

Call Me. Maybe?

Outlook on European Bank Tier I

- **We downgrade our recommendation on Tier I from Neutral to Underweight given that we see significant regulatory challenges which make current valuations difficult to justify.** In our opinion the most significant challenge relates to the implementation of point of non viability provisions within the context of the RRD ('Resolution and Recovery Directive) from January 1, 2015. Crucially, we note that the ability to write down capital instruments is independent of any resolution tool being deployed, with the decision to provide extraordinary public support to a financial institution being a sufficient condition to enforce losses post January, 2015. We assume that the market's focus on the implementation of the bail-in tool, scheduled for January 1, 2018, has diverted attention from the implementation of point of non viability for capital instruments from January 1, 2015.
- We note that liability management has been an important support for valuations of hybrid capital instruments providing the ultimate back-bid for investors. However as Tier I instruments become loss absorbing from January 1, 2015, regulators are less likely to allow for liability management exercises on Tier I. We think that by making the full notional value of Tier I loss absorbing, the potential core Tier I generation of below par tenders is completely undermined. Additionally we note that within the context of resolution frameworks, regulators are starting to emphasize total capital as a result of the move towards loss-absorbing buffers, such as the 17% PLAC defined in the HMT White Paper on Regulatory Reform or the 10% of liabilities as proposed by the RRD. In our opinion, the ability to populate this buffer using legacy Tier I instruments would increase the utility of a capital instrument which had been undermined by the amortising transitional arrangements for Basel II hybrids. Additionally, we note that the focus on total loss absorbing would again undermine the core Tier I capital generation benefits of liability management.
- The implementation of point of non viability provisions for all existing capital instruments from January 1, 2015 makes the issue of calls being exercised all the more relevant. To this extent we highlight the number of liability management exercises which have been undertaken and where issuers have taken advantage of the opportunity to expunge themselves of any remaining responsibility to call Tier I instruments, potentially extending these instruments beyond the implementation of point of non viability. As a result of these instruments becoming loss absorbing and contributing to the buffer requirements, **we think that investors should rely on yield to perpetuity, rather than the yield to the end of the transition period for legacy Basel II instruments.**

See page 18 for analyst certification and important disclosures.

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Overview

We downgrade our recommendation on Tier I from Neutral to Underweight given that we see significant regulatory challenges which make current valuations difficult to justify. In this note we will examine how some of these challenges will impact on the risk profile of the asset class, which we maintain is not fully reflected in the valuation levels for Tier I instruments. The aspects which we will analyze are the following:

- The point of non viability as proposed by the Resolution and Recovery Directive, the timing of its implementation and the implications for the risk profile of the asset class
- How effective will liability management exercises be within the context of the full notional of legacy hybrid instruments becoming fully loss absorbing under the existing RRD proposals?
- How will the delay in the implementation of CRD IV proposals impact the regulatory capital utility which issuers are able to extract from legacy capital instruments under existing transitional arrangements?
- Will legacy hybrid capital instruments have greater utility as part of the overall loss-absorbing buffer requirements which are being proposed as part of RRD? How will this impact issuer decision to call such instruments?
- What is the impact of the liability management exercises which have been undertaken to date and how will this influence the decision to call or extend existing Tier I instruments?

Our base case is that the above considerations will have a transformational impact on the risk profile of the asset class and will challenge current valuations.

Point of Non-Viability for Subordinated Debt

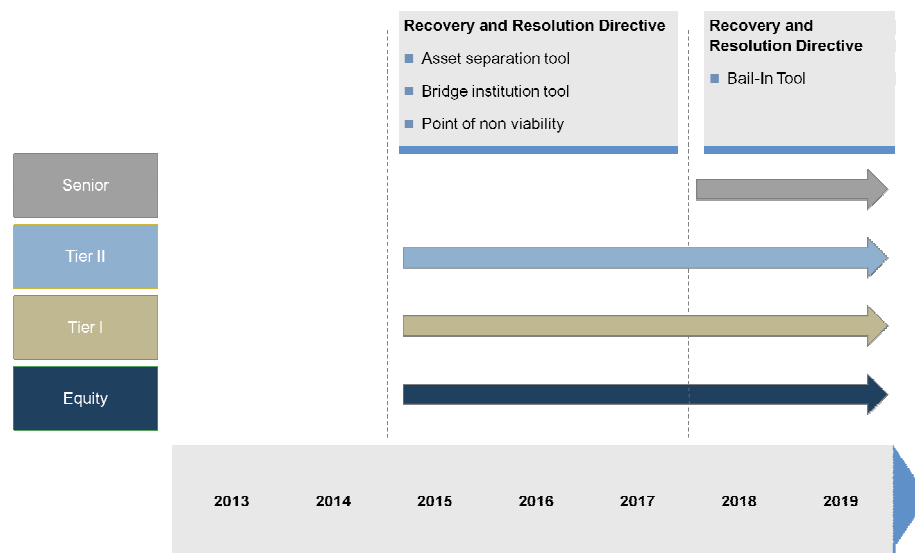
We highlight that of the various provisions highlighted in the RRD, only senior bail-in is carved with implementation until Jan 1, 2018, with all other being implemented from Jan 1, 2015

In our opinion the implementation of the RRD will bring with it a significant change in the risk profile of legacy subordinated debt instruments. We think that the market currently does not price the severity of the changes and the timing thereof on the existing stock of hybrid capital instruments. The RRD has laid down very specific guidance with regard to the implementation of the resolution tools in Article 115, paragraph 1 of the RRD, according to which “*Member states shall apply those provisions from 1 January 2015*”. Significantly we note a very important carve-out for the implementation of bail-in on senior debt which is delayed until 2018, as per the same article of the RRD, which highlights; “*Member States shall apply provisions adopted in order to comply with Section 5 of Chapter III of Title IV from 1 January 2018 at the latest*”.

We note that the powers to write down capital instruments within the context of the point of non-viability will come into force from Jan 1, 2015, thereby impacting all existing hybrid capital instruments

The relevance of the above extracts from the RRD is that provisions with the exception of the bail-in are applicable from 1 January 2015, with the most relevant of the provisions applicable from this date being Chapter IV of Title IV, “*Write Down of Capital Instruments*”. This section of the RRD deals with how capital instruments are written down when the point of non-viability is enforced. In our opinion, the market has potentially focused more on the January 1, 2018 deadline for the implementation of the bail-in resolution tool and largely tended to overlook the fact that as from January 1, 2015, all existing or new issue subordinated debt instruments will be liable to impairments, even if they do not contain any explicit provisions for such outcomes in their bond documents. We think that this is a game changer for the asset class and one which does not seem to be appropriately reflected in the risk premiums for instruments which are potentially going to be left outstanding for a longer period of time.

Figure 1: Resolution and Recovery Directive: Implementation Schedule



Source: J.P. Morgan.

