m+165bp		5.5	2015
FR0010291997	24/02/2006	5.136	24/02/2016	Yes	GBP	199	231	3m+157.5bp		6.9	2016
IT0004743818	29/06/2011	7.675		No	EUR	120	120	3m+729bp			
FR0010359794	11/08/2006	5.5	11/08/2016	Yes	CAD	60	44	3m+175bp			
USF22797FJ25	31/05/2007	6.637	31/05/2017	No	USD	890	668	3m+123.25bp		7.4*	2017
CACEIS	01/11/2007	6.315	01/11/2017	Yes	EUR	40	40	3m+280bp			
NZCASD0001S5	19/12/2007	5.04	19/12/2017	No	NZD	250	150	3m+190bp			
FR0010603159	31/03/2008	8.2	31/03/2018	Yes	EUR	850	850	3m+480bp		5.0	2018
FR0010670422	30/09/2008	10.653	30/09/2018	Yes	EUR	500	500	3m+680bp			
USF22797FK97	13/10/2009	8.375	13/10/2019	Yes	USD	1000	751	3m+698.2bp	Yes	6.5	2019
FR0010814434	26/10/2009	7.875	26/10/2019	Yes	EUR	550	550	3m+642.4bp	Yes	6.0	2019
FR0010814418	26/10/2009	8.125	26/10/2019	Yes	GBP	291	338	3m+614.6bp	Yes	7.3	2019
FR0010575654	30/01/2008	7.589	30/01/2020	Yes	GBP	172	200	3m+355bp		7.6	2020
FR0000140071	24/10/1984			?	EUR	238	238	n/a		4.6	2022
							6,393				
Total							8,934				

Source: Company reports. Bloomberg, \*6.4% YTP & 10yr Call resets,

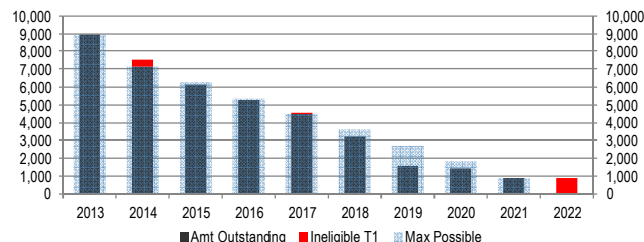


Figure 28: ACAFP: Tier I amortisation profile assuming first calls on step up instruments coming due are made



Source: Company reports and J.P. Morgan estimates. Assume 9.75% gets call at first call date given the high back end even though it does not step on this date

Figure 29: ACAFP: Tier I amortisation profile assuming later call of non steps only once they become ineligible



Source: Company reports and J.P. Morgan estimates.

**Investors are currently pricing high coupon non steps to call, yet do not provide the same benefit to other issuers where it is economical to call non steps**

### Trades Ideas for ACAFP's capital structure

Whilst we continue to believe ACAFP is over levered in comparison to its peers and has one of the largest shortfalls for bail-in debt as we highlight in our [YE 2013 Outlook](#) we find the ACAFP 9.75% \$14P interesting given its high coupon and yet non step characteristics. We believe this bond acts as a poster child for the other potential trades highlighted in this report. Clearly investors price this instrument to the first call date regardless of the fact it is a non step where all previous non step have been extended. This is due to the large coupon associated with the instrument therefore making it more economical for ACAFP to call this instrument. By the same reasoning, investors should consider that if non step instrument is economically expensive for a bank when comparing to long dated bail-in debt then these instruments should price with a shorter duration and therefore a tighter spread.

Following this line of thinking, we turn our attention to the ACAFP 6.637% \$17P which currently trades to call with a Yield c.8.0% which would arguably look cheap had it not been for the back end spread of only €3m+123.25bps. This is in contrast to 10yr senior cash Z-spreads c.103bps and subordinated 7yr spreads of c.220bps. In our opinion this would put the cost of bail in debt c165bp and therefore the Tier I non step would make economic bail-in debt. As such, looking at this instrument as a perpetual gives a yield of circa 6.4%, which in our opinion is expensive given the reduced expectation of seeing a return in principal. **More importantly, we highlight that the ACAFP 6.637% \$17P has 10yr call resets and as such would argue this instrument would make cheap Tier II capital and therefore has an increase probability of being extend. As such, we believe the ACAFP 6.637% \$17P is expensive. The prospectus states:**

*“The Notes may be redeemed (in whole but not in part) on May 31, 2017 and on the Interest Payment Date falling on or about each tenth anniversary thereafter, at the option of the Issuer.*

This is similar language to that seen with RBS 7.0916% €17P and therefore we do not believe this instrument will have too much trouble being included in Tier II capital of ACAFP.

Table 30: ACAFP Tier I non stepwith low back end

ISIN	Sub	Issued	Ticker	Coupon	Call date	Maturity	Price*	YTP	Ccy	Amt
USF22797FJ25	T1	31/05/2007	ACAF	6.637	31/05/2017	Perp	97.5	6.4	USD	890

Source: J.P. Morgan.

## SOCGEN

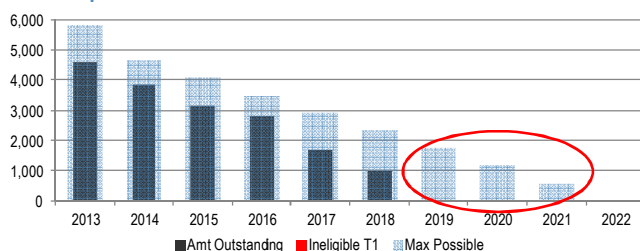
The first thing we would note is that Socgen has called all of its Tier I instruments to date, this has been a mixture of both step and non step instruments and whilst this is not a predictor of future behaviour given that one of the calls (US7842102052) took place in Dec 2011, during the middle of the Sovereign crisis we would wonder what it would take for Socgen to extend its Tier I instruments. Socgen's remaining instruments largely consist of step up instruments with only 3 non step instruments one of which is a private placement we have little information on.

Table 31: SOCGEN: Tier I Capital instruments outstanding

ISIN	Issue Date	Coupon	First Call	Innovative	Ccy	Amt	€ Equiv	Back End	RPC	Price	YTD	Year
Call Date 31st Dec 2011 - 31st Dec 2013												
XS0179207583	10/11/2003	5.419	10/11/2013	Yes	EUR	420	420	3m+195	CALLED	100.0	11.0	2013
XS0365303329	22/05/2008	7.756	22/05/2013	No	EUR	795	795	3m+335				
							1,215					
Call Date Post 31st Dec 2013												
FR0010136382	26/01/2005	4.196	26/01/2015	Yes	EUR	728	728	3m+153	Yes ?	97.9	6.1	2015
XS0454569863	07/10/2009	8.75	07/04/2015	No	USD	1000	754	FIXED		105.5	7.8	2015
Priv Placement	27/02/2009	9.5049	27/02/2016	No	USD	450	339	3m+677				
USF8586CAA02	05/04/2007	5.922	05/04/2017	Yes	USD	808	609	3m+175		100.4	5.8	2017
US83367TAB52	05/04/2007	1.0239	05/04/2017	Yes	USD	63	47	3m+175				2017
XS0336598064	19/12/2007	6.999	19/12/2017	Yes	EUR	468	468	3m+335		106.0	5.5	2017
XS0369350813	16/06/2008	8.875	16/06/2018	No	GBP	506	586	3m+340		106.3	7.4	2018
XS0373447969	07/07/2008	7.715	07/07/2018	Yes	EUR	100	100	3m+370				
XS0449487619	04/09/2009	9.375	04/09/2019	Yes	EUR	1000	1000	3m+890.1	Yes	114.0	6.6	2019
							4,631					
Total							5,847					

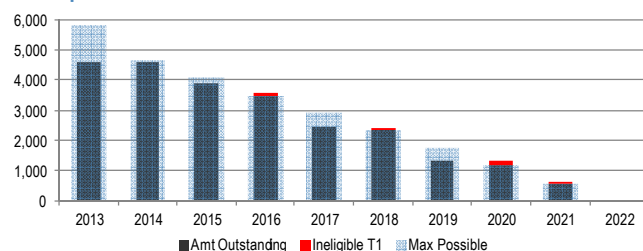
Source: Company reports. Bloomberg

Figure 30: SOCGEN: Tier I amortisation profile assuming earliest call of non steps



Source: Company reports and J.P. Morgan estimates.

Figure 31: SOCGEN: Tier I amortisation profile assuming later call of non steps



Source: Company reports and J.P. Morgan estimates.

We note that due to the call history of Socgen, the grandfathering schedule for Socgen is already as efficient as it can be. In fact, the only way it could be made more efficient is if Socgen were to wait until a later date to call some of its non step instruments. However, given Socgen's behavior and importance of reputation, we believe that an extension of these instruments is unlikely especially given their ability to issue AT1 instruments.

