

EUROPEAN BANKS OUTLOOK 2011

Finely balanced

- We change our stance on the European banking sector to Market Weight from Overweight. The credit negatives of resolution regimes and sovereign risks could largely offset the credit positives of Basel III-induced balance sheet improvements and lower loan loss charges, in our view. Continued headline risks relating to resolution regimes and sovereign risk could prevent bank senior bonds from outperforming non-financial corporate bonds in 2011. On the other hand, the possibility of underperformance in 2011 is constrained by historically wide relative spreads and attractive technicals. We also note that a well-executed EU banking stress test in H1 11 could surprise the market positively.
- In the senior space, we continue to prefer high-quality, large-cap banks and compelling restructuring stories, where we see near-term improvement in stand-alone credit fundamentals with attractive valuation upside. These banks should be able to absorb base-case shocks while continuing their internal restructuring/integration programmes. Our top picks are RBS, Intesa Sanpaolo and Banco Santander. Our top pans are Banca Monte dei Paschi, Dexia SA and Banco Comercial Portugues. In Lower Tier 2, we expect to see some retracement of recent spread widening, particularly for AA-rated banks such as BNP, HSBC and Intesa Sanpaolo. In Tier 1, we continue to see good value but note the idiosyncrasies of each bond, for instance with regards to regulatory/first call probabilities.
- For bank bond investors, losses given default (LGDs) will go up (due to resolution regimes), whereas probabilities of default (PDs) will come down (due to Basel III and improvements in macro-prudential oversight). In 2011, these two long-term structural forces may be overshadowed by continued concerns about sovereign debt from peripheral Europe, in our view. We acknowledge the threat of possible sovereign debt restructuring on banks' capital positions and note the inter-linkages between banking systems.
- In 2011, we expect European banks' gross issuance of medium- and long-term debt (senior unsecured, covered bonds, subordinated debt) to match redemptions. This is because we expect increasing customer deposits and falling interbank funding to largely offset each other and aggregate balance sheet growth to remain muted. We expect the shift to covered bond funding from senior unsecured funding to continue, but note that this should not negatively affect banks' issuer ratings in the medium term due to significant spare capacity for covered bond issuance. BPCE, Commerzbank and Dexia currently obtain the largest share of their funding from covered bonds.

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SECTOR STANCE

European banks – finely balanced

We change our stance on European banks to Market Weight from Overweight. The credit negatives of resolution regimes and sovereign risks could largely offset the credit positives of Basel III-induced balance sheet improvements and lower loan loss charges, in our view. Continued headline risks related to resolution regimes and sovereign risk could prevent bank senior bonds from outperforming non-financial corporate bonds in 2011. On the other hand, the possibility of underperformance in 2011 is constrained by historically wide relative spreads and attractive technicals.

Several long-term structural forces currently at play are affecting European bank bonds' risk profile in opposite ways. On the one hand, the EU resolution regime proposals of 6 January 2011 and the resolution regimes already implemented in the UK (2009), Denmark (October 2010), Germany (November 2010) and Ireland (December 2010) are explicitly removing the sovereign support that benefited senior and subordinated bonds of certain banks in the past and are providing the regulatory framework for regulators to impose losses on bank bondholders. (Please refer to the *Resolution Regime* section of this report for further detail.) This implies higher losses given default (LGD) for those bonds from hereon. On the other hand, European governments are expected to start the formal implementation of the final Basel III proposals in 2011 (as announced on 16 December 2010), ahead of the framework's staggered introduction beginning in 2013. This is a credit positive for issuer ratings, as it implies lower probabilities of default (PD) due to more stringent capital requirements and the introduction, for the first time, of liquidity rules, among other factors (eg, improved macro-prudential supervisory oversight). Despite the long implementation trajectory of Basel III, we expect banks to continue their proactive balance sheet improvements by increasing their capital ratios and terming out their funding structures. The benefits of these measures for banks' creditworthiness are, therefore, much nearer in time than the actual Basel III introduction dates, we believe. So LGDs will go up, whereas PDs will come down. In other words, although credit investor losses will be more severe than in the past upon default, banks should be less likely to fail in the future.

In 2011, these two long-term structural forces may be overshadowed by the continuing concerns about sovereign debt issued by the European periphery. We acknowledge the threat of possible sovereign debt restructuring on banks' capital position and note the interlinkages between banking systems, although the imposition of severe haircuts (ie, beyond the ones used by CEBS in the July 2010 stress test) is not currently our base case. If the sovereign debt worries subside, and assuming the economic recovery is sustained, we expect European banks' credit fundamentals to continue to improve, not only driven by Basel III-induced balance sheet improvements, but also by lower loan loss charges. For 2011, our economists forecast 2.0% y/y real GDP growth (1.7% in 2010, -4.0% in 2009). We believe the boost this gives to European banks' asset quality more than offsets the threat to asset quality of higher borrower benchmark interest rates (in response to higher inflation).

Since the start of 2010, European banks' senior bond spreads have widened significantly relative to non-financial corporate bond spreads. In 2011, we expect the factors that drove this underperformance (ie, resolution frameworks and Europe's sovereign debt crisis) to remain in place. The related headline risks are therefore likely to keep bank senior bonds from outperforming this year. As for Lower Tier 2, we expect to see some retracement from the spread underperformance relative to senior bonds since November 2010, particularly for higher-rated banks. In Tier 1, we see good value, but note the idiosyncrasies of each bond's documentation.

On a positive note, we believe the technical backdrop for European bank bonds is good. In the first place, with the majority of banks still in deleveraging mode (ie, low loan growth) and banks shifting their funding mix towards covered bonds, senior supply should be contained. The positive impact that this could have on bank bond spreads may be mitigated by a shift in demand toward covered bonds and away from senior unsecured bonds. Secondly, subordinated supply should also be limited, due to the increased focus on core Tier 1 capital instead of Tier 1 / total capital. Thirdly, many investors remain underweight financials. With large cash balances to put to work, this could support bank spread performance.

Key risks to our Market Weight stance: 1) if the European sovereign debt crisis is not contained in 2011, banks are likely to underperform non-financial corporates; 2) higher borrower benchmark interest rates could lead to renewed asset quality strains, causing bank bonds to underperform; and 3) a well-executed EU banking stress test in H1 11 could surprise the market positively, leading to diminished sovereign risk aversion and driving bank bonds to outperform.

Figure 1: European banks – rating snapshots

Issuer	Rating	Comment
Allied Irish Banks plc	Suspended	Irish state owns 92.8% after €3.7bn capital injection in Dec 2010. Still needs to raise €6.1bn of additional capital by end-Feb 2011. LT2 tender offer launched in January 2011. Conversion of the state's €3.5bn preference shares into common equity highly likely.
Anglo Irish Bank	Not rated	Please refer to the <i>European banks – rating changes</i> section
Banca Monte Dei Paschi Di Siena SpA	Underweight	Weak capitalisation and reliance on wholesale funding. Poor asset quality relative to peers and still high cost base despite improvements. High cost of government participations puts a drag on profitability. Valuation does not compensate investors for these risks.
Banco Bilbao Vizcaya Argentaria SA	Overweight	Only 34% of operating profit from Iberia and 55% from Mexico/LatAm/US. In Nov 2010, agreed to acquire 24.9% stake in Turkish bank Garanti (with option to take majority control after five years) for USD5.8bn, funded by €5bn rights issue.
Banco Comercial Portugues SA	Underweight	Weak capitalisation, high reliance on wholesale funding, deteriorating asset quality relative to peers. Sprawling franchise, with a presence in Greece, Poland, Angola, among others.
Banco Espirito Santo SA	Underweight	Third largest Portuguese bank. High reliance on wholesale funding, despite recent improvement. Above average asset quality relative to peers. Liquidity appears adequate. 40% of net operating profit from abroad (Angola, Spain, UK, Brazil). Thinly capitalised.
Banco Santander SA	Overweight	Cheapest large-cap European bank. Only 20% of revenues from Iberia and 50% from LatAm, so should be resilient to knock-on effects of sovereign debt crisis. Strong internal capital generation should boost capital ratios after recent acquisitions. Solid liquidity profile.
Bank of Ireland	Suspended	Seeking to raise €1.6bn by end-Feb 2011 away from the Irish government to avoid the latter increasing its stake from current 36%.
BNP Paribas SA	Market Weight	Largest bank in the euro area by total assets. Sound credit fundamentals, but valuations unappealing. Owns BNL in Italy.
BPCE	Market Weight	France's second-largest retail bank, fourth-largest by total assets. Limited exposure to peripheral Europe (over 90% of assets and revenue domestic). Asset quality appears healthy, but core Tier 1 ratio still lagging peers. Remains over-reliant on wholesale funding, reflecting 72%-owned subsidiary Natixis. Tier 1 bonds look attractive.
Commerzbank AG	Overweight	Turnaround story. Dresdner Bank integration progressing well. Strong German Mittelstand franchise. Returned to profitability in 9M10 (driven by lower loan loss charges), but 9% dividend on €17bn silent participations. Launched tender offer for some of its Trust Preferred Securities in January 2011.
Credit Agricole SA	Market Weight	Largest French retail banking franchise and second-largest French bank by total assets. Most exposed to peripheral Europe, mainly through Greek subsidiary (Emporiki) and stakes in Bankinter (22.8%) and BES (23.4%).
Credit Suisse Group AG	Market Weight	Offshore private banking model under threat – move to lower-margin onshore private banking continues. Proposals to increase Swiss capital requirements well above Basel III minimums would strengthen its credit profile, although it could put pressure on capital-intensive investment banking operations.

Issuer	Rating	Comment
Deutsche Bank AG	Overweight	Acquisition of Deutsche Postbank should boost Private Clients and Asset Management division, rebalancing the group away from volatile revenues of Corporate and Investment Banking division (77% of 9M10 revenues). €10bn rights issue in Q4 10 also improved capital ratios.
Dexia SA	Underweight	Still overly reliant on wholesale funding. Retrenchment in public finance continues. De-risking in all dimensions (credit/ market/ funding and liquidity), but any upside to credit ratings may be some time off.
HSBC Holdings plc	Market Weight	Impressive emerging markets franchise, but noted slowing growth in some key growth markets in Q3 10 trading update. Walked away from acquiring Nedbank in South Africa, which may have dented its prospects in that continent. New CEO. Credit fundamentals robust, but valuations unappealing.
Intesa Sanpaolo SpA	Overweight	Largest Italian bank by domestic assets and branch network. Asset quality improving, with decelerating NPL additions. Limited CEE exposure, with International Subsidiary Banks division accounting for 14% of 9M10 revenues. Corporate and Investment Banking accounted for 21% of 9M10 revenues.
Lloyds Banking Group plc	Market Weight	Profit warning in Dec 2010 over Irish exposure. In Sep 2011, the UK's Independent Commission on Banking may recommend the group's breakup to improve competition. We would not expect UK government to fully adopt this. New CEO.
Royal Bank Of Scotland Group plc	Overweight	Compelling restructuring story. Core bank has healthy profitability and non-core deleveraging progressing well. Core Tier 1 ratio above 10% and balance sheet liquidity improving. Ireland exposure contained. We see value across the capital structure.
Societe Generale	Market Weight	Well-diversified group, both by geography and business line, with Corporate and Investment Banking limited to 30% of 9M10 revenues. Limited exposure to southern Europe (eg, small Greek subsidiary) but significant franchise in CEE/Russia (International Retail Banking 19% of 9M10 revenues).
Standard Chartered plc	Market Weight	Impressive emerging markets franchise in Asia, Middle East and Africa, but noted slowing momentum in these markets in Q3 10 trading update. Credit fundamentals robust, but valuations unappealing.
UBS AG	Market Weight	Offshore private banking model under threat – move to lower-margin onshore private banking continues. Proposals to increase Swiss capital requirements well above Basel III minimums would strengthen its credit profile, although it could put pressure on capital-intensive investment banking operations.
Unicredit SpA	Overweight	Italy's largest banking group by total assets, with major presence in Germany (24% of 9M10 revenues), Austria (8%) and CEE (18%). Asset quality appears to be stabilising, although loan loss charges eroded two-thirds of 9M10 gross operating profits. New CEO.

Note: Barclays Capital research on Allied Irish Banks plc and The Bank of Ireland is restricted and the ratings and estimates are suspended due to Barclays Capital's role as financial advisor to the Central Bank of Ireland in relation to its Prudential Capital Assessment Review and Prudential Liquidity Assessment Review.

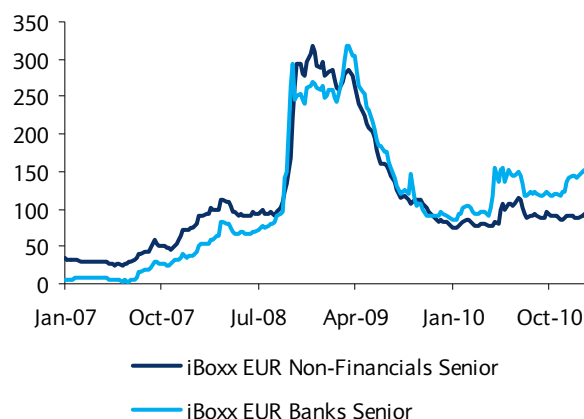
Source: Barclays Capital

RECOMMENDATIONS AND TRADE IDEAS

European banks – valuation

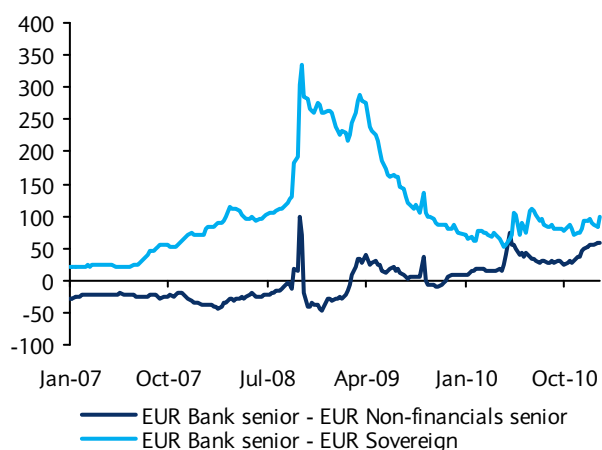
Over the past 2.5 years, the relationship between EU bank senior bond cash spreads and non-financial corporate bond spreads has changed fundamentally. Whereas until mid-2008, banks' senior bonds used to trade tighter than non-financial corporate bonds (z-spread 27bp tighter, on average, during 2006-07), in early 2010 bank bonds started to trade wider. Since then, a valuation gap has opened up that persists until today (see Figure 2 and Figure 3), and the difference between the two is now close to the peak reached in May 2010 (58bp versus 73bp). Over the same time period, banks' senior bonds have also underperformed sovereign bonds, although this has been less pronounced.

Figure 2: European banks' senior bonds versus non-financial corporate and sovereign bonds (z-spread to swap in bp)



Source: iBoxx, Barclays Capital

Figure 3: European banks' senior bonds versus non-financial corporate and sovereign bonds (z-spread differences in bp)



Source: iBoxx, Barclays Capital

The factors that are responsible for European banks' recent underperformance are two-fold, we believe. In the first place, the introduction of resolution regimes by Denmark, Germany and Ireland (see *Resolution Regimes* section for detail), and the expectation that more countries will follow, has removed the implicit sovereign support that many banks enjoyed in the eyes of the market. This belief has been reinforced by the EU resolution proposals announced on 6 January 2011. Secondly, the sovereign debt crisis in the European periphery has yet to be fully resolved. The market remains wary of the possibility of sovereign debt restructurings and the impact that this would have on banks' capital position. In 2011, both factors, and the accompanying headline risks, will continue to weigh on investor sentiment towards the sector, we believe. Therefore, we do not expect European banks senior bonds to outperform non-financial corporate bonds.

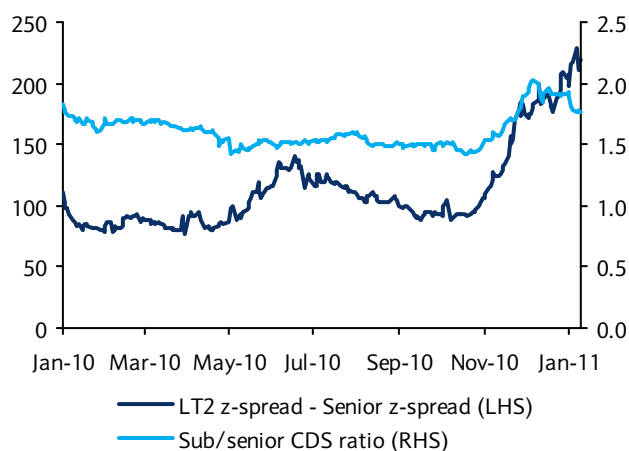
Since early November 2010, a major shift has also taken place in the valuation of European banks' capital structures, with Lower Tier 2 widening significantly relative to senior unsecured. Behind this shift are the increased loss-given-default assumptions for Lower Tier 2 bonds. A number of events contributed to this change in perceptions. Firstly, in late October, Anglo Irish Bank launched a punitive liability management exercise for its hybrid bonds that imposed large haircuts on investors (see [Anglo Irish Bank: Liability Management Exercise](#), 26 October 2010 for details). In particular, the Lower Tier 2 bonds were taken out

Figure 4: European banks – Senior and Lower Tier 2 bullets z-spreads (bp)



Source: Barclays Capital

Figure 5: European banks – z-spread differential and sub/senior CDS ratio



Source: Barclays Capital

at 20% of par. Secondly, the adoption of banking resolution regimes by some European countries and the EU proposals of 6 January 2011 reinforced the notion that burden sharing by subordinated bondholders in future bank failures is highly likely. Thirdly, renewed concerns about Europe's periphery reminded investors of banks' exposure to sovereign risk, not only in terms of balance sheet exposure, but also in terms of policy risk exposure. Faced with large fiscal deficits (partly due to bank rescues), the willingness of governments to impose losses on investors is arguably higher than it would otherwise be. In Figure 4 and Figure 5 we show this shift in valuation.

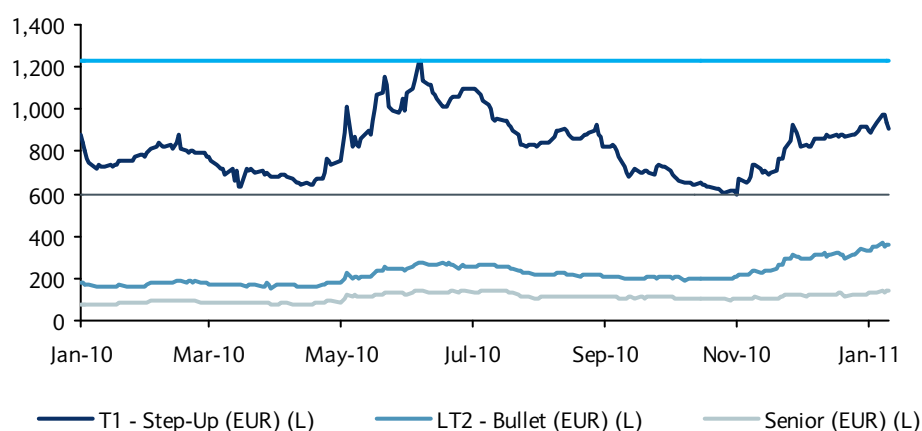
Between the start of 2007 and early November 2010, the average z-spread differential between Lower Tier 2 bullets and senior unsecured was 70bp. On 13 January 2011, this differential stood at 219bp – three times as high. We believe the shift in risk/return of Lower Tier 2 is structural and that we are unlikely to ever see a return to the tightness of 2007. Having said that, we think the spread widening is overdone, and we expect to see some retracement, particularly for fundamentally sound banks (see table below).

Figure 6: Selected EUR LT2 bullet bonds of AA-rated European banks – recent performance

Security name	Z-spread (bp)				YTM (%)			
	01-Nov-10	14-Jan-11	Increase (bp)	Increase (%)	01-Nov-10	14-Jan-11	Increase (bp)	Increase (%)
BNP 5 1/4 12/17/12	58	116	58	100	2.18	2.94	76	35
BNP 5.431 09/07/17	73	146	73	100	3.12	4.37	125	40
DB 5 06/24/20	137	172	35	25	4.06	4.95	90	22
DB 5 1/8 01/31/13	84	149	65	77	2.47	3.32	85	34
HSBC 5 3/8 12/20/12	68	141	73	107	2.29	3.20	91	40
HSBC 6 06/10/19	137	192	55	40	3.95	5.03	109	27
HSBC 6 1/4 03/19/18	127	188	61	48	3.71	4.85	114	31
ISPIM 5 09/23/19	189	223	33	17	4.51	5.38	87	19
ISPIM 5.15 07/16/20	194	243	50	26	4.62	5.67	104	23
ISPIM 5 3/8 12/12	114	201	87	76	2.74	3.79	105	38
Average	118	177	59	62	3.36	4.35	99	31

Source: Bloomberg, Barclays Capital.

Figure 7: European banks – Tier 1 bonds (z-spread)



Source: Barclays Capital

Tier 1 valuations are back to where they were at the start of 2010, as can be seen in Figure 7. On average, Tier 1 bonds are currently priced in the middle of their one-year trading range. We continue to see good value in this space, but note that investors need to be discerning. Issuer analysis will be insufficient; investors need to familiarise themselves with each bond's language. Particularly with regards to callability of instruments (either regulatory calls or scheduled first calls), investors will need to take note of factors that could influence call decisions, such as funding cost incentives, reputational incentives (retail/institutional), the issuer's past call record and capital position. Please refer to the Basel III section of this report for further details.

The risk/reward profiles of the following EUR-denominated Tier 1 bonds look attractive, we believe. These are institutional bonds with high back-end spreads and their respective issuers have a strong call record. All these factors point to high call probability. Regulatory calls would be at par.

- ISPIM EUR 9.5% '16s – YTC 10.6%, z-spread 801bp;
- UCGIM 9.375% '20s – YTC 10.0%, z-spread 690bp;
- BPCEGP EUR 9% '15s – YTC 9.3%, z-spread 699bp.

European banks – top picks

In the senior space, we continue to prefer high-quality, large-cap banks and compelling restructuring stories, where we see near-term improvement in standalone credit fundamentals with attractive valuation upside. These banks should be able to absorb base-case shocks while continuing to make progress with their internal restructuring/integration programmes. Our Overweight recommendations (highest conviction on top) are as follows:

- RBS offers investors a compelling restructuring story that should see its standalone credit ratings continue improving. As a result, we believe that the downside to its ratings from potentially lower sovereign support is diminishing. The core bank has healthy profitability (ROE 12% in Q3), and the deleveraging of the non-core bank is progressing well. At end-Q3 10, its cT1 ratio stood at 10.2% and its loan/deposit ratio declined to 126% (down 2 percentage points q/q), indicating that balance sheet liquidity is improving. Although its NPL ratio continued to increase, the cost of risk kept declining, suggesting that we may be nearing an inflection point. Although its Irish loan book could give rise to further loan losses, we note that this book is geared to residential mortgage lending. We see value across its capital structure.

Figure 8: RBS – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	6.7%	6.4%	5.5%	11.0%	10.6%	10.5%	10.2%
Equity / Assets (ex derivatives)	4.7%	5.1%	5.0%	7.2%	7.0%	7.3%	7.0%
Loans / Deposits	155%	143%	139%	134%	130%	128%	126%
Gross NPL ratio	3.5%	5.2%	6.0%	6.3%	6.6%	6.7%	7.2%
Coverage ratio	46%	44%	43%	43%	46%	45%	46%
Provision gearing	94%	413%	187%	177%	100%	61%	73%
Cost of risk	1.65%	3.14%	2.23%	2.23%	1.93%	1.84%	1.48%
Net interest margin	0.69%	0.75%	0.83%	0.92%	0.92%	1.00%	0.90%
PTP RoA	-0.02%	-0.06%	-0.50%	0.02%	0.00%	0.29%	-0.34%
PTP RoE	-1.8%	0.7%	-17.7%	0.6%	-0.1%	13.4%	-7.4%

Source: Company data, Barclays Capital.

- ISPM: We see good value at the long end of the senior EUR curve. ISPM is the largest Italian bank by domestic assets and has the most extensive branch network. Its asset quality is improving, with NPL additions decelerating. It has limited CEE exposure – its International Subsidiary Banks division accounted for only 14% of 9M10 revenues – although its Hungarian operation could underperform. Corporate & Investment Banking's contribution is also limited, accounting for 21% of 9M10 revenues.