According to the RRD, provisions relating to the writedown of capital instruments can be enforced independently of the deployment of any resolution tool

In our opinion, even though the RRD is fairly explicit with regard to the implementation of PONV (point of non-viability), writedown of capital instruments from January 1, 2015 onwards, we note that the market may be assuming that the implementation of PONV would be contingent on bail-in being in place. We note however that the RRD is clear with regard to the independence of the writedown of capital instruments and the implementation of resolution tools. To this effect we note Article 51, paragraph 1 refers to the fact that “*before any resolution action is taken, resolution authorities exercise the write down power, in accordance with the provisions of Article 52 and without delay*”, which indicates that the writedown is a necessary condition before any resolution action is taken. Further we note paragraph 4 of Article 51, which clarifies that “*Resolution authorities shall comply with the requirement set out in paragraph 1 irrespective of whether they also apply a resolution tool or exercise any other resolution power in relation to that institution.*” This would tend to underline the fact that the writedown of capital instruments is independent and would not necessarily have to be undertaken within the context of another resolution tool.

In our opinion the capital instrument writedown, enforceable from January 2015, will be triggered by the provision of state aid

While the deployment of a resolution tool might be seen as an extreme outcome which the relevant authority may be loath to enforce, we think that the writedown of capital instruments is a much more consensual outcome, thereby ensuring appropriate burden sharing

We think that the guidance on being able to enforce capital instrument write-down without deploying a resolution tool is a key consideration and one which in our opinion would tend to increase the probabilities of hybrid capital instruments being written down in the process. To this extent we highlight the triggers which would potentially result in the deployment of the writedown of capital instruments as per Article 51 paragraph 1, which we reproduce below. While resolution is one trigger point for the implementation of writedown of capital instruments, we note that the provision of state aid is itself a catalyst for such an outcome. In our opinion, out of all of the catalysts which are listed below, the provision of state aid is the most likely one to be deployed.

We think that even in an environment where resolution tools are available, considerations with regard to systemic risk implications are still likely to remain relevant. This in turn implies that rather than pulling the trigger on a complex asset split (bridge bank, asset segregation), we would assume that a more low impact and low cost form of intervention would be the burden sharing of the capital structure by enforcing the capital instrument writedown, only to be followed by some type of state aid. This type of intervention would overcome most of the shortcomings of the current regime, where providers of hybrid risk capital have mostly seen their positions reinforced by state aid coming in at a more deeply subordinated part of the capital structure. This has been a source of regulatory and political frustration, with more latterly the recourse to liability management exercises being seen as a means to enforce a modicum of burden sharing. Clearly, with the possibility to deploy the writedown of capital instruments from January 1, 2015, there will be greater scope to enforce losses on hybrid capital instruments.

Article 51 Requirements to write down capital instruments

1 Member States shall require that before any resolution action is taken, resolution authorities exercise the write down power, in accordance with the provisions of Article 52 and without delay, in relation to relevant capital instruments issued by an institution when one or more of the following circumstances apply:

- a) the appropriate authority determines that the institution meets the condition for resolution;*
- b) the appropriate authority determines that unless that power is exercised in relation to the relevant capital instruments, the institution will no longer be viable;*
- c) a decision has been made in a Member State to provide extraordinary public support to the institution or parent undertaking and the appropriate authority makes a determination that without the provision of such support the institution would no longer be viable;*
- d) the relevant capital instruments are recognized for the purposes of meeting the own fund requirements on an individual and a consolidated basis, or on a consolidated basis, and the appropriate authority of the Member State of the consolidating supervisor makes a determination that unless the write down power is exercised in relation to those instruments, the consolidated group would no longer be viable.*

The prospect of writedown of capital instruments will likely imply much more severe outcomes beyond the coupon deferral witnessed during the current crisis, a consideration which we feel is not necessarily being priced in Tier I valuations at the moment

We think that the implementation of a resolution regime framework will tend to change the regulatory rationale for allowing liability management exercises on subordinated debt

As Tier I instruments become *de-facto* loss absorbing under resolution regimes, we would assume a greater degree of reluctance to allow for LME on the asset class

With core Tier I levels post the EBA exercise moving in line with Basel III requirements, we think that the emphasis will shift to building loss-absorbing buffers under resolution regimes

The significance of the writedown provisions for capital instruments will not be lost on the market, especially considering the lengthy list¹ of European banks which to date have benefitted from state aid during the crisis. If the PONV language had been available for deployment during the crisis to date, we would venture that the outcome for investors in deeply subordinated instruments such as Tier I would certainly have been more negative and most likely would have gone beyond the coupon deferral outcomes witnessed. As a result, we think that the prospect of these Tier I instruments remaining outstanding beyond January 1, 2015, when such outcomes will become enforceable, strikes us as a hugely negative development for the asset class. Particularly in the context of a banking sector which will still be feeling the consequences of sub-par European economic growth, together with the challenge of implementation of Basel III capital requirements.

What Resolution Regimes Mean For LME

Increasingly one of the drivers of subordinated debt valuations throughout the crisis has been that of liability management exercises (LMEs) which have provided a back-bid for these instruments as the market has sold off at various points, with two main periods of such activity being discernable. While we think that there is some scope for opportunistic exercises by European issuers as pressures on regulatory solvency remain high, we note that the implementation of a European resolution regime framework as per the EC's RRD (Resolution and Recovery Directive) is likely to change the dynamic of LME from the regulators' perspective as they shift the emphasis from core Tier I generation to a total buffer requirement which is available for absorbing losses under a resolution regime framework.

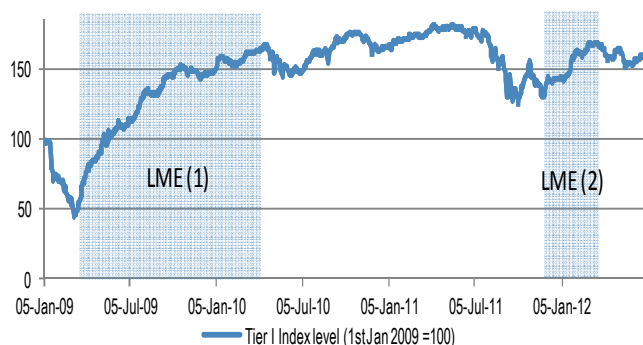
We expect that this will lead regulators to change their evaluation of the relative trade-off between core Tier I and total capital when considering the merits of LME. In our opinion, the move towards total buffer capital requirements will tend to undermine the core Tier I generation benefits of LME, given that will invariably be at the cost of a reduction in the total loss-absorbing buffer under future resolution regimes. In essence the greater degree of loss absorbency of subordinated debt via resolution regimes will tend to negate the rationale of exchanging these instruments into the only part of the capital structure which is currently loss absorbing. We note that the lack of LME for loss-absorbing German Tier I instruments to date would tend to validate this view, with the domestic regulator preferring to maintain the full notional of loss absorbing Tier I rather than exchange into a smaller volume of core Tier I. Our assumption would be that with Tier I becoming *de-facto* loss absorbing with the implementation of resolution regimes, regulators may be less willing to approve LME on the asset class. Our considerations with regard to the enforceability of writedown of capital instruments from 2015 onwards will make the considerations on a weaker outlook for LME all the more pertinent.