Table 32: SOCGEN: Assuming capital management based upon call of innovative instruments

Grand-fathering Cap %	Year	Grand-fathering Cap Amt	Called Amt	Coupon of Called Bond	Called Amt	Coupon of Called Bond	Amt Outstanding post calls	Eligible T1	Ineligible T1 Post Calls
			<i>Steps</i>	<i>Steps</i>	<i>Non Step</i>	<i>Non Step</i>			
100%	2013	5,847	1215	5.419			4,626	4,626	-1,215
80%	2014	4,677	0		751	8.75	3,875	3,875	-798
70%	2015	4,093	728	4.196			3,147	3,147	-942
60%	2016	3,508	0		338	9.5049	2,809	2,809	-695
50%	2017	2,923	1122	5.922FRN/6.999			1,688	1,688	-1,233
40%	2018	2,339	100	7.715	588	8.875	1,000	1,000	-1,336
30%	2019	1,754	1000	9.375			0	0	-1,752
20%	2020	1,169	0				0	0	-1,168
10%	2021	585	0				0	0	-584
0%	2022	0	0				0	0	0

Source: J.P. Morgan estimates. €

Table 33: SOCGEN: Assuming capital management based upon later call of non steps

Grand-fathering Cap %	Year	Grand-fathering Cap Amt	Called Amt	Coupon of Called Bond	Called Amt	Coupon of Called Bond	Amt Outstanding post calls	Eligible T1	Ineligible T1 Post Calls
			<i>Steps</i>	<i>Steps</i>	<i>Non Step</i>	<i>Non Step</i>			
100%	2013	5,847	1215	5.419			4,626	4,626	-1,215
80%	2014	4,677	0				4,626	4,626	-47
70%	2015	4,093	728	4.196			3,898	3,898	-191
60%	2016	3,508	339		338	9.5049	3,560	3,505	55
50%	2017	2,923	1124	5.922FRN/6.999			2,438	2,438	-482
40%	2018	2,339	100	7.715			2,338	2,336	2
30%	2019	1,754	1000	9.375			1,338	1,338	-414
20%	2020	1,169	0				1,338	1,168	170
10%	2021	585	0		751	8.75	588	584	4
0%	2022	0	0		588	8.875	0	0	0

Source: J.P. Morgan estimates. €m

## Trades Ideas for SOCGEN's capital structure

The upside is skewed in the investor's favour at current cash prices, where the downside is limited

Given the pricing of Socgen's Tier I instruments, we in fact find its recent UT2 6.625% \$18P instrument more interesting from a valuation point of view. We highlight that the coupons on this instrument are not only **cumulative** but also the **arrears of interest bear interest at 6.625%** also. Furthermore, we note the deferred coupons would be payable following payment on any class of share capital of Socgen. We highlight SOCGEN 6.125% €18 LT2 trade c2.7% whilst the SOCGEN 6.625% \$18 trade c6.3% as per Table 34.

Table 34: SOCGEN: UT2 and comparables

ISIN	Issue Date	Coupon	First Call	Innovative	Ccy	Amt	€ Equiv	Back End	RPC	Price	YTC	Type
XS0383634762	20/08/2008	6.125			EUR	778	778			115.7	2.7	LT2
XS0813929782	11/12/2012	6.625	11/06/2018	No	USD	1500	1135	5yr+575.4	Yes	101.5	6.3	UT2
XS0449487619	04/09/2009	9.375	04/09/2019	Yes	EUR	1000	1000	3m+890.1	Yes	114	6.6	T1

Source: Company reports. Bloomberg

## Ratings Event is a short term suppressant

We highlight the loss of equity treatment from S&P allows SOCGEN certain rights to vary the terms and conditions of the bonds in a similar way as the Dankse 7.125% which we have previously mentioned in our [2H 2013 outlook](#). In short, as long as SOCGEN inserts a call pre 1st of Jan 2014 then SOCGEN could potentially call the

bonds back at par. To do this, SOCGEN must give between 30-60 days notice to note holders. This means that the ratings event par call is essentially a short term depressant given the risk of a par call. However if, like us, the investor believes SOCGEN would not utilize the call itself without offering investors an alternative then at current cash prices the downside is limited and the upside is skewed in the investors favour. In our opinion, investors should be long SOCGEN UT2 instruments, we believe that the downside is limited by the investor friendly nature of the French banks especially SOCGEN and could even offer upside via an LME which includes a small market premium. However, we view the UT2 instruments as a good method of securing a low cost option that SOCGEN leaves these instruments outstanding. Under these circumstances we would expect significant price appreciation post 1st December 2013, especially given the pricing of the recent AT1 instrument.

We note that if this instrument is not exchanged or called back then the instrument should trade with a I degree of certainty to its first call date with little extension risk given the reduced utility the SOCGEN would be receiving for this instrument. We believe this would justify a compression between the SOCGEN LT2 and the UT2.

### Additional Tier I

We highlight Socgen's recent \$1.25bn 8.25% AT1 issue, this is likely to improve pricing on legacy subordinated instruments as the future calls become more likely and the level of buffer below the legacy instruments increase. We highlight the key features of this instrument in Table 35.

**We believe the SOCGEN AT1 should be thought of as a lower strike permanent write down instrument (i.e. lower than 7%) rather than a temp write-down structure with a trigger at 5.125%**

In our opinion, the 5.125% trigger for temporary write down is in fact a red herring given the likelihood of actually interacting with this trigger. We highlight comments from the UK's PRA (usually at the forefront of regulatory change):

*"The PRA expects UK firms, especially those whose failure may have systemic consequences for the United Kingdom, to set AT1 triggers at a level that is unambiguously consistent with being able to recover from a stress without entering into resolution. This may be at a level higher than 5.125% CET1."*

This suggests that in order to make it unambiguous that a trigger would occur before resolution the trigger "may" have to be above 5.125%. We note that UK issuers now expect all future AT1 issuance in the UK to have a trigger of 7% CET1. In our opinion, this suggests that the Point of Non Viability lies somewhere between 5.125% and 7% as suggested in our ["European Bank Bail-in Survey 2013"](#). We will review the SOCGEN AT1 in greater detail in another research publication however a summary of the Terms and Conditions can be found in Table 35.

Table 35: SOCGEN 8.25% \$18P

<b>ISIN</b>	<b>XS0867614595</b>
<b>Issue Date</b>	06/09/2013
<b>Issuer</b>	SOCIETE GENERALE
<b>Ticker</b>	SOGEN
<b>Coupon</b>	8.25
<b>Coupon Type</b>	Fixed-Float
<b>Call Date</b>	29/11/2018
<b>Maturity</b>	Perpetual
<b>Type</b>	Callable Perp
<b>Currency</b>	USD
<b>Amt</b>	1,250
<b>Issuing Spread</b>	5yr+639.4bp
<b>Back End</b>	5yr+639.4bp
<b>Host</b>	AT1
<b>Trigger type</b>	CET1 Phase/EBA CT1
<b>Trigger level</b>	5.125%
<b>Other Trigger</b>	RRD in risk factors
<b>Conversion Form</b>	Write down / Write up
<b>Regulatory Call</b>	Par
<b>Call Notice</b>	30 - 45 Days notice
<b>Contingency Event</b>	<b>Capital Ratio Event</b> i) EBA CT1 group < 5.125% if before CRD IV ii) CET1 of group < 5.125% if after CRD IV <b>Write down amount -</b> i) amount which would be sufficient to cure the Capital Ratio Event ii) amount required to reduce principal to 1cent if it cannot cure the capital ratio event
<b>Viability Event</b>	<b>Return to Financial Health</b> If a positive consolidated net income is recorded, issuer may AT FULL DISCRETION may increase principal amount PRO RATA with other notes and any other temp write-down instruments - must not exceed max distributable amount or write up amount, <b>Max write up amt</b> - net income * notional/total Tier I (i.e. % of loss absorbing capital)
<b>Comment</b>	Full discretionary non cumulative coupon, if before CRD IV mandatory deferral upon breach of regulatory ratios. If after CRD IV mandatory deferral if all distributions on own funds instruments would exceed distributable items AND interest is only paid if payment would not cause the maximum distributable amount to be exceeded
<b>Regulatory Capital Event</b>	<b>Capital Event:</b> not foreseeable at issue, reg changes, are fully or partially excluded from Tier I capital as long as it is not due to limits (if before CRD IV) at Par Contains <b>Tax Event</b> <b>Substitution and Variation</b> Given capital or tax event substitution or vary can occur to remain qualifying notes, (could restrict special redemption events).terms not otherwise materially less favourable to holders
<b>Capital Buffer at issue</b>	6.0% of RWAs
<b>Law</b>	English/French

Source: Company data.

## BPCE

In June 2011, BPCE made a clear statement that it intends to call its step up instruments and would treat its non steps on an economic basis. Specifically it made the following two statements:

### **Tier I hybrids without step-up**

*“The market usually **does not expect the call options to be exercised**”*

*“In the context of the grandfathering provisions of Basel III, **Groupe BPCE may exercise the call options**, subject to prior approval of the French banking supervisor”*

### **Tier I hybrids with step-up**

*“The market **usually expects the call options to be exercised at first call**”*

*“Groupe BPCE **intends to exercise the call options at first call**, subject to prior approval of the French banking supervisor”*

Furthermore, we note that BPCE has many bonds, much like ACAFP, which have a RPC, however, to this extent we highlight comment made on the same slide with regards to the RPC and intentions around using this feature.