Figure 9: ISPM – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	6.4%	6.9%	7.2%	7.1%	7.2%	7.7%	7.7%
Equity / Assets (ex derivatives)	8.3%	8.5%	8.8%	9.0%	8.9%	8.7%	8.4%
Loans / Deposits	195%	187%	188%	189%	187%	185%	192%
Gross NPL ratio	5.8%	6.5%	7.1%	7.9%	8.1%	8.2%	9.6%
Coverage ratio	52%	49%	48%	47%	48%	52%	43%
Provision gearing	42%	46%	38%	62%	38%	46%	40%
Cost of risk	0.76%	1.12%	0.87%	1.14%	0.82%	0.85%	0.75%
Net interest margin	1.90%	1.97%	1.86%	1.81%	1.74%	1.71%	1.68%
PTP RoA	0.60%	0.72%	0.83%	0.59%	0.71%	0.48%	0.62%
PTP RoE	7.5%	8.6%	9.9%	6.4%	8.3%	5.8%	7.7%

Source: Company data, Barclays Capital.

- SANTAN: This is the cheapest large-cap European bank. Only 20% of its revenues come from Iberia and 50% from LatAm, so it should be resilient to knock-on effects of Europe's sovereign debt crisis. Strong internal capital generation should boost capital ratios after recent acquisitions. €94bn of customer deposit inflow in the first nine months of 2010 and available liquidity of €100bn at group level (versus MLT redemptions of €27bn in 2011) underpin a solid liquidity profile.

Figure 10: SANTAN – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	7.3%	7.5%	7.7%	8.6%	8.8%	8.6%	8.5%
Equity / Assets (ex derivatives)	5.8%	6.0%	6.6%	6.5%	6.5%	6.4%	6.7%
Loans / Deposits	147%	145%	142%	136%	130%	126%	125%
Gross NPL ratio	2.8%	3.2%	3.5%	3.7%	3.8%	3.8%	3.9%
Coverage ratio	80%	72%	73%	75%	74%	73%	75%
Provision gearing	42%	40%	44%	40%	41%	41%	50%
Cost of risk	1.32%	1.42%	1.58%	1.38%	1.45%	1.39%	1.66%
Net interest margin	1.95%	2.07%	2.21%	2.25%	2.29%	2.26%	2.16%
PTP RoA	0.98%	1.10%	1.07%	1.07%	1.11%	1.04%	0.82%
PTP RoE	17.7%	18.9%	16.5%	15.8%	16.6%	15.7%	11.5%

Source: Company data, Barclays Capital.

European banks – top pans

- MONTE: Looking at the bank's senior EUR curve, the valuation of its bonds does not compensate investors for some key risks. The bank is weakly capitalised (core Tier 1 ratio 6.1% at end-Q3 10), has a challenging asset quality profile (NPL ratio 12.8%, NPL coverage ratio 41%) and remains reliant on wholesale funding (loan/deposit ratio 190%), although the latter two points partly reflect Italian peculiarities. With a net ROE in the low single digits, internal capital generation is poor.

Figure 11: MONTE – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	4.7%	4.8%	5.1%	5.1%	5.1%	5.6%	6.1%
Equity / Assets (ex derivatives)	7.6%	7.5%	7.4%	8.1%	8.0%	7.2%	7.4%
Loans / Deposits	191%	177%	166%	177%	179%	186%	190%
Gross NPL ratio	8.6%	9.6%	9.8%	9.7%	11.8%	12.3%	12.8%
Coverage ratio	41%	39%	40%	40%	41%	40%	41%
Provision gearing	48%	68%	67%	127%	54%	52%	50%
Cost of risk	0.79%	1.10%	0.96%	1.12%	0.81%	0.74%	0.74%
Net interest margin	1.97%	1.94%	1.88%	1.79%	1.74%	1.70%	1.64%
PTP RoA	0.91%	0.24%	0.33%	-0.56%	0.37%	0.52%	0.37%
PTP RoE	12.5%	3.3%	4.6%	-7.4%	5.0%	8.0%	5.4%

Source: Company data, Barclays Capital.

- DEXIA: Last June, Dexia voluntarily exited the French/Belgian state debt guarantee four months early. It is de-risking in all dimensions (credit/market/funding and liquidity), for instance by running off its portfolio of legacy assets and by retrenching in public finance. But any upside to credit ratings may be some time off. In the meantime, funding vulnerabilities may keep upward pressure on spreads. Also, doubts persist regarding its business model, and a further restructuring/breakup of the group cannot be ruled out, in our view.

Figure 12: DEXIA – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	9.8%	10.4%	10.8%	11.3%	11.5%	11.3%	11.8%
Equity / Assets (ex derivatives)	0.6%	1.3%	1.8%	1.9%	1.9%	1.4%	1.7%
Loans / Deposits	315%	294%	288%	293%	281%	287%	283%
Gross NPL ratio	1.0%	1.0%	1.1%	1.4%	1.5%	1.7%	1.5%
Coverage ratio	63%	64%	64%	55%	55%	55%	58%
Provision gearing	33%	63%	28%	94%	71%	30%	32%
Cost of risk	0.45%	0.37%	0.10%	0.31%	0.30%	0.14%	0.06%
Net interest margin	1.03%	0.86%	0.76%	0.74%	0.71%	0.71%	0.61%
PTP RoA	0.25%	0.27%	0.24%	0.17%	0.22%	0.16%	0.14%
PTP RoE	41.2%	19.6%	13.6%	10.2%	11.5%	11.6%	8.8%

Source: Company data, Barclays Capital.

- BCP: The bank's capitalisation remains weak (core Tier 1 ratio 5.6% at end-3Q 10). In addition, its reliance on wholesale funding is high (loan/deposit ratio 164%) and has not really improved since end-2009. In contrast to national peers, asset quality deterioration has accelerated in recent quarters, and although it still appears adequate (NPL ratio 3.5%; 4.5% as per the Bank of Portugal's definition), we note that NPL figures reported by Portuguese banks are systematically understated as they only count overdue amounts (and not the full loan amount). We also have business model doubts – BCP's sprawling geographic franchise, with presences in, for example, Greece, Poland and Angola, seems to lack a common denominator. But should visibility on Portugal's sovereign improve, BCP's attractive valuation could come into focus.

Figure 13: BCP – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	5.4%	6.1%	6.2%	6.3%	6.4%	5.6%	5.6%
Equity / Assets (ex derivatives)	6.3%	6.6%	7.3%	7.3%	7.3%	7.0%	7.0%
Loans / Deposits	175%	169%	166%	162%	163%	172%	164%
Gross NPL ratio	1.5%	1.9%	2.3%	2.4%	2.6%	2.8%	3.5%
Coverage ratio	161%	132%	119%	119%	109%	105%	93%
Provision gearing	53%	62%	122%	71%	55%	57%	79%
Cost of risk	0.84%	0.63%	0.69%	0.80%	0.88%	1.16%	0.98%
Net interest margin	1.85%	1.47%	1.56%	1.61%	1.64%	1.71%	1.81%
PTP RoA	0.61%	0.27%	0.15%	0.23%	0.55%	0.32%	0.29%
PTP RoE	9.4%	3.7%	2.1%	2.5%	6.6%	3.9%	3.3%

Source: Company data, Barclays Capital.

European banks – rating changes

- We downgrade LLOY to Market Weight from Overweight. LLOY's restructuring story is similar to RBS's, and valuations of its senior EUR bonds appear attractive. However, we do see some risks. The UK's Independent Commission on Banking will report its final findings in September 2011, in which it may recommend LLOY to be restructured or possibly even broken up, in order to improve competition in the UK market for some key financial products. We do not expect the UK government to fully adopt such proposals, but prefer bonds issued out of Lloyds TSB Bank over those issued out of HBOS for this reason. The bank surprised the market with a profit warning in December 2010 over its Irish exposure. With the arrival of Mr Horta-Osorio as its new CEO, the group's restructuring could receive some renewed impetus.

Figure 14: LLOY – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	6.3%	6.3%	7.2%	8.1%	8.6%	9.0%	n/a
Equity / Assets (ex derivatives)	3.2%	3.3%	3.8%	4.4%	4.6%	4.8%	n/a
Loans / Deposits	159%	152%	153%	154%	150%	146%	n/a
Gross NPL ratio	6.0%	7.5%	8.4%	9.4%	9.8%	10.3%	n/a
Coverage ratio	44%	42%	43%	44%	45%	45%	n/a
Provision gearing	215%	215%	215%	215%	80%	80%	n/a
Cost of risk	4.09%	4.04%	4.22%	4.24%	1.75%	1.77%	n/a
Net interest margin	1.35%	1.35%	1.41%	1.42%	1.55%	1.55%	n/a
PTP RoA	-0.72%	-0.72%	-0.76%	-0.76%	0.25%	0.25%	n/a
PTP RoE	-24.9%	-23.9%	-22.7%	-19.6%	5.3%	5.1%	n/a

Source: Company data, Barclays Capital.

- We downgrade ACAFP to Market Weight on valuation. Although its balance sheet liquidity is good, its asset quality profile has stabilised and profitability is improving, this is mitigated by its weak capital position. Of the French banks, it is also the most exposed to peripheral Europe, mainly through its Greek subsidiary (Emporiki) and stakes in Bankinter (22.8%) and BES (23.4%). As its EUR senior curve lies between those of SOGCGEN/BPCE on the one hand and BNP on the other, we do not believe that investors are sufficiently rewarded for those risks.

Figure 15: ACAFP – key ratios

	Q1 09	Q2 09	Q3 09	Q4 09	Q1 10	Q2 10	Q3 10
cT1 ratio	5.9%	6.1%	6.6%	6.1%	5.6%	6.5%	6.7%
Equity / Assets (ex derivatives)	3.2%	3.3%	3.4%	3.5%	3.4%	3.2%	3.3%
Loans / Deposits	83%	75%	76%	77%	76%	79%	86%
Gross NPL ratio	4.0%	4.1%	4.3%	4.5%	4.9%	4.9%	4.9%
Coverage ratio	72%	71%	73%	74%	68%	67%	66%
Provision gearing	100%	72%	67%	97%	65%	47%	55%
Cost of risk	1.25%	1.26%	1.33%	1.45%	1.14%	0.97%	0.93%
Net interest margin	0.74%	0.87%	0.93%	1.12%	0.92%	0.99%	0.92%
PTP RoA	0.08%	0.12%	0.13%	0.08%	0.20%	0.22%	0.27%
PTP RoE	2.6%	3.4%	3.4%	2.3%	5.9%	6.3%	8.4%

Source: Company data, Barclays Capital

- We withdraw our rating on ANGIRI. Due to recent developments, the future of this bank as a going concern is doubtful, we believe. The incumbent Irish government has consistently stated that ANGIRI's senior unsecured bonds will not be haircut. We do not expect that a possible near-term change of government in Ireland would alter this policy. The Credit Institutions Stabilisation Bill 2010 deliberately did not include a reference to burden sharing by senior bondholders. In our view, this was partly due to pressure from the EU and the ECB, fearing that haircutting senior Irish bank bonds could lead to contagion of other peripheral banking markets in Europe.

Figure 16: European banks – Barclays Capital ratings

Issuer	Rating		CDS view	
	Old	New	Old	New
Allied Irish Banks plc	Restricted	Restricted	Restricted	Restricted
Anglo Irish Bank	Underweight	Not rated	Long protection	Not rated
Banca Monte Dei Paschi Di Siena SpA	Underweight	Underweight	Long protection	Long protection
Banco Bilbao Vizcaya Argentaria SA	Overweight	Overweight	Short protection	Short protection
Banco Comercial Portugues SA	Underweight	Underweight	Long protection	Long protection
Banco Espirito Santo SA	Underweight	Underweight	Long protection	Long protection
Banco Santander SA	Overweight	Overweight	Short protection	Short protection
Bank of Ireland	Restricted	Restricted	Restricted	Restricted
BNP Paribas SA	Market Weight	Market Weight	Neutral	Neutral
BPCE	Market Weight	Market Weight	n/a	n/a
Commerzbank AG	Overweight	Overweight	Short protection	Short protection
Credit Agricole SA	Overweight	Market Weight	Neutral	Neutral
Credit Suisse Group AG	Market Weight	Market Weight	Neutral	Neutral
Deutsche Bank AG	Overweight	Overweight	Short protection	Short protection
Dexia SA	Underweight	Underweight	Neutral	Long protection
HSBC Holdings plc	Market Weight	Market Weight	Neutral	Neutral
Intesa Sanpaolo SpA	Overweight	Overweight	Neutral	Short protection
Lloyds Banking Group plc	Overweight	Market Weight	Short protection	Neutral
Royal Bank Of Scotland Group plc	Overweight	Overweight	Short protection	Short protection
Societe Generale	Market Weight	Market Weight	Neutral	Neutral
Standard Chartered plc	Market Weight	Market Weight	Neutral	Neutral
UBS AG	Market Weight	Market Weight	Neutral	Neutral
Unicredit SpA	Overweight	Overweight	Short protection	Short protection

Source: Barclays Capital

European banks – cash switches

In the table below we show our top switch ideas in cash. They touch on two main themes: 1) cross-currency trades, where we include three pairs of senior bonds of comparable maturity, where the difference between EUR and USD z-spreads is largest across our space (USD bond cheap relative to EUR bond); and 2) calls on LT2 instruments, where we point out a number of bond pairs where we see a relatively high call probability, given both the call record of the issuer and/or likelihood of regulatory call, which could lead to a substantial yield pick-up. Please refer to comment box for trade-specific details.

Figure 17: European banks – cash switches

Cross currency senior switches				PICK UP			Comments
Out of	Price	Into	Price	in Cash	in YTM (bp)	in Z-Spread (bp)	
EUR ISPIM 3 7/8 15s	99.16	USD ISPIM 3 5/8 15s	95.55	n/m	62.6	102.5	Extend maturity by 4 months, pick up 60bp in YTM, 100bp in Z; institutional issues
EUR BNP 2 7/8 15s	99.02	USD BNP 3 1/4 15s	100.69	n/m	-3.8	71.7	Shorten maturity by 4 months, pick up 70bp in Z, no pick up in YTM; retail issues
EUR ACAFP 3 15s	106.34	USD ACAFP 3 1/2 15s	99.92	n/m	69.4	99.1	Extend maturity by 5 months, pick up 70bp in YTM, 100bp in Z; institutional issues

LT2s				PICK UP			Comments
Out of	Price	Into	Price	in Cash	in YTC	in Z to Call	
EUR SANTAN 4 1/4 13-18s	88.01	EUR SANTAN 5.435 12-17s	90.95	-2.94	115.25	134.85	Institutional issues; shorten/call by 7 months, pick up 135bp in Z to call, 35bp in Z to maturity. Negative cash takeout due to coupon difference
EUR ISPIM 5 3/8 12s	102.92	EUR ISPIM 5 3/4 13-18s	97.17	5.75	332.84*	323.59*	Switch out of retail non-callable LT2 maturing in Dec 2012 into institutional LT2 with maturity 2018 but callable in May 2013
EUR ISPIM 4 3/8 13-18s	95.66	GBP ISPIM 6 3/8 12-17s	95.90	NA	54.92	272.39	Out of EUR LT2 callable in June 2013 and into GBP LT2 callable in Nov 2012; pick up of almost 275bp in Z to call, also positive pick-up in Z and yield to maturity
EUR RBS 6 13s	100.20	EUR LLOYD 5 5/8 13-18s	94.60	5.60	261.05	263.41	Out of non-callable RBS maturing in May 2013 and into callable LLOYDS maturing in 2018 but callable in Mar 2013; limited liquidity in these issues, though
EUR CMZB 5 5/8 12-17s	93.20	EUR CMZB 4 1/8 11-16s	86.00	7.20	1,959.85	2,151.73	Shorten call/maturity by 3 months; also positive pick-up to maturity, although small (40bp in Z)

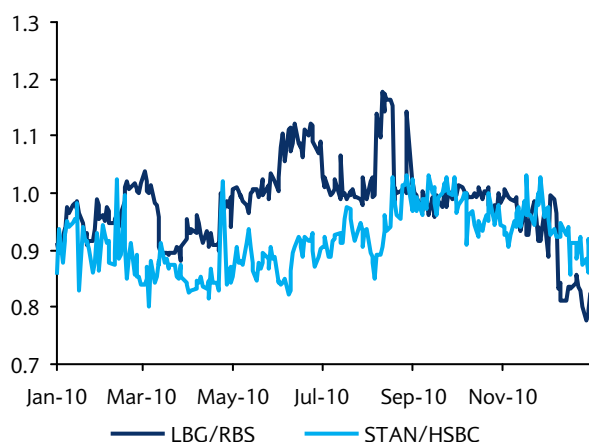
* Pick-up in YTM versus YTC, as ISPIM's EUR 5 3/8% '12s are not callable.
Source: Bloomberg, Barclays Capital

European banks – CDS pair trades

Below we highlight two CDS pair trade ideas in the European banking sector:

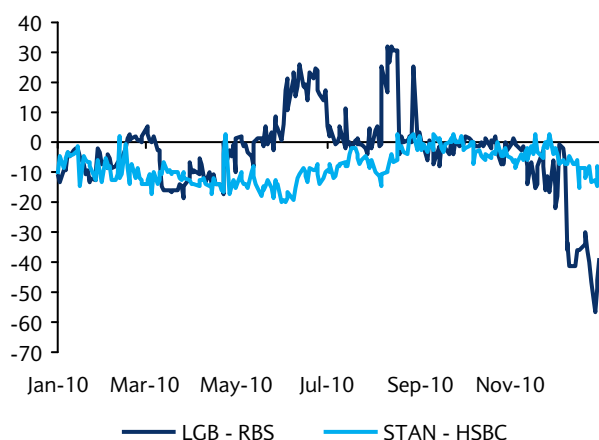
- Buy 5y senior CDS protection on Lloyds Banking Group, sell protection on RBS. Although fundamentally we like both credits, RBS has made more progress in its restructuring programme, in our view. Its core Tier 1 ratio is higher (10.2% versus 9.0%), its NPL ratio lower (7.2% versus 9.8%) and its funding profile is also better (loan/deposit ratio 126% versus 146%). Furthermore, although we believe the chances of the UK government breaking up Lloyds Banking Group are low (if the Independent Commission on Banking recommends such a split), headline risk could lead to CDS spread underperformance versus RBS. Finally, both banks are exposed to Ireland, but RBS's loan book is more geared to residential mortgages, whereas Lloyds Banking Group is more geared to commercial real estate.

Figure 18: UK banks – 5y senior CDS ratios



Source: MarkIt, Barclays Capital

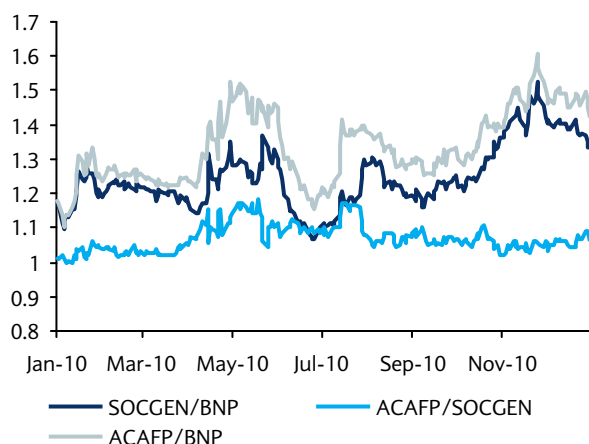
Figure 19: UK banks – 5y senior CDS differences



Source: MarkIt, Barclays Capital

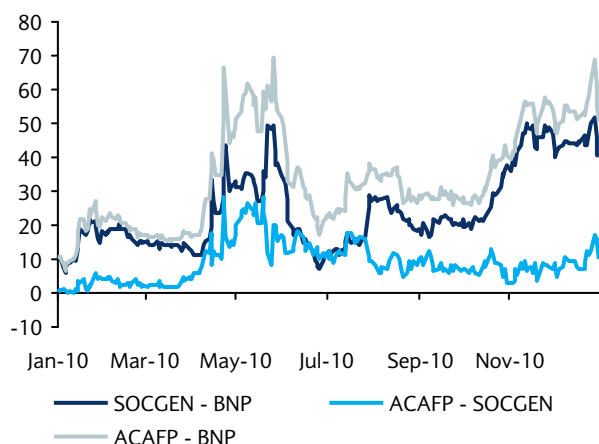
- Buy 5y senior protection on BNP, sell protection on SOCGEN. Both banks enjoy healthy credit fundamentals in terms of capital, asset quality, balance sheet liquidity and profitability. But both banks have exposure to the European periphery – mainly to western Europe in the case of BNP (eg, BNL in Italy, Greek government bond portfolio) and mainly to Central and Eastern Europe in the case of SOCGEN (Czech Republic, Russia, Romania, although it also owns a small Greek bank (Geniki)).

Figure 20: French banks – 5yr senior CDS ratios



Source: MarkIt, Barclays Capital

Figure 21: French banks – 5yr senior CDS differences



Source: MarkIt, Barclays Capital

European banks – banks CDS sub/senior ratios

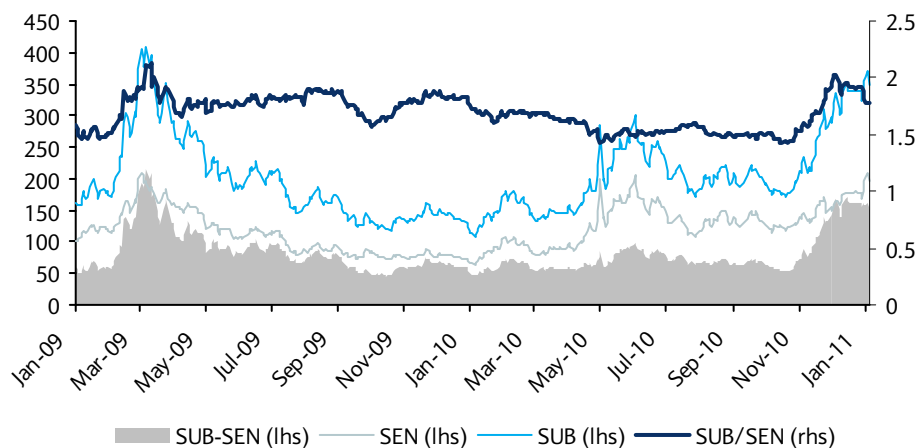
The iTraxx Euro 5y sub/senior CDS ratio started 2011 at 1.8x, a level similar to that of January 2010. However, 2010 was a volatile year for sub/senior ratios. We identify three distinct periods.

- Until early May, both sub and senior CDS spreads rose steadily on the back of growing sovereign debt concerns sparked by uncertainties about banking system losses in euro area countries. The difference between sub and senior spreads remained constant in absolute terms, in the 50-70bp range, and consequently the sub/senior ratio declined to 1.5x from 1.8x.
- The ratio remained between 1.45x and 1.6x in the six months to November. The Basel III announcement in August 2010 proposed loss absorbency for all capital instruments, including Lower Tier 2. This implied an increasing probability of writedowns on subordinated debt instruments, but had little impact on sub/senior ratios.
- However, markets had a rude awakening at the end of October, when Anglo Irish launched an exchange offer for its LT2 securities at an 80% haircut. Other liability management exercises by Irish banks affecting LT2 instruments followed, focusing the market's attention on this portion of the capital structure. Ireland's Credit Institutions Stabilisation Bill and Germany's Restrukturierungsgesetz established the legal framework to allow authorities to impose subordinated debt writedowns without the consent of subordinated debtholders. The sub/senior ratio rose from 1.4x on 4 November to over 2.0x on 10 December 2010.

A new reversal followed at the beginning of 2011. On 6 January, the EC announced a proposal for an EU-wide resolution framework for failing banks (see the "Resolution regimes" section of this report). The higher probability of senior debt writedowns implied by the proposal once again shifted the relationship between expected recovery rates on senior and subordinated debt, leading to a decline in sub/senior ratios to 1.78x from 1.9x in the two days following the announcement.