We note that in the early stages of the banking crisis there was a great deal of focus on core Tier I as the most relevant metric from a regulatory and market perspective. Part of this focus can be attributed to the losses which impacted sector ratios at the time, in addition to the implementation of Basel III minimum capital requirements which implied a significant effort to build on the sector's previous core capital levels. Given that the major European banks have largely fulfilled these requirements post

¹ [State aid: Overview of decisions and on-going in-depth investigations in the context of the financial crisis](#)

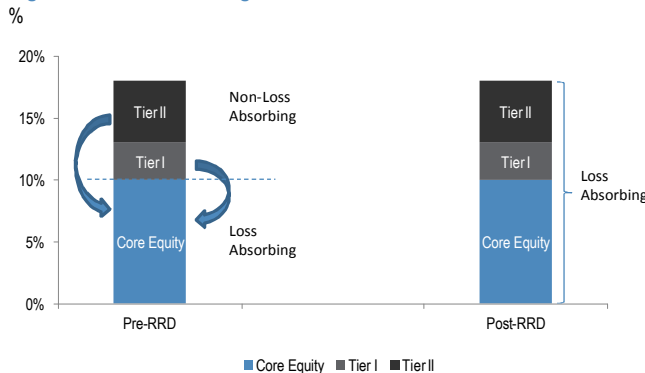
EBA stress tests, we think that there will be a greater emphasis on total buffer requirements within the context of the implementation of resolution framework, where an increased proportion of the liability structure ultimately becomes loss absorbing relative to the current situation. While regulators to date have focused on core Tier I as the only part of the capital structure which is high quality in the sense that it can absorb losses, we think that the expansion of the loss absorbing part of the liability beyond core Tier I will result in a significant change in the LME dynamic. To this extent, it would become less obvious for a regulator to sanction an LME which resulted in a reduction in total capital, albeit with an overall net positive impact on core Tier I. We would expect that on the basis that ultimately the entire subordinated (and even senior) debt capital structure will be loss absorbing, that regulators will most likely be reluctant to allow for any action which will tend to reduce the mass of loss-absorbing instruments via cash tenders.

Figure 2: Historical: Liability Management Periods



Source: J.P. Morgan.

Figure 3: How RRD changes the LME drivers for Sub Debt



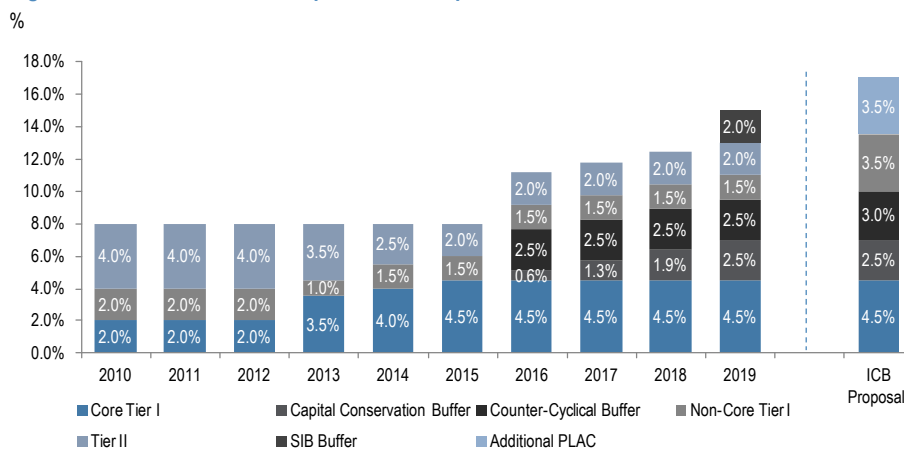
Source: J.P. Morgan.

The only caveat which we would have with regard to regulators still being more receptive to liability management would be in the case of financial institutions which are still struggling to meet their core capital requirements. Only in these circumstances would regulators allow liability management in order to first meet core Tier I requirements ahead of the potential impact that this may have on the overall quantum of loss-absorbing capital.

In our opinion the UK regulator has already shifted towards managing regulatory capital from a total buffer perspective, with LME only being allowed to the extent that it does not undermine the total loss-absorbing buffer

In our opinion, the only scenario which would still facilitate potential LMEs would be exchanges where the issuer would be offering investors instruments of similar regulatory strength. Under these circumstances the issuer would be able to maintain the same quantum of loss-absorbing capital, whilst being able to monetize some of the value of a below par tender. We are starting to see anecdotal evidence of this within the UK regulatory environment where more recent examples of LME (Lloyds and RBS LTII) have only been permitted on the basis that they would be done without either issuer experiencing a reduction in total capital levels. We believe that this is the result of the UK regulator starting to adjust to a framework where the PLAC will become the predominant loss-absorbing metric, in addition to the implementation of debt-write tool mechanisms. The sum total of these two initiatives would in our opinion shift the focus from core Tier I to total loss-absorbing capacity.

Figure 4: Basel III Versus ICB Capital Buffer Proposals



Source: J.P. Morgan.

We expect that conditions for Tier I LME will weaken as we approach the implementation of the EC's CMD

The sum total of these considerations would be that any weakening of the LME bid for Tier I instruments would necessarily imply that one of the more compelling pricing supports for the market will tend to recede as we approach the implementation of the CMD, as this will tend to improve the value of legacy Tier I instruments which will become loss absorbing with the implementation of the EC's Crisis Management Directive. In a more bearish scenario we would even potentially question the viability of regulators allowing issuers to call these instruments if this implies a reduction in the overall loss-absorbing buffer.

CRD IV Process

We think that the delay in implementing CRD IV will result in the amortising transition proposals for Basel II hybrids also being delayed