### **Tier I hybrids with regulatory call under Basel III**

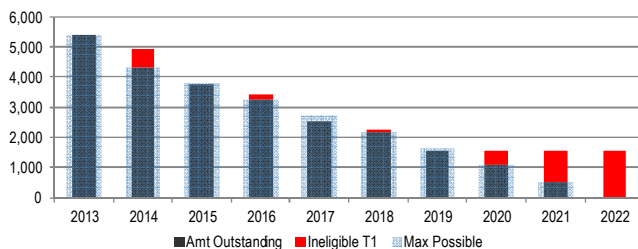
*“In the context of the grandfathering provisions of Basel III and given our intention to exercise the call options at first call for Tier 1 hybrids with step and given the possibility we have to exercise the call options for Tier 1 hybrids without step-up **Groupe BPCE believes that it will not need to use regulatory call provisions**”*

Table 36: BPCE: Tier I Capital instruments outstanding

ISIN	Issue Date	Coupon	First Call	Step?	Ccy	Amt	€ Equiv	Back End	RPC	Price	YTD	Year
Call date Pre Dec 2011												
FR0010125757	12/10/2004	1.938	12/10/2009	No	EUR	80	80	CMS				2022
FR0010101949	30/07/2004	2.85	30/12/2009	No	USD	200	152	CMS		75.8	7.2	2022
FR0010154278	25/01/2005	3.75	25/01/2010	No	EUR	185	185	CMS		73.3		2022
							416					
Call Date 31st Dec 2011 - 31st Dec 2013												
FR0010279208	27/01/2006	6.75	27/01/2012	No	USD	300	228	FIXED		98.5	7.1	2014
							228					
Call Date Post 31st Dec 2013												
FR0010031138	26/11/2003	5.25	30/07/2014	Yes	EUR	471	471	3m+184		99.5	6.4	2014
FR0010871269	17/03/2010	9	17/03/2015	Yes	EUR	818	818	12m+653.3/12m+853.3		105.5	6.6	2015
FR0010814558	22/10/2009	9.25	22/04/2015	No	EUR	750	750	FIXED	Yes	105.6	5.7	2015
FR0010117366	06/10/2004	4.625	30/07/2015	Yes	EUR	368	368	3m+153		98.3	5.9	2015
FR0010777532	06/08/2009	13	30/09/2015	No	USD	134	101	FIXED	Yes	111.0	7.6	2015
FR0010777516	06/08/2009	13	30/09/2015	No	EUR	52	52	FIXED	Yes	112.8	6.8	2015
FR0010279273	01/02/2006	4.75	01/02/2016	Yes	EUR	350	350	3m+135	Yes	88.0	11.2	2016
FR0010531012	18/10/2007	6.307	18/10/2017	Yes	EUR	372	372	3m+268		100.0	6.6	2017
FR0010535971	30/10/2007	6.117	30/10/2017	Yes	EUR	509	509	3m+237	Yes	99.5	6.4	2017
FR0010600163	31/03/2008	8.65	28/03/2018	Yes	EUR	150	150	3m+532				2018
USF6483LHM57	30/04/2008	10	30/04/2018	Yes	USD	186	141	3m+651		113.0	7.0	2018
USF11494AA36	06/08/2009	12.5	30/09/2019	Yes	USD	444	337	3m+1298	Yes	125.3	7.4	2019
FR0010777524	06/08/2009	12.5	30/09/2019	Yes	EUR	374	374	3m+1313	Yes	126.5	7.2	2019
							4,794					
Total							5,438					

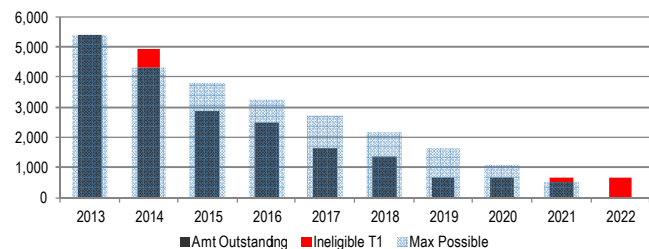
Source: Company reports. Bloomberg

Figure 32: BPCE: Tier I amortisation profile assuming NO CALL of non step including high coupon non steps.



Source: Company reports and J.P. Morgan estimates.

Figure 33: BPCE: Tier I amortisation profile assuming call of high coupon non steps



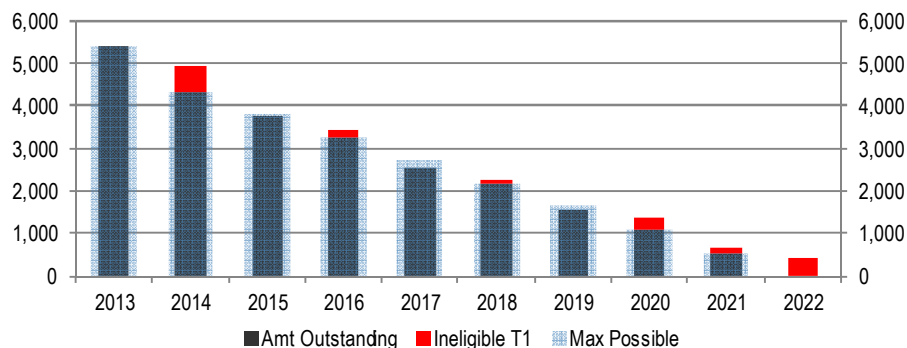
Source: Company reports and J.P. Morgan estimates. Assuming call of high coupon (9.25% & 13%) non step instruments

## Trades Ideas for BPCE's capital structure

We highlight that BPCE has two short dated high coupon non steps that currently price to call. Looking at Figure 32 we can see that even if BPCE did not call these instruments they would comfortably receive Tier I treatment until 2020 (before they exceed their grandfathering limits). However, given that SOGEN has just priced an AT1 instrument inside of 9.25% (the lower coupon of the two high coupon short call instruments) it is likely that the economic decision to call these instruments and issue new style AT1 will be taken. As such, we believe trading to first call can currently be justified for these non step instruments. We highlight in Figure 34 that even extending the non step instruments does little to change the efficiency of the Tier I grandfathering bucket.



Figure 34: BPCE: Tier I grandfathering assuming non step instruments maximise usage of grandfathering period



Source: J.P. Morgan estimates, Company data.

Table 37: BPCE: Tier I Capital instruments outstanding

ISIN	Coupon	First Call	Step?	Ccy	Amt	€ Equiv	RPC	Price	YT15
FR0010814558	9.25	22/04/2015	No	EUR	750	750	Yes	105.55	5.5
FR0010777532	13	30/09/2015	No	USD	134	101	Yes	111.00	7.1
FR0010777516	13	30/09/2015	No	EUR	52	52	Yes	112.84	6.2

Source: Company reports. Bloomberg

### BPCE 4.75% €16P

We highlight the BPCE 4.75% €16P as a relative cheap bond in the BPCE capital structure. This bond contains a step at its first call date and as such according to BPCE's own presentation, they should call this bond. However, due to the low back end of €3m+135bp investors are more skeptical. We note that calling this bond would fall in line with previous French bank behavior and follow previous bank guidance. Given our assumption that instruments that have been classified as having an incentive to redeem cannot be reclassified then these instruments cannot get Tier II capital treatment, not only because of the quarterly calls as clarified by the EBA. In our opinion the total capital of BPCE is too low for BPCE to trying and cover at total capital ratio of 17% with subordinated debt alone, therefore we believe it is likely that senior will ultimately be part of the bail-in buffer for BPCE. We highlight the BPCE 2.875% 16-Jan-24 trade circa Z+80bps and therefore the BPCE 4.75% €16P could also be considered expensive bail-in debt. We find 10.7% YTC attractive for the BPCE 4.75% €16P.

Table 38: BPCE: Tier I Capital instruments outstanding

ISIN	Coupon	First Call	Step?	Ccy	Amt	Back end	Price	YTC	YT22	YTP
FR0010279273	4.75	01/02/2016	Yes	EUR	350	3m+135	88.0	10.7	6.0	5.5

Source: Company reports. Bloomberg

### Point of note

We note that the BPCE 9% €15P is in fact a step instrument, however the step is not concurrent with first call date in 2015 but with the call in 2020. As such, the CRD IV grandfathering rules are likely to view 2020 as the effective maturity date with a step

up. As such BPCE could gain additional time for Tier I treatment of this bond. However, as we have highlighted above, we believe BPCE could likely bring a new AT1 deal around a similar interest level and therefore would likely call this instrument at first call date. Furthermore, this would be more inline with their original guidance.

Table 39: BPCE: Tier I Capital instruments outstanding

ISIN	Coupon	First Call	Step?	Ccy	Amt	Back end	Price	YT15	YT20
FR0010871269	9	17/03/2015	Yes	EUR	818	12m+653.3/12m+853.3	106.0	4.7	7.7

Source: Company reports. Bloomberg

## KBC

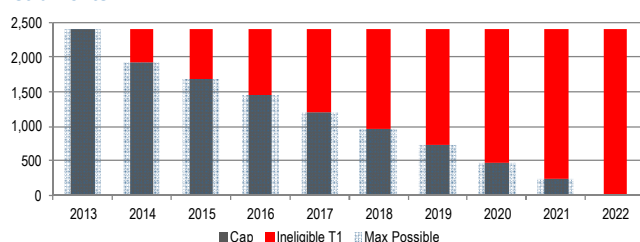
We have previously mentioned KBC in our [“Financials Trade Idea Portfolio: No Bail-in, No Capital Recognition”, 18th Feb 2013](#) however we continue to believe KBC capital structure can be optimized by strategically calling certain capital instruments. KBC has 2 fixed pref style instruments placed with both retail and institutional clients. The company has previously given guidance that they are not looking to redeem these bonds. The remaining 4 bonds are old step up instruments that have passed their first call date before Dec 2011 and therefore should receive the benefit of the entire grandfathering period. However, as we highlight below we believe that these instruments are likely to be retired earlier than expected. Furthermore, we highlight that the company has stated it would look at these issues opportunistically, we believe this to be in contrast to comments made about the 8% prefs.

Table 40: KBC: Tier I Capital instruments outstanding

ISIN	Issue Date	Coupon	First Call	Step?	Ccy	Amt	€ Equiv	Back End	Price	YTD	Year
Call date Pre Dec 2011											
USU2445QAA68	02/11/1999	4.3156	02/11/2009	Yes	USD	173	130	3m+405bp	90	8.5	2022
XS0099124793	30/06/1999	3.222	30/06/2009	Yes	EUR	130	130	3m+300bp	90	6.4	2022
US48239FAA66	10/11/1999	4.127	10/11/2009	Yes	EUR	121	121	3m+390bp	90	7.4	2022
BE0119284710	19/12/2003	6.202	19/12/2019	Yes	GBP	62	72	3m+193bp			
							452				
Call Date 31st Dec 2011 - 31st Dec 2013											
BE0934378747	14/05/2008	8	14/05/2013	No	EUR	1,250	1250	FIXED	103.25	7.4	2022
XS0368735154	27/06/2008	8	27/06/2013	No	EUR	700	700	FIXED	103.25	7.4	2022
							1,950				
Call Date Post 31st Dec 2013											
Total							2,402				

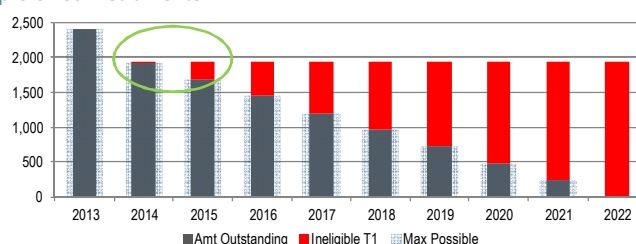
Source: Company reports. Bloomberg

Figure 35: KBC: Tier I amortisation profile assuming no call of any instruments



Source: Company reports and J.P. Morgan estimates.