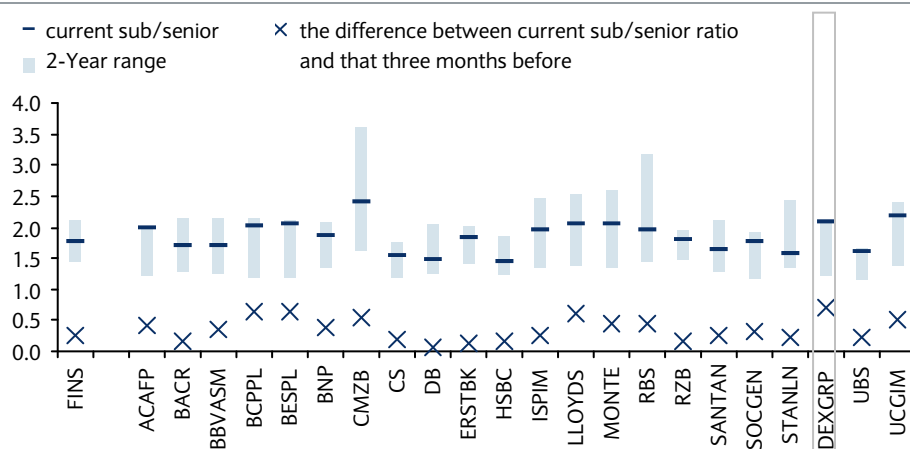
Where do we go from here? If the final text of the EU resolution framework includes the senior debt writedown language in its current form, sub/senior ratios should fall from current levels, as senior spreads factor in higher LGDs. However, the proposal also includes a pledge to "preserve

Figure 22: iTraxx financial 5y sub/senior ratio



Source: MarkIt, Barclays Capital

Figure 23: Historical sub/senior ratios

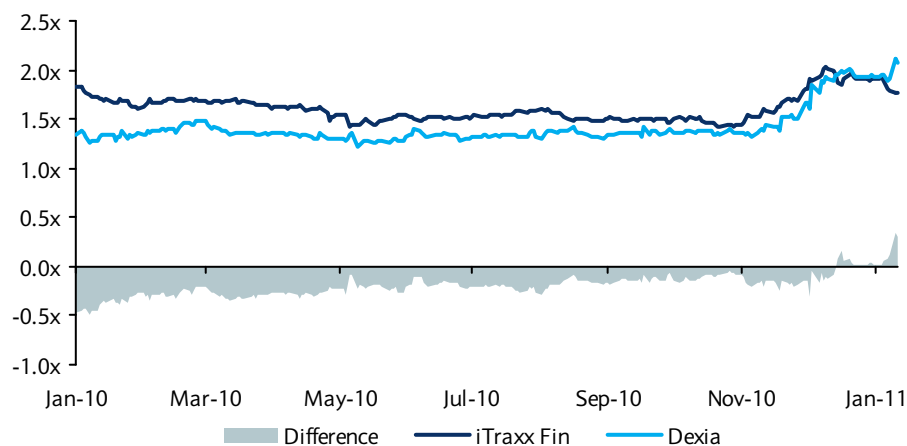


Source: Barclays Capital

as far as possible the ranking of senior claims on insolvency”, whereby “equity should be wiped out before any debt is written down, and subordinated debt should be written down completely before senior debt holders bear any loss”. This would lead to a higher difference between sub and senior recoveries than in the recent past (Anglo Irish, 20% and 80%, respectively) and could be supportive of higher sub/senior ratios. On balance, we believe we are likely to see further sub/senior compression in CDS spreads in the coming months.

Bank-specific factors also come into play. In its current form, the EU proposal document makes certain exclusions from potential senior claims subject to writedowns, in order to ensure the proper functioning of credit markets. In particular, swaps, repos and derivatives, short-term debt, customer deposits and secured debt (including covered bonds) would not be written down. Institutions that have large amounts of secured debt relative to senior unsecured funding are, therefore, likely to impose higher losses on senior unsecured bondholders upon default, given that a smaller senior unsecured funding base would need to be subject to greater haircuts to plug a given capital shortfall. Senior debt writedowns would also be greater if the bank has a relatively small non-core subordinated capital base, which would absorb the first losses once the bank reaches the point of non-viability.

Figure 24: Dexia sub/senior ratio vs. iTraxx financials



Source: MarkIt, Barclays Capital

Dexia appears to be a good candidate for sub/senior ratio compression within our coverage universe. The ratio is currently close to a two-year high of 2x, compared with a stable 1.4x during 2009 and most of 2010, and it has not declined in line with iTraxx Sub/Senior Financials since the announcement of the EU resolution proposal. The weight of long-term unsecured funding in the bank's balance sheet is among the lowest within our universe, at 8% (both senior and subordinated, see Figure 25), while the proportion of total liabilities and equity represented by covered bonds is highest at 17% (see Covered bond section). Also, non-core capital is only €3.7bn, low relative to core Tier 1 capital of €17bn and unguaranteed LT senior unsecured funding of €45bn.

Figure 25: Dexia – liabilities structure

<i>amounts in €bn</i>	Core	LPM	Consol.	% total
Customer deposits	115	-	115	19%
ST repo and unsecured unguaranteed	64	57	121	20%
Covered bonds	78	24	102	17%
LT unsecured unguaranteed	40	5	45	8%
LT state guaranteed	-	46	46	8%
Derivatives	92	0	92	15%
Other liabilities	61	5	66	11%
Equity	11		11	2%
Total	461	137	598	100%

Source: Company data, Barclays Capital. Note: LPM = Legacy Portfolio Management

RESOLUTION REGIMES

EU resolution framework

On 6 January 2011, the EC announced detailed proposals regarding an EU-wide resolution framework for failing EU banks. A consultation period will run until 3 March. The EC then aims for a legislative proposal before summer 2011. Although these are just proposals and subject to change, our view is that the majority will be implemented. However, we note that the likelihood of delays in implementation is high. This is because the legal challenges that must be overcome to implement this framework across 27 jurisdictions are significant. Indeed, the proposals state that any required legislative changes would be “subject to a full impact assessment, appropriate transitional provisions and transitional period of sufficient length and designed in such a way so as to avoid any market instability or unintended consequences.” So we may see a long implementation trajectory, similar to Basel III.

How will these proposals affect European bank bond spreads? Importantly, the debt writedown provisions, when adopted, will not apply to outstanding bonds. However, existing bonds will need to be refinanced, and if there are concerns that some banks may struggle with this, it could lead to spread widening. Also, the proposals imply higher future funding costs for banks, as investors will need to be compensated for the possibility of debt writedown, putting pressure on profitability/internal capital generation. This weakening of credit fundamentals could also lead to spread widening. But these proposals do not come as a complete surprise and should, therefore, already have been partly discounted.

Both the UK and Germany have adopted resolution regimes that contain similar measures, as have Denmark and Ireland (see below for detail). The drawback of having each country announcing its own framework is that these initiatives are uncoordinated and risk distorting bank funding costs between countries. From that angle, having an EU-wide approach is a positive.

EU resolution framework – background

Last October, the EC announced that it had started developing a resolution framework, the overriding objectives of which are: 1) to ensure that failing banks can be resolved in ways that minimise the risk of contagion; 2) to ensure continuity of essential financial services; and 3) to avoid taxpayers footing the bill of a failing bank. The main proposals announced on 6 January 2010 were flagged in October.

The proposals seek to impose burden sharing on fixed income investors (also with negative ramifications for equity investors). During the financial crisis, senior and subordinated debtholders were generally not made to share the burden of the large losses that many European banks suffered. The reason for not doing so was to avoid creating further systemic risks. As senior unsecured bondholders rank *pari passu* with depositors (Switzerland being the exception in Europe), imposing burden-sharing on the former in the wake of the large losses that banks reported would have been complex (requiring legal amendments) and potentially risky, possibly leading to bank runs. Therefore, the treatment of senior unsecured bondholders of banks that benefited from state capital injections has not caused much controversy. The hands-off approach to subordinated bondholders of those banks, on the other hand, has been widely criticized; although subordinated bond documentation often allow for burden sharing, in practice banks preferred to keep servicing their subordinated obligations, in order to avoid reputational damage and to ensure continued access to funding markets. Hence, the subordinated bondholders of those European banks that received government support during the crisis are generally perceived to have been bailed out by taxpayers.

The European Commission did prohibit banks that received state aid above a certain limit (capital injections plus asset shields exceeding 2% of risk-weighted assets) from paying coupons on junior subordinated debt (Tier 1 and Upper Tier 2) and from calling those instruments, typically for a two-year period. But missing coupons for only two years while still being entitled to the principal amount arguably amounts to lenient treatment, if the alternative is bankruptcy. Also, senior subordinated debt (Lower Tier 2) generally escaped this treatment entirely.

EU resolution framework – detail

The proposals state that “resolution authorities should have the power to apply the following resolution tools [...]: (a) the sale of business tool; (b) the bridge bank tool; (c) the asset separation tool [ie. good bank/bad bank]; and (d) the debt conversion tool”. In the Annex to the proposals, debt writedown (including senior unsecured) is presented as an additional resolution tool for “those cases where the application of the standard resolution tools is not an option”. For instance, there may not be sufficient time to implement a good bank/bad bank split in a crisis situation, given the size and complexity of the failing bank. In practice, therefore, debt writedowns might be most useful for failing banks that are large, complex financial institutions. All these measures represent different ways of imposing burden sharing on debtholders. It is clear that the EU seeks maximum flexibility for authorities to respond to an emerging bank failure.

The proposals for debt writedowns contain two broad approaches (not mutually exclusive):

- A “comprehensive”, or statutory, approach (only applicable to new debt or existing debt rolled over), whereby the resolution authorities have the statutory power to write down a failing bank’s debt or convert it into equity, irrespective of bond’s language (although a clause would need to be inserted recognising this statutory power). The authorities would have complete discretion as to which classes of debt would be written down or converted, as well as the extent of the haircut (taking into account that writing down certain creditors could pose systemic risks – eg, in the case of derivatives/repos). The advantage of this approach is the speed with which it can be applied. The disadvantage is that the authorities’ discretion creates uncertainty for creditors. Importantly, according to the proposals, this approach should “preserve as far as possible the ranking of claims on insolvency. For this reason, equity should be wiped out before any debt is written down, and subordinated debt should be written down completely before senior debt holders bear any losses”.
- A “targeted”, or contractual, approach (again, only applicable to new debt or existing debt rolled over), whereby the burden-sharing provisions (ie, either writedowns or equity conversions) are explicitly stated in the bond’s terms and conditions. Here, the resolution authorities would require credit institutions to issue a fixed volume of “bail-in-able” debt. The advantage of this approach is that both the institution and its creditors have certainty about what would happen in a resolution situation. The problem is that it will take a while for banks to achieve the minimum required level of bail-in debt. Also, judging the appropriate issuance level is a challenge. Furthermore, this approach would create a new level of seniority in banks’ capital structures – senior in name, but subordinate to senior bonds with no bail-in language.

The EU notes that both the Basel Committee and the Financial Stability Board are also studying the “bail-in” concept and aim for consistency with their recommendations.

In our view, there are three key questions that need to be answered before the EU proposals could be adopted.

- In the first place, the potential impact on the CDS market is an important consideration and is subject to a great deal of uncertainty. If bail-ins were provided for in new bond documentation, then it is possible that a write down of the debt would not constitute a credit event for CDS (while a write down of existing, grandfathered debt might). Furthermore, following a credit event, new bail-in debt may not satisfy the “Not Contingent” deliverable obligation characteristic requirement and therefore not be deliverable; alternatively, if it is deliverable it may be at a lowest possible amount that the debt could be written down to. It is far from clear how the CDS market may have to adapt but for contracts to provide adequate protection, modifications to the current standard contracts would likely be required, leading to additional complexity in the CDS market or a need for further standardisation.
- Secondly, a key question is what the market’s capacity is for bank bonds with writedown language. We discuss this issue in further detail in the *Innovative bond structures* section.
- Thirdly, there is the wider, global perspective – if all EU member states were to implement a harmonised resolution regime, this could leave EU banks disadvantaged if other economic regions do not adopt similar measures. For a detailed discussion of the US framework, see [Comparing Resolution Authority with Bail-in Schemes](#), 17 September 2010.

In addition to the bank resolution tools, many other proposals are included in the framework, including a requirement for banks to write “living wills”, the ability for authorities to remove managements, and the creation of resolution funds funded by the bank themselves.

Overview of existing European resolution regimes

So far, only the UK (2009), Denmark (October 2010), Germany (November 2010) and Ireland (December 2010) have adopted resolution regimes for their banking sectors (please see Figure 26 for details). The expectation is that more EU countries will follow, although they may want to wait for the EU to publish its final proposals in June 2011.

In Figure 26, we have set out what we believe are the key provisions of the resolution regimes that have been announced so far by EU countries. What can be seen is that, broadly speaking, these regimes contain two alternative ways of achieving burden sharing for fixed income investors:

1. Unsecured debt/equity conversion and/or writedown. This enables the relevant authorities to convert fixed income instruments into common equity or write down a certain proportion of par value, *irrespective of bond language*. (Insured depositors and secured claims are likely to be excluded from this treatment.) This approach can be justified on the grounds of timeliness (ie, debt restructuring negotiations can be very time consuming, whereas in a crisis, a fast response is required). Note that separate from this, innovative bond structures are also being considered, under which the bond documentation specifically states under what circumstances equity conversions and/or par value writedowns can take place (see *Innovative bond structures* section). The latter allows for an automatic conversion/ writedown and could be more suitable for cross-border banks and/or be more timely.

2. Good bank/bad bank frameworks, whereby selected good assets and/or liabilities can be segregated from the rest and put into a good bank. This could break the pari passu ranking between depositors and senior unsecured bondholders, if depositors move across into the good bank while senior unsecured funding stays behind in the bad bank.

There may be legal and timeliness reasons why one option would be preferred over the other. Therefore, these new frameworks provide regulators with a high degree of flexibility to respond to emerging crises, in our opinion.

Figure 26: European bank resolution regimes – selected provisions of new legislation

Germany	Restrukturierungsgesetz 2010	
	Article 1 - Law for the Reorganization of Credit Institutions	
	Chapter 3 - Reorganization procedure	
	Paragraph 7 - Introduction	“If a restructuring procedure fails, then a reorganization procedure can be started, with the consent of the credit institution”.
	Paragraph 9 - Debt/equity swaps	“The reorganization procedure can provide for the conversion of creditor claims into share capital of the credit institution”.
	Paragraph 12 - Changes to creditor rights	“The reorganization procedure will indicate to what extent creditor claims will be written down, over what time period the creditor claims will be extended, and [...]”
	Paragraph 17 - Creditor votes	“Each group of eligible creditors will be required to vote on the reorganization plan”.
	Article 2 - Changes to the Banking Law	
	Paragraph 48.a - Transfer order	“The authorities can order the transfer of a credit institution's assets and liabilities to another entity, but only if the credit institution's viability is at stake and its collapse could lead to systemic risks for the financial system”.
	Note: Translated from German for illustration purposes only; please refer to the German text for full details.	
Ireland	Credit Institutions (Stabilisation) Bill 2010	
	Part 4 - Subordinated Liabilities	
	28 - (3)	“A proposed subordinated liabilities order may make provision for (a) any one or more or all of the matters referred to in subsection (4), and (b) the granting of a shareholding in the relevant institution to the subordinated creditors affected by the order or any class of them”.
	28 - (4)	“The matters referred to in subsection (3) are the following: (a) the postponement, termination, suspension or other modification of specific rights, liabilities, terms and obligations associated with all or any of such subordinated liabilities including (i) the payment of interest; (ii) the repayment of principal; (iii) what constitutes an event of default; [...] (v) the timing of obligations; (vi) the due date; [...]”
	Part 5 - Transfer of Assets and Liabilities	
	33 - (1)	“[...] The Minister may make a proposed transfer order in relation to the transfer of assets and liabilities of a relevant institution”.
	37 - (6)(a)	“A transfer order may relate to the transfer of (a) all or any specified part of the assets of the transferor, (b) all or any specified part of the liabilities of the transferor, or (c) any combination of some or all of the assets and liabilities of the transferor”.
	Part 7 - Miscellaneous	
	69 - (1)	“This Act [...] ceases to have effect on 31 December 2012 or a later date substituted by resolution of both Houses of the Oireachtas [Irish parliament]”.
UK	Banking Act 2009	
	Part 1 - Special Resolution Regime - The Stabilisation Options	
	11 - Private sector purchaser	“The first option is to sell all or part of the business of the bank to a commercial purchaser.”
	12 - Bridge bank	“The second stabilization option is to transfer all or part of the business of the bank to a company which is fully owned by the Bank of England (a "bridge bank")”.
	Part 1 - Special Resolution Regime - Transfer of Securities	
	14 - Interpretation: "Securities"	“In this Part, “securities” includes anything falling within any of the following classes: Class 1: shares and stock. Class 2: debentures, including—(a)debenture stock, (b)loan stock, (c)bonds, (d)certificates of deposit, and (e)any other instrument creating or acknowledging a debt”.
	19 - Conversion and Delisting	“A share transfer instrument [“an instrument which provides for securities issued by a specified bank to be transferred”] or order may provide for securities to be converted from one form or class to another”.

Note: for a summary of Denmark's new resolution regime (only available in Danish), please refer to Moody's *Banking System Profile: Denmark*, 16 December 2010.
Source: National governments

We welcome the EU proposals, as there were a number of problems with the implementation of country-specific frameworks.

1. If countries announce their own frameworks independent of each other, then there is a risk that there is no co-ordination between them. Such a fragmented approach could have led to national distortions in banks' funding costs. This process appears to have been partly driven by political pressure (ie, governments want to be seen by their electorate as being proactive).
2. Legal ambiguity. It appears that some elements of the frameworks that have been announced so far have been too hastily conceived. The criticism by the ECB with regards to the uncertain position of repo lenders under the Irish Credit Institutions Stabilisation Bill is a case in point.¹
3. How to ensure that the relevant national authorities use their discretionary resolution powers expediently? For instance, a regulator may decide that a bank is no longer viable without resolution measures, although this could be borne out of over-conservatism. In other words, there is a risk that some regulators could be perceived to exercise their resolution powers prematurely. Clearly, the opposite is also possible, whereby a regulator is perceived to be lax in exercising its resolution powers, for instance out of fear for contagion. In order to address this issue and achieve a level of consistency, predictability and objectivity across Europe, using the same rule book is a minimum requirement.

It is unclear at this stage whether those countries that have already adopted their own resolution frameworks would replace them with the EU proposals, if enacted, or whether they would selectively adjust their frameworks.

¹ 'Opinion of the European Central Bank of 17 December 2010 on emergency stabilisation of credit institutions'

Will receding government support put pressure on credit ratings?

The developments discussed in the previous section show that EU governments are deliberately removing the implicit sovereign support that many EU-based banks have benefited from during the crisis. Could this trend put downward pressure on the banks' credit ratings? It depends. According to Fitch Ratings's methodology, a bank's Issuer Default Rating is driven either by perceived sovereign/institutional support in case of need (Fitch Ratings has a distinct 'Support rating' scale) or by a bank's intrinsic strength (the 'Individual' rating). Moody's and Standard & Poor's also acknowledge this support factor, by adding a few notches to a bank's intrinsic strength rating (Moody's calls the latter the 'baseline credit assessment' and S&P calls it the 'standalone credit profile'). Therefore, until now a bank with weak credit fundamentals (such as weak capitalisation, asset quality, liquidity and profitability) could still have high credit ratings if it was perceived to be systemically important and therefore likely to benefit from sovereign support in case of need. Looking ahead, a bank's credit rating will become more sensitive to its intrinsic credit fundamentals.

The table below shows us that, according to Fitch Ratings and S&P, most large cap European bank ratings are driven by their intrinsic strengths, not by the implicit support they enjoy. This means that any decrease in support propensity (reflected by a lower support rating in the case of Fitch Ratings and by lower or no support notch uplift by S&P) will not lead to credit rating downgrades for those banks. The opposite is true for Moody's, where virtually all of European banks' credit ratings benefit from a few notches support uplift.²

² We note Standard & Poor's consultation document regarding changes to its banks rating methodology, published on 6 January 2011. S&P estimates that the potential impact on outstanding ratings will be limited (with 85% of long-term ratings on its 138-strong banks sample (47 in Europe) remaining the same or moving one notch up/down.

Figure 27: European banks – credit ratings

Name	FITCH				MOODY'S				S&P			
	Issuer Default Rating	Outlook/ Watch	Support	Support rating floor	Issuer Rating	Outlook/ Watch	Baseline Credit Assessment	Support Uplift (notches)	Counterparty credit rating	Outlook/ Watch	Stand-alone credit profile	Support Uplift (notches)
Allied Irish Banks plc	BBB	Stable	2	BBB	Baa3	Negative	Ba3	3	BBB	Negative	BB-	4
Anglo Irish Bank	BBB-	Negative	2	BBB-	Ba3	Negative	n/a	n/a	B	Negative	n/a	n/a
Banca Monte Dei Paschi Di Siena SpA	A-	Stable	2	BBB+	A2	Stable	Baa3	4	A-	Stable	BBB+	1
Banco Bilbao Vizcaya Argentaria SA	AA-	Stable	1	A	Aa2	Negative	A1	2	AA	Negative	AA	0
Banco Comercial Portugues SA	BBB+	Negative	2	BBB	A3	Negative	Baa3	3	BBB+	Negative	n/a	n/a
Banco Espirito Santo SA	BBB+	Negative	2	BBB-	A2	Negative	Baa2	3	A-	Negative	A-	0
Banco Santander SA	AA	Stable	1	A	Aa2	Negative	A1	2	AA	Negative	AA	0
Bank of Ireland	BBB	Stable	2	BBB	Baa2	Negative	Ba2	3	BBB+	Negative	BB	4
BNP Paribas SA	AA-	Stable	1	A+	Aa2	Stable	A1	2	AA	Negative	AA	0
BPCE SA	A+	Stable	1	A+	Aa3	Stable	Baa1	4	A+	Stable	A	1
Commerzbank AG	A+	Stable	1	A+	Aa3	Negative	Baa1	4	A	Negative	BBB	3
Credit Agricole SA	AA-	Stable	1	A+	Aa1	Stable	A1	3	AA-	Negative	AA-	0
Credit Suisse Group AG	AA-	Stable	5	n/a	Aa2	Negative	n/a	n/a	A	Stable	n/a	n/a
Credit Suisse AG	AA-	Stable	1	A	Aa1	Negative	Aa3	2	A+	Stable	A+	0
Deutsche Bank AG	AA-	Negative	1	A+	Aa3	Stable	A2	2	A+	Stable	A	1
Dexia SA	A+	Stable	1	A+	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
HSBC Holdings plc	AA	Stable	5	n/a	Aa2	Negative	n/a	n/a	AA-	Stable	AA-	0
HSBC Bank plc	AA	Stable	1	A+	Aa2	Negative	A2	3	AA	Stable	n/a	n/a
Intesa Sanpaolo SpA	AA-	Stable	1	A-	Aa2	Stable	A1	2	A+	Stable	n/a	n/a
Lloyds Banking Group plc	AA-	Stable	1	AA-	A1	Stable	n/a	n/a	A	Stable	BBB	3
Lloyds TSB Bank plc	AA-	Stable	1	AA-	Aa3	Stable	Baa1	4	n/a	n/a	n/a	n/a
Royal Bank Of Scotland Group plc	AA-	Stable	1	AA-	A1	Stable	n/a	n/a	A	Stable	BBB	3
Royal Bank Of Scotland plc	AA-	Stable	1	AA-	Aa3	Stable	Baa2	5	n/a	n/a	n/a	n/a
Societe Generale	A+	Stable	1	A+	Aa2	Negative	A2	3	A+	Stable	A+	0
Standard Chartered plc	AA-	Stable	n/a	n/a	A2	Stable	n/a	n/a	A	Stable	n/a	n/a
Standard Chartered Bank	AA-	Stable	1	A-	A1	Stable	A1	0	A+	Stable	A+	0
UBS AG	A+	Stable	1	A+	Aa3	Negative	A3	3	A+	Stable	A	1
Unicredit SpA	A	Negative	1	A-	Aa3	Stable	A3	3	A	Stable	A	0

Note: In the above table, we have ignored the difference between rating outlooks and rating watches.

Source: Fitch Ratings, Moody's, Standard & Poor's, Barclays Capital

Innovative bond structures

The EU resolution proposals and Basel III lead to two new bond structures, both of which are examples of contingent capital (ie, debt which effectively becomes regulatory capital once a trigger is activated). So far, only LBG and Rabobank have issued contingent capital instruments (see *Lloyds Banking Group ECNs – One year on*, 27 October 2010).