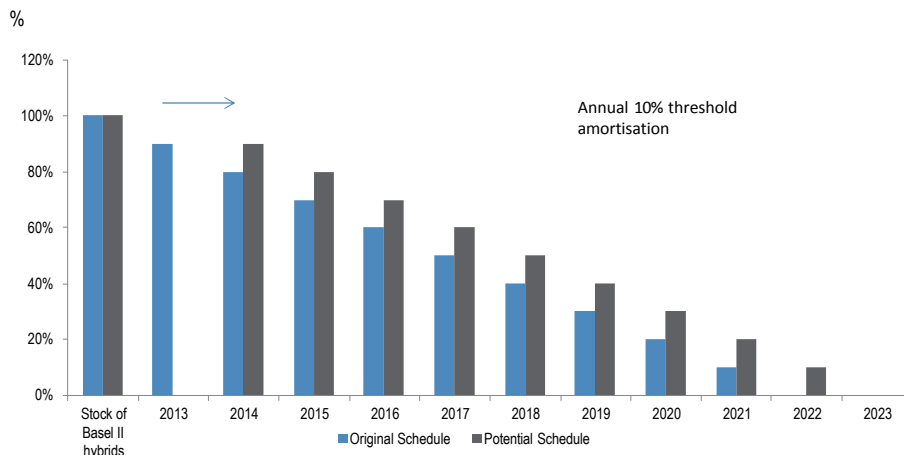
In our opinion the delays with the implementation of CRD IV will also have a knock-on impact in terms of the valuation of the asset class. According to the proposed implementation time-frame, CDR IV would have been implemented from January 1, 2013, as per the original European Commission proposals of July 2011. However, the delay in the European Parliament's plenary vote following slow progress in the 'trialogue' discussion between the European Parliament, European Commission and the Council of Ministers implies that the original time-line will no longer be achievable. In our opinion the delay in implementation of CDR IV will also imply that there is a delay in the implementation of the transition mechanisms for legacy subordinated debt instruments. We assume this on the basis that it would hardly seem to be equitable to start amortising or phasing out existing instruments without giving the issuers the opportunity to issue replacement instruments, given that these would as yet not be fully defined in terms of structure. The net result of this is that the time horizon over which the legacy Tier I instruments contributes to the capital base of the issuer will be extended by at least one year.

The delay in implementing CRD IV should imply that the starting point for the transition mechanisms should also be delayed, implying that the 10-year amortisation period may only commence in Jan 2014.

We would therefore expect that in the event that the issuers were managing their outstanding stock of hybrids with regard to the amortization threshold, we would expect that there should be a benefit in that the average utility of the existing stock of outstanding hybrid instruments should be extended by one year. Conversely, we would expect that this should imply some erosion of value for the investors on the basis that the expected maturity increases, with the market value of the hybrids declining as the average principal redemption amounts are delayed by a year. In

practical terms and if we assume that issuers are being entirely rational about managing the stock of outstanding hybrids, this would imply that investors should discount their Tier I to 2023 rather than 2022. This is due to the fact that the initial transitioning proposals for legacy Basel II hybrids were based on defining the stock of non-compliant instruments at Jan, 2013, and then applying an amortising threshold ceiling which would reduce to zero in 2021. The delay in implementing CRD IV should imply that the starting point for the transition mechanisms should also be delayed, implying that the 10-year amortisation period may only commence in Jan 2014. We would therefore expect that the market value of the Tier I instruments should decline as the expected cash-flows from these instruments have to be discounted by an additional year. While the extension of an additional year of utility for Tier I instruments is likely a marginal consideration, we think that the ability to include Tier I instruments within the context of a loss-absorbing buffer will be the key determinant in how banks manage their Tier I instruments.

Figure 5: Grandfathering Schedule Potentially Shifted To 2014?



Source: J.P. Morgan.

Managing Loss Buffer Requirements

We think that PLAC/LAC buffer requirements could result in a step change in the perceived utility of legacy Basel II hybrids and their potential contribution to meeting such buffer requirements

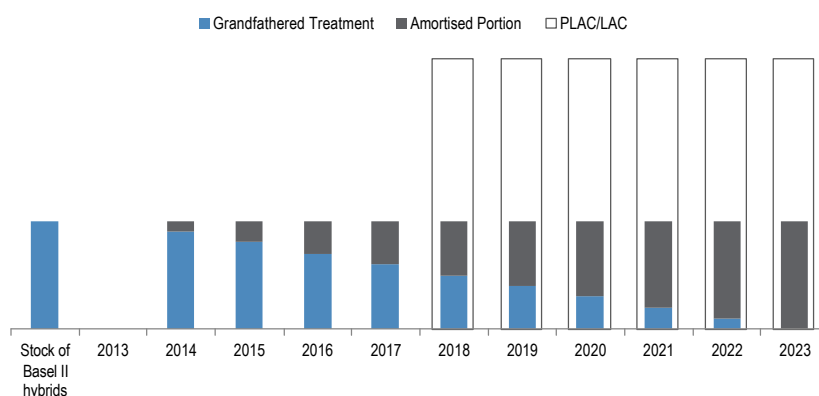
As we suggested above, the delays in implementing the CRD IV process can result in the average useful life of legacy hybrids being extended by up to one year if issuers would seek to extract the maximum regulatory capital value from these instruments. However, we would expect that loss buffer requirements may become a more important factor driving issuer behavior in terms of managing the outstanding stock of hybrids. As such, the emphasis would shift from managing regulatory capital requirements to managing the loss-absorbing buffer requirements which are defined either in terms of risk-weighted assets or liabilities. These buffer requirements would be met through a broad range of instruments which crucially would include subordinated debt, which would be potentially quite valuable in that these instruments are potentially available to fulfill these requirements and would not be subject to any type of amortization. Specifically we note that these buffer requirements within the context of the EC's CMD would be set at a minimum of 10% of balance sheet liabilities, with this being defined as the LAC ('Loss Absorbing Capacity'). In the UK, the HMT white paper has specifically called for 17% of PLAC ('Primary Loss Absorbing Capacity') to which subordinated debt can

In our opinion, the implementation of loss-absorbing buffer requirements will tend to make legacy Tier I more valuable from a regulator and issuer perspective

contribute, amongst other loss-absorbing instruments. In our opinion the introduction of these buffer requirements could result in a step change in terms of how issuers manage their outstanding stock of hybrid instruments. In Figure 6 we highlight how the dynamic in terms of the value of hybrid debt may change with the implementation of resolution regimes in 2018, where loss-absorbing capacity becomes a more relevant regulatory metric.

In our opinion the implementation of loss-absorbing buffer requirements within the context of resolution regime frameworks will change the perceived utility of Tier I instruments both from a regulator and an issuer perspective. In the first instance, we maintained that regulators would be less likely to sanction LME on Tier I if it came at the cost of a reduction of total capital, even if it implied a partial increment in core Tier I. We would also maintain that for issuers, the potential to use Tier I as a component of buffer requirements would also tend to increase the value of these instruments and potentially prolong their longevity beyond the transitional timeframe originally envisaged under Basel III. While legacy Tier I instruments were previously seen as having limited loss absorption features and hence were being phased out quicker, we now note that under resolution regime outcomes they will have a much greater ability to participate in burden sharing. The core implication of having Tier I instruments being able to contribute to the loss-absorbing buffers under resolution frameworks is that their useful life is increased substantially. As a result, in a worst case scenario investors should rely on the true yield to perpetuity rather than the yield to 2022.

Figure 6: Tier I: Regulatory Amortisation Versus PLAC/LAC Buffer Requirements



Source: J.P. Morgan.