Figure 36: KBC: Tier I amortisation profile assuming call trust preferred instruments



Source: Company reports and J.P. Morgan estimates.

## Trades Ideas for KBC's capital structure

In our opinion, the KBC FRN €P could be called or tendered as early as 2014 in order to maximise the existing stock of non-innovative instruments during the grandfathering period. Whilst an alternative to this could be to tender a capped amount of the KBC 8% €13P, we believe that the high cash price of this instrument as well as comments from management would deem this as unlikely. Under these circumstances, the average back end spread of the trust instruments is between +300bp and +405bp in comparison to the average senior cash spread (5yr) or even subordinated CDS spread of z+80bp or 265bps respectively, therefore KBC would be incentivised to call these instruments from an economical stand point sooner than the 31st December 2021 grandfathering deadline.

**We highlight that the Trust instruments also have dividend pushers**

We note that the KBC FRN €P have passed their first call date as such, although they are considered an innovative instrument by the company, we expect that these instruments will continue to receive grandfather Tier I status when Basel III/CRD IV is implemented on the 1st Jan 2014.

**Foreign law bonds create a problem for bail-in**

Furthermore, as per our previous note we also highlight a key difference between the KBC 8% €13P and the FRNs is the governing law, as also mentioned in our note "A Question of Law". We highlight in that note, we do not expect these instruments to qualify as bailable and therefore, under these circumstances we do not expect them to qualify as bail-in debt for the expected RRD requirement. This is because we believe they will be excluded due to the fact they would cause issued for the regulator at the point of non viability. The most recent publication that acknowledges this problem is the UK's PRA publication on "Strengthening capital standards: implementing CRD IV" which states:

*"It is likely that instruments issued under foreign law will be outside of the reach of the Banking Act 2009, making it unlikely that they would be of use in recapitalising a failing bank"*

We note that whilst the PRA refers to the Banking Act 2009 specifically, we highlight that the Banking Act allowed for creditors to be converted to equity at the point of non viability and thus is likely in our view to encounter similar problems with the RRD (Recovery and Resolution Directive).

In Figure 35 & Figure 36, we contrast the difference in optimization for KBC if the trust instruments are called or tendered through time as we progress with CRD IV grandfathering. We highlight in Figure 36 by taking out Trust instruments in 2014, the capital efficiency of the remaining outstanding bonds is improved. This is because the grandfathering references the stock of eligible instruments as of the 31st of Dec 2012. Under these circumstances starting in 2014 only 80% of the outstanding €2.4bn will be likely to receive recognition as Tier I capital from the regulator. This would result in €480m of lost Tier I recognition. However, if KBC were to take out some of the Trust securities, the amount of inefficient capital reduces from €480m to €29m.

## ISPIM

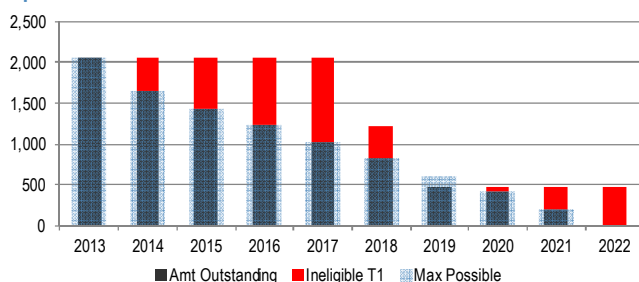
As per our [2H 2013 outlook](#) we remain cautious of peripheral institutions especially given the potential impact of the AQR. Nevertheless we highlight that given the high back end of many of the remaining Tier I instruments, we believe these instruments are likely to be called given that they would be expensive under most circumstances even as Tier II capital. Intesa has 4 remaining Tier I bonds; 1 non step and 3 step instruments. We highlight that it is likely that the ISPIM 9.5% €16P is the non step instrument which reverts to 5yr swaps + 757bps. It is likely that this instrument could count in its own right towards ISPIMI Tier II capital, however, the credit spread of 757bps is much more expensive than their recent deal that was offered to investors at MS+450bps. Therefore in our view, the ISPIM 9.5% €16P are likely to be called at their first call date given where current spreads are.

Table 41: ISPIM: Tier I Capital instruments outstanding

ISIN	Issue Date	Coupon	First Call	Step	Ccy	Amt Out	(€) Equiv	Back End	RPC	Price	YTC
Call date Pre Dec 2011											
Call Date 31st Dec 2011 - 31st Dec 2013											
Call Date Post 31st Dec 2013											
XS0545782020*	01/10/2010	9.5	01/06/2016	No	EUR	478	478	5y+757bp	Yes	105.25	7.3
XS0371711663	20/06/2008	8.047	20/06/2018	Yes	EUR	580	580	3m+410bp		101.75	7.6
XS0388841669	24/09/2008	8.698	24/09/2018	Yes	EUR	250	250	3m+505bp		98.06	9.2
XS0456541506	14/10/2009	8.375	14/10/2019	Yes	EUR	742	742	3m+687.1bp		104.00	7.5
						2,050					
Total						2,050					

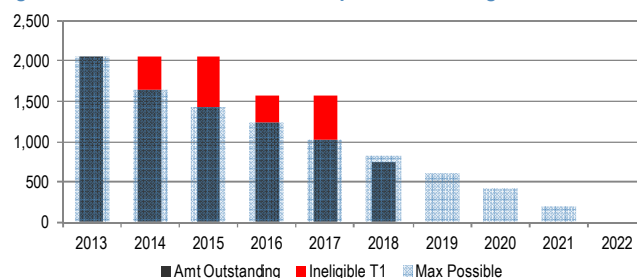
Source: Company reports. Bloomberg, \*Trigger if total capital falls below 6% or Bol min

Figure 37: ISPIM: Tier I amortisation profile assuming no call non step



Source: Company reports and J.P. Morgan estimates.

Figure 38: ISPIM: Tier I amortisation profile assuming all calls



Source: Company reports and J.P. Morgan estimates.

## Tier II Liability Management improves capital

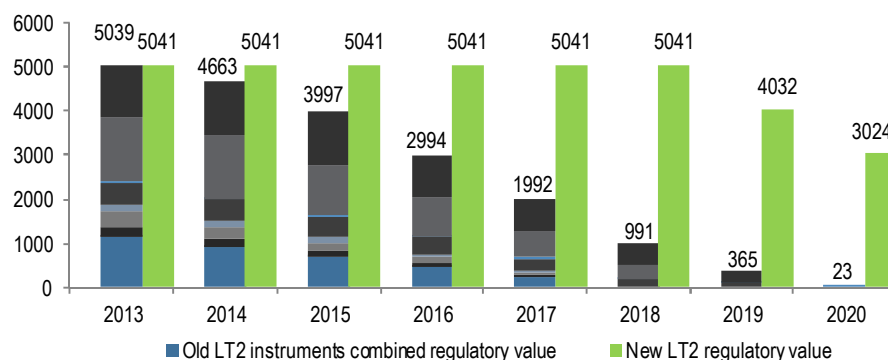
In our opinion, the recent liability management carried out by ISPIM is likely to benefit ISPIM in two ways:

- 1) The instrument specific amortization over the next 5yrs can be avoided by issuing a CRD IV compliant bullet Tier II, i.e. LT2 maturity extension.
- 2) Creating room in the Tier II grandfathering bucket to allow Tier I instruments that have become derocognised (due to being in excess of grandfathering limits) to be recognized as a Tier II instruments within the scope of grandfathering. (Refer to page 16 for more information on this).

### Improving regulatory capital through maturity extension

As we highlight in Figure 39 for illustrative purposes, if ISPIM were able to secure the full exchange of the old instruments for the new instruments, then by 2020 ISPIM could have secured an overall capital improvement of €3bn the a more significant benefit achieved in 2018 of €€4bn just before the amortization of the newly issued LT2 would take effect (straight line over the final 5yrs to maturity). The benefit that ISPIM receives from this transaction will be scaled depending on the investor participation.

Figure 39: ISPIM: Change in Tier II profile assuming 100% exchange of instruments for illustrative purposes

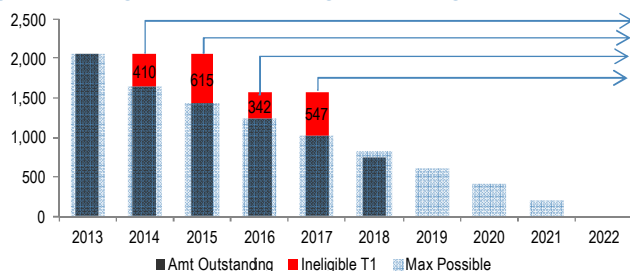


Source: J.P. Morgan estimates, Company data.