- Contingent convertible bonds ('CoCos'). These bonds are convertible into common equity if triggered. Apart from a few small UK building societies, only LBG has issued CoCos, which it calls enhanced capital notes – 'ECNs'. The conversion trigger is for LBG's core Tier 1 ratio to drop below 5% as per Basel II. ECNs started trading in November 2009.
- Bail-in bonds. The par value of these bonds can be written down ('haircut') when the write-down trigger is activated, without this constituting an event of default. The regulator could require banks to issue a certain proportion of its bonds under this format. So far, only Rabobank (not rated) has issued this type of instrument, which it calls senior contingent notes – 'SCNs'. The write-down trigger is for Rabobank's equity Tier 1 ratio to drop below 7%, in which case SCNs are written down permanently to 25% of par value (and Rabobank would subsequently redeem all SCNs at their written-down redemption price). SCNs started trading in March 2010. (As Rabobank is a co-operative bank without a stock market listing, A CoCo structure with an equity conversion trigger was not feasible.)

Most market observers believe it is too early to say whether these two deals herald a surge of new issuance into the space. They note that the ECNs were issued in exchange for some of LBG's distressed hybrid bonds that were going to be subject to EC-imposed coupon skips and/or call extensions. In other words, the circumstances were very issuer-specific and there is no read-across for other European banks without comparable problems. Similarly, Rabobank's SCNs may not presage a flood of bail-in bond issuance. We note that the bank's very high credit ratings (AAA/Aaa/AA+) helped it to place this bond, whereas lower-rated banks may find it more difficult to issue similar paper. (In our view, the main reason why Rabobank decided to issue this instrument appears to be to enhance its profile as a regular and innovative fixed income issuer.) Importantly, because of their equity conversion/writedown features, neither the ECNs nor the SCNs have been included in major bond indices. This limits potential demand from investors using those indices as benchmarks. So far, it appears that non-traditional investors (eg, hedge funds, sovereign wealth funds, banks' employees, retail investors) comprise the largest source of demand.

However, recent announcements from the Basel Committee on Banking Supervision could be supportive of more contingent capital issuance, in two ways. First, the Basel proposals announced on 12 September 2010 explicitly provided for such instruments to play a significant role in the additional buffer for systemically important banks (ie, the buffer on top of the capital conservation buffer and the counter-cyclical buffer), in combination with capital surcharges. Work in this respect is ongoing and the Committee expects to complete its assessment by mid-2011. Secondly, the greater clarity provided with regards to the definition of capital (announcement of 26 July) could make conversion triggers more objective (ie, less subject to regulator's discretion). This improved transparency and predictability could help make the rating agencies more comfortable in rating those instruments which, in turn, could attract more investors into the space.

After a one-year trading record for ECNs and SCNs and further regulatory clarity, more issuance in the space may be forthcoming in the coming quarters/years. A government-appointed panel in Switzerland proposed on 30 September 2010 that UBS and CS Group issue a combined CHF72bn of CoCo-type instruments by 2019³, in order to meet a total capital ratio of 19% (of which 9% in the form of CoCos and at least 10% in the form of common equity). This amount seems too high for this nascent asset class – even taking into account the long implementation period – and may be negotiated down by the banks before being endorsed by the government and approved by parliament. But it does illustrate the eagerness of regulators to develop this market.

In order for more investors to be attracted to the contingent capital space, though, structures may need to be standardised in some key aspects. For instance, if the CoCo equity conversion triggers are uniform and objective (a core Tier 1 ratio trigger appears to be best suited for this), then that would facilitate comparison between the various instruments. In a similar vein, using a uniform haircut across all banks for bail-in bonds (when triggered) would make the loss-given-default uniform, so that market participants can focus on the probability of default instead.

Also, we note that it will take banks many years to have a sufficiently large amount of contingent capital instruments outstanding before they can contribute meaningfully to the restoration of a distressed bank's capital levels. This is why the comprehensive/statutory approach (whereby the relevant authorities can impose losses on bonds, irrespective of their language) and good bank/bad bank schemes may still be needed.

Finally, if a bank issues both CoCos and bail-in bonds, then this poses questions about their respective rankings in its capital structure. Rabobank's SCNs are classified as senior bonds whereas LBG's ECNs are classified as Lower Tier 2 bonds (with a few exceptions). Should this relative ranking be maintained in future issuance by other banks? If so, then this will have implications for the level at which triggers are set (ie, the CoCo trigger should be set at a higher level than the bail-in bond trigger, assuming these triggers are defined in core Tier 1 ratio terms).

³ Final report of the Commission of Experts for limiting the economic risks posed by large companies

Figure 28: The contingent capital market today – tradeable universe

ISIN	Currency	CPN	Maturity	Announced	Size (mn)	Price	Price as % of High	Z-spread	YTM
LLOYDS BANKING GROUP - ENHANCED CAPITAL NOTES ('ECNs')									
XS0459086582	GBP	7.5884	12/05/2020	03/11/2009	732	87.2	91%	627	9.7
XS0459086749	GBP	7.8673	17/12/2019	03/11/2009	331	88.2	91%	649	9.9
XS0459093364	GBP	7.869	25/08/2020	03/11/2009	597	87.7	91%	642	9.9
XS0459088109	GBP	9.334	07/02/2020	03/11/2009	208	96.0	93%	662	10.0
XS0459088877	GBP	11.04	19/03/2020	03/11/2009	736	103.7	93%	707	10.4
XS0459089255	GBP	15	21/12/2019	03/11/2009	775	129.1	94%	675	10.0
XS0459090188	GBP	9.125	15/07/2020	03/11/2009	148	95.9	95%	635	9.8
AVERAGE								657	10.0
XS0459087986	EUR	8.875	07/02/2020	03/11/2009	125	96.3	92%	658	9.5
XS0459088281	EUR	6.439	23/05/2020	03/11/2009	711	82.9	91%	624	9.2
XS0459088794	EUR	6.385	12/05/2020	03/11/2009	662	82.9	91%	619	9.2
XS0459089412	EUR	15	21/12/2019	03/11/2009	487	131.6	95%	683	9.6
XS0459090774	EUR	7.375	12/03/2020	03/11/2009	95	87.5	92%	650	9.5
XS0459091236	EUR	7.625	14/10/2020	03/11/2009	226	88.6	92%	645	9.5
AVERAGE								647	9.4
XS0459093521	USD	7.875	01/11/2020	03/11/2009	986	90.0	89%	633	9.5
XS0471767276	USD	8	Perpetual	11/12/2009	1,259	87.5	91%	702	8.6
AVERAGE								668	9.0
RABOBANK - SENIOR CONTINGENT NOTES ('SCNs')									
XS0496281618	EUR	6.875	19/03/2020	12/03/2010	1,250	95.7	94%	455	7.5

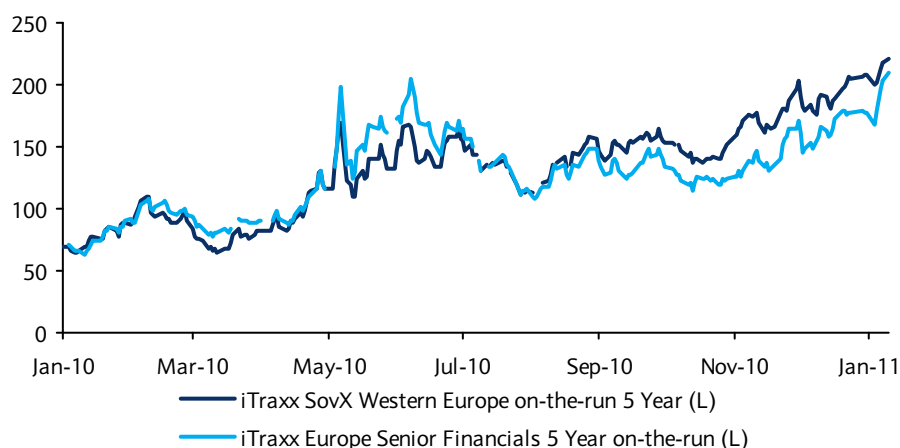
Source: Bloomberg, company data, Barclays Capital

SOVEREIGN RISK

Sovereign risk – a key spread driver

Much of European banks' spread performance in 2010 was driven by concerns over their exposure to sovereign risk. In H1 2010, Greece took centre stage, with investors' focus shifting to Ireland in H2 2010. Whether 2011 will see further contagion to other European countries or sovereign concerns can be contained, depends, to a large extent, on European policymakers being able to shift to a proactive policy from their past reactive stance (*Euro Area Bank and Sovereign Debt – Preemptive action needed*, 30 November 2010). In the graph below we have shown the spread performance of both the iTraxx SovX and iTraxx Senior Financials indices. The correlation between these two CDS indices over 2010 was 89%.

Figure 29: European banks spreads vs. sovereign spreads



Source: Markit

In the Appendix, we show for nine European countries the spread performance of their 5-year sovereign CDS versus the average spread performance of their largest banks' 5-year senior CDS in 2010. What can be seen in the table below is that the correlation between these two data series has been very high in most instances.

Figure 30: European banks CDS spreads vs. sovereign CDS spreads – quarterly correlations

	Quarterly average	1Q10	2Q10	3Q10	4Q10
France	87%	84%	86%	92%	87%
Germany	74%	78%	75%	55%	89%
Greece	82%	63%	95%	76%	92%
Ireland	77%	42%	92%	83%	90%
Italy	88%	88%	87%	85%	92%
Portugal	85%	88%	89%	81%	85%
Spain	89%	70%	96%	92%	97%
Switzerland	40%	-7%	75%	67%	24%
UK	70%	43%	66%	75%	94%

Source: Markit

European banks' exposure to sovereign bonds

In July 2010, the Committee of European Banking Supervisors (CEBS) coordinated an EU-wide stress test in which 91 banks participated (see *European Banks Stress Test Results*, 26 July 2010). The purpose of the exercise was to provide clarity on banks' exposure to European Economic Area sovereign bonds and the impact of a stress scenario on their Tier 1 capital. Although the increased transparency was welcomed by the market, the stress test results themselves (with only seven banks failing) were not taken seriously, as the assumptions of the tests were not deemed to be sufficiently severe (eg, sovereign exposures in the banking book were not subjected to haircuts). Furthermore, as the bail-out of the Irish banking system in November 2010 showed, the tests were incomplete in that banks' liquidity resilience should have been tested as well. (Both AIB and BKIR passed the CEBS stress test, ANGIRI was not tested).

On 17 December 2010, the European Council agreed that a new round of stress tests will be conducted in H1 2011 (no precise date given). The crucial difference with the previous one is that the new test will be conducted by the European Banking Authority⁴. This authority, which has replaced CEBS, will have investigative powers (unlike CEBS), which should enhance the credibility of the test:

'In order to carry out its duties effectively, the Authority should have the right to request all necessary information. To avoid the duplication of reporting obligations for financial market participants, that information should normally be provided by the national supervisory authorities which are closest to the financial markets and financial market participants and should take into account already existing statistics. ***However, as a last resort, the Authority should be able to address a duly justified and reasoned request for information directly to a financial market participant where a national competent authority does not or cannot provide such information in a timely fashion. Member States' authorities should be obliged to assist the Authority in enforcing such direct requests.'***⁵

In the table below, we have recapped the holdings of peripheral European sovereign bonds by European banks under our coverage, as per the CEBS stress test. These bond holdings relate to end-Q1 2010 data and will likely have shifted for the majority of banks, in some cases materially. In particular, some peripheral banks may have increased their government bond holdings as these are repo-eligible assets with low risk weights. We also compare the amounts with banks' end-Q3 10 core Tier 1 capital, instead of end-09 Tier 1 capital as used by CEBS.

⁴ One of three new authorities being established, the other two being the European Insurance and Occupational Pensions Authority and the Joint Committee of the European Supervisory Authorities

⁵ Regulation (EU) no. 1095/2010 of the European Parliament and of the Council

Figure 31: European banks – exposure to peripheral sovereign bonds, as per July 2010 CEBS stress test

Issuer (€mn)	core Tier 1 capital (end-Q3)	Ireland	Portugal	Greece	SUB-TOTAL	as % of cT1 cap	Spain	SUB-TOTAL	as % of cT1 cap	Italy	TOTAL	as % of cT1 cap
Allied Irish Banks	6,172	4,136	257	41	4,434	72%	391	4,825	78%	671	5,496	89%
Banca Monte Dei Paschi Di Siena	8,326	3	93	35	131	2%	116	247	3%	27,756	28,003	336%
Banco Bilbao Vizcaya Argentaria	24,969	16	646	293	955	4%	52,131	53,086	213%	6,230	59,316	238%
Banco Comercial Portugues	3,453	200	953	718	1,871	54%	0	1,871	54%	50	1,921	56%
Banco Espírito Santo	5,303	0	4,688	464	5,152	97%	59	5,211	98%	0	5,211	98%
Banco Santander	50,307	16	5,118	513	5,647	11%	50,642	56,289	112%	1,184	57,473	114%
Bank of Ireland	8,598	1,186	0	0	1,186	14%	0	1,186	14%	30	1,216	14%
BNP Paribas	54,720	559	2,526	5,005	8,090	15%	3,021	11,111	20%	23,196	34,307	63%
BPCE	30,900	524	456	1,540	2,520	8%	384	2,904	9%	7,493	10,397	34%
Commerzbank	27,108	0	1,100	2,900	4,000	15%	3,600	7,600	28%	10,000	17,600	65%
Credit Agricole	21,800	929	1,478	854	3,261	15%	2,286	5,547	25%	12,347	17,894	82%
Deutsche Bank	20,948	200	0	500	700	3%	0	700	3%	0	700	3%
Dexia	16,988	147	2,817	3,747	6,711	40%	1,823	8,534	50%	17,553	26,087	154%
HSBC Holdings	87,017	816	698	1,935	3,449	4%	101	3,550	4%	6,247	9,797	11%
Intesa Sanpaolo	27,180	156	25	828	1,009	4%	556	1,565	6%	63,681	65,246	240%
Lloyds Banking Group	51,137	0	143	0	143	0%	0	143	0%	94	237	0%
Royal Bank Of Scotland Group	55,682	4,280	660	2,010	6,950	12%	821	7,771	14%	3,919	11,690	21%
Societe Generale	27,972	464	404	4,225	5,093	18%	901	5,994	21%	5,149	11,143	40%
Unicredit	39,047	80	186	801	1,067	3%	560	1,627	4%	38,832	40,459	104%

Note: Standard Chartered was not included in the CEBS stress test, nor were CS Group and UBS as not part of EU. Core Tier 1 capital as per H1 2010 for AIB, BKIR, Lloyds and HSBC. Country exposures as per end-Q1 2010.

Source: CEBS, company data, Barclays Capital

What we observe from this table is that: 1) banks in peripheral countries have large exposures to their own sovereign, but limited exposure to other peripheral sovereigns; and 2) this exposure frequently exceeds the capital base of the institution in question (taxes ignored). This explains why bank CDS spreads and sovereign CDS spreads are so highly correlated (Figure 29). Of the core European countries, the French banks are the most exposed to peripheral sovereign risk.

European banks' wider exposure to sovereign risks

In order to get a more complete picture of European banks' sovereign risk exposure, their exposure to a country's banking system should also be taken into account. This is because if a sovereign gets into difficulty, its banking system may follow, due to the latter's holding of sovereign bonds, implicit/explicit government support and funding squeezes (ie, investors/counterparties cutting their limits to a sovereign, may do the same thing for its banking system).

In the table below we have shown the inter-dependency of European banking systems, both for end-09 (shortly after Greek concerns had escalated) and end-Q2 10 (latest available BIS data). What can be seen is that this inter-dependency came down across the board. In other words, European banks disengaged from other European banking systems. We expect this

trend to have continued in H2 2010, taking into account renewed sovereign concerns and the Irish bail-out in that period.

Figure 32: Cross-border banking system exposure among EU-15 members (%)

	Jun 10	AU	BE	FI	FR	GE	GR	IR	IT	NE	PO	SP	EU-12	DE	SW	UK	EU-15
Austria	AU	0	0	0	2	6	0	0	9	1	0	0	18	0	0	1	19
Belgium	BE	0	0	0	17	2	0	0	0	7	0	0	28	0	0	2	30
Finland	FI	0	0	0	2	3	0	0	0	1	0	0	6	7	19	1	32
France	FR	0	1	0	0	2	0	0	0	1	0	0	4	0	0	3	7
Germany	GE	1	0	0	3	0	0	0	3	2	0	0	8	0	1	2	11
Greece	GR	0	0	0	9	6	0	1	1	1	2	0	19	0	0	2	21
Ireland	IR	0	1	0	2	6	0	0	1	1	0	1	12	1	0	6	19
Italy	IT	0	1	0	8	3	0	1	0	1	0	1	15	0	0	1	16
Netherlands	NE	0	1	0	4	5	0	0	1	0	0	1	13	0	0	5	18
Portugal	PO	0	1	0	6	5	0	1	1	1	0	11	26	0	0	3	29
Spain	SP	0	0	0	4	4	0	1	1	2	1	0	11	0	0	2	14
EU-12	EU-12	0	0	0	5	4	0	0	1	1	0	1		0	1	3	
Denmark	DE	0	0	0	2	4	0	0	0	1	0	0	7	0	13	1	21
Sweden	SW	0	0	0	1	3	0	0	0	0	0	0	5	5	0	2	12
UK	UK	0	0	0	3	4	0	2	0	1	0	3	14	0	0	0	15
EU-15	EU-15	0	0	0	4	4	0	1	1	1	0	1		0	1	2	

	Dec 09	AU	BE	FI	FR	GE	GR	IR	IT	NE	PO	SP	EU-12	DE	SW	UK	EU-15
Austria	AU	0	0	0	2	7	0	0	8	1	0	0	20	0	0	0	20
Belgium	BE	0	0	0	20	3	0	0	0	8	0	1	33	0	0	2	35
Finland	FI	0	0	0	2	3	0	0	0	1	0	1	7	7	20	1	36
France	FR	0	1	0	0	2	0	0	0	1	0	1	5	0	0	2	7
Germany	GE	1	0	0	3	0	0	0	3	2	0	1	9	0	1	2	12
Greece	GR	1	1	0	12	7	0	1	1	2	1	0	26	0	0	2	28
Ireland	IR	0	2	0	2	8	0	0	1	1	0	1	16	1	0	8	25
Italy	IT	1	1	0	10	4	0	1	0	1	0	1	18	0	0	2	20
Netherlands	NE	1	1	0	5	5	0	1	1	0	0	1	14	0	0	3	18
Portugal	PO	0	0	0	6	7	0	1	1	2	0	12	30	0	0	4	34
Spain	SP	0	0	0	5	5	0	1	1	3	1	0	15	0	0	2	17
EU-12	EU-12	0	1	0	6	5	0	0	2	2	0	1		0	1	3	
Denmark	DE	0	0	0	2	4	0	0	0	1	0	0	9	0	13	1	22
Sweden	SW	0	0	0	1	3	0	0	0	1	0	0	6	5	0	1	13
UK	UK	0	0	0	3	4	0	2	0	2	0	4	16	0	0	0	16
EU-15	EU-15	0	0	0	5	4	0	1	1	2	0	1		0	1	2	

Source: Bank for International Settlements. Note: As a percentage of Austrian banking system assets (Jun 10), 2% are held by French (FR) institutions, 6% by German (GE) institutions, and so forth. Luxembourg excluded.

It is conceivable that, if the banks' retrenchment from doing business with other European banks persists for a sufficiently long period, this could influence policymakers' propensity to support future EU member state bail-outs. This is because if the solvency of a member country's banks is no longer threatened by the collapse of another's banking system, then the latter's spill-over effects will have diminished. However, other political/economic considerations may supersede this particular point.

Figure 33: European banking systems –foreign claims versus capital (excluding tax effects)

H1 10 (EURbn)	Capital	Ireland	Portugal	Greece	SUB-TOTAL	as % of capital	Spain	SUB-TOTAL	as % of capital	Italy	TOTAL	as % of capital
Austria	92	4	2	3	8	8%	6	13	15%	18	32	34%
Belgium	56	24	4	2	29	52%	16	45	81%	22	68	120%
Finland	24	0	0	0	0	0%	0	0	0%	0	0	0%
France	467	36	34	47	116	25%	135	251	54%	347	598	128%
Germany	367	113	30	30	174	47%	148	322	88%	126	448	122%
Greece	40	0	0	0	0	1%	1	1	3%	0	1	4%
Ireland	93	0	4	6	11	12%	22	32	35%	33	65	71%
Italy	360	12	4	4	20	6%	21	41	11%	0	41	11%
Netherlands	96	16	5	4	25	26%	59	85	88%	35	120	126%
Portugal	42	3	0	8	11	26%	20	31	72%	3	34	79%
Spain	282	11	64	1	76	27%	0	76	27%	27	103	36%
EU-12	1,918	218	147	105	470	25%	427	897	47%	612	1,509	79%

2009 (EURbn)	Capital	Ireland	Portugal	Greece	SUB-TOTAL	as % of capital	Spain	SUB-TOTAL	as % of capital	Italy	TOTAL	as % of capital
Austria	89	5	2	3	11	12%	6	17	19%	18	35	39%
Belgium	56	28	2	3	33	60%	15	48	87%	21	69	124%
Finland	24	0	0	0	0	0%	0	0	0%	0	0	0%
France	455	36	31	55	123	27%	147	270	59%	354	624	137%
Germany	379	128	33	31	193	51%	166	359	95%	132	491	130%
Greece	39	0	0	0	1	1%	0	1	2%	0	1	3%
Ireland	90	0	4	6	10	11%	22	32	35%	32	64	71%
Italy	294	12	5	5	22	7%	22	43	15%	0	43	15%
Netherlands	103	20	10	9	38	37%	84	122	119%	48	170	166%
Portugal	43	6	0	7	13	30%	20	33	77%	4	37	85%
Spain	270	10	59	1	70	26%	0	70	26%	33	103	38%
EU-12	1,841	247	146	119	513	28%	482	995	54%	642	1,638	89%

Source: European Central Bank, Bloomberg, Barclays Capital

BASEL III

Outstanding issues

With the final Basel III rules text published on 16 December 2010 and the Annex on 13 January 2011, after the G20 sign-off on 12 November 2010, the majority of changes to the global regulatory framework for banks has taken shape. At the heart of the new framework lie more stringent capital requirements (both in terms of quality and quantity) as well as the introduction of liquidity rules. Member countries must now translate the new rules into national laws and regulations before 2013. It remains to be seen whether most countries will stick to the 7% minimum core Tier 1 ratio requirement or whether countries will want to be more conservative by requiring higher minimum ratios. Switzerland is a case in point (see the *Innovative bond structures* section). The key remaining issues centre on systemically important financial institutions ('SIFIs') and their additional capital requirements ('systemically important banks should have loss absorbing capacity beyond the minimum standards') – these additional requirements may comprise a combination of capital surcharges and contingent capital, which could be either in the form of contingent convertibles ('CoCos') or bail-in debt (see the *Innovative Bond Structures* section). Final proposals on SIFI's additional capital requirements are expected by mid-2011.

Figure 34: BASEL III – Key announcements

Date	Title of paper	Key proposals / measures
17 December 2009	'Consultative proposals to strengthen the resilience of the banking sector announced by the Basel Committee' and 'International framework for liquidity risk measurement, standards and monitoring'.	Initial proposals regarding banks' capital and liquidity requirements.
16 April 2010	End of public consultation to the December 2009 proposals	
26 July 2010	'The Group of Governors and Heads of Supervision reach broad agreement on Basel Committee capital and liquidity reform package'	Taking into account the feedback received during the public consultation, amendments to the December 2009 proposals are contained in the 'Annex' to those proposals. For instance, the capital deductions proposals are softened.
19 August 2010	'Basel Committee proposal to ensure the loss absorbency of regulatory capital at the point of non-viability'	The contractual terms of capital instruments (including Tier 2 instruments) should allow them to be permanently written-off or converted into common shares in the event that a bank is unable to support itself in the private market, without this being deemed an event of default.
12 September 2010	'Group of Governors and Heads of Supervision announces higher global minimum capital standards'	New minimum capital ratios announced: core Tier 1 ratio of 7.0% (including 2.5% capital conservation buffer) to be met by 1 January 2019. Also announcement of grandfathering arrangements for non-Basel III compliant instruments.
01 October 2010	End of public consultation to the August 2010 proposals	
19 October 2010	'Report to the G20 on response to the financial crisis released by the Basel Committee'	
12 November 2010	G20 (Seoul, South Korea) endorses Basel III	
16 December 2010	'Basel III: A global regulatory framework for more resilient banks and banking systems' and 'International framework for liquidity risk measurement, standards and monitoring'.	Final text.
13 January 2011	'Minimum requirements to ensure loss absorbency at the point of non-viability' – Annex to the December text	The August proposals regarding loss absorption language of capital instruments (including Tier 2 instruments) formally incorporated into the text.