Liability Management Exercises

Issuers have taken advantage of the LME opportunity to manage down expectations that subordinated debt will be called in future for any reason other than pure economics

While we have looked at the potential for the drivers of Tier I LME to become less relevant, it is also relevant to think about how the exercises undertaken to date by issuers will have an impact on the willingness to call these instruments. To this extent we highlight that LMEs have been seen as a means for issuers to discharge their responsibility to investors in terms of call. We would even think that the LME can be seen as the “new” call, whereby investors are offered a way out of their bonds. This point has frequently been stressed within the actual tender offer documentation, with issuers highlighting that future calls post the LME will be undertaken on a purely economic basis. In Table 1 we summarize the LME undertaken by major

European banks with regard to the language employed on future calls of the instruments subject to liability management. We note that the majority of issuers have taken advantage of the opportunity to manage down expectations of instruments being called in future, while at the same time providing a negative incentive which would encourage a high acceptance rate of such tenders. As a result, we would expect that this would tend to undermine the rationale for such instruments to be called in future, which tied to the changing economic value for the asset class will tend to make extension a more common occurrence.

Table 1: Historical: Summary of issuer language used during LMEs

Issuer	Subordination included in LME	Language used with LME
BAWAG	Tier I	Future Calls based on Economic Rationale
BBVA	Tier I	Future Calls based on Economic Rationale
BFASM	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale
BPIM	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale
CMZB	Lower Tier I	Future Calls based on Economic Rationale
CXGD	Upper Tier II, Tier I	Future Calls based on Economic Rationale
DEXGRP	Tier I	Future Calls based on Economic Rationale
ERSTBK	Lower Tier II, Tier I	Future Calls based on Economic Rationale
HSHN	Lower Tier II	Future Calls based on Economic Rationale
INTNED	Lower Tier II, Tier I	Future Calls based on Economic Rationale
JYBC	Tier I	Future Calls based on Economic Rationale
LLOYDS	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale
MONTE	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale
RBS	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale
RZB	Tier I	Future Calls based on Economic Rationale
SANTAN	Lower Tier II, Upper Tier II, Tier I	Future Calls based on Economic Rationale
UBIIM	Tier I	Future Calls based on Economic Rationale
BESPL	Upper Tier II, Tier I	Other (options to meet minimum CT1)
UCGIM	Upper Tier II, Tier I	Other (Best interests of the Group)
ABN	Lower Tier II	No Economic Based language used
ACAFP	Upper Tier II, Tier I	No Economic Based language used
BACR	Tier I	No Economic Based language used
BCPPL	Lower Tier II, Tier I	No Economic Based language used
BFCM	Tier I	No Economic Based language used
BNP	Lower Tier II, Tier I	No Economic Based language used
BPCEGP	Tier I	No Economic Based language used
CMZB*	Tier I	No Economic Based language used
ISPIIM	Tier I, Lower Tier II	No Economic Based language used
SNSSNS	Lower Tier II	No Economic Based language used
SOCGEN	Lower Tier II, Tier I	No Economic Based language used

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

How Are We Left?

In our opinion the sum total of the above considerations would tend to undermine the long-term bull case for the asset class. In summary we see the following factors as contributing to a weakening in Tier I valuations, namely;

- **Writedown for capital instruments enforceable from January 1, 2015** according to RRD proposals, which will definitively change the risk profile of legacy Tier I instruments.
- **Weaker LME potential for Tier I** as regulators begin to manage to a total loss-absorbing metric, which will imply greater resistance to liability management exercises which result in improved core Tier I at the cost of a reduction in total capital.

- The delay in CRD IV implementation will most likely result in the timetable for grandfathering being delayed for another year, implying that the ten-year grandfathering time-line has to be delayed to the start of 2014. **This will tend to increase the regulatory value of the existing stock of legacy instruments.**
- **The implementation of LAC/PLAC requirements by the EC/HMT, will result in issuers seeing legacy Tier I subordinated debt as contributing to these buffer requirements on a non-amortising, perpetual basis.** Thus their utility may tend to extend beyond the grandfathering arrangements.
- **The scale of LME undertaken to date would imply that many issuers have taken advantage of the fact that they no longer feel obliged to call these bonds at the first available opportunity.**

UK Tier I: A Case Study

The Relevance of PLAC

As we have noted previously, the implementation of resolution regimes will likely have an impact on the regulatory value of legacy hybrid Tier I instruments. This change stems from the fact that these instruments will likely be able to contribute towards the loss-absorbing buffers required by the implementation of resolution regimes. To this extent we note that the Banking Reform proposals² explicitly refer to existing subordinated debt being eligible to meet PLAC requirements; *“On the basis that the proposed RRD notes that subordinated debt currently in issuance should count towards the minimum eligible requirement, the Government’s provisional view is that these instruments should be eligible to count towards PLAC.”* In addition, we note that more recent liability management exercises for the UK banks have only been allowed on the basis that the issuer did not experience a reduction in total capital and which we assume is symptomatic of the fact that regulation has already shifted towards a total capital basis. Under current proposals banks would have to achieve a PLAC (Primary Loss Absorbing Capacity) of 17%, with legacy Tier I being one of the instruments which can be used to fulfill this requirement, in addition to equity, Additional Tier I, Tier II and bail-in senior.

UK banking reform proposals point to legacy Tier I being eligible to count towards 17% PLAC requirements

Legacy Tier I hybrids would appear to be the most cost-effective means of populating the PLAC requirement

We think that legacy Tier I instruments provide a very low-cost alternative to populating the loss-absorbing buffer requirements

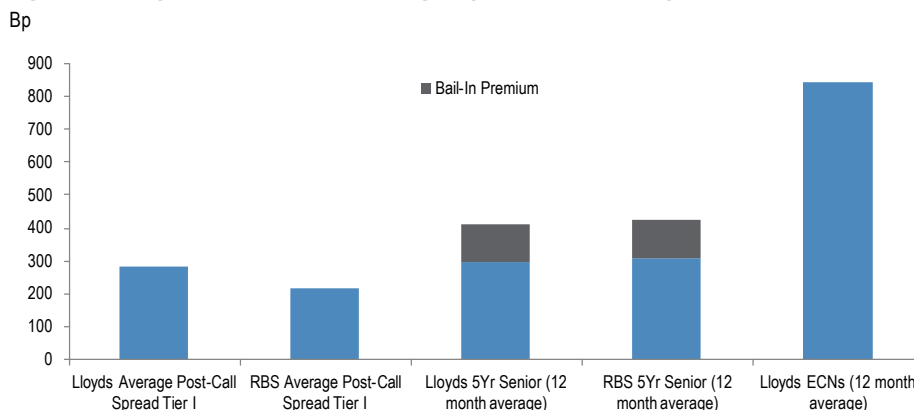
If UK banks have to manage their existing Tier I instruments within a PLAC framework, then the allocation of these instruments to this buffer requirement has to be assessed against the alternative instruments which could be used to populate this requirement, namely: Basel III eligible regulatory capital resources, high quality bail-inable debt or existing legacy instruments which do not qualify as AT1 or Tier II. Clearly the relative cost of these different sources of capital should be a consideration as to how an issuer would choose to populate the PLAC requirements and to this extent we look at estimates of these various sources of PLAC instruments.