### Improving regulatory capital via utilization of spare Tier II grandfathering space

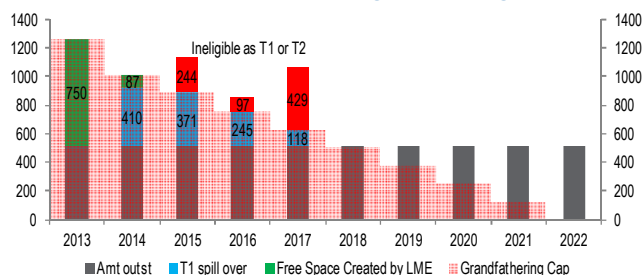
We highlight in Figure 40 how the excess Tier I instruments that are ineligible as Tier I capital due to the being in excess of the Tier I grandfathering limits can flow down into any spare space that is in the Tier II grandfathering buckets. We highlight that by conducting this liability management, ISPIM could free up space in their Tier II grandfathering buckets to allow the ineligible Tier I to count as Tier II capital.

Figure 40: ISPIM: Tier I amortisation profile assuming call non step, Tier 1 in excess of grandfathering limits that is still eligible for grandfathering can flow into Tier II grandfathering



Source: Company reports and J.P. Morgan estimates.

Figure 41: ISPIM: Tier II amortisation profile assuming €750m take out of the instruments which were issued with an incentive to redeem and therefore entered the Tier II grandfathering bucket



Source: Company reports and J.P. Morgan estimates.

In Figure 41 we show that ISPIM could potentially gain an additional €410m of Tier II capital in 2014, €371m in 2015 and €245m in 2016 if there were a 60% take up amongst the LT2 instruments which contain an incentive to redeem. These instruments are listed in Table 42. It might be interesting to see if other banks consider this as a means of capital optimization.

Table 42: ISPIM: LT2 instruments with and incentive to redeem involved in the LME of Aug 2013

ISIN	Ticker	Coupon	Ccy	Amt	Original First call	Maturity	€ Amt
XS0324790657	ISPIM	1.8625	GBP	5.4	12/11/2012	12/11/2017	6
XS0243399556	ISPIM	1.076	EUR	220	20/02/2013	20/02/2018	220
XS0365303675	ISPIM	2.205	EUR	362	28/05/2013	28/05/2018	362
XS0258143477	ISPIM	1.221	EUR	168	26/06/2013	26/06/2018	168
XS0213101230	ISPIM	3.75	EUR	478	02/03/2015	02/03/2020	478
XS0188046543	ISPIM	5.625	GBP	25	18/03/2019	18/03/2024	29

Source: Company reports and J.P. Morgan



## UCGIM

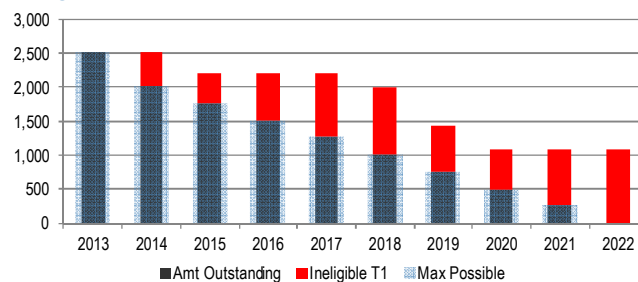
Unicredit has a relatively low amount of Tier I instruments outstanding following LME in the past. The bulk of the liquid instruments are in fact step up instruments callable from 2015-2020 which currently trade to the first call date. This is unsurprising given the fact that UCGIM have called their LT2 instruments and all previous step instruments in the Tier I space to date. We note the most recent issue from UCGIM contains a write down feature if total capital falls below 6% of Bank of Italy minimum requirements.

Table 43: UCGIM: Tier I Capital instruments outstanding

ISIN	Issue Date	Cpn	First Call	Step	Ccy	Amt Out	(€) Equiv	Back End	RPC	Mid Price	YTC
Call date Pre Dec 2011											
DE000A0DD4K8	28/10/2004	1.614	28/10/2011	No	EUR	98	98	10yr +10bps			
DE000A0DYW70	22/02/2005	1.838	22/03/2012	No	EUR	51	51	10yr +15bps			
							149				
Call Date 31st Dec 2011 - 31st Dec 2013											
Call Date Post 31st Dec 2013											
XS0231436238	27/10/2005	4.028	27/10/2015	Yes	EUR	280	280	3m+176bp		94.25	7.0
XS0231436667	27/10/2005	5.396	27/10/2015	Yes	GBP	26	31	3m+176bp		89.71	11.1
XS0372556299	27/06/2008	8.5925	27/06/2018	Yes	GBP	178	207	3m+395bp		100.50	8.5
XS0470937243	10/12/2009	8.125	10/12/2019	Yes	EUR	585	585	3m+665bp		103.75	7.4
XS0527624059*	21/07/2010	9.375	21/07/2020	Yes	EUR	339	339	3m+749bp	Yes	106.25	8.1
US404398AA77	15/07/1999	8.741	30/06/2029	No	USD	106	79			97.51	9.0
US404399AA50	22/10/1999	9	22/10/2029	No	USD	48	36			98.19	9.2
XS0126207728	09/04/2001	3.5	31/12/2029	No	JPY	25000	194				
XS0102826673	13/10/1999	7.76	13/10/2034	No	GBP	17	20			96.08	8.2
							1,772				
Total							1,921				

Source: Company reports. Bloomberg, \*Trigger if total capital falls below 6% or BoI min

Figure 42: UCGIM: Tier I amortisation profile assuming first calls on innovative instruments coming due are made



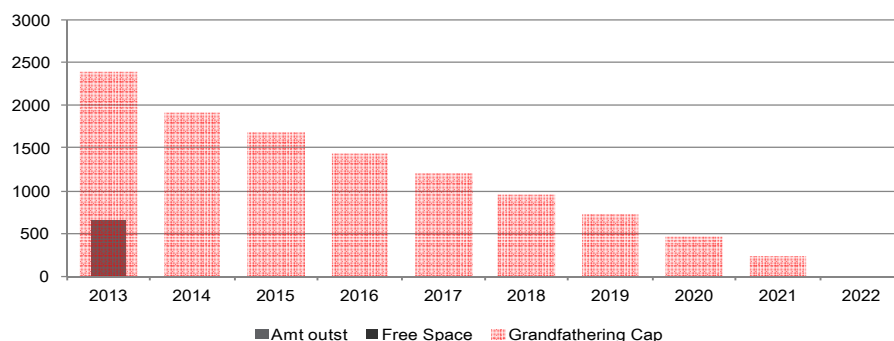
Source: Company reports and J.P. Morgan estimates.

## Trades Ideas for UCGIM's capital structure

Given our view on the periphery, we find the capital structure of UCGIM relatively uninteresting. However, we would highlight the UCGIM 4.028% €15P as bonds which trade to call but could face significant downside if these are not called. We note that UCGIM 7yr cash bonds trade c Z+210bps and 10yr UCGIM senior CDS trades c360bps. Therefore if extended, the UCGIM 4.028% €15P would make cheap senior funding and currently these bonds price in little change of extension. In our opinion this might be justified for an institution which were operating under much sounder financial conditions.

We highlight that in their **LME on these bonds in 2012 they stated that future calls shall be considered in the “best interests of the group”**. Obviously if financial conditions substantially improve for UCGIM then a call may be much more likely. Currently we think the bonds offer as over 10pts of downside versus only 5pts of upside and therefore view the risk reward characteristics of this bond as undesirable. We would therefore take profits if this hasn't been done already. We note due to the low amount outstanding many of the UCGIM bonds may be very illiquid.

Figure 43: UCGIM: Tier II best case grandfathering amortisation schedule



Source: J.P. Morgan estimates, Company data.

Table 44: UCGIM: Tier I Capital instruments outstanding

ISIN	Issue Date	Cpn	First Call	Step	Ccy	Amt Out	(€) Equiv	Back End	Price	YTC
Call Date Post 31st Dec 2013										
XS0231436238	27/10/2005	4.028	27/10/2015	Yes	EUR	280	280	3m+176bp	94.25	7.0

Source: Company reports. Bloomberg,

## Appendix I: Forward Curves & Opportunity Cost example

Below are the forward curve rates that were used to determine the annual cost of coupon for instruments that move from fixed to floating instruments. This allows us to calculate the opportunity cost of leaving legacy Tier I instruments outstanding versus issuing a blend of other instruments.

Table 45: Forward Curve Assumptions as of Aug 2013

ISIN	Back	Ccy	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
XS0179207583	3m+195	EUR	0.23%	0.44%	0.79%	1.33%	1.80%	2.14%	2.43%	2.70%	2.91%	3.09%
FR0010136382	3m+153	EUR	0.23%	0.44%	0.79%	1.33%	1.80%	2.14%	2.43%	2.70%	2.91%	3.09%
XS0454569863		USD	Fixed									
Priv Placement	3m+677	USD	0.20%	0.41%	0.93%	2.06%	2.94%	3.56%	3.91%	4.12%	4.31%	4.43%
USF8586CAA02	3m+175	USD	0.20%	0.41%	0.93%	2.06%	2.94%	3.56%	3.91%	4.12%	4.31%	4.43%
US83367TAB52	3m+175	USD	0.20%	0.41%	0.93%	2.06%	2.94%	3.56%	3.91%	4.12%	4.31%	4.43%
XS0336598064	3m+335	EUR	0.23%	0.44%	0.79%	1.33%	1.80%	2.14%	2.43%	2.70%	2.91%	3.09%
XS0369350813	3m+340	GBP	0.63%	0.71%	1.07%	1.71%	2.37%	2.90%	3.36%	3.72%	3.96%	4.07%
XS0449487619	3m+890	EUR	0.23%	0.44%	0.79%	1.33%	1.80%	2.14%	2.43%	2.70%	2.91%	3.09%

Source: J.P. Morgan.

Table 46 shows the converted annual interest amounts. These were calculated simply by adding the forward curve assumption for 3m libor/euribor to the credit spread associated with the instrument.

