J.P.Morgan

Europe Credit Research
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Tier I is Dead, Long Live Tier I

Regulatory Proposals for Hybrid Capital Instruments

- Following the slew of recent regulatory proposals **we maintain our base case that proposed regulatory changes to hybrid Tier I capital will not provide explicit incentives for issuers to call existing instruments given the generous provisions for grandfathering which have been clearly articulated in the FSA Consultation Paper 09/29**, which are consistent with prior CEBS proposals for the implementation of a new regulatory capital regime. In our opinion the concept of grandfathering is crucial to determining the future behavior of issuers with regard to outstanding capital instruments. Effectively while the new regulatory proposals imply an end for the current generation of Tier I, we think that grandfathering will result in these instruments remaining outstanding for the foreseeable future. We think the need for grandfathering of hybrids is even more important given Basel III proposals which will negatively impact core Tier I ratios.

- We review the impact of the FSA Consultation Paper 09/29 on the major UK banks in terms of the grandfathering provisions. According to our analysis, both Lloyds and RBS have sufficient capacity under the proposed grandfathering limits to maintain existing Tier I instruments beyond their initial call date. Given that Barclays will likely have an excess of existing hybrids over the grandfathering limits in 2020, liability management remains an attractive alternative of managing the excess given that for an issuer a below-par tender is always an attractive alternative to calling instruments which will eventually lose their regulatory benefit.

- While a strong market rally may serve as a pretext to take a more benign view on how issuers will manage their capital base, we think that the IG Tier I market is being increasingly priced for perfection with investors increasingly looking at these instruments on a yield to call basis. In our opinion, we only see scope for issuers to call existing Tier I instruments if they can refinance with similar structures with extension becoming a reality once issuers are operating within the constraints of the new regime. FSA proposals are clear that non-compliant instruments outstanding as at December 31, will be grandfathered and that instruments which are refinanced during the first 10-year period will cease to be grandfathered if they are not compliant.

- We remind investors of our J. P. Morgan Bank Capital Survey which will remain open until COB 28/01/2010.

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FSA Leads the Way

The FSA Consultation Paper is the first example of a regulator assimilating proposed hybrid capital regulatory changes

Within the various regulatory reform proposals which have been recently published, we think that the FSA's Consultation Paper 09/29 is the most interesting to the extent that it provides the highest degree of granularity and detail with regard to the future framework for hybrid bank capital. While there seems to be material consensus amongst the various forums for regulatory capital reform, we highlight that the CEBS process will likely take a lead role in terms of the global process given its earlier implementation than the Basel Committee proposals. As such the implementation of the CEBS proposals by end-2010 will pre-date the implementation of Basel III scheduled for end-2012 and therefore we believe that it will likely have a determinant impact in terms of shaping the Basel Committee proposals.

Given that CEBS proposals target the harmonization of hybrid capital within the EU we expect more regulators to follow these proposals

In this note we highlight key aspects of the FSA proposals and how we believe these will impact issuers and investors alike. While this discussion may appear somewhat UK-centric we think that this will potentially allow for a wider read-across for European banks given that a) the FSA stills remains one of the reference regulatory entities and its proposals may serve as a template for European peers and b) the FSA proposals adhere to the CEBS proposals will serve as the base for the harmonization of the hybrid capital framework. At the very least, given the objective of harmonizing hybrid capital at EU level we would expect regulator peers to adopt the recommendations of the CEBS proposals as enshrined in the Directive 2009/111/EC. We first look at the proposed structure of the Tier I structures compliant with the new regime, before looking at how grandfathering proposals will have a practical impact on the outstanding Tier I instruments of UK banks and how these issuers are likely to manage outstanding hybrid capital instruments. We think that it is important to first understand key changes in the structure of hybrid capital and how this will impact the pricing of any prospective new issuance and hence the ability of issuers to refinance existing hybrids. We therefore look specifically at how the new regulatory capital regime will impact the existing hybrid capital structure of Lloyds, RBS and Barclays. We also look at the current hybrid Tier I market in terms of valuations given the recent market moves.

Tier I is Dead, Long Live Tier I!

While regulatory change could end the current generation of Tier I, incentives to extend via grandfathering will ensure that existing Tier I may be around for a long time yet

The focus of the current slew of regulatory proposals is the improvement of the quality of hybrid capital within a wider objective of improving the quality of overall bank capital. We note that while initially the CEBS proposals were designed to create a consistent framework across the EU for hybrid capital, the perceived lack of effectiveness of the current generation of Tier I instruments in light of the current banking crisis has also given greater urgency to upgrading the asset class. In terms of the qualitative improvement of hybrid capital, the key aspect is the introduction of loss absorption capabilities on a going concern basis which goes beyond the existing coupon deferral or deep subordination features. Specifically the ability to absorb losses will be introduced either through conversion and write-down features.