In Figure 7 we review the alternatives for UK banks to compose the PLAC, highlighting the average post-call Tier I spread for RBS and Lloyds step Tier I instruments relative to the estimated cost of bail-in senior debt, as well as a proxy spread level for a Basel III instrument, which would be the Lloyds ECNs. This chart would seem to suggest that the average post-call spread for the Tier I instruments of both RBS and Lloyds, effectively the cost at which these bonds can be extended into

² Banking reform: delivering stability and supporting a sustainable economy, June 2012, HMT

maturity, would be lower than the strategic alternatives. We have taken as a proxy for the cost of issuance of bail-in debt, the average 5-year senior CDS spread for Lloyds and RBS, to which we have added a 117bp bail-in premium, according to the responses in our [European Bank Bail-In Survey](#), July 2012. This comparison would tend to highlight that the legacy Tier I instruments would be the most cost-effective alternative in terms of meeting PLAC requirements. We would therefore assume that the issuers in this case would rationally tend to opt for the lowest cost alternative which would likely be the legacy hybrid Tier I instruments. In generic terms, as the implementation of resolution regimes will imply an upward shift in the average cost of liabilities, we assume that instruments with locked-in costs from a pre-resolution regime should tend to be more cost effective.

Figure 7: Strategic Alternatives for PLAC eligibility: Relative Cost Analysis



Source: J.P. Morgan estimates.

The value of legacy Tier I instruments will be all the more relevant if UK banks wish to avoid having any bail-in senior debt count towards their PLAC requirements

Additionally we highlight the larger UK banks are likely to wish to keep their senior unsecured debt obligations out of the scope of the PLAC as they will not wish to ‘contaminate’ the senior issuance by explicitly including it within their 17% loss-absorbing buffer. As a result, we would expect that these banks would prefer to meet PLAC requirements by equity or hybrid capital instruments, and leave the senior debt out of the scope of the PLAC. We would therefore expect that the value of the existing Tier I instruments would increase as they are a cost effective way of meeting PLAC requirements, with the UK banks likely to issue Tier II instruments to meet the 17% PLAC requirement. We highlight that while the senior unsecured debt instruments will still be subject to bail-in under the new regulatory regime, banks will still prefer to keep them out of the scope and beyond the first loss tranche of 17% of RWA as a positive signal to investors in senior debt that such instruments will not be impaired. The RRD does however provide for full discretion to national regulators in terms of deciding as to how the loss-absorbing buffer requirements should be populated.

RBS and Lloyds have been very clear in their liability management exercises on Tier I that future calls would be decided on economic rationale only

The additional conditionality which comes with meeting PLAC requirements may inhibit an issuer from making coupon distributions if the PLAC is breached

The nature of the investor base in RBS and Lloyds Tier I instruments could also have an impact on the probabilities of more investor-friendly outcomes for these instruments, which if anything will be lower

Liability Management Exercises

We note that for UK banks such as Lloyds and RBS, there has been extensive use of liability management across the capital structure with both institutions taking the opportunity to guide investors towards the reality that future calls on tendered instruments would only be decided on an economic basis. As a result, we think that these issuers have effectively expunged their moral obligation to call these instruments at the first call date, which combined with the potential benefits of having these instruments contribute to the PLAC, would make indefinite extension a more likely outcome. In addition, we highlight that during the two-year embargo defined by the EC, some of these instruments would have already been extended beyond their first call date, thereby contributing to a further dilution of the expectation of call. As a result, and in line with the guidance provided by these issuers when they undertook liability management, we expect that these instruments would only be called if it were to be economically viable for the issuer.

As an additional risk factor with regard to the UK Tier I instruments, we note that the HMT White Paper on Banking Reform makes provisions for issuers to have “*sufficient incentives for banks not to choose to operate below the required PLAC levels as a matter of course*”. The HMT White Paper on Banking Reform goes further, noting that in addition to producing a credible plan to restore its PLAC levels, “*it might be appropriate for supervisors to have scope to apply restrictions on distributions, for example dividends, in the style of the capital conservation buffer, should a bank’s PLAC requirement fall below the required level.*” The practical implications of such additional requirements would be that there would be an additional layer of conditionality which could potentially impact the issuer’s ability to make distributions across the capital structure. In our opinion this additional layer of conditionality on coupon payments on discretionary instruments, would tend to increase risk premiums on these instruments. Interestingly enough, under the conditionality referred to above, a well capitalized bank with a core Tier I ratio above minimum requirements could see its ability to pay coupons inhibited by the regulator in the event of breaching PLAC requirements.

In addition to the above considerations, we note that the nature of the investor base could also be a determinant with regard to the decision to call these instruments at the first call date. We would maintain that post the downgrade of the Tier I instruments of Lloyds and RBS into non-IG in line with the decision to defer coupons, there was a significant transition to a non traditional investor which included both hedge funds and distressed debt investors. As a result of the change in the investor base of the Tier I instruments, we now note that there is very limited overlap with the traditional credit investor base that will support these institutions’ funding requirements, both in the secured and unsecured space. Hence, we see another reason why there would be a very limited incentive for the issuers to provide some positive surprise in terms of calling these instruments. This would contrast with the financial effort which both Lloyds and RBS demonstrated when they announced liability management exercises on their callable LTII instruments, given that these instruments still remain largely in the hands of traditional credit investors.

Our base case is that investors in Tier I are not being compensated for the risks which we have enumerated above, especially for instruments where the return is being judged on a yield to call basis

Valuations

In our opinion, given the above considerations, we would find it difficult to justify why investors should be receiving a yield of less than 10% on Tier I instruments. In the case of the non-step instruments in Table 4, the expectation is that these instruments will not be called at first call date and will remain outstanding well into the implementation of the point of non viability language from January 1, 2015. Further we expect that the potential contribution towards meeting loss-absorbing buffer requirements will incentivize banks to keep these instruments outstanding potentially beyond the ten-year transitional period for legacy Basel II instruments. We think that many of these considerations will be applicable to step instruments listed in Table 2 and Table 3.