Table 46: Annual Interest Assumptions as of Aug 2013

ISIN	Back	Ccy	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
XS0179207583	3m+195	EUR	5.419%	2.390%	2.740%	3.280%	3.750%	4.090%	4.380%	4.650%	4.860%	5.040%
FR0010136382	3m+153	EUR	4.196%	4.196%	4.196%	2.860%	3.330%	3.670%	3.960%	4.230%	4.440%	4.620%
XS0454569863		USD	8.750%	8.750%	8.750%	8.750%	8.750%	8.750%	8.750%	8.750%	8.750%	8.750%
Priv Placement	3m+677	USD	9.505%	5.922%	5.922%	5.922%	5.922%	10.330%	10.680%	10.890%	11.080%	11.200%
USF8586CAA02	3m+175	USD	5.922%	5.922%	5.922%	5.922%	5.922%	5.310%	5.660%	5.870%	6.060%	6.180%
US83367TAB52	3m+175	USD	0.950%	1.160%	1.680%	2.810%	3.690%	5.310%	5.660%	5.870%	6.060%	6.180%
XS0336598064	3m+335	EUR	6.999%	6.999%	6.999%	6.999%	6.999%	5.490%	5.780%	6.050%	6.260%	6.440%
XS0369350813	3m+340	GBP	8.875%	8.875%	8.875%	8.875%	8.875%	8.875%	6.760%	7.120%	7.360%	7.470%
XS0449487619	3m+890	EUR	9.375%	9.375%	9.375%	9.375%	9.375%	9.375%	9.375%	11.601%	11.811%	11.991%

Source: J.P. Morgan.

In comparison to Table 12 in the main text, Table 47 assumes that SOCGEN calls its step up instruments at their first call date. We model the opportunity cost of SOCGEN leaving the non step instruments outstanding versus issuing cheaper bail-in debt. As we highlighted in the main text, it becomes more beneficial for SOCGEN to call and replace the legacy capital instruments with a blend of new instruments.

**Table 47: SOCGEN: Example Opportunity Cost of leaving capital outstanding, assuming calls of innovative instruments**

			2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	
ISIN	Backend	Call	€ Amt										
XS0179207583	3m+195	2013											
FR0010136382	3m+153	2015	728	728									
XS0454569863*	FIXED	2015	754	754	754	754	754	754	754	754	754	754	
Priv Placement	3m+677	2016	339	339	339								
USF8586CAA02	3m+175	2017	609	609	609	609							
US83367TAB52	3m+175	2017	47	47	47	47							
XS0336598064	3m+335	2017	468	468	468	468							
XS0369350813*	3m+340	2018	586	586	586	586	586	586	586	586	586	586	
XS0373447969	3m+370	2018	100	100	100	100	100						
XS0449487619	3m+890.1	2019	1,000	1,000	1,000	1,000	1,000	1,000					
Tier I outstanding			4,631	4,631	3,903	3,564	2,440	2,340	1,340	1,340	1,340	1,340	
Eligible for Gr.Fthing			4,631	4,631	3,903	3,564	2,440	2,340	1,340	1,340	1,340	1,340	
Grandfathering Cap			5,847	4,677	4,093	3,508	2,923	2,339	1,754	1,169	585	0	
T1	Eligible		4,631	4,631	3,903	3,508	2,440	2,339	1,340	1,169	585	0	
Bail-in Debt	Excess		0	0	0	56	0	1	0	170	755	1,340	
Annual Cost			353	353	323	291	221	213	106	109	110	111	
Reference Data			Yield	Swap	Spread	Tenor							
Cost of New T1			8.25%	1.90%	6.35%	5yr							
Cost of Sub			6.50%	2.00%	4.50%	10yr							
Cost of Senior			4.67%	1.87%	2.80%	9yr							
Alternatives													
Exp Annual Cost			AT1	383	383	323	289	202	193	112	96	48	0
			Sub	0	0	0	5	0	1	0	12	50	89
			Senior	0	0	0	3	0	1	0	9	37	66
Route 1: Sub issue			Cost	383	383	323	294	202	194	112	108	99	89
			Saving	-31	-30	-1	-3	18	19	-5	0	12	22
Route 2: Sen issue			Cost	383	383	323	293	202	194	112	105	85	66
			Saving	-31	-30	-1	-2	18	19	-5	3	25	45
50% Sub/50% Sen			An. Cost	0	0	0	4	0	1	0	10	44	77
Route 3:			Cost	383	383	323	293	202	194	112	107	92	77
			Saving	-31	-30	-1	-3	18	19	-5	2	18	34

Source: J.P. Morgan.\*Non Step instruments, \*\* innovative instruments lose all capital recognition at first call date

Table 48: Tier I capital instruments

ISIN	Ticker	Issue Date	Coupon	First Call	Innovative	Ccy	Amt Out	Mid Price
Call date Pre Dec 2011								
XS0161441000	ACAFP	30/01/2003	7.000	30/01/2009	No	USD	1,500	97.75
XS0173838847	ACAFP	08/08/2003	7.000	30/07/2009	No	USD	550	97.50
NL0000113868	ACAFP	19/12/2003	6.000	30/07/2009	No	EUR	550	95.65
DE000A0DD4K8	BACA	28/10/2004	1.614	28/10/2011	No	EUR	98	54.88
DE000A0DYW70	BACA	22/02/2005	1.838	22/03/2012	No	EUR	51	55.25
US06739F3901	BACR	25/04/2006	6.625	15/09/2011	No	USD	750	24.36
FR0010239319	BNP	17/10/2005	4.875	17/10/2011	No	EUR	1,000	90.70
FR0010239368	BNP	17/10/2005	6.250	17/10/2011	No	USD	400	98.20
FR0010125757	BPCEGP	12/10/2004	1.938	12/10/2009	No	EUR	80	61.00
FR0010101949	BPCEGP	30/07/2004	2.850	30/12/2009	No	USD	200	75.75
456837202*	INTNED	18/07/2002	7.050	15/09/2007	No	USD	800	18.00
456837301*	INTNED	12/12/2002	7.200	15/12/2007	No	USD	1,100	18.00
456837400*	INTNED	28/10/2003	6.200	15/01/2009	No	USD	500	17.01
XS0389462341	INTNED	29/09/2008	9.000	29/09/2009	No	EUR	10	
456837509*	INTNED	26/09/2005	6.125	15/01/2011	No	USD	700	22.80
US44978NAA37	INTNED	15/12/2000	3.874	31/12/2010	Yes	USD	522	97.00
XS0099124793	KBC	30/06/1999	3.222	30/06/2009	Yes	EUR	130	87.50
USU2445QAA68	KBC	02/11/1999	4.316	02/11/2009	Yes	USD	173	86.25
US48239FAA66	KBC	10/11/1999	4.127	10/11/2009	Yes	EUR	121	86.44
BE0119284710	KBC	19/12/2003	6.202	19/12/2019	Yes	GBP	62	87.00
FR0010154278	KNFP	25/01/2005	3.750	25/01/2010	No	EUR	185	73.25
XS0156372343	LLOYDS	22/10/2002	6.900	22/11/2007	No	USD	343	99.25
XS0165483164	LLOYDS	21/03/2003	6.850	23/03/2009	No	USD	1,000	95.75
<b>XS0109138536</b>	LLOYDS	14/03/2000	6.059	31/05/2010	Yes	GBP	250	96.50
GB0058322420	LLOYDS	09/12/1999	3.075	09/12/2011	Yes	EUR	183	80.49
US6385398820*	RBS	08/04/1997	7.763	09/04/2002	No	USD	246	25.15
US7800978790*	RBS	08/02/1999	7.250	31/03/2004	No	USD	242	24.07
US7800978048	RBS	26/03/1997	7.650	31/03/2007	No	USD	156	24.72
XS0159056208	RBS	05/12/2002	6.800	31/03/2008	No	USD	486	87.25
74928K208*	RBS	03/07/2003	5.900	03/07/2008	No	USD	1,285	19.76
74928M204*	RBS	30/09/2003	6.250	30/09/2008	No	USD	200	20.39
74928P207*	RBS	18/02/2004	6.080	18/02/2009	No	USD	1,800	19.40
US7800977883*	RBS	23/06/2003	5.750	30/09/2009	No	USD	751	21.41
US7800977966	RBS	26/08/2004	6.400	30/09/2009	No	USD	578	20.99
XS0205935470	RBS	29/11/2004	5.500	31/12/2009	No	EUR	1,250	75.50
US780097AE13	RBS	06/03/2000	9.118	31/03/2010	No	USD	65	98.19
DE000A0E6C37	RBS	28/06/2005	5.250	30/06/2010	No	EUR	785	73.25
US7800977701	RBS	19/05/2005	6.350	30/06/2010	No	USD	553	19.91
US7800977628*	RBS	09/11/2005	6.250	31/12/2010	No	USD	247	20.05
XS0121856859	RBS	14/12/2000	7.387	31/12/2010	No	GBP	15	73.88
US7800977545*	RBS	25/05/2006	6.750	30/06/2011	No	USD	516	21.24
US7800977479*	RBS	27/12/2006	6.125	30/12/2011	No	USD	254	19.91
Call Date 31st Dec 2011 - 31st Dec 2013								
FR0010533554	ACAFP	19/10/2007	7.375	19/10/2012	No	USD	500	99.90
Newedge	ACAFP	01/12/2008	8.600	01/12/2013	No	USD	103	
US06739H7769*	BACR	13/09/2007	7.100	15/12/2012	No	USD	1,375	24.94
US06739H5110*	BACR	07/12/2007	7.750	15/03/2013	No	USD	1,150	25.00
US06739H3628*	BACR	11/04/2008	8.125	15/06/2013	No	USD	2,650	25.28
FR0010477125	BNP	06/06/2007	6.500	06/06/2012	No	USD	600	98.25
FR0010661314	BNP	11/09/2008	8.667	11/09/2013	Yes	EUR	650	100.00
FR0010279208	BPCEGP	27/01/2006	6.750	27/01/2012	No	USD	300	98.35
456837608*	INTNED	13/06/2007	6.375	15/06/2012	No	USD	1,045	22.00
456837707*	INTNED	04/10/2007	7.375	15/10/2012	No	USD	1,500	24.85
XS0356687219	INTNED	18/04/2008	8.000	18/04/2013	No	EUR	1,500	104.00
EC991667	INTNED	19/06/2003	2.710	30/06/2013	No	EUR	432	72.25
456837806*	INTNED	17/06/2008	8.500	15/09/2013	No	USD	2,000	25.26
BE0934378747	KBC	14/05/2008	8.000	14/05/2013	Yes	EUR	1,250	103.25
XS0368735154	KBC	27/06/2008	8.000	27/06/2013	Yes	EUR	700	103.38
XS0406095637	LLOYDS	19/01/2009	7.875	29/11/2013	No	EUR	173	99.75
XS0406095041	LLOYDS	19/01/2009	7.875	29/11/2013	No	USD	424	100.00
<b>XS0156923913</b>	LLOYDS	25/10/2002	2.700	25/02/2013	Yes	EUR	261	90.00
US7800977396*	RBS	28/06/2007	6.600	30/06/2012	No	USD	661	20.84
XS0323839042	RBS	04/10/2007	2.840	05/10/2012	No	GBP	54	55.00