Source: Bank for International Settlements.

In addition to its work on SIFIs, the Basel Committee is assessing cross-border bank resolution issues, building on its 2010 report⁶. This report argues for effective national resolution frameworks but also recommends that these frameworks converge, in order to achieve coordinated resolution of distressed financial institutions active in multiple jurisdictions. The EU resolution proposals of 6 January are a step in that direction.

Separately, higher capital requirements for trading, derivative and securitisation activities will be introduced at the end of 2011, as per the Pillar 1 and Pillar 3 enhancements to the Basel II framework announced on 13 July 2009. This will be accompanied by a fundamental review of the trading book framework, particularly studying whether or not the distinction between the banking and the trading book should be maintained.

Why Basel III may not improve European banks' credit ratings

Through higher capital requirements and the first-time introduction of liquidity/funding requirements, Basel III will enhance European banks' standalone creditworthiness and is therefore credit-positive. However, this does not mean that their credit ratings can only go up. There are three reasons for caution:

- In the first place, the Basel proposals envisage a long implementation period (one important reason being to avoid banks curtailing lending at a time when the economic recovery is still fragile). During this time, banks could conceivably strengthen their capital and liquidity ratios, while at the same time seeing deteriorating trends in asset quality (eg, driven by renewed economic weakness) and/or profitability (eg, driven by net interest margin pressure). These negatives could mitigate, or even offset, the Basel III-driven positives of higher capital/liquidity, preventing rating upgrades.
- Secondly, strategy risk could curtail credit rating upside. Certain banks are likely to retrench from activities that are capital-intensive/generate ROEs below COEs. For some, this retrenchment can be disruptive and pose broader questions about the viability of their banking business models.
- Thirdly, many European banks still enjoy the credit rating uplift of sovereign support. As this support is gradually being withdrawn (see *Resolution regimes* section), some banks' credit ratings could actually come down.

⁶ Report and Recommendations of the Cross-border Bank Resolution Group, March 2010

Figure 35: Basel III - Phase-in arrangements

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio	Observation period begins							Introduce minimum standard	

Note: Shading indicates transition periods - all dates are as of 1 January.

Source: Bank for International Settlements.

How Basel III will affect European banks' new bond issuance

A key feature of the new regulatory framework is the introduction of liquidity requirements, namely the liquidity coverage ratio (stock of high-quality liquid assets should at least equal the total net cash outflow over the next 30 calendar days) and the net stable funding ratio (NSFR – the available amount of stable funding should exceed the required amount of stable funding over a one-year horizon). It is the latter ratio that is expected to have a significant impact on banks' bond issuance. The rationale of introducing the NSFR is to limit over-reliance on short-term wholesale funding and to promote more medium and long-term funding, thereby better maturity-matching their funding with their asset bases. As a result, banks will seek to term out their funding profile by issuing longer-dated paper. The increased supply further up the curve could drive up yields. However, we note the long implementation period, which means that banks will have many years to adjust to the new requirements. As a result, increased supply at the long end of the curve is likely to be spread out over a number of years.

As for hybrid issuance, one of the results of Basel III is that in future years European banks are likely to issue less hybrid capital instruments relative to common equity than in the past. This is a reflection of the increased focus of Basel III on core Tier 1 capital as opposed to total capital. However, much depends on national discretion – if every country follows Switzerland's lead (see the *Innovative bond structures* section), then the opposite may actually happen. Secondly, new hybrid issuance will need to meet the new Basel III criteria, in order to be treated as regulatory capital. For Tier 1 capital instruments, their terms and conditions should specify a pre-set *automatic* writedown/conversion trigger level (eg, a minimum core Tier 1 ratio), are loss-absorbing when triggered by *the regulator* (ie, when the regulator decides that the point of non-viability has been reached), have a non-cumulative

discretionary coupon (ie, 'must-pay' Tier 1 bonds and Alternative Coupon Satisfaction Mechanism (ACSM) language are no longer allowed) and be genuinely perpetual (ie, no call incentive in the form of step-up coupons). For Tier 2 capital instruments (the distinction between Upper and Lower Tier 2 will disappear), the requirement is that there are no step-ups or other incentives to redeem and that they are loss-absorbing when triggered. The trigger event for all Basel III-compliant capital securities is the earlier of: 1) a decision by the authorities that a writedown is necessary in order to maintain the bank's viability; and 2) the decision to make a public sector injection of capital.

We also note that new hybrid bonds are likely to become more expensive for banks to issue, reflecting the higher return demanded by investors to compensate them for the weaker bond language. This could restrict new Tier 1 issuance even further, as banks decide to issue straight core Tier 1 capital instead.

How Basel III is affecting European banks' existing bonds

The large majority of outstanding hybrid bonds will lose their regulatory capital treatment under Basel III, we believe. This is because they do not tend to meet all of the eligibility criteria set out above. We note the ambiguous language of the Annex published on 13 January 2011. It states that 'The terms and conditions of all non-common Tier 1 and Tier 2 instruments [...] must have a provision that requires such instruments [...] to either be written off or converted into common equity upon the occurrence of the trigger event, unless: (a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event; [...]' This suggests that if a country has adopted a resolution regime, the capital instruments issued by its banks are not required to have loss-absorption language. Even so, we would still expect most hybrid bonds to lose their regulatory capital treatment under Basel III, because of the other requirements that would need to be met in order to be counted as regulatory capital.

The loss of regulatory capital treatment under Basel III means that regulatory call options could be triggered. This would allow banks to call their hybrid bonds early, ie. ahead of their first call date. Most Tier 1 bonds contain such language. As regulatory calls would be either at par value or at make-whole value, the 12 September announcements on Basel III (stipulating phase-out arrangements) triggered a rally in those Tier 1s trading below par value. Banks may want to be seen as forward-looking by calling old-style Tier 1 bonds at the earliest opportunity and have only new-style Basel III-compliant instruments outstanding as soon as possible. However, we note the uncertainty as to when exactly a regulatory call option can be triggered. In general, the trigger should be set off when the regulator informs the banks that their outstanding Tier 1 bonds are no longer eligible for Tier 1 capital treatment. We would expect this communication to shortly follow the adoption of the Basel III framework by the various European governments. To what extent the grandfathering provisions as allowed under Basel III would influence the timing of the regulatory call trigger, is open to interpretation.

Figure 36: European banks - EUR Tier 1s: likelihood of regulatory / first calls

Bond	Next call date	Outstanding	CRITERIA									VALUATION			
			Min piece	Back-end spread	Core Tier 1 ratio (latest)	Tier 1 ratio (latest)	Past call record ⁽¹⁾	Regulator's stance	Likelihood of reg call	Reg call language ⁽²⁾	Likelihood of first call ⁽³⁾	Price	Z-spread	YTP	YTC
ACAFP4.13 11/29/49	09/11/2015	600	50,000	165	6.7%	10.0%	3 called, 6 extended (1 T1 called, 2 extended)		Medium	At par	Medium	86	519	3.7	7.8
ACAFP 7.047 04/49	26/04/2012	750	1,000	261					High	Make whole	Low	99	587	3.9	7.5
ACAFP 7 7/8 10/49	26/10/2019	550	50,000	642					High	At par	n/m	101	460	7.7	7.7
ACAFP 8.2 03/29/49	31/03/2018	850	50,000	480					High	Par	Medium-High	103	477	6.7	7.7
BBVASM 3.798 09/49	22/09/2015	86	50,000	165	8.2%	9.2%	3 called, 2 LMEd (only T1 called)		Low	Make whole	Medium	75	847	4.3	11.0
BBVASM 4.952 09/49	20/09/2016	164	50,000	195					Low-Medium	Make whole	Medium	75	840	5.1	11.1
BBVASM 8 1/2 10/49	21/10/2014	645	50,000	574					High	Make whole	High	101	581	7.2	8.1
BCPPL 4.239 10/49	13/10/2015	500	50,000	195	5.6%	8.5%	1 called (LT2 though)	Restrictive	Low	Make whole	Low-Medium	50	1,981	7.3	22.3
BCPPL 5.543 06/49	09/06/2014	500	100	207					Low	Make whole	Low	48	3,080	8.2	33.0
BESPL 5.58 07/29/49	02/07/2014	600	1,000	265	7.9%	8.3%	None	Restrictive	Low	Make whole	Low	47	3,132	9.4	33.5
BNP 4.73 04/29/49	12/04/2016	750	50,000	169	9.0%	11.2%	9 called (only 1 T1)		High	Par	High	88	505	3.8	7.7
BNP 5.019 04/29/49	13/04/2017	750	50,000	172					High	Par	High	87	484	4.1	7.7
BNP 5.868 01/29/49	16/01/2013	700	1,000	248					High	Par	Medium	98	541	3.9	7.2
BNP 6.342 01/29/49	24/01/2012	660	1,000	233					High	Par	Medium	99	551	3.6	7.1
BNP 6 5/8 10/29/49	23/10/2011	500	1,000	260					High	Make whole	Medium	100	472	3.7	6.1
BNP 7.781 06/29/49	02/07/2018	500	50,000	375					High		High	105	393	5.6	6.9
BNP 8.667 09/29/49	11/09/2013	650	50,000	405					High	Par	High	105	453	5.4	6.5
BPCEGP 4 5/8 07/49	30/07/2015	700	1,000	153	7.7%	9.8%	1 extended, 2 LMEd		Medium-High	Make whole	Low-Medium	79	829	4.1	10.8
BPCEGP 4 3/4 12/49	01/02/2016	350	50,000	135					High	Par	Medium	77	819	4.1	10.8
BPCEGP 5 1/4 07/49	30/07/2014	800	1,000	184					High	Make whole	Low-Medium	81	998	4.3	12.2
BPCEGP 6.117 10/49	30/10/2017	850	50,000	237					High	Par	Medium	81	730	5.6	10.2
BPCEGP 9 03/29/49	17/03/2015	1,000	50,000	653					High	Par	High	100	666	8.4	9.0
BPCEGP 9 1/4 10/49	22/04/2015	750	1,000	n/a					Low / High	Par	Low / High	100	585	9.3	9.3
CMZB5.012 03/29/49	12/04/2016	1,000	50,000	215	9.7%	11.2%	LME launched Jan 2011	Restrictive	Low	Make whole	Low	69	1,257	6.2	15.2
CMZB5.321 06/30/16	n/a	750	1,000	n/a					n/m	n/a	n/m	78	920	11.9	n/a
CMZB6.352 07/29/49	30/06/2017	1,000	1,000	200					n/m	n/a	n/m	73	1,103	6.9	13.8
CS 6.905 11/29/49	07/11/2011	400	1,000	320	11.6%	16.7%	4 called, 2 T1s		High	Make whole	Medium	102	268	4.5	4.1
DB 5.33 09/29/49	19/09/2013	1,000	1,000	199	7.6%	11.5%	LT2s extended		High	Make whole	Low	89	826	3.9	10.3
DEXGRP 4.3 11/29/49	18/11/2015	700	50,000	173	11.8%	12.8%	1 UT2 called	Restrictive	Low-Medium	Par	Low-Medium	43	2,467	8.4	27.2
DEXGRP 4.892 11/49	02/11/2016	500	50,000	178					Low-Medium	Make whole	Low-Medium	53	1,637	7.3	19.1
DEXGRP 6.821 07/49	06/07/2011	225	10,000	230					Low-Medium	Par	Low-Medium	n/a	n/a	n/a	n/a

Bond	Next call date	Outstanding	CRITERIA									VALUATION			
			Min piece	Back-end spread	Core Tier 1 ratio (latest)	Tier 1 ratio (latest)	Past call record ⁽¹⁾	Regulator's stance	Likelihood of reg call	Reg call language ⁽²⁾	Likelihood of first call ⁽³⁾	Price	Z-spread	YTP	YTC
DPB 5.983 06/29/49	29/06/2017	500	50,000	207	7.6%	11.5%	2 T1 extended, 1 LT2 LMEd		High	Make whole	Medium	78	813	5.5	11.0
EURHYP 6.445 05/49	23/05/2013	600	1,000	367	11.6%	16.7%	None	Restrictive	Low	Make whole	Low	54	4,383	10.7	45.7
HBOS7.627 12/29/49	09/12/2011	415	50,000	288	9.0%	10.3%	Weak	Restrictive	Low	Make whole	Low	87	2,351	4.9	24.7
HSBC 5.13 12/29/49	29/03/2016	750	1,000	190	9.9%	11.5%	Relatively strong		High	Make whole	Medium-High	93	403	3.8	6.7
HSBC 5.3687 10/49	24/03/2014	1,400	1,000	200					High	Make whole	Medium-High	97	420	3.5	6.4
HSBC 8.03 12/29/49	30/06/2012	600	1,000	365					High	Make whole	Medium-High	104	334	4.8	5.0
HVB 7.055 03/29/49	28/03/2012	422	100	257	8.6%	9.7%	Relatively strong		High	Make whole	Medium	97	831	4.0	9.9
ISPIM 6.988 07/49	12/07/2011	500	1,000	260	7.7%	8.9%	Strong		Medium-High	Make whole	Medium	99	749	3.8	8.5
ISPIM 8.047 06/49	20/06/2018	1,250	50,000	410					Medium-High	Make whole	Medium-high	95	609	6.8	9.0
ISPIM 9 1/2 06/49	01/06/2016	1,000	50,000	757					Medium-High	Par	High	96	792	10.4	10.5
ISPIM 8 3/8 10/49	14/10/2019	1,500	50,000	687					Medium-High	Make whole	n/m	97	587	8.6	8.9
KNFP6.307 10/29/49	18/10/2017	372	50,000	268	7.7%	9.8%	1 extended, 2 LMEd		High	Make whole	Medium-High	81	750	6.0	10.4
LLOYDS 4.385 05/49	12/05/2017	88	1,000	168	9.0%	10.3%	Weak	Restrictive	Low	Make whole	Medium	66	1,067	5.7	13.5
LLOYDS 6.35 10/49	25/02/2013	261	1,000	250					Low	Par	Medium	89	1,064	4.5	12.5
MONTE7.99 12/29/49	07/05/2011	350	1,000	390	6.1%	8.4%	3 called	Restrictive	Low	Make whole	Low	95	2,252	5.3	23.0
RBS 4.243 12/29/49	12/01/2016	166	1,000	169	10.2%	12.5%	Weak	Restrictive	Low	Par	Low-Medium	62	n/a	n/a	n/a
RBS 6.467 12/29/49	30/06/2012	391	1,000	210					Low	Make whole	Low-Medium	68	n/a	n/a	n/a
RBS7.0916 10/29/49	29/09/2017	471	50,000	233					Low	Par	Low	68	n/a	n/a	n/a
SOCGEN 4.196 01/49	26/01/2015	1,000	1,000	153	8.4%	10.4%	Strong		Low	Make whole	Medium	84	678	3.7	9.2
SOCGEN 5.419 11/49	10/11/2013	650	1,000	195					High	Make whole	Medium	93	637	3.7	8.4
SOCGEN 6.999 12/49	19/12/2017	600	50,000	335					High	Make whole	Medium-High	95	504	5.7	7.9
SOCGEN 7.756 05/49	22/05/2013	1,000	50,000	335					High	Make whole	Medium-High	100	573	4.8	7.6
SOCGEN 9 3/8 09/49	04/09/2019	1,000	50,000	890					High	Par	n/m	107	517	9.1	8.2
UBS 4.28 04/29/49	15/04/2015	1,000	1,000	158	14.2%	16.7%	2 called, 1 LMEd (only T1 called)		Medium	Make whole	Medium	87	557	3.6	8.0
UBS 7.152 12/29/49	21/12/2017	600	50,000	345					High	Make whole	Medium-High	102	396	5.4	6.8
UBS 8.836 04/29/49	11/04/2013	1,000	50,000	465					High	Make whole	Medium-High	105	427	5.8	6.1
UCGIM 4.028 10/49	27/10/2015	750	50,000	176	8.6%	9.7%	Relatively strong		Medium	Make whole	Medium	75	866	4.5	11.2
UCGIM 8 1/8 12/49	10/12/2019	750	50,000	665					Medium-High	Make whole	n/m	97	551	8.3	8.6
UCGIM 9 3/8 07/49	21/07/2020	500	50,000	749					Medium-High	Par	n/m	97	675	9.4	9.9

Note: 1) 2009 and 2010, stats relate to group-wide call record, LME stats only include bonds with first call dates in 2009/2010

2) 'Make whole' means the greater of par or make whole

3) We have ignored call dates beyond 2018 (when Basel III implementation has been completed)

4) Z-spread to call

Source: Bloomberg, companies, Barclays Capital

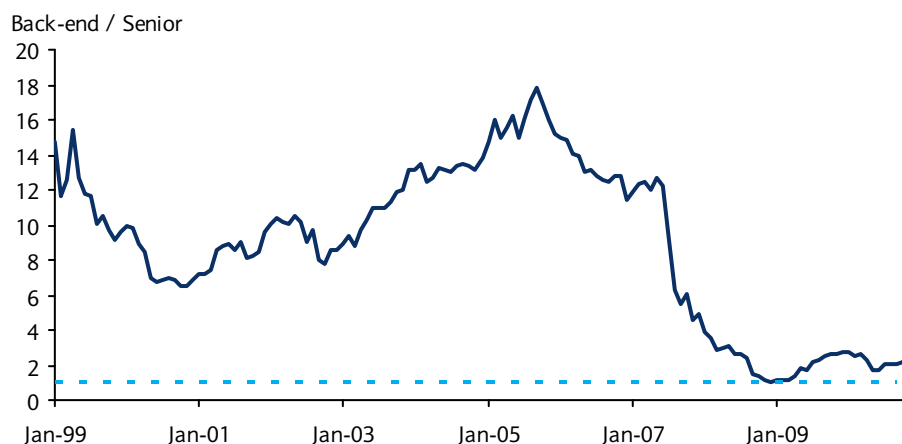
Indeed, the uncertain timeline for the final implementation by national regulators of these rules in the shape of country specific legislation, may push banks to delay hybrid calls and maintain their current composition of capital, as new instruments would have high costs but give no certainty about future eligibility for inclusion in capital. This was the motivation behind UBI Banca's announcement in December to extend 3 Tier 1 bonds coming up for call in 2011, as well as Monte's announcement on 18 January to extend its 7.99% Tier 1 bond coming up for call in February 2011.

We also note that banks have the option, not the obligation, to exercise regulatory calls. In some instances, it would make economic sense not to exercise regulatory calls, because the bank would be unable to replace the Tier 1 bond with senior funding at materially lower yields (either because the current fixed income coupon is high, or because the Tier 1 bond is close to its first call date, after which the fixed coupon switches to a lower floating-rate coupon). Should a regulatory call option not be exercised, the next question is whether a bank will exercise the regular call option at first call date. In the tables above, we have aimed to ascribe a likelihood on regulatory/first calls being exercised. Criteria that could influence first call decisions, include:

- the type of bond. Generally speaking, retail Tier 1 bonds are more at risk of extension than institutional Tier 1 bonds, owing to lower reputational implications;
- the funding cost advantage of calling / not calling;
- the bank's capital position (ie, if thinly capitalised, calling a Tier 1 bond is less likely);
- its past call record; and
- the regulator's stance. Banks will need regulatory approval before they can call their Tier 1 bonds (except possibly for regulatory call options, as these would be triggered when the bonds no longer count towards regulatory capital). For those banks that have weak capital ratios, such approval may not be forthcoming. Although the higher Basel III capital requirements will be only gradually introduced from 1 January 2013 onwards, regulators may want their banks to start preparing now.

In Figure 36, we have tried to put a likelihood on regulatory or first calls being exercised for EUR-denominated Tier 1 bonds. We have also included a similar table for GBP-denominated Tier 1 bonds in the appendices. In the graph below, it can be seen how the economic incentive to exercise a first call option on Tier 1 bonds has decreased in recent years, as benchmark rates for back-end spreads have come down.

Figure 37: European banks – Ratio of average T1 back-end spread to EUR senior spread over Euribor



Source: Barclays Capital.

CREDIT FUNDAMENTALS

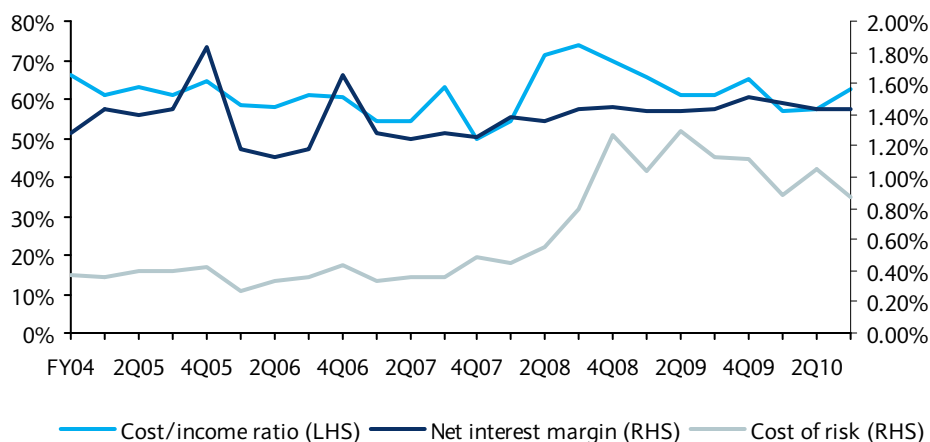
Lower credit charges to improve net profitability in H1 11

We expect European banks' gross profitability to remain subdued in H1 11, when further net interest margin compression, balance sheet deleveraging and depressed revenues from capital markets activities (namely trading and related commission income) will continue to weigh on banks' earnings. This could ease in the latter part of the year as economic growth gathers momentum and sovereign debt issues are worked through. However, net operating profitability should benefit from continued reductions in loan loss charges.

European banks' Q3 10 profits were on average 3.6% ahead of consensus, a clear slowdown relative to the 16% consensus beat of Q2. The composite of 17 European banks under our coverage that published Q3 results reported a q/q decline in pre-impairment profitability of 16.1% to €31.1bn. 14 banks reported a decline in operating profit compared to only three institutions reporting a quarterly increase. This was largely driven by lower trading results, which fell by €3.2bn in a period characterised by high risk aversion and low liquidity. Credit Suisse and UBS accounted for most of this decline (€3.6bn), due to lower client-driven trading volumes. Net interest income was also lower, recording a 2.6% q/q decline, on the back of lower asset volumes, as net interest margin remained flat at around 1.45%.

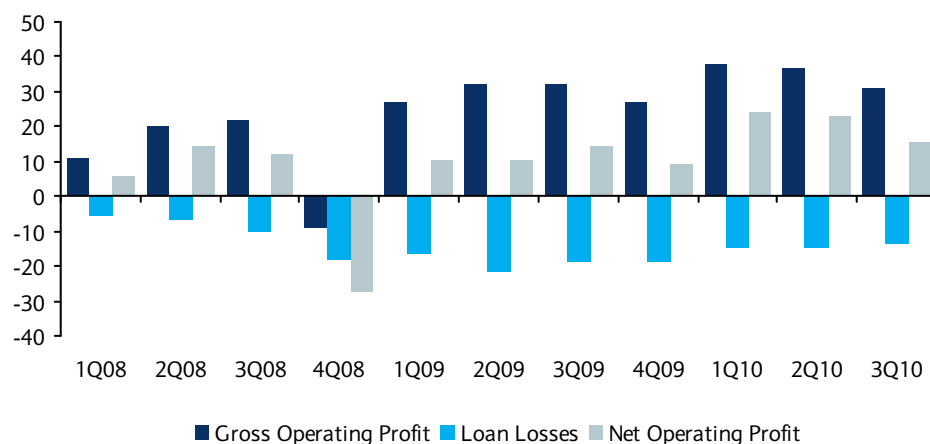
Banks stepped up their cost-containment efforts in Q3 in a move to boost bottom-line earnings and operating expenses fell in the quarter (0.4% in EUR terms, 1.4% in constant currency terms). However, this was not sufficient to offset the decline in revenue and the average cost-to-income ratio increased to 62.3%, from 57.5% in Q2. Spain remained the most efficient banking market with an average efficiency ratio of 45.7%. CS and UBS, on the other hand, maintained the heaviest cost structures with cost-to-income ratios of 85% and 88%, respectively. Banks are likely to up their cost-reduction efforts in 2011, particularly if gross revenues remain depressed as we expect.