Table 2: European Institutional Step Tier I: Yield to call, yield to 2022 and yield to perpetuity

ISIN	Ticker	Cpn	Next Call	Ccy	Amt (m)	Price	Yield to Call	Yield to 2022	Yield to perp
XS0157873760	DNBNO	7.068	19/11/2012	EUR	350	101	2.5	4.9	5.6
XS0160850227	BNP	5.868	16/01/2013	EUR	700	98	12.3	4.5	5.0
XS0284776274	NWIDE	6.024	06/02/2013	GBP	350	81	74.7	5.2	4.7
XS0156923913	LLOYDS	6.35	25/02/2013	EUR	261	72	98.6	8.8	7.1
XS0176823424	DB	5.33	19/09/2013	EUR	1,000	82	29.8	6.8	5.8
XS0179207583	SOCGEN	5.419	10/11/2013	EUR	420	89	17.6	5.6	5.2
US749768AA51	RABOBK	5.26	31/12/2013	USD	733	100	5.1	4.0	4.6
XS0178404793	HSBC	5.3687	24/03/2014	EUR	1,400	98	6.8	4.5	4.7
XS0188132202	SAMBNK	5.407	31/03/2014	EUR	125	95	9.1	5.0	5.1
USK22272CP99	DANBNK	5.914	16/06/2014	USD	750	94	9.8	5.1	5.1
XS0195376925	CXGD	1.022	28/06/2014	EUR	106	40	57.0	13.8	8.1
XS0171467854	BESPL	5.58	02/07/2014	EUR	212	43	73.2	17.4	11.8
FR0010031138	BPCEGP	5.25	30/07/2014	EUR	471	84	16.3	6.7	5.7
DE0001365880	DAA	7.133	31/07/2014	EUR	150	88	15.4	8.8	8.2
XS0201146064	NYKRE	4.901	22/09/2014	EUR	500	98	6.0	4.5	4.5
US74927QAA58	RBS	5.512	30/09/2014	USD	950	67	28.1	9.9	7.6
US74927FAA93	RBS	1.1635	30/09/2014	USD	1,000	51	36.3	12.0	8.9
BE0119806116	FBAVP	4.625	27/10/2014	EUR	1,000	85	13.7	6.1	5.3
XS0347919457	STANLN	9.5	24/12/2014	USD	1,500	112	4.0	7.8	8.8
FR0010136382	SOCGEN	4.196	26/01/2015	EUR	728	77	17.1	7.4	5.7
FR0010871269	BPCEGP	9	17/03/2015	EUR	818	101	8.7	5.7	5.4
XS0453319039	NDASS	8.375	25/03/2015	USD	1,000	108	4.9	7.2	8.3
DE000A0D1KX0	UBS	4.28	15/04/2015	EUR	995	91	8.1	5.2	4.8
USW5816FCM42	NDASS	5.424	20/04/2015	USD	600	99	5.8	4.6	4.9
USF1058YHV32	BNP	5.186	29/06/2015	USD	1,070	94	7.6	5.3	5.2
XS0110560165	HSBC	8.208	30/06/2015	GBP	500	109	4.7	4.7	5.4
XS0223454512	BPIM	6.742	30/06/2015	EUR	373	81	15.7	10.6	9.7
XS0456513711	NDB	10.25	30/06/2015	USD	500	88	15.9	13.4	13.3
XS0225590362	POPSM	4.564	27/07/2015	EUR	161	31	62.8	23.1	16.0
FR0010117366	BPCEGP	4.625	30/07/2015	EUR	368	76	16.0	7.9	6.0
XS0231436238	UCGIM	4.028	27/10/2015	EUR	280	74	15.5	8.0	6.2
XS0218324050	BFCM	4.471	28/10/2015	EUR	404	85	10.6	6.4	5.5
FR0010248641	ACAFP	4.13	09/11/2015	EUR	329	84	10.4	6.2	5.3
XS0238196942	SHBASS	4.194	16/12/2015	EUR	500	98	5.0	4.4	4.5
XS0237530497	RBS	4.243	12/01/2016	EUR	166	60	23.1	11.5	7.8
FR0010291997	ACAFP	5.136	24/02/2016	GBP	199	75	15.2	8.6	6.9
XS0246487457	ABNANV	4.31	10/03/2016	EUR	1,000	77	13.2	7.8	6.0
XS0188779028	SWEDA	5.75	17/03/2016	GBP	200	103	5.0	4.7	5.3
XS0188550114	ABBEY	5.827	22/03/2016	GBP	110	70	18.1	10.3	8.2
FR0010306738	BNP	4.73	12/04/2016	EUR	557	88	9.2	6.2	5.4
XS0129229141	STANLN	8.103	11/05/2016	GBP	600	109	5.4	6.3	7.2
US90264AAA79	UBS	6.243	15/05/2016	USD	1,000	102	5.8	5.0	5.0
XS0253262025	RZB	5.169	16/05/2016	EUR	307	68	18.1	10.3	7.5
XS0125681345	LLOYDS	7.286	31/05/2016	GBP	150	86	12.1	9.3	8.5
XS0257650019	AGSBB	5.125	20/06/2016	EUR	500	68	17.5	10.2	7.5
GB00B177CL57	COVBS	6.092	29/06/2016	GBP	120	93	8.5	6.6	6.3
FR0010348557	BNP	5.954	13/07/2016	GBP	163	85	11.0	7.5	6.6
XS0583302996	RABOBK	8.375	26/07/2016	USD	2,000	106	6.7	8.1	8.5
XS0266971745	BBVASM	4.952	20/09/2016	EUR	164	67	17.3	10.4	7.6
XS0268694808	ERSTBK	5.294	28/09/2016	EUR	132	67	17.7	10.8	8.1
XS0203891840	RABOBK	5.254	21/10/2016	USD	755	100	5.2	4.9	4.9
XS0269453139	BACR	5.926	15/12/2016	USD	533	96	6.9	5.8	5.5
GB00B120GX99	NWIDE	6	15/12/2016	GBP	140	86	10.4	7.9	7.2
XS0279056419	DANBNK	5.6838	15/02/2017	GBP	500	87	9.6	7.1	6.3
XS0214342569	DANBNK	5.563	16/03/2017	GBP	150	85	9.9	7.2	6.2
XS0285087358	DNBNO	6.0116	29/03/2017	GBP	350	100	6.1	5.4	5.5
USF8586CAA02	SOCGEN	5.922	05/04/2017	USD	808	86	10.0	8.0	6.8
XS0295383524	SLHNVX	5.849	12/04/2017	EUR	590	83	10.8	8.2	6.8
FR0010456764	BNP	5.019	13/04/2017	EUR	638	87	8.9	6.7	5.6
US225448AA76	CS	5.86	15/05/2017	USD	232	101	5.5	5.2	5.2
XS0287195233	DANBNK	4.878	15/05/2017	EUR	600	92	7.1	5.8	5.1
XS0277453774	RBS	5.6457	08/06/2017	GBP	400	68	16.0	10.8	8.2
XS0703303262	RABOBK	8.4	29/06/2017	USD	2,000	106	7.0	8.7	9.7
XS0307741917	DPB	5.983	29/06/2017	EUR	500	81	11.4	8.5	6.7

Source: J.P. Morgan. Priced at COB 25 September 2012 Table 3: European Institutional Tier I: Yield to call, yield to 2022 and yield to perpetuity