ISIN	Ticker	Issue Date	Coupon	First Call	Innovative	Ccy	Amt Out	Mid Price
US7800977131*	RBS	27/09/2007	7.250	31/12/2012	No	USD	1,281	22.98
XS0149161217	RBS	10/06/2002	2.319	30/06/2012	Yes	EUR	227	77.00
US749274AA41	RBS	21/05/2003	2.139	01/07/2013	Yes	USD	846	78.75
XS0179207583	SOCGEN	10/11/2003	5.419	10/11/2013	Yes	EUR	420	99.99
Call Date Post 31st Dec 2013								
FR0010772244	ACAFP	26/06/2009	9.750	26/12/2014	No	USD	1,350	106.65
FR0010161026	ACAFP	04/02/2005	1.916	04/02/2015	No	EUR	371	66.38
USF22797FJ25	ACAFP	31/05/2007	6.637	31/05/2017	No	USD	890	97.55
NZCASH0001S5	ACAFP	19/12/2007	5.040	19/12/2017	No	NZD	250	
FR0000140071	ACAFP	24/10/1984			No	EUR	238	
FR0010248641	ACAFP	09/11/2005	4.130	09/11/2015	Yes	EUR	329	97.63
FR0010291997	ACAFP	24/02/2006	5.136	24/02/2016	Yes	GBP	199	97.00
FR0010359794	ACAFP	11/08/2006	5.500	11/08/2016	Yes	CAD	60	
CACEIS	ACAFP	01/11/2007	6.315	01/11/2017	Yes	EUR	40	
FR0010603159	ACAFP	31/03/2008	8.200	31/03/2018	Yes	EUR	850	113.00
FR0010670422	ACAFP	30/09/2008	10.653	30/09/2018	Yes	EUR	500	135.81
USF22797FK97	ACAFP	13/10/2009	8.375	13/10/2019	Yes	USD	1,000	109.10
FR0010814434	ACAFP	26/10/2009	7.875	26/10/2019	Yes	EUR	550	109.75
FR0010814418	ACAFP	26/10/2009	8.125	26/10/2019	Yes	GBP	291	105.00
FR0010575654	ACAFP	30/01/2008	7.589	30/01/2020	Yes	GBP	172	101.00
XS0205937336	BACR	08/12/2004	4.875	15/12/2014	No	EUR	1,000	81.25
<b>XS0222208539</b>	BACR	22/06/2005	6.000	15/12/2017	No	GBP	750	89.50
<b>XS0214398199</b>	BACR	15/03/2005	4.750	15/03/2020	No	EUR	1,400	77.50
US06738C8284	BACR	08/06/2005	6.278	15/12/2034	No	USD	1,000	92.20
XS0269453139	BACR	28/09/2006	5.926	15/12/2016	Yes	USD	533	102.25
XS0322792010	BACR	25/09/2007	7.434	15/12/2017	Yes	USD	347	108.50
XS0397801357	BACR	27/11/2008	14.000	15/06/2019	Yes	GBP	3,000	133.50
XS0305103482	BACR	12/06/2007	6.369	15/12/2019	Yes	GBP	95	91.00
<b>XS0155141830</b>	BACR	25/09/2002	6.860	15/06/2032	Yes	USD	681	99.00
XS0150052388	BACR	04/07/2002	6.000	15/06/2032	Yes	GBP	91	91.00
XS0248675364	BACR	31/03/2006	5.330	15/12/2036	Yes	GBP	81	83.00
FR0010306787	BNP	19/04/2006	5.945	19/04/2016	No	GBP	450	97.07
FR0010533026	BNP	23/10/2007	7.436	23/10/2017	No	GBP	200	100.50
US05565AAB98	BNP	25/06/2007	7.195	25/06/2037	No	USD	1,100	99.58
US05565AAA16	BNP	29/06/2005	5.186	29/06/2015	Yes	USD	1,070	98.90
FR0010306738	BNP	12/04/2006	4.730	12/04/2016	Yes	EUR	557	99.50
FR0010348557	BNP	13/07/2006	5.954	13/07/2016	Yes	GBP	163	100.00
FR0010456764	BNP	13/04/2007	5.019	13/04/2017	Yes	EUR	638	99.50
FR0010638338	BNP	30/06/2008	7.781	02/07/2018	Yes	EUR	500	110.00
FR0010662023	BNP	18/09/2008	7.570	18/09/2018	Yes	EUR	100	
FR0010821108	BNP	29/12/2009	7.028	29/12/2019	Yes	EUR	20	
FR0010821116	BNP	29/12/2009	3.968	29/12/2019	Yes	EUR	3	
FR0010821132	BNP	30/12/2009	4.024	30/12/2019	Yes	USD	70	
FR0010821124	BNP	30/12/2009	7.384	30/12/2019	Yes	USD	1	
FR0010348565	BNP	13/07/2006	5.450	13/07/2026	Yes	EUR	150	
FR0010814558	BPCEGP	22/10/2009	9.250	22/04/2015	No	EUR	750	105.55
FR0010777532	BPCEGP	06/08/2009	13.000	30/09/2015	No	USD	134	111.00
FR0010777516	BPCEGP	06/08/2009	13.000	30/09/2015	No	EUR	52	112.84
FR0010031138	BPCEGP	26/11/2003	5.250	30/07/2014	Yes	EUR	471	99.50
FR0010871269	BPCEGP	17/03/2010	9.000	17/03/2015	Yes	EUR	818	105.50
FR0010117366	BPCEGP	06/10/2004	4.625	30/07/2015	Yes	EUR	368	98.25
FR0010279273	BPCEGP	01/02/2006	4.750	01/02/2016	Yes	EUR	350	88.00
FR0010535971	BPCEGP	30/10/2007	6.117	30/10/2017	Yes	EUR	509	99.50
USF11494AA36	BPCEGP	06/08/2009	12.500	30/09/2019	Yes	USD	444	125.25
FR0010777524	BPCEGP	06/08/2009	12.500	30/09/2019	Yes	EUR	374	126.50
IT0004743818	CARPP	29/06/2011	7.675		No	EUR	120	
BE0119806116	FBAVP	27/10/2004	4.625	27/10/2014	Yes	EUR	1,000	99.50
US404398AA77	HVB	15/07/1999	8.741	30/06/2029	No	USD	106	97.51
US404399AA50	HVB	22/10/1999	9.000	22/10/2029	No	USD	48	98.19
XS0126207728	HVB	09/04/2001	3.500	31/12/2029	No	JPY	25,000	
XS0102826673	HVB	13/10/1999	7.760	13/10/2034	No	GBP	17	96.05
ED480560	INTNED	16/06/2004	2.310	30/06/2014	No	EUR	563	68.75
XS0221619033	INTNED	08/06/2005	4.176	08/06/2015	Yes	EUR	169	98.75
EF195916	INTNED	08/12/2005	5.775	08/12/2015	Yes	USD	364	98.008
XS0246487705	INTNED	17/03/2006	5.140	17/03/2016	Yes	GBP	66	93.50
XS0545782020	ISPIM	01/10/2010	9.500	01/06/2016	No	EUR	478	105.25