Figure 38: European banks – profitability drivers



Source: Company data, Barclays Capital. Note: Composite comprised of 17 European banks under our coverage that reported full Q3 2010 financial statements.

Figure 39: European banks – quarterly profitability (€bn)

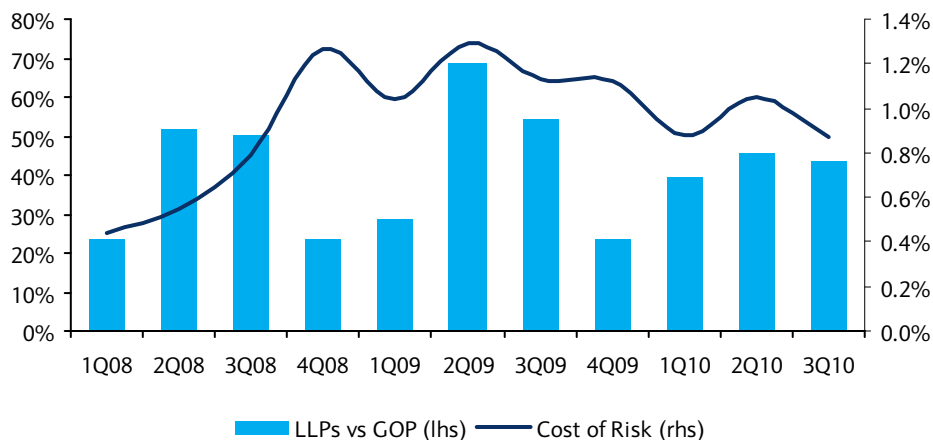


Source: Company data, Barclays Capital. Note: Composite comprised of 17 European banks under our coverage that reported full Q3 2010 financial statements.

The improving credit trend in the sector led to a 6.4% q/q decline in aggregate loan losses to €13.9bn, from €14.8bn in Q2, after a 2% increase in the second quarter. This is substantially below the €21.7bn peak observed in Q2 09, although it remains well above pre-crisis levels (€5.8bn in Q1 08). Within our composite, 14 banks reported a decline in loan loss charges, with only three reporting an increase (SANTAN, POPSM and DB). The average cost of risk fell back to Q1 levels (87bp) after a sharp increase in Q2 (1.05%). Spanish banks continue to lag the rest of the sector with an average cost of risk of 140bp. In our view, a continued reduction in provisioning levels should prove supportive for banks earnings in 2011, although the knock-on effect of the various fiscal austerity packages in European periphery economies, as well as higher borrower costs, may set a floor to the potential decline in aggregate credit-impairment charges.

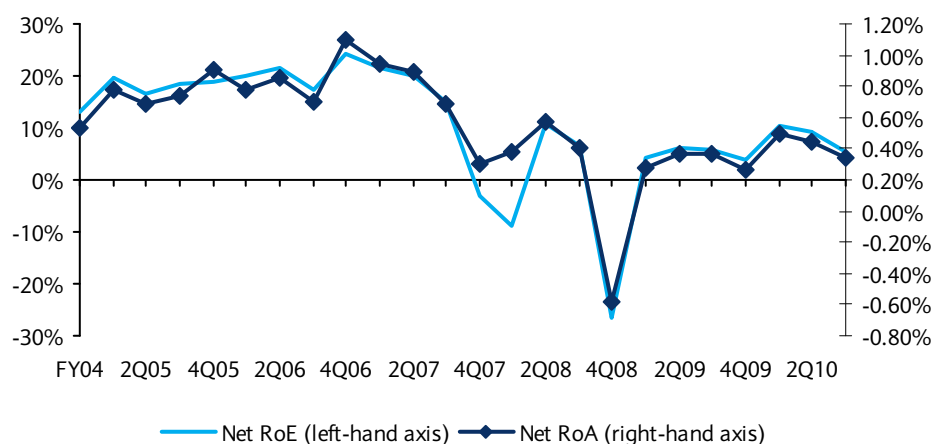
Return measures fell for the second quarter in a row. The average net return on equity fell by almost 4 percentage points to 5.44% (after a 1 percentage point decline in the second quarter), and return on assets fell by 9bp to 0.35% after a 6bp decline in Q2. On the basis of the higher core capital requirements contemplated under the Basel III rules, we expect bank return measures to remain well below pre-crisis levels, even if profit levels exceed our expectations.

Figure 40: European banks – asset quality trends



Source: Company data, Barclays Capital. Note: Composite comprised of 17 European banks under our coverage that reported full Q3 2010 financial statements.

Figure 41: European banks – profitability ratios



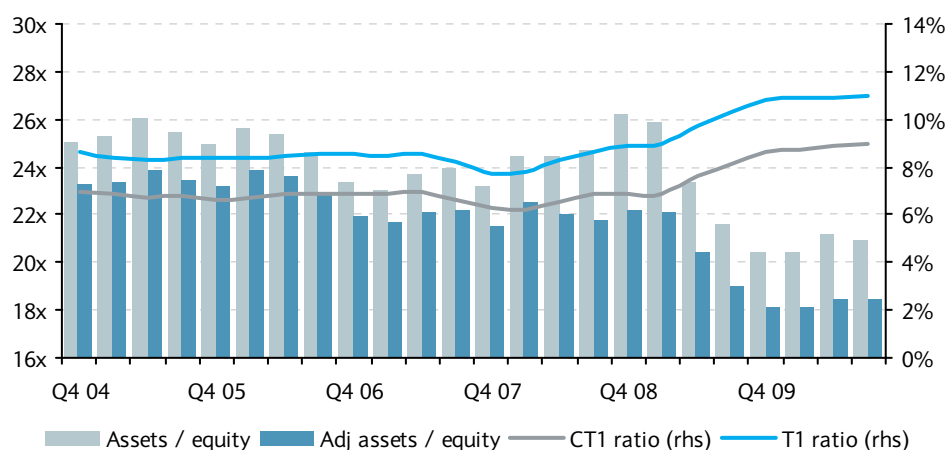
Source: Company data, Barclays Capital. Note: Composite comprised of 17 European banks under our coverage that reported full Q3 2010 financial statements.

UK BANKS. With the exception of RBS, UK banks did not report full Q3 results. The information released was limited to qualitative trading updates, which revealed an overall continuation of the underlying trends, which we highlighted in our 1H2010 recap (*European Banks: Q2/H1 10 results recap, 2 September 2010*). The restructuring stories of RBS and LLOY seem to be well on course: balance sheet deleveraging continues to meet or exceed previously set targets, liquidity is improving and underlying profitability is on the rise on the back of lower loan impairment charges (we note, however, that RBS reported a £1.5bn quarterly loss as a result of two large one-offs totalling £1.7bn). As for the more emerging market-exposed groups, both HSBC and STANLN pointed to strong performance relative to 2009, partly thanks to falling asset-quality charges, but also noted slowing momentum in their high-growth markets. We expect RBS and LLOY to continue to deliver on their restructuring plans and see further improvement in 2011. We are less bullish on the already tight valuations and slowing trends at HSBC and STANLN.

Solvency: steady in Q3 10, but further strengthening expected

Q3 was an uneventful quarter for the capitalisation of European banks. Adding to volatile capital markets and high levels of risk aversion on the back of persisting sovereign debt concerns, the lack of clarity regarding the final form of the Basel III regulation (final text announced on 16 December 2010), deterred most European banks from doing rights issues. The main driver for the 9bp quarterly improvement in the average core tier 1 across the sector was continued balance sheet deleveraging (RWA fell by an average 1.2% over the quarter), as absolute capital levels actually fell over the period: 0.2% in core tier 1 terms, 0.5% on a tier 1 basis. Deleveraging was most pronounced in the securities portfolios (the aggregate AFS book fell by an aggregate 2.6%), whereas the aggregate loan book only declined by 0.3%. Average core tier 1 and tier 1 ratios stood at 8.95% and 10.94% at the end of the quarter, respectively. Switzerland remained the best-capitalised banking market, with both CS and UBS reporting a core tier 1 in excess of 11.5%, whereas Portugal continues to run on the thinnest capital base, at around 6.75%. Spain, France, Germany and Italy all maintain average core tier 1 ratios in the 8.0-8.5% range.

Figure 42: European banks – capitalisation trends



Source: Company data, Barclays Capital.

Since the end of the quarter, three banking groups completed rights issues: STANLN (£3.3bn); BBVA (€5.0bn); and DB (€10.2bn). Out of these, only STANLN's was formally aimed at strengthening the bank's capital base in anticipation of Basel III (although this is also likely to have been a consideration for DB's). Those of DB and BBVA were mainly aimed at financing the acquisitions of Deutsche Postbank and 25% of Türkiye Garanti Bankası, respectively. We expect new equity rights issues by European banks in the coming year, as banks now have full visibility on the new capital rules of Basel III. Furthermore, we do not dismiss the possibility of new government capital injections, particularly in the European periphery if sovereign risk concerns intensify, although we expect these to be limited to smaller players outside our coverage universe (eg, Spanish cajas).

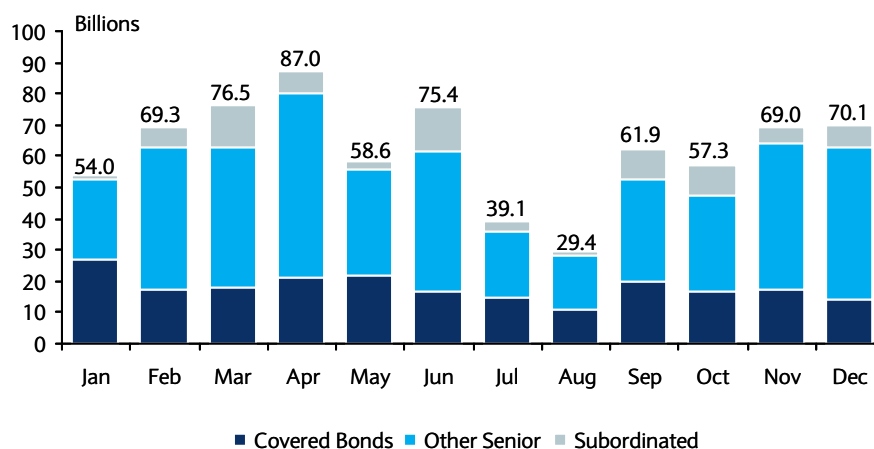
Asset quality: Slowing deterioration, greater regional differences

Loan delinquencies continued to rise in Q3 with our 17 bank composite posting a 2% rise in gross non-performing loans, the lowest q/q increase since the end of 2007. The average NPL ratio marked a new high of 4.91%, up from 4.72% in Q2. Regional differences became ever more apparent, as both Germany and Switzerland recorded a decline in delinquency ratios, whereas those of Spain, Portugal, France and Italy increased. Switzerland continued to be the best-performing banking market with an average NPL ratio of only 0.9%, supported by the low risk profile of its private banking business model. We expect the softening of credit deterioration to continue into 2011 and anticipate a stabilisation of the aggregate NPL ratio around the 5% level. Regional differences are, however, likely to become more pronounced, with divergent asset quality trends in the European core and periphery. Anaemic economic growth and persistently high levels of unemployment could push delinquency ratios beyond our expectation.

FUNDING OUTLOOK

In 2011, we expect European banks' gross issuance of medium- and long-term debt (ie, debt with an original maturity of more than one year, including senior, subordinated and covered bonds) to match debt redemptions, after negative net issuance of €52bn in 2010 and positive net issuance of €114bn in 2009. In our base case, customer deposit funding continues to rise, albeit at a lower rate than that seen in 9M 10 (4.0% y/y for our 17 bank composite), as households' falling purchasing power curtails further improvement in their saving rates. Interbank funding should decline during the year, as banks seek to term-out their institutional funding to better maturity-match their asset base. This is likely to be achieved by the stronger institutions in the European core, as peripheral banks could remain heavy users of central bank funding. These two effects (ie, increasing customer deposits and falling interbank funding) could largely offset each other. On the asset side, we expect aggregate balance sheet growth to remain muted. Although some banks are growing their loan books once more, many are still in deleveraging mode.

Figure 43: European banks – MLT redemptions in 2011 (€bn)



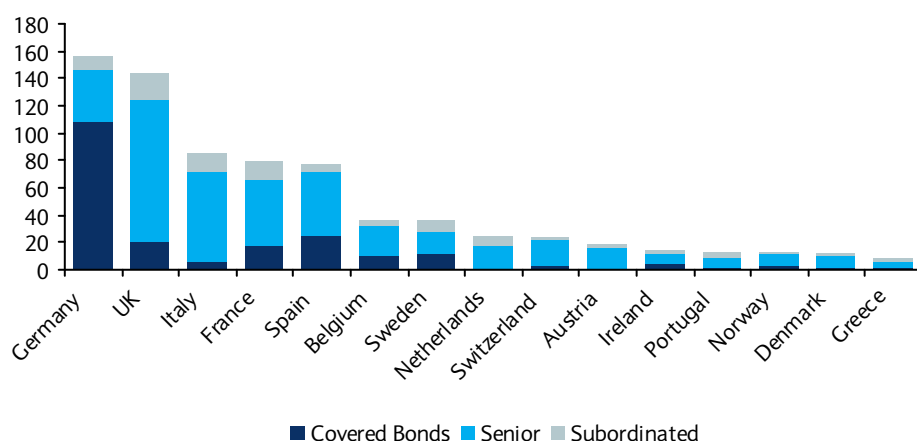
Source: Dealogic, Barclays Capital

Supply drivers: issuance and redemption

European banks (including banks not currently under coverage) face gross medium- and long-term redemptions of €745bn in 2011 (across all currencies), below the 2009 and 2010 figure of around €800bn a year. We can explain this reduction by examining supply dynamics in the year of issuance of maturing debt. Bank issuance tends to concentrate in specific maturity buckets, namely 2, 3, 5, 7 and 10 years. These maturities accounted for 70% of all debt issued by European banks in the 2008-10 period. Looking back to the year of issuance, for each bucket for the 2011 maturities, we find that a number of key maturity buckets were negatively affected by macroeconomic cyclical troughs. For example, we find that 10y debt maturing in 2011 (therefore issued in 2001) was €62bn, materially down from the €95bn of 10y maturing in 2010 (issued in 2000, the peak of the previous cycle). We find a similar effect on four-year debt issues maturing in 2011 (issued in 2007 when credit markets started to show the first signs of deterioration), which amounted to €27bn, materially below the €44bn of 4y debt maturing in 2010. Despite increased overall supply in 2009, 2y debt issued in 2009 was €144bn, almost €60bn below the 2y debt maturing in 2010. This was motivated by a simultaneous move by banks to lengthen the maturity profile of new debt in 2009, leading to increased issuance in all maturity buckets above the 2y bucket. These three maturity buckets

alone (2, 4 and 10y) account for a €108bn y-o-y reduction in debt redemptions in 2011, which more than offsets the €74bn of increased redemptions in the other key redemption buckets (3, 5 and 7y). Other maturity buckets account for the remaining €27.4bn y-o-y reduction in redemptions in 2011 relative to 2010. By region, German banks face €157bn of gross redemptions in 2011, followed by UK banks with €143bn, Italian with €85bn, French with €79bn and Spanish with €78bn (see Figure 44).

Figure 44: European banks - 2011 MLT redemptions by country (€bn)



Source: Dealogic, Barclays Capital

Figure 45: European Banks – 2011 MLT redemptions by bank

absolute amounts in €bn	Covered Bonds	Other Senior Funding	Subordinated Funding*	2011 MLT Redemptions	Total Assets	2011 Redempt. (% TA)
Espirito Santo Financial Group SA	1.3	4.0	0.4	5.6	81	7.0%
Intesa Sanpaolo SpA	0.0	32.4	4.7	37.1	677	5.5%
Dexia SA	10.4	20.8	0.6	31.8	599	5.3%
Banco de Sabadell SA	1.7	1.5	1.1	4.3	86	5.0%
Lloyds Banking Group plc	4.9	31.8	3.8	40.5	1,185	3.4%
Commerzbank AG	21.3	2.9	2.3	26.4	848	3.1%
Banco Commercial Portugues	0.0	2.0	1.0	3.0	99	3.0%
Banco Santander SA	9.1	16.4	5.7	31.2	1,236	2.5%
BBVA	5.5	5.9	1.4	12.9	558	2.3%
UniCredit SpA	4.5	11.7	3.9	20.1	969	2.1%
BPCE SA	7.6	9.4	2.0	19.1	1,106	1.7%
Barclays plc	6.4	17.8	6.1	30.3	1,829	1.7%
Royal Bank of Scotland Group plc	0.0	22.9	5.3	28.2	1,822	1.5%
HSBC Holdings plc	1.5	22.9	2.8	27.2	1,774	1.5%
Credit Suisse Group	0.0	10.7	0.8	11.5	797	1.4%
Banco Popular Espanol SA	0.0	1.7	0.0	1.7	128	1.3%
BNP Paribas SA	4.5	9.7	5.8	20.0	2,149	0.9%
Deutsche Bank AG	0.2	13.1	1.7	14.9	1,958	0.8%
Societe Generale	0.1	6.6	1.5	8.2	1,150	0.7%
Credit Agricole SA	0.0	11.2	0.9	12.1	1,725	0.7%
UBS AG	0.0	4.2	2.2	6.4	1,090	0.6%
Standard Chartered plc	0.0	1.5	0.0	1.5	353	0.4%

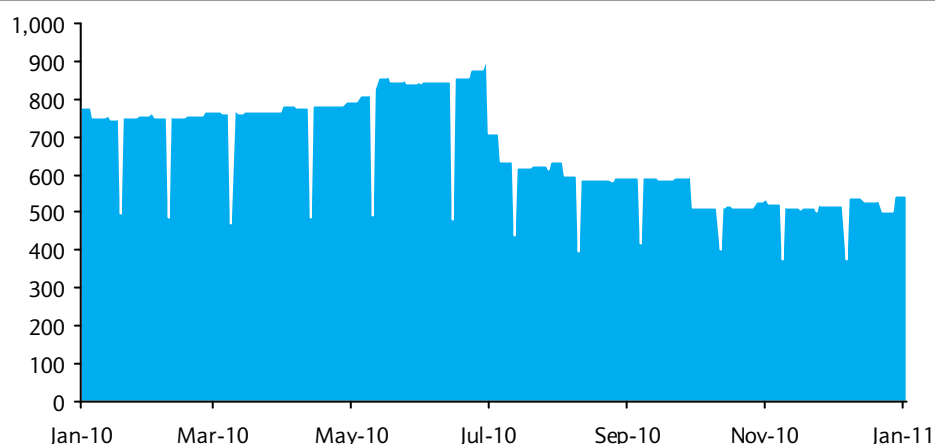
Note: * Includes first time calls as well as bullet maturities. Source: Dealogic, Companies, Barclays Capital

We estimate gross MLT debt issuance in 2010 to have fallen to €750bn, from €895bn in 2009, leading to a negative net supply of €52bn for the year after a positive €114bn one year earlier. As pointed out by our strategy colleagues last November (*European Credit Alpha: Supplying an outlook*, 5 November 2010), a substantial portion of 2009 issuance was aimed at pre-funding 2010 maturities as banks rushed back to debt markets coinciding with the return of investor risk appetite after effective closure of funding markets since Q4 08. In addition to the pre-funding activity in 2009, high risk aversion on the back of sovereign risk concerns and related capital market volatility contributed decisively to the reduction in gross and net supply in 2010. This also motivated a shift in investor preference towards secured debt issues: gross covered bond issuance for the year reached €283bn, from €241bn in 2009, while aggregate unsecured debt issuance fell to €475bn from €608bn one year earlier. The geographical split of new covered bond issues also changed, as the lack of issuance by traditional covered bond issuers, such as German banks, was filled by French, Scandinavian and Spanish banks. Our covered bond strategists expect covered bond issuance in 2011 to be even higher than that observed in 2010 (Covered Bond section below), as the conditions supportive of this type of funding remain in place while new ones appear in the horizon (eg, resolution regimes allowing burden sharing by senior unsecured bondholders, expiry of central bank asset repurchase programmes such as the Special Liquidity Scheme in the UK, 'SLS'). The continued expansion of banks' customer deposit bases in 2010 also helped absorb the contraction in bank bond supply over the year, with the aggregate of 17 banks under our coverage reporting Q3 results showing a y-o-y average increase in customer deposits of 4.0% to September 2010.

Money markets: monetary authorities to remain supportive

The difficulties faced by euro area banks throughout 2010 in tapping funding markets were widespread. This reflected the impact that the sovereign debt crisis in the European periphery was having on market liquidity. Strong perceived linkages between governments' fiscal positions and the health of their domestic banks (see the *Sovereign risk* section) meant that access to wholesale funding dried up for many banks. As a result, since May 2010 euro area money markets have been largely dependent on the Eurosystem's liquidity support, although there have been some positive market developments. The increased transparency brought by the publication of the CEBS banking stress-test results in July 2010 led to an improvement in the availability of both secured and unsecured term funds, although with notable cross-country differences. In general, funding conditions for large banks in the European core improved, whereas weaker peripheral banks have continued to find access to term funding difficult and thus remain reliant on liquidity provided by the Eurosystem. The establishment of central clearing counterparties for repo transactions on government bonds also helped alleviate some pressures, enabling banks to finance holdings of bonds issued by their own sovereigns (which other banks had become reluctant to finance directly). Furthermore, contrary to expectations, the maturity of two one-year ECB long-term refinancing operations in July and September 2010 was met with less-than-complete refinancing of these maturities, which reduced excess system liquidity without substantial market disruptions.

Figure 46: ECB liquidity supply (EUR bn)

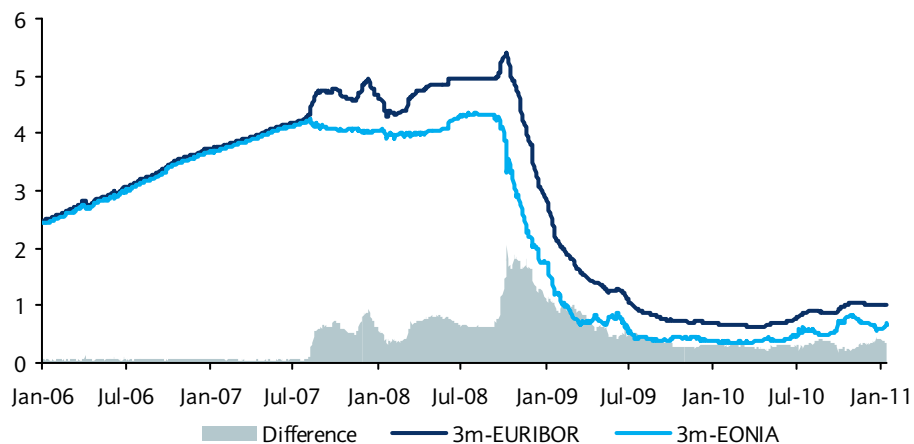


Source: European Central Bank

Despite these positive developments, counterparty credit risk concerns continue to drive funding availability. The difference between unsecured and secured interbank lending rates in the euro area remains at high levels (see Figure 40) and banks continue to place excess liquidity in the ECB's deposit facility, a safer alternative to short-dated interbank loans. Also, the volume of outstanding euro commercial paper has continued to decline in recent quarters and money market funds, which are regular buyers of euro commercial paper and important liquidity providers in the money markets generally, have continued to suffer outflows. Amid persisting market tensions, the ECB announced in early December that it would retain the commitment to meet euro area banks' demand for weekly liquidity in full until at least 12 April 2011, and for monthly and three-month liquidity in full until at least the end of the first quarter (see *ECB: A Pause, not a U-turn* in *Euro Weekly*, 3 December 2010).