ISIN	Ticker	Cpn	Next Call	Ccy	Amt	Price	Yield to Call	Yield to 2022	Yield to perp
XS0310904155	SNSSNS	6.258	17/07/2017	EUR	250	51	25.1	16.4	11.5
XS0310904155	SNSSNS	6.258	17/07/2017	EUR	250	51	25.1	16.4	11.5
XS0323865047	RBS	6.99	05/10/2017	USD	564	92	9.1	8.0	7.1
FR0010531012	KNFP	6.307	18/10/2017	EUR	372	72	14.7	10.8	8.4
FR0010535971	BPCEGP	6.117	30/10/2017	EUR	509	80	11.7	8.8	7.1
XS0322792010	BACR	7.434	15/12/2017	USD	347	104	6.6	6.6	6.7
XS0336598064	SOCGEN	6.999	19/12/2017	EUR	468	88	10.0	8.5	7.5
XS0337453202	SEB	7.0922	21/12/2017	EUR	500	105	6.1	6.0	5.4
XS0336744650	UBS	7.152	21/12/2017	EUR	600	102	6.6	6.5	5.6
XS0337685324	VENBAN	6.411	21/12/2017	EUR	200	71	14.6	10.9	8.5
FR0010603159	ACAFFP	8.2	31/03/2018	EUR	850	102	7.8	7.8	7.8
USF6483LHM57	KNFP	10	30/04/2018	USD	186	99	10.2	10.0	10.5
XS0371711663	ISPIIM	8.047	20/06/2018	EUR	580	93	9.8	8.9	8.1
XS0045071932	RBS	9.5	12/08/2018	GBP	104	103	8.8	7.8	7.1
XS0139175821	LLOYDS	6.461	30/11/2018	GBP	600	78	11.6	10.0	8.2
XS0247065674	YBS	5.649	27/03/2019	GBP	150	74	11.6	10.2	8.1
XS0431744282	RABOBK	11	30/06/2019	USD	2,868	131	5.5	7.5	9.9
XS0449487619	SOCGEN	9.375	04/09/2019	EUR	1,000	105	8.5	9.3	10.3
USF22797FK97	ACAFFP	8.375	13/10/2019	USD	1,000	99	8.5	9.4	9.9
XS0456541506	ISPIIM	8.375	14/10/2019	EUR	742	97	9.0	9.2	9.5
FR0010814434	ACAFFP	7.875	26/10/2019	EUR	550	96	8.6	8.9	9.2
FR0010814418	ACAFFP	8.125	26/10/2019	GBP	291	90	10.3	9.2	7.8
XS0468954523	SNSSNS	11.25	27/11/2019	EUR	320	76	17.3	15.0	11.3
XS0470937243	UCGIM	8.125	10/12/2019	EUR	585	92	9.8	9.8	9.4
XS0203783286	RABOBK	5.556	31/12/2019	GBP	350	91	7.1	6.6	6.0
FR0010575654	ACAFFP	7.589	30/01/2020	GBP	172	82	11.4	10.7	9.3
XS0189704140	HSBC	5.862	07/04/2020	GBP	300	97	6.3	6.2	6.0
XS0527624059	UCGIM	9.375	21/07/2020	EUR	339	94	10.5	9.8	7.6
XS0109139344	LLOYDS	7.754	31/05/2021	GBP	150	85	10.4	10.7	9.7
GB0033627968	NWIDE	6.25	22/10/2024	GBP	125	92	7.3	7.8	7.2
XS0184519139	NWIDE	5.769	06/02/2026	GBP	400	80	8.3	9.2	7.6
XS0124569566	ABBKEY	7.037	14/02/2026	GBP	132	83	9.3	9.9	8.8
XS0125686229	LLOYDS	7.281	31/05/2026	GBP	150	85	9.3	10.5	9.3
USG4637HAB45	HSBC	10.176	30/06/2030	USD	900	136	6.6	5.9	7.2
US780097AH44	RBS	7.648	30/09/2031	USD	762	98	7.9	8.5	7.8
XS0179407910	HSBC	5.844	05/11/2031	GBP	700	90	6.8	7.3	6.5
GB0058327924	LLOYDS	7.881	09/12/2031	GBP	245	86	9.6	10.2	9.4
US74927PAA75	RBS	6.425	03/01/2034	USD	650	86	7.8	8.6	7.6
XS0368541032	RABOBK	6.91	10/06/2038	GBP	250	90	7.9	9.1	8.0

Source: J.P. Morgan. Priced at COB 25 September 2012

Table 4: Institutional Non-Step Tier I: Yield to call, yield to 2022 and yield to perpetuity

ISIN	Ticker	Cpn	Next Call	Ccy	Amt	Price	Yield to Call	Yield to 2022	Yield to perp
XS0357283257	UBS	8.836	11/04/2013	EUR	995	102	4.9	6.6	7.1
USG463802037	HSBC	4.61	27/06/2013	USD	1,250	100	5.3	4.1	4.8
FR0010661314	BNP	8.667	11/09/2013	EUR	650	102	6.0	6.1	6.6
XS0205937336	BACR	4.875	15/12/2014	EUR	1,000	70	23.8	8.1	5.8
XS0454821462	SEB	9.25	31/03/2015	EUR	500	109	4.6	7.8	8.5
XS0347918640	NYKRE	9	01/04/2015	EUR	900	109	5.2	7.4	8.2
XS0216072230	NDB	5.344	30/06/2015	EUR	300	48	39.7	15.1	9.7
FR0010279273	BPCEGP	4.75	01/02/2016	EUR	350	61	22.5	11.1	7.4
FR0010306787	BNP	5.945	19/04/2016	GBP	450	76	15.3	8.7	6.7
XS0545782020	ISPIIM	9.5	01/06/2016	EUR	478	99	10.0	10.1	10.4
US539439AB54	LLOYDS	6.267	14/11/2016	USD	398	72	15.9	9.9	7.1
USG84228AT58	STANLN	6.409	30/01/2017	USD	750	99	6.6	5.6	5.2
US225313AA37	ACAFFP	6.637	31/05/2017	USD	890	81	12.2	8.9	6.7
XS0304963373	BPIM	6.756	21/06/2017	EUR	140	67	17.6	11.9	8.4
DE000A0KAA7	CMZB	6.352	30/06/2017	EUR	416	70	16.4	10.9	7.9
XS0323734961	RBS	7.0916	29/09/2017	EUR	471	77	13.9	10.2	7.8
XS022208539	BACR	6	15/12/2017	GBP	750	74	13.4	9.9	8.1
XS0369350813	SOCGEN	8.875	16/06/2018	GBP	506	89	11.6	10.0	8.9
XS0214398199	BACR	4.75	15/03/2020	EUR	1,400	63	12.7	11.1	7.0
USF1058YHX97	BNP	7.195	25/06/2037	USD	1,100	97	7.5	8.3	7.4
US853254AC43	STANLN	7.014	30/07/2037	USD	750	103	6.8	6.5	5.8

Source: J.P. Morgan. Priced at COB 25 September 2012

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