ISIN	Ticker	Issue Date	Coupon	First Call	Innovative	Ccy	Amt Out	Mid Price
XS0371711663	ISPIM	20/06/2008	8.047	20/06/2018	Yes	EUR	580	101.75
XS0388841669	ISPIM	24/09/2008	8.698	24/09/2018	Yes	EUR	250	98.06
XS0456541506	ISPIM	14/10/2009	8.375	14/10/2019	Yes	EUR	742	104.00
BE0934378747	KBC	14/05/2008	8.000	14/05/2013	Yes	EUR	1,250	103.25
XS0368735154	KBC	27/06/2008	8.000	27/06/2013	Yes	EUR	700	103.38
FR0010531012	KNFP	18/10/2007	6.307	18/10/2017	Yes	EUR	372	100.00
FR0010600163	KNFP	31/03/2008	8.650	28/03/2018	Yes	EUR	150	
USF6483LHM57	KNFP	30/04/2008	10.000	30/04/2018	Yes	USD	186	113.00
GB00B3KSBH82	LLOYDS	19/01/2009	6.413		n/a	USD	375	
GB00B3KSBK12	LLOYDS	21/11/2008	6.657		n/a	USD	5	
XS0408828803	LLOYDS	19/01/2009	6.088	12/05/2015	No	GBP	11	69.69
US539439AA71	LLOYDS	13/11/2006	6.267	14/11/2016	No	USD	398	86.70
XS0408826427	LLOYDS	19/01/2009	6.367	17/06/2019	No	GBP	3	
GB00B3KSB568	LLOYDS	19/01/2009	6.475	15/09/2024	No	GBP	56	95.00
GB00B3KSB238	LLOYDS	19/01/2009	9.750		No	GBP	56	127.88
GB00B3KS9W93	LLOYDS	15/04/2009	9.250		No	GBP	300	121.75
USG43648AA57	LLOYDS	24/06/2004	6.071	30/06/2014	Yes	USD	750	96.75
XS0107228024	LLOYDS	07/02/2000	7.834	07/02/2015	Yes	GBP	5	
USG5533WAB30	LLOYDS	19/01/2009	5.920	01/10/2015	Yes	USD	213	86.71
XS0255242769	LLOYDS	23/05/2006	4.939	23/05/2016	Yes	EUR	39	80.37
XS0125681345	LLOYDS	28/02/2001	7.286	31/05/2016	Yes	GBP	150	99.40
XS0218638236	LLOYDS	12/05/2005	4.385	12/05/2017	Yes	EUR	88	70.01
XS0353590366	LLOYDS	19/03/2008	9.540	19/03/2018	Yes	GBP	14	105.00
XS0139175821	LLOYDS	28/11/2001	6.461	30/11/2018	Yes	GBP	600	94.90
XS0408620135	LLOYDS	21/01/2009	13.000	22/01/2019	Yes	GBP	9	
XS0408623311	LLOYDS	21/01/2009	13.000	22/01/2019	Yes	EUR	46	142.20
XS0109139344	LLOYDS	14/03/2000	7.754	31/05/2021	Yes	GBP	150	101.00
US539473AE82	LLOYDS	16/12/2009	12.000	16/12/2024	Yes	USD	2,000	133.67
XS0125686229	LLOYDS	28/02/2001	7.281	31/05/2026	Yes	GBP	150	99.00
XS0408620721	LLOYDS	21/01/2009	13.000	21/01/2029	Yes	GBP	591	150.54
GB0058327924	LLOYDS	09/12/1999	7.881	09/12/2031	Yes	GBP	245	100.00
XS0323734961	RBS	04/10/2007	7.092	29/09/2017	No	EUR	471	87.00
US780097AU54	RBS	04/10/2007	7.640	29/09/2017	No	USD	1,013	90.38
US780097AH44	RBS	20/08/2001	7.648	30/09/2031	No	USD	762	97.01
GB0006227051	RBS	16/09/1991	9.000		No	GBP	140	114.00
US74927FAA93	RBS	24/08/2004	1.076	30/09/2014	Yes	USD	276	75.25
US74927QAA58	RBS	24/08/2004	5.512	30/09/2014	Yes	USD	950	85.06
XS0237530497	RBS	12/12/2005	4.243	12/01/2016	Yes	EUR	166	77.00
XS0277453774	RBS	08/12/2006	5.646	08/06/2017	Yes	GBP	93	75.00
CA780097AT83	RBS	04/10/2007	6.666	05/10/2017	Yes	CAD	321	
US780097AS09	RBS	04/10/2007	6.990	05/10/2017	Yes	USD	564	98.82
US74927PAA75	RBS	10/12/2003	6.425	03/01/2034	Yes	USD	394	85.00
XS0454569863	SOCGEN	07/10/2009	8.750	07/04/2015	No	USD	1,000	105.50
XS0369350813	SOCGEN	16/06/2008	8.875	16/06/2018	No	GBP	506	106.25
FR0010136382	SOCGEN	26/01/2005	4.196	26/01/2015	Yes	EUR	728	97.88
USF8586CAA02	SOCGEN	05/04/2007	5.922	05/04/2017	Yes	USD	808	100.38
US83367TAB52	SOCGEN	05/04/2007	1.024	05/04/2017	Yes	USD	63	
XS0336598064	SOCGEN	19/12/2007	6.999	19/12/2017	Yes	EUR	468	106.00
XS0373447969	SOCGEN	07/07/2008	7.715	07/07/2018	Yes	EUR	100	
XS0449487619	SOCGEN	04/09/2009	9.375	04/09/2019	Yes	EUR	1,000	114.00
XS0231436238	UCGIM	27/10/2005	4.028	27/10/2015	Yes	EUR	280	94.25
XS0231436667	UCGIM	27/10/2005	5.396	27/10/2015	Yes	GBP	26	89.71
XS0372556299	UCGIM	27/06/2008	8.593	27/06/2018	Yes	GBP	178	100.50
XS0470937243	UCGIM	10/12/2009	8.125	10/12/2019	Yes	EUR	585	103.75
XS0527624059	UCGIM	21/07/2010	9.375	21/07/2020	Yes	EUR	339	106.25

Source: J.P. Morgan. Pricing source in this table is from Bloomberg and may not match pricing in the rest of the report, \*\*\$25 securities



Table 49: Trade Portfolio Summary: Open Trades

Direct ion	Opening date	Trades	Size (m)	Trade Price	Trade Spread	Current Price	Current Spread	Capital Gain / Loss	Net Trade Carry	Total Trade P&L	Trade Status	Total Trade P&L
<b>Open Trades</b>												
BUY	06/03/2012	INTNED 0.79585% \$05/16	5.0	92		97		250,000	59,634	309,634	Open	
SELL	06/03/2012	HSBC 0.522% €09/20	5.0	88.25		97.5		-462,500	-39,114	-501,614	Open	-191,980
BUY	25/10/2012	RBS 5yr SUB CDS	5.0		420		321	-207,535	-180,658	-388,192	Open	
SELL	25/10/2012	BACR 5yr SUB CDS	6.7		315		215	298,590	180,658	479,247	Open	91,055
BUY	25/10/2012	CCAMA 4.375% €A /1e	3.0	53		80		810,000	112,911	922,911	Open	
SELL	25/10/2012	CCAMA 7.875% €10/39	3.0	73.25		96.5		-697,500	-203,240	-900,740	Open	22,171
SELL	09/01/2013	DEXGRP 5yr SEN CDS	5.0		390		380	18,787	127,151	145,938	Open	
BUY	09/01/2013	FRTR 5yr SEN CDS	2.5		88.5		69.4439	-22,461	-14,427	-36,888	Open	
BUY	09/01/2013	BELG 5yr SEN CDS	2.5		82		61.3886	-25,228	-13,367	-38,595	Open	70,455
BUY	14/02/2013	MONTE 6.525% €13	2.0	46.5		51.5		100,000	72,222	172,222	Open	
SELL	14/02/2013	MONTE 0% €13	2.0	43.5		41.5		40,000	0	40,000	Open	212,222
SELL	14/02/2013	CABKSM 3.25% €01/16	6.0		288		227.5	-80,569	-107,918	-188,486	Open	
SELL	14/02/2013	CABKSM 4.125% €11/14	6.0		258		133.9	-85,012	-136,973	-221,984	Open	
BUY	14/02/2013	CABKSM 3.5% €03/16	4.0		243		179.9	60,777	77,479	138,257	Open	
BUY	14/02/2013	CABKSM 5.125% €04/16	4.0		242		178.2	62,317	113,452	175,769	Open	
BUY	14/02/2013	CABKSM 4.75% €03/15	4.0		201		123.7	45,013	105,151	150,164	Open	53,719
SELL	14/02/2013	KBC 8% €14	2.0	102.15		103.25		-22,000	-88,548	-110,548	Open	
BUY	14/02/2013	KBC 4.127% €13	2.0	78.5		87.5		180,000	45,680	225,680	Open	115,132
BUY	12/04/2013	MAPSM 5.921% €07/37	5.0	91		94.125		156,250	117,609	273,859	Open	
SELL	12/04/2013	ASSGEN 7.75% €12/42	5.0	106		108.625		-131,250	-153,938	-285,188	Open	-11,329
BUY	12/04/2013	LLOYDS 5yr CDS CDS	5.0		160		135.5	-56,698	-31,781	-88,479	Open	
SELL	12/04/2013	KBC 5yr CDS CDS	5.0		170		135	75,681	33,767	109,448	Open	20,969
BUY	12/04/2013	BCPPL 5yr CDS CDS	4.8		530		684	259,067	-101,301	157,766	Open	
SELL	12/04/2013	BESPL 5yr CDS CDS	5.0		510		588.55	-147,611	101,301	-46,309	Open	111,457
SELL	04/06/2013	NDB 5.625% €14	2.0	71		74		-60,000	-28,356	-88,356	Open	
BUY	04/06/2013	RBS 5.89% \$13Q**	2.0	22.25		20.2		-164,000	29,692	-134,308	Open	-222,664
BUY	19/07/2013	DEXGRP 0.867% €07/17	5.0	72.5		71.75		-37,500	5,582	-31,918	Open	-31,918
BUY	04/09/2013	LLOYDS 2.725% €13	2.0	90.5								
BUY	04/09/2013	SOCGEN 6.625% \$18	5.0	101.5								

Source: J.P. Morgan. \*\*basis swap at cost of 19bps to annual carry

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Date	Rating	Instrument
15 Mar 13	Neutral	5yr CDS

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#### Lloyds Banking Group - J.P. Morgan Recommendation History

Date	Rating	Instrument
17 Jun 11	Neutral	5yr CDS

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#### Credit Agricole - J.P. Morgan Recommendation History

Date	Rating	Instrument
09 Sep 11	Underweight	5y Senior CDS

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27 May 11	Overweight	5yr CDS

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26 Sep 07	Neutral	CDS

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17 Jun 11	Underweight	5yr CDS

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04 Sep 13	Neutral	5yr Senior CDS

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Date	Rating	Instrument
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11 Oct 06	Neutral	CDS

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09 Mar 11	Overweight	5yr senior CDS

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26 Aug 13	Not Rated	CDS

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11 May 04	Neutral	CDS

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