For 2011, we anticipate an aggregate reduction in money market funding by European banks. We believe that both the ECB and national central banks will remain committed to the provision of ample liquidity until there is sufficient evidence that all banks can fund themselves independently. This is unlikely to happen in H1 11, in our view. At the same time, strong banks with relatively cheap access to institutional debt markets will likely seek to term out their funding mix, while weaker banks in peripheral European countries will remain heavy users of central bank liquidity support.

Figure 47: Secured vs. unsecured interbank lending rates



Source: Bloomberg

Government guarantee schemes: what's left

In the wake of the financial crisis, European states have adopted a wide range of support schemes aimed at avoiding the collapse of their financial sector. These rules included debt-guarantee schemes, recapitalisation measures, asset shields and other liquidity measures. Between October 2008 and October 2010, the volume of measures approved by the European Commission (ie maximum approved volume of state interventions) was €4.6trn or 39% of EU-27 GDP in 2009. These included €3.5trn for sector-wide aid schemes and €1.1trn for individual financial institutions. 76% of all approved aid was in the shape of bank debt guarantees (€3.5trn), 12% as recapitalisation measures (€546bn) and 9% as asset relief interventions (€401bn). States seemed to rely principally on guarantee measures, seeking a stabilising effect without immediate impact on public finances.

Aimed at ensuring the temporary nature of these measures, the guarantee schemes were initially approved for limited periods of time, with the possibility to extend them. Between autumn 2008 and October 2010, the European Commission approved or renewed 41 schemes and individual interventions. The use of guarantees was at its height at the end of 2008 and the first half of 2009, but decreased significantly thereafter. Lower usage levels and an improving sector outlook led in December 2009 to discussions on a gradual phase-out of State support measures, which the EcoFin Council concluded needed to start with the debt guarantee schemes. A preliminary analysis by the European Commission suggested specific pre-requisites for the renewal of guarantees after 30 June 2010, with the main change concerning the increase in guarantee fees based on banks' creditworthiness. This was aimed at bridging the difference in funding costs, encouraging sound institutions to exit the State guarantee while requiring weaker entities to assess their long-term viability and address structural weaknesses through restructuring where necessary. As of January 2011, seven sector-wide guarantee schemes had been extended until June 2011 (see table below). Of these, only the extension of the Portuguese scheme was pending approval by the European Commission at the time of writing.

Figure 48: Government guarantee schemes: what's left

Country	Expired in late 2009 /early 2010	Expired in Dec 10	Extended into 2011
Austria	-	-	✓
Denmark	-	✓	-
France	✓	-	-
Germany	-	✓	-
Greece	-	-	✓
Hungary	-	✓	-
Ireland	-	-	✓
Italy	✓	-	-
Latvia	-	✓	-
Netherlands	-	✓	-
Poland	-	-	✓
Portugal*	-	-	✓
Slovenia	-	✓	-
Spain	-	-	✓
Sweden	-	-	✓
UK	✓	-	-

Note: Belgium never operated a sector-wide scheme but chose to provide State aid in the form of individual aid measures instead. *Pending European Commission approval at time of writing.

Source: European Commission

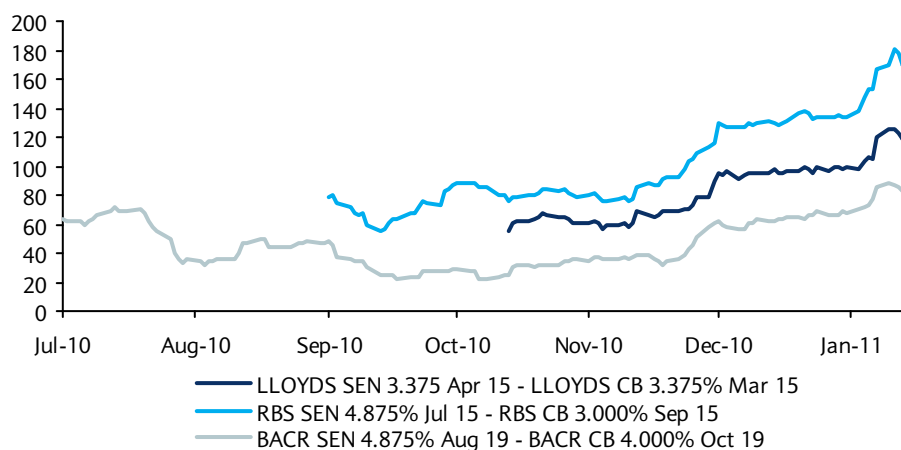
Covered bonds

Previously, European banks' senior unsecured bondholders assumed that they would always be made whole (except in extreme circumstances), partly because they rank *pari passu* with depositors. However, the resolution regimes adopted by several European countries and the resolution proposals published by the EU on 6 January 2011 (see the *Resolution Regimes* section) has shaken this belief, making it possible (at least in theory) to impose burden sharing on senior unsecured bondholders of failed EU banks. As a result, we expect that some investors will reallocate money away from senior unsecured bonds into covered bonds.

We note that the senior unsecured and covered bonds investor bases do not currently overlap to a large extent. Covered bond investors tend to limit themselves to rates instruments, avoiding the credit asset class. Conversely, credit investors may be barred from holding AAA-rated paper. In other words, many investors are constrained by their fund's mandate in switching out of one and into the other. To the extent that they can stray into different asset classes, they may not want to deviate from their benchmark too much (by making off-benchmark bets). The most likely outcome could be that (1) credit funds will not venture outside their asset class, but go underweight financials; and (2) the cost of senior unsecured funding will go up (*ceteris paribus*), to compensate investors for the higher loss-given-default implications of the resolution regimes.

However, certain investors (such as pension funds, insurance companies and also bank treasuries) may be less constrained by their investment mandate and could make the switch into covered bonds more easily. On balance, therefore, we do believe that the shift described above will occur. We note that the gap between senior and covered bond yields has already widened significantly in recent months for some banks. In the graph below we have shown this trend for UK banks. This illustrates the funding cost savings that banks can make in the current climate by issuing covered bonds instead of senior unsecured bonds.

Figure 49: UK banks – YTM differential (bp) between senior unsecured and covered bonds



Source: Bloomberg, Barclays Capital

Structural subordination

Issuing covered bonds allows banks to fund more cheaply, extend their funding maturity and access a different pool of investors. Therefore, having access to this funding market is a credit positive. But if banks rely too much on covered bond funding, then this could actually become a credit negative. This is because if the majority of a troubled bank's asset pool

serves as collateral for covered bonds, then the recovery values for other creditors in a liquidation scenario may be low (ie, there may be few unencumbered assets left to compensate them).

At what point does increased covered bond funding have negative rating implications? Fitch Ratings estimates that this 'inflection point' for a bank's Issuer Default Rating (ie, the point at which the agency will apply "an increased level of scrutiny of the overall funding mix") is reached when covered bonds funding amounts to around 25% of total funding. The agency also notes that an increase in covered bond funding at the expense of other wholesale funding is less concerning than when it is at the expense of retail funding. None of the banks under our coverage appear to be close to this limit yet, as can be seen in the table below. BPCE, Commerzbank (through Eurohypo) and Dexia (through Dexia Municipal Agency and Dexia Kommunalbank) have the highest reliance on covered bond funding, at 12%, 13% and 17% of total liabilities (assets – equity), respectively, at end-2009.

As for the impact on senior unsecured bond ratings, the agency notes that the inflexion point would need to be considered on a case-by-case basis. 'In some special cases, an institution could even have covered bonds funding up to 60-70% of total liabilities before this subordination effect puts pressure on the senior unsecured rating.' (We have not seen similar quantitative guidance from the other two agencies, which may be due to differences in rating methodology.)

Figure 50: European banks – covered bond funding as % of total liabilities (2009)

Issuer	Covered bonds (EURbn)	Debt funding (EURbn)	Non-equity funding (EURbn)	Total assets (EURbn)	Covered bonds as % of debt funding	Covered bonds as % of non-equity funding	Covered bonds as % of total assets
Allied Irish Banks plc	10.8	35.2	163	174	30.5%	6.6%	6.2%
Anglo Irish Bank	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Banca Monte Dei Paschi Di Siena SpA	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Banco Bilbao Vizcaya Argentaria SA	34.7	117.8	504	535	29.5%	6.9%	6.5%
Banco Comercial Portugues SA	4.5	20.0	88	96	22.6%	5.1%	4.7%
Banco Espirito Santo SA	3.6	35.7	75	82	10.2%	4.8%	4.4%
Banco Santander SA	27.8	243.3	1,037	1,111	11.4%	2.7%	2.5%
Bank of Ireland	9.0	49.2	175	181	18.4%	5.2%	5.0%
BNP Paribas SA	19.5	239.2	1,989	2,058	8.2%	1.0%	0.9%
BPCE (incl. CCF)	115.4	219.4	985	1,029	52.6%	11.7%	11.2%
Commerzbank AG ⁽¹⁾	109.3	171.4	818	844	63.8%	13.4%	12.9%
Credit Agricole SA	4.8	217.9	1,505	1,557	2.2%	0.32%	0.30%
Credit Suisse Group AG	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Deutsche Bank AG ⁽²⁾	7.0	154.0	1,685	1,727	4.5%	0.42%	0.41%
Dexia SA ⁽³⁾	99.1	213.1	567	578	46.5%	17.5%	17.2%
HSBC Holdings plc (amounts in USD)	15.6	177.4	2,236	2,365	8.8%	0.70%	0.70%
Intesa Sanpaolo SpA	2.0	185.2	572	625	1.1%	0.35%	0.30%
Lloyds Banking Group plc (amounts in GBP)	40.7	268.2	984	1,027	15.2%	4.1%	4.0%
Royal Bank Of Scotland Group plc	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Societe Generale	6.2	315.0	977	1,024	2.0%	0.63%	0.60%
Standard Chartered plc	n/a	n/a	n/a	n/a	n/a	n/a	n/a
UBS AG	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Unicredit SpA	6.0	214.8	866	929	2.8%	0.7%	0.6%

Note: 1) Including Eurohypo. 2) Pro forma for Deutsche Postbank. 3) Including Dexia Kommunalbank Deutschland and Dexia Municipal Agency.

Source: Company data, Barclays Capital

We note that banks can only issue covered bonds if they have sufficient eligible assets on their balance sheet, taking into account the required over-collateralisation for those instruments. Only residential and commercial mortgage loans as well as public sector finance assets tend to be eligible for covered bond pools. This limits this funding tool for some banks. Since the start of 2011, many European banks have announced covered bond issues (see table below). For a more elaborate discussion on covered bonds, please refer to The AAA Investor, 10 December 2010.

Figure 51: EUR-benchmark covered bonds, gross issuance, 2011 (ytd)

Supply date	Country	Issuer	Coupon (%)	ISIN	Volume (€bn)	Redemption	Yield over mid-swaps – at issue	Yield over mid-swaps - current
03-Jan-11	GER	MUNHYP	2.5	DE000MHB05J3	1	Jan-16	10	12
04-Jan-11	NOR	DNBNOR	2.625	XS0576372691	2	Jan-16	32	34
04-Jan-11	FR	BNPPCB	3.75	FR0010988873	1.75	Jan-21	65	67
04-Jan-11	NED	INTNED	3.375	XS0576072622	1.25	Jan-18	60	62
04-Jan-11	ESP	BBVASM	4.125	ES0413211410	1.5	Jan-14	225	227
05-Jan-11	GER	HVB	1.5	DE000HV2AB92	1	Jan-13	0	2
05-Jan-11	FR	CFF	2.875	FR0010989152	1	Jan-16	57	60
05-Jan-11	FR	ACACB	3.875	FR0010989087	1.5	Jan-21	73	72
05-Jan-11	NED	ABNANV	3.5	XS0576912124	1.25	Jan-18	70	72
05-Jan-11	UK	BACR	4	XS0576797947	1	Jan-21	85	83
05-Jan-11	ESP	SANTAN	4.625	ES0413900228	1	Jan-16	225	233
06-Jan-11	FR	CRH	3.9	FR0010989889	1.25	Jan-21	74	73
06-Jan-11	FR	CDEE	2.75	FR0010989806	1.25	Jan-15	60	59
07-Jan-11	UK	LLOYDS	4.875	XS0577606725	0.75	Jan-23	150	151
07-Jan-11	UK	RBS	4.125	XS0577751141	1	Jan-18	125	125
10-Jan-11	GER	NDB	3.25	DE000NLB2DX9	1	Jan-21	20	22
10-Jan-11	FR	CMCICB	4.125	FR0010990390	1	Jan-23	85	83
10-Jan-11	GER	LBBW	1.75	DE000LB0ECU9	1.5	Jan-14	3	2
10-Jan-11	GER	DEXGRP	2.75	DE000DXA1NH2	1	Jan-16	35	36
12-Jan-11	GER	EURHYP	2.875	DE000EH1ABV8	1.25	Jan-16	40	39

Source: Barclays Capital

HYBRID CAPITAL

Bank hybrids: 2009/10 call recap

We estimate that 125 European bank hybrid bonds had their first call date in 2010, equivalent to an aggregate principal of €50.6bn (93 issues in 2009, €32.4bn in aggregate notional). 68 issues were called on their first call date (€31.1bn), whereas 37 issues were extended and are currently fully outstanding (€12.3bn). Furthermore, 20 issues (with first call date in 2010) had been subject to partial buybacks/exchange/tender offers prior to their call date (€7.8bn), mostly as part of LME exercises.

Figure 52: Bank hybrids: 2009/10 call recap

2010 hybrid call summary								
	Called		LME		Extended		Total	
	No. issues	Notional	No. issues	Notional	No. issues	Notional	No. issues	Notional
T1	16	€8.9bn	6	€2.9bn	13	€4.1bn	35	€15.9bn
UT2	3	€1.7bn	6	€2.2bn	0	€0.0bn	9	€3.8bn
LT2	49	€20.5bn	8	€2.8bn	24	€7.6bn	81	€30.8bn
Total	68	€31.1bn	20	€7.8bn	37	€11.7bn	125	€50.6bn
2009 hybrid call summary								
	Called		LME		Extended		Total	
	No. issues	Notional	No. issues	Notional	No. issues	Notional	No. issues	Notional
T1	3	€1.3bn	8	€1.8bn	13	€6.9bn	24	€10.1bn
UT2	7	€2.8bn	4	€1.0bn	2	€0.3bn	13	€4.1bn
LT2	38	€13.7bn	5	€1.3bn	13	€3.2bn	56	€18.2bn
Total	48	€17.8bn	17	€4.1bn	28	€10.4bn	93	€32.4bn

Source: Dealogic

BNP Paribas was the most active caller with nine issues called during the year (€4.1bn of bonds outstanding, €3.7bn of LT2s and €380mn of T1s). This followed the exercise of a single call on a LT2 bond falling due in 2009. BNP did not extend on any of its bonds. Other active callers in 2009-10 (ie, banks which did not extend or offer to exchange their subordinated issues coming up for call in 2009 and 2010) included: Standard Chartered (five bonds called in 2009-10); Intesa (four); Credit Suisse (four); Monte Paschi (three); Societe Generale (three); and Svenska Handelsbanken (three). With some minor exceptions, Unicredit, HSBC and Nordea have also called all their subordinated debt issues over the last two years (seven, six and five issues called in 2009 and 2010, respectively).

Conversely, RBS continues to be the most active non-caller. As required by the European Commission in relation to the aid package given to the group by the UK Treasury, the bank extended five issues in 2010 (€4.0bn) and a further four issues were exchanged or tendered for prior to their call date (€1.9bn). This followed three extensions and two exchanges for an aggregate notional of €2.4bn in 2009. Lloyd's also falls in this category (one extension, two exchanges in 2010), as do the Irish banks.

A number of institutions decided to extend their subordinated bonds beyond the first call date in order to maintain capital levels or avoid higher funding costs (if the called instruments were to be reissued at market rates), despite the absence of government participations in the banks' capital. Within this category, Deutsche Bank has continued to extend all its subordinated instruments coming up for call since its first sub debt extension in December 2008 (5 in 2009, 4 in 2010). Credit Agricole has shown a mixed call record. Between January and July 2009, the bank extended €3.2bn of subordinated issues (€1.2bn of LT2 bonds and €2.0bn of T1 bonds), which remain currently outstanding. Since then the bank has called all sub debt up for call, two LT2s and one T1 with an aggregate notional of €1.4bn.

Finally, some institutions have taken advantage of depressed market prices and boosted their core capital levels by launching exchange or tender offers for their subordinated bonds. For instance, in July 2009 Banco Santander launched an exchange offer for 30 T1 and UT2 securities, with exchange ratios varying widely across issues, some of them below market price. The offer results were varied, with issues offered at rates below prevailing market prices receiving no take-up by investors. At the time of the announcement, the bank indicated that future redemption decisions for those securities included in the exchange offer and not offered for exchange by investors would be made on a purely economic basis. Since then, the bank has stood by this statement and the remaining bonds of the 5 sub debt issues included in the exchange offer which have become callable since July 2009 are still outstanding. Aside from these, the bank has called all other sub debt issues coming up for call: two issues in 2009 (although both were called after the first called date) and five issues in 2010 (all called on the first call date).

2011 call outlook

We estimate that there are 160 European bank subordinated debt issues coming up for first call in 2011, of which 35 have already been subject to early exchange/tender offers. In our view, a bank's past call record provides valuable guidance with regards to the likelihood of future calls. We therefore expect BNP Paribas (eight sub debt issues coming up for call in 2011), UniCredit (five), Intesa (five), HSBC (three), SocGen (two), CS (one) as well as the Nordic banks to continue to call their sub debt issues on the first call date. Likewise, we expect Deutsche Bank to continue to extend its hybrid bonds. Due to EC restrictions, we also expect continued extensions in the case of RBS and Lloyd's in 2011.

A number of bank-specific factors may contribute to changes in previous call behaviour in the current environment. Given current market demand for stronger solvency levels (further boosted by Basel III) and uncertain investor appetite for new bank capital, some institutions with relatively low solvency ratios or perceived capital shortfalls, may be less likely to call their hybrid instruments on the first call date. Further tenders/exchanges are also possible for these names (although such options would only make sense if the instrument in question is trading well below par, which is more likely to be the case for T1 instruments). We believe Monte dei Paschi, BCP and BES would fall under this category, although the implications of these measures, which would likely translate in higher costs of future hybrid funding, could prove to be a strong incentive for banks to continue to call their hybrid instruments.

Given the current dislocations in bank funding markets, particularly in the European periphery, banks whose cost of funding has risen significantly in recent months may be discouraged from calling hybrid instruments with low back-end spreads (mainly in the LT2 space although also some T1s), as these would still be cheap senior funding even if they do not qualify as regulatory capital. Institutions facing particular funding pressures would fall under this

category: Dexia; Bankinter; Banco Popolare; the Portuguese banks and some Spanish cajas, in our view.

Finally, the implementation of the Basel III capital rules by national regulators could lead to many capital instruments losing their regulatory capital treatment. This could lead to regulatory calls at par or make-whole amount, a price-supportive factor (see Basel III section of this report).

Figure 53: European banks – Hybrid capital instruments with first call date in 2011

January	February	March
KNFP LT2 EUR750mln (FR0010239400)	ISPIM LT2 EUR1,500mln (XS0242832599) AIB T1 EUR500mln (XS0120950158) MONTE T1 EUR350mln (XS0121342827) CFCM LT2 EUR300mln (FR0010292052) UBIIM T1 EUR300mln (XS0123998394) DNBNOR UT2 GBP250mln (XS0243050589)	INTNED LT2 EUR1,000mln (XS0240868793) SANTAN LT2 EUR1,000mln (XS0245339485) CRLOG T1 EUR800mln (FR0010301713) SOCGEN LT2 EUR700mln (XS0187584072) SHBASS LT2 USD800mln (XS0246446859) HSBC LT2 EUR600mln (XS0164883992) BKIR T1 EUR600mln (XS0125611482) ACAFP LT2 USD700mln (XS0237452320) HBOS LT2 EUR500mln (XS0249026682) NBHSS LT2 EUR500mln (XS0246023112) BPEIM LT2 EUR400mln (XS0247784100) BBVASM LT2 GBP300mln (XS0248171729) EURHYP T1 EUR300mln (DE000A0DZJZ7)
April	May	June
UBS LT2 USD2,000mln (XS0250503637) BACR LT2 EUR1,250mln (XS0240949791) RBS LT2 USD1,500mln (XS0250214797) SHBASS LT2 EUR600mln (XS0250873642) CRLOG UT2 EUR500mln (FR0010306597) ISPIM LT2 EUR500mln (XS0249938175) UCGIM LT2 EUR400mln (XS0249857094) LLOYDS LT2 GBP300mln (XS0218023447)	SABSM LT2 EUR1,000mln (ES0213860036) INTNED LT2 USD1,250mln (XS0255306671) DANBNK UT2 NOK1,770mln (XS0176497013)	BACR T1 USD1,250mln (XS0117441922) ISPIM LT2 EUR700mln (XS0194783352) NBHSS LT2 USD850mln (XS0237631501) BACR LT2 USD750mln (XS0259172277) NDB T1 EUR550mln (DE000A0EUBN9) FBAVP LT2 EUR500mln (BE0931714290) BANCAR LT2 EUR500mln (XS0256396697) BILBIZ LT2 EUR500mln (ES0214100010) ANGIRI LT2 EUR500mln (XS0257752013) BPIM LT2 EUR500mln (XS0256368050) RZB LT2 EUR400mln (XS0258576403) UBS T1 USD500mln (US90262WAA18) SANTAN LT2 USD500mln (US80281TAB44) SANTAN LT2 USD500mln (US80281TAA60) HSHN T1 USD500mln (XS0221141400) DNBNOR T1 USD400mln (XS0131911314) DPB T1 EUR300mln (DE000A0D24Z1) HESLAN T1 EUR250mln (DE000A0E4657) WESTLB T1 EUR240mln (DE000A0D2FH1) WESTLB T1 USD300mln (XS0216711340) MONTE T1 EUR220mln (XS0131739236)
July	August	September
ISPIM T1 EUR500mln (XS0131944323) TPEIR LT2 EUR400mln (XS0261785504) LAVORO LT2 EUR250mln (XS0196740376) DEXGRP T1 EUR225mln (XS0132253468)	DANBNK UT2 EUR500mln (XS0346728065) DB LT2 CAD300mln (CA251541AA62)	CMZB LT2 EUR1,250mln (DE000CB07899) FBAVP T1 EUR1,000mln (BE0117584202) UCGIM LT2 EUR1,000mln (XS0267703352) ABNANV LT2 EUR1,000mln (XS0267063435) HBOS LT2 USD750mln (XS0269136163) SANTAN LT2 EUR500mln (ES0213495007) NBHSS LT2 EUR500mln (XS0201915385) UCGIM LT2 EUR500mln (XS0267704087) DB LT2 EUR500mln (DE0003933685) CAJAME LT2 EUR400mln (XS0268160768) DNBNOR LT2 USD500mln (XS0265516335) AUSTVB T1 EUR250mln (XS0201306288) POHBK LT2 USD325mln (XS0266888683)
October	November	December
BBVASM LT2 EUR1,000mln (XS0271771239) BNP LT2 EUR1,000mln (XS0270531147) BNP T1 EUR1,000mln (FR0010239319) CAJAMM LT2 EUR750mln (ES0214950166) BACRED LT2 EUR700mln (XS0270008864) UCGIM LT2 EUR650mln (XS0203450555) HSBC LT2 USD750mln (XS0269733258) BNP T1 EUR500mln (XS0135791217) SOCGEN LT2 USD523mln (XS0271682139) RBS LT2 USD500mln (XS0202629407) BNP T1 USD400mln (FR0010239368) BACA T1 EUR250mln (DE000A0DD4K8)	DZBK T1 EUR500mln (DE000A0DCXA0) KNFP LT2 EUR450mln (XS0203880991) SEB UT2 GBP375mln (XS0276252581) CS T1 EUR400mln (XS0138429575) AUSTVB LT2 EUR300mln (XS0275528627) BPIM LT2 EUR250mln (XS0276033510)	ISPIM LT2 GBP1,000mln (XS0260456065) BFCM LT2 EUR1,000mln (XS0278568026) BNP LT2 USD1,000mln (XS0262788051) BACR T1 USD750mln (XS0129959978) FRLBP LT2 EUR500mln (FR0010405761) HBOS T1 EUR415mln (GB0058322420) BCPPL LT2 EUR400mln (XS0278435226) NWIDE LT2 EUR300mln (XS0279585169) HESLAN LT2 EUR250mln (XS0278214563) INTNED LT2 CAD321mln (CA456847AA01) CXGD LT2 USD265mln (XS0277713433)

Source: Dealogic.

APPENDIX 1 – EUROPEAN BANKS KEY STATS

Figure 54: European Banks - Key Stats Sheet - Q3 2010

3Q10	FRANCE				GERMANY				ITALY		PORTUGAL		SPAIN				SWITZERLAND				UK			UK/ASIA	
	ACAF EUR	BNP EUR	BPCEGP EUR	DEXGRP EUR	SOCGEN EUR	DB EUR	CMZB EUR	ISPIM EUR	UCGIM EUR	MONTE EUR	BCPPL EUR	BESPL EUR	BBVASM EUR	SANTAN EUR	BANSAB EUR	POPSM EUR	CS CHF	UBS CHF	BACR GBP	LBG GBP	RBS GBP	HSBC USD	STANLN USD		
BALANCE SHEET																									
Interbank deposits	344,909	77,662	146,048	60,862	70,600	70,856	115,117	45,175	77,977	12,606	2,283	7,701	24,846	58,045	2,557	4,619	49,377	41,084	45,924	31,251	60,330	196,296	49,390		
Trading Assets	531,500	914,061	232,342	71,237	481,800	1,256,752	259,103	123,769	197,984	47,818	4,378	5,978	69,306	222,177	2,216	8,651	573,663	913,344	912,053	238,089	806,368	724,322	68,842		
AFS	234,100	217,199	68,749	91,748	98,800	25,553	44,690	60,307	24,787	10,934	2,682	7,779	57,558	83,191	11,218	11,765	12,207	74,797	52,674	47,696	115,288	385,471	70,781		
Customer loans	419,991	679,517	554,206	355,756	362,200	279,826	325,911	378,832	558,836	152,737	74,254	47,606	333,741	705,584	62,902	95,504	222,660	301,972	448,266	612,133	528,049	893,337	215,005		
Goodwill	19,000	11,366	5,139	2,324	7,160	11,702	2,077	20,422	20,570	6,474	473	16	7,785	23,928	694	485	8,874	10,321	8,824	2,016	14,369	27,859	6,513		
Total assets	1,725,000	2,148,684	1,106,221	598,517	1,150,000	1,957,748	847,889	677,378	968,804	242,522	99,434	80,718	557,761	1,235,712	85,682	128,387	1,067,388	1,460,509	1,587,146	1,028,125	1,628,663	2,418,454	480,827		
Off-balance sheet commitments	287,179	395,146	n/a	n/a	n/a	173,168	101,625	196,063	191,187	32,067	23,174	26,660	95,243	231,981	23,296	35,293	323,552	81,315	269,565	123,860	321,122	615,023	148,078		
Interbank funding	163,900	209,476	104,676	98,640	85,500	43,813	130,451	47,242	106,059	29,626	18,419	10,977	75,225	82,468	11,474	19,170	32,430	88,188	94,304	69,640	80,186	127,316	31,903		
Customer Deposits	488,600	589,346	393,102	125,845	323,800	398,641	263,576	196,836	408,221	80,498	45,319	24,416	255,798	566,653	43,433	58,991	278,128	392,251	360,980	420,414	420,639	1,147,321	279,089		
Debt funding	183,700	197,116	221,503	222,210	134,700	134,718	153,382	143,652	180,349	68,245	17,778	31,571	94,394	200,138	18,701	23,648	189,240	137,152	151,728	221,825	235,083	153,600	33,364		
Trading	461,300	810,757	224,666	112,105	380,500	1,016,763	226,925	99,618	150,733	29,474	6,160	1,628	47,706	206,837	2,121	14,610	339,321	744,327	874,734	80,976	728,214	642,286	61,805		
Subordinated debt	38,482	27,182	14,174	3,876	12,500	9,171	18,980	24,277	26,760	6,158	2,043	2,702	18,553	32,287	2,071	1,859	25,260	10,433	25,929	35,243	27,890	28,247	15,555		
Equity	47,300	69,753	44,929	9,070	45,600	38,508	27,314	52,978	64,487	16,397	6,871	6,424	31,483	76,259	5,448	8,233	34,088	47,713	49,591	46,773	75,600	135,943	29,458		
Loans / Assets	24%	32%	50%	60%	31%	14%	38%	56%	58%	63%	75%	59%	60%	57%	73%	74%	21%	21%	28%	60%	33%	37%	44%		
Loans / Deposits	86%	115%	141%	283%	112%	70%	124%	192%	137%	190%	164%	195%	130%	125%	145%	162%	80%	77%	124%	146%	126%	78%	77%		
CAPITALISATION																									
cTier 1 capital	21,800	54,720	30,900	16,995	27,972	20,948	27,108	27,180	39,047	8,326	3,453	5,303	24,969	50,307	4,411	8,045	26,441	29,579	39,593	41,869	48,311	106,491	20,980		
Tier 1 capital	32,800	68,096	39,500	18,418	34,632	31,787	31,416	31,680	43,848	11,408	5,282	5,589	28,235	57,718	5,026	8,423	37,928	34,817	51,976	47,686	59,175	124,068	26,251		
Total capital	33,800	86,563	n/a	20,661	43,149	33,897	40,805	44,409	58,821	17,520	6,353	7,396	39,290	77,068	6,142	8,682	49,863	42,130	65,210	61,970	64,289	154,886	36,246		
Risk weighted assets	327,000	608,000	403,000	143,962	333,000	277,065	279,600	354,970	453,478	135,811	62,107	67,210	306,319	593,693	56,297	92,897	227,683	208,289	395,025	463,196	475,000	1,075,264	234,184		
Core Tier 1 ratio	6.67%	9.00%	7.67%	11.81%	8.40%	7.56%	9.70%	7.66%	8.61%	6.13%	5.56%	7.89%	8.15%	8.47%	7.84%	8.66%	11.61%	14.20%	10.02%	9.04%	10.17%	9.90%	8.96%		
Tier 1 capital ratio	10.03%	11.20%	9.80%	12.79%	10.40%	11.47%	11.24%	8.92%	9.67%	8.40%	8.50%	8.32%	9.22%	9.72%	8.93%	9.07%	16.66%	16.72%	13.16%	10.29%	12.46%	11.54%	11.21%		
T1 leverage	34%	20%	22%	8%	19%	34%	14%	14%	12%	27%	35%	11%	12%	13%	12%	4%	30%	15%	24%	12%	18%	14%	20%		
Equity / Assets (ex derivatives)	3.34%	3.99%	4.10%	1.69%	3.97%	3.38%	4.29%	8.45%	7.46%	7.38%	7.05%	8.17%	6.07%	6.68%	6.53%	6.50%	3.38%	5.06%	4.58%	4.84%	7.00%	6.38%	6.75%		
Equity / Assets	2.74%	3.25%	4.06%	1.52%	3.97%	1.97%	3.22%	7.82%	6.66%	6.76%	6.91%	7.96%	5.64%	6.17%	6.36%	6.41%	3.19%	3.27%	3.12%	4.55%	4.64%	5.62%	6.13%		
ASSET QUALITY																									
Non-performing loans	20,474	35,200	20,614	5,470	24,000	9,398	19,928	36,551	65,167	19,497	2,576	1,093	15,122	27,195	3,404	5,928	1,323	3,612	22,717	62,875	38,195	27,887	4,296		
Loan loss reserves	13,497	28,700	11,258	3,147	12,500	3,657	10,476	15,715	29,465	7,918	2,384	1,426	9,343	20,490	1,771	2,787	1,109	1,219	11,747	28,265	17,543	22,033	2,727		
NPL ratio	4.9%	5.2%	3.7%	1.5%	6.6%	3.4%	6.1%	9.6%	11.7%	12.8%	3.5%	2.3%	4.5%	3.9%	5.4%	6.2%	0.6%	1.2%	5.1%	10.3%	7.2%	3.1%	2.0%		
Coverage ratio	66%	82%	55%	58%	52%	39%	53%	43%	45%	41%	93%	130%	62%	75%	52%	47%	84%	34%	52%	45%	46%	79%	63%		
NPL / (Reserves + cT1 capital)	58.0%	42.2%	48.9%	27.2%	59.3%	38.2%	53.0%	85.2%	95.1%	120.0%	44.1%	16.2%	44.1%	38.4%	55.1%	54.7%	4.8%	11.7%	44.2%	89.6%	58.0%	21.7%	18.1%		
Provision gearing	55%	29%	15%	32%	41%	22%	84%	40%	63%	50%	79%	27%	43%	50%	50%	80%	-3%	-4%	41%	80%	73%	43%	12%		
Cost of risk	0.93%	0.72%	0.18%	0.06%	1.01%	0.52%	0.76%	0.75%	1.17%	0.74%	0.98%	0.70%	1.42%	1.66%	0.76%	1.79%	-0.05%	-0.04%	1.42%	1.77%	1.48%	1.69%	0.42%		
OPERATIONAL RATIOS																									
Net interest margin	0.92%	1.21%	n/a	0.61%	1.48%	0.87%	0.78%	1.68%	1.79%	1.64%	1.81%	1.90%	2.47%	2.16%	1.82%	2.00%	0.77%	0.47%	1.05%	1.55%	0.90%	1.80%	2.03%		
Cost/income ratio	64.3%	61.0%	69.9%	81.4%	64.1%	77.8%	74.8%	57.5%	60.2%	60.1%	64.0%	48.5%	45.0%	44.4%	55.3%	38.0%	85.2%	88.1%	57.2%	50.6%	61.8%	51.7%	54.8%		
Tax rate	25%	30%	38%	300%	27%	-16%	-16%	39%	43%	45%	3%	16%	22%	25%	23%	23%	12%	-101%	26%	49%	19%	35%	30%		
PTP RoA	0.27%	0.59%	0.53%	0.14%	0.48%	-0.21%	0.05%	0.62%	0.37%	0.37%	0.29%	1.02%	1.15%	0.82%	0.65%	0.69%	0.38%	0.22%	0.53%	0.25%	-0.34%	0.93%	1.36%		
PTP RoE	8.4%	15.6%	11.9%	8.8%	10.8%	-10.8%	1.4%	7.7%	4.3%	5.4%	3.3%	9.1%	18.6%	11.5%	10.1%	10.5%	8.1%	6.9%	13.9%	5.1%	-7.4%	15.5%	21.7%		
RoA	0.20%	0.41%	0.33%	0.15%	0.35%	-0.25%	0.06%	0.38%	0.21%	0.20%	0.28%	0.85%	0.90%	0.62%	0.50%	0.53%	0.33%	0.45%	0.39%	0.13%	-0.28%	0.61%	0.95%		
RoE	6.3%	10.9%	7.5%	9.0%	7.9%	-12.6%	1.7%	3.9%	2.1%	2.3%	3.1%	7.7%	14.5%	8.6%	7.8%	8.1%	7.1%	14.0%	10.3%	2.6%	-6.0%	10.1%	15.2%		

Note: Q2 10 data for BACR, LBG, HSBC and STANLN, as their 3Q 10 interim management statements did not include full quarterly financial statements. Source: Company data, Barclays Capital

APPENDIX 2 – GBP TIER 1 BONDS

Figure 55: European banks – GBP Tier 1s: likelihood of regulatory / first calls

Bond	Next call date	Outstanding	Min piece	CRITERIA				Regulator's stance	Likelihood of reg call	Reg call language ^(2,3)	Likelihood of first call ⁽⁴⁾	VALUATION			
				Back-end spread	Core Tier 1 ratio (latest)	Tier 1 ratio (latest)	Past call record ⁽¹⁾					Price	Z-spread	YTP	YTC
ABBEY 5.827 03/49	22/03/2016	110	1,000	213	8.5%	9.7%	Medium: 7 called (6 LT2s), 6 LMEd, 1 UT2 extended		Low	Make Whole	Low	83	720	6.1	10.1
ABBEY 7.037 08/49	14/02/2026	132	1,000	375					Medium	Par	n/m	89	441	7.7	8.4
ACAFP 5.136 12/49	24/02/2016	500	50,000	158	6.7%	10.0%	3 called, 6 extended (1 T1 called, 2 extended)		Medium	Make Whole	Low-Medium	81	714	4.0	10.0
ACAFP 7.589 01/49	30/01/2020	400	50,000	355					High	Make Whole	n/m	91	545	6.6	9.0
ACAFP 8 1/8 10/49	26/10/2019	300	50,000	647					High	Par	n/m	96	528	8.1	8.8
BBVASM9.1 10/29/49	21/10/2014	251	50,000	570	8.2%	9.2%	3 called, 2 LMEd (only T1 called)		High	Make Whole	Medium	91	966	8.0	12.1
BNP 5.945 04/29/49	19/04/2016	450	50,000	113	9.0%	11.2%	9 called (only 1 T1)		High	Par	High	86	644	3.5	9.4
BNP 5.954 07/29/49	13/07/2016	325	50,000	181					High	Par	High	88	579	4.1	8.8
BNP 7.436 10/29/49	23/10/2017	200	50,000	185					High	Par	High	97	486	4.3	8.1
CMZB5.905 03/29/49	12/04/2018	800	50,000	216	9.7%	11.2%	None	Restrictive	Low	Make Whole		69	1,073	6.8	14.0
CS 8.514 06/29/49	15/06/2015	150	1,000	440	11.6%	16.7%	4 called, 2 T1s		High	Make Whole		106	433	6.9	7.0
HBOS6.059 05/29/49	31/05/2015	250	1,000	385	9.0%	10.3%	Weak	Restrictive	Low-Medium	Substitution / Make Whole	Low	n/a	n/a	n/a	n/a
HBOS6.461 11/29/49	30/11/2018	600	1,000	285					Low-Medium	Make Whole	Low	76	777	7.9	11.1
HBOS7.281 05/29/49	31/05/2026	150	1,000	410					Medium	Make Whole	n/m	81	572	8.8	9.6
HBOS7.286 05/29/49	31/05/2016	150	1,000	365					Medium	Make Whole	Low	84	844	7.8	11.3
HBOS7.881 12/29/49	09/12/2031	245	50,000	440					Medium	Make Whole	n/m	80	620	9.7	10.2
HSBC5.844 11/29/49	05/11/2031	700	1,000	176	9.9%	11.5%	Relatively strong		High	Make Whole	n/m	87	299	6.1	7.1
HSBC5.862 04/29/49	07/04/2020	300	1,000	185					High	Make Whole	n/m	93	332	4.5	6.8
HSBC8.208 06/29/49	30/06/2015	500	1,000	465					High	Make Whole		105	405	7.0	6.7
LLOYDS 13 01/29/49	21/01/2029	591	100,000	1,340	9.0%	10.3%	Weak	Restrictive	High	Make Whole	n/m	116	n/a	n/a	n/a
LLOYDS 7.754 03/49	31/05/2021	150	1,000	420					Medium	Make Whole	n/m	80	748	9.3	11.1
RBS5.6457 12/29/49	08/06/2017	93	1,000	169	10.2%	12.5%	Weak	Restrictive	Low	Substitution	Low	63	1,314	6.5	16.3
SANTAN 11.3 07/49	27/07/2014	679	50,000	766	8.5%	9.7%	Medium: 7 called (6 LT2s), 6 LMEd, 1 UT2 extended		High	n/a	High	101	843	9.3	10.8
SOCGEN 8 7/8 06/49	16/06/2018	700	50,000	340	8.4%	10.4%	Strong		High	Make Whole	High	96	639	6.4	9.7
STANLN 8.103 05/49	11/05/2016	600	1,000	428	9.0%	11.2%	Strong - 5 called (1 T1)		High	Make Whole	Medium-High	105	397	6.8	6.9
UCGIM 5.396 10/49	27/10/2015	300	50,000	176	8.6%	9.7%	Relatively strong		Medium	Make Whole	Medium-High	74	1,028	4.7	13.1
UCGIM 8.5925 12/49	27/06/2018	350	50,000	395					High	Make Whole	High	88	779	7.4	11.1

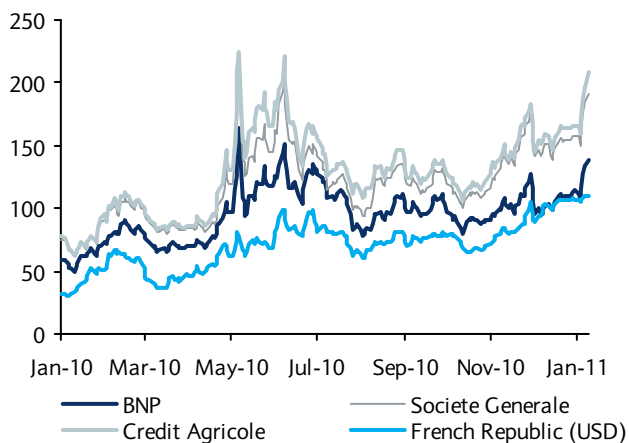
Note: (1) 2009 and 2010, stats relate to group-wide call record, LME stats only include bonds with first call dates in 2009/2010. (2) 'Make whole' means the greater of par or make whole..

(3) Upon loss of Tier 1 recognition, some Tier 1 bonds issued by UK banks allow for either exchange into Upper Tier 2 bonds or redemption. As Basel III will no longer recognize Upper Tier 2 as part of regulatory capital, we have assumed redemption instead of exchange. (4) We have ignored call dates beyond 2018 (when Basel III implementation has been completed).

Source: Bloomberg, companies, Barclays Capital

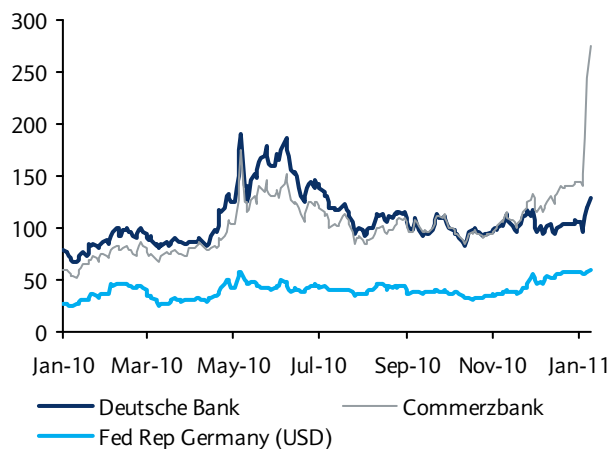
APPENDIX 3 – 5Y SOVEREIGN CDS VERSUS 5Y SENIOR BANKING CDS

Figure 56: France



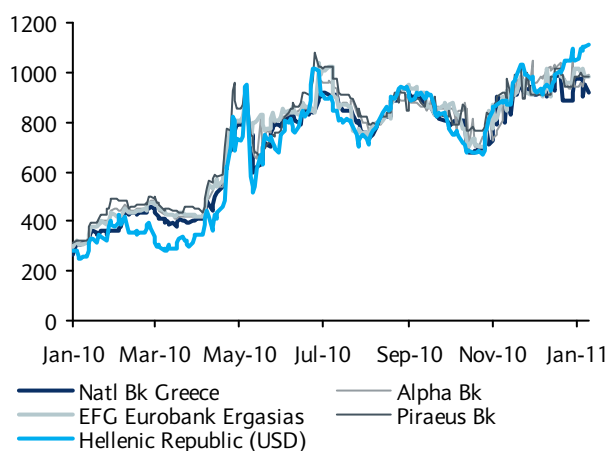
Source: Markit

Figure 57: Germany



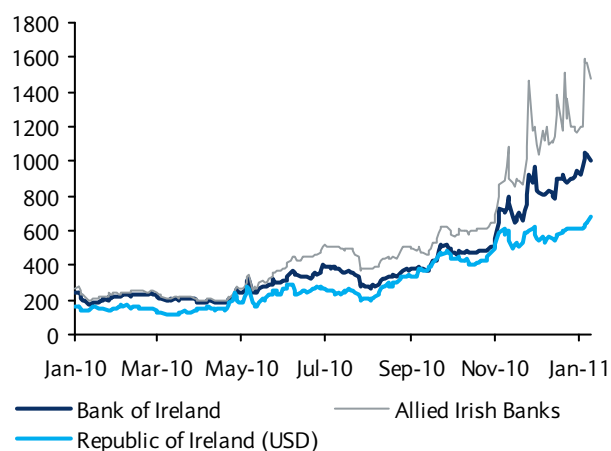
Source: Markit

Figure 58: Greece



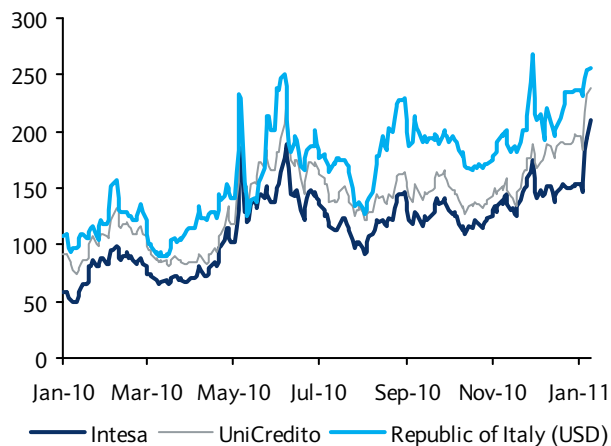
Source: Markit

Figure 59: Ireland



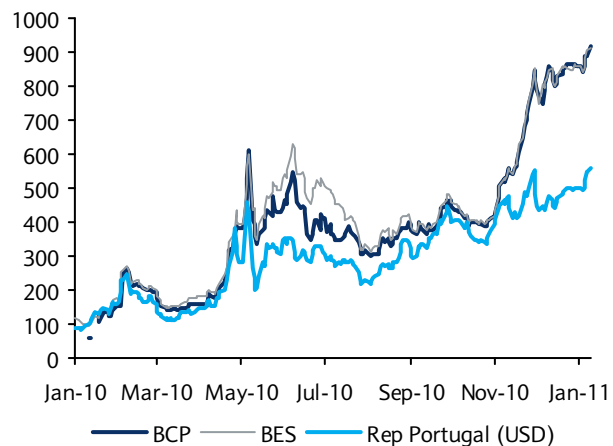
Source: Markit

Figure 60: Italy



Source: MarkIt

Figure 61: Portugal



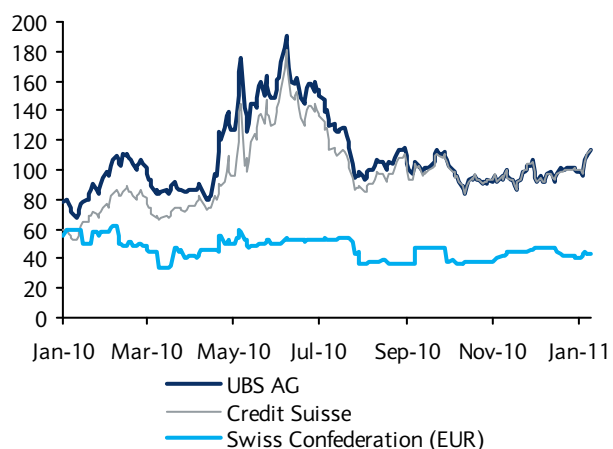
Source: MarkIt

Figure 62: Spain



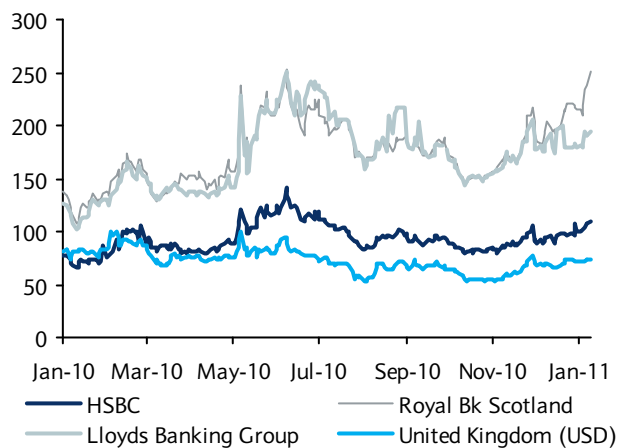
Source: MarkIt

Figure 63: Switzerland



Source: MarkIt

Figure 64: United Kingdom



Source: MarkIt

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