Conversion

With fixed levels for contingent capital instruments, the Tier I instruments are effectively pari passu with equity

While recognizing that conversion can either come in formats where the number of shares is either fixed or unlimited, the FSA consultation paper appears to privilege instruments where the number of shares is fixed by making them eligible for the larger 50% bucket. Conversion into a fixed number of shares translates into the conversion price being defined at issuance. Under these circumstances and assuming a high degree of correlation between the solvency trigger metric and issuer share price, the holder of the contingent convertible instrument will have exactly the same downside risk profile of the as the equity investor upon conversion. We see this as a material change with regard to the ranking of hybrid debt vis-à-vis equity given that whilst previously hybrid Tier I was senior to equity within the capital structure, the conversion features and structure imply that this instrument is effectively pari passu with equity in a downside risk scenario. As a result the risk profile of hybrid instruments from an investor perspective will be negatively impacted, with such instruments effectively having the upside of credit and the downside of equity instruments. At the very least, this will result in a relatively higher cost for issuers in comparison to current generation Tier I.

FSA proposals partially mitigate market risk of conversion, however we assume that losses will still accrue to the bondholder on conversion

By contrast the FSA consultation paper explicitly gives a lower regulatory value to instruments where the number of shares is not limited by restricting such instruments to the bucket which can represent a maximum of 35% of Tier I. But even in these circumstances, the number of shares is not unlimited and can potentially be limited to 150% of the market value of the hybrid, based on the share price at the issue date. As a result such instruments mitigate some of the risk of conversion for the bondholder, given that the downside of conversion is reduced by contemplating conversion at a price below that of issuance. We think that this makes the instruments more acceptable for bondholders, however with the maximum number of shares limited to 150% this implies that upon conversion and for any decline in the market value of the stock in excess of 33.3%, the bondholder will experience a loss on the original notional invested. Given the assumption that conversion will likely be in a scenario of distress, we think that it is very likely that the downward pressure on share valuation should be in excess of 33%, particularly if the solvency and going concern nature of the issuers may be questioned by the market. Hence, even in these circumstances the bondholder will still tend to have a downside risk profile commensurate with that of the shareholder.

Write-Down

FSA proposals on write-down structures will make the instruments pari passu with equity in the risk capital structure

In our opinion the FSA proposals for instruments with write-down features also reflect the regulator's agenda in hybrid instruments which in a down-side risk scenario have the same degree of subordination as equity. Essentially this is made possible by ensuring that beyond a pre-defined trigger level, both equity and the hybrid Tier I instruments absorb losses on a pari passu basis. It will of course provide scant comfort to bondholders to know that above the trigger level they will be senior to equity given that subordination only really matters in extreme downside scenarios where losses need to be absorbed. Hence, to all intents and purposes the write-down of Tier I will be pari passu with equity in terms of the market valuing the risk profile of these instruments. This structure is not necessarily unique as we note that German hybrid capital instruments already include provisions for a write-down on a pari passu basis with equity. However, there is an important difference between these structures which relates to the ranking in the event of a write-up based on future profitability.

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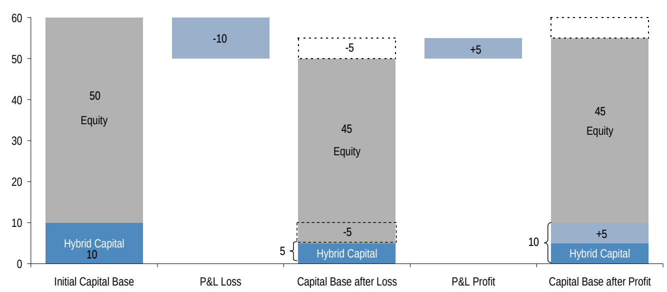
German Tier I write-down structures have priority on the write-up which contrasts with FSA proposals where the write-up would also be pari passu between hybrid Tier I and equity

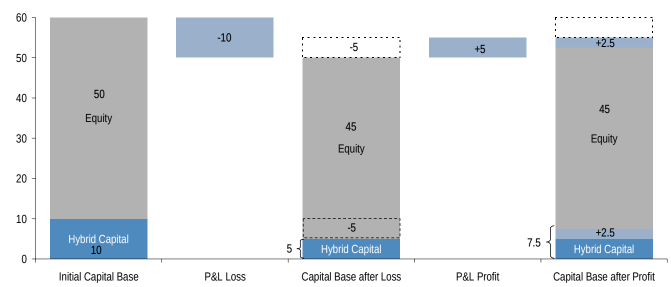
We note that crucially for German hybrid capital with write-down provisions, the write-up of the Tier I based on future profitability ranks ahead of the replenishment of equity. Effectively, German hybrid capital instruments establish a pari passu ranking in write-down, but effectively rank senior to equity with regard to the write-up. However, we note that FSA proposal to the effect that hybrid capital and equity ranked pari passu on the write-down as well as the subsequent write-up on future profitability. We think that such a provision will undermine the interests of bondholders by potentially increasing the length of time during which coupon is deferred given FSA proposals that no coupons can be paid on the hybrid during the time which it is written down below par amount. Further the FSA proposes that dividend stoppers be deactivated, in line with the principle of not inhibiting or hindering recapitalization. The practical implications of these proposals are that it will likely take a longer time to write-up the hybrid to par, thus lengthening the duration of the coupon deferral period for the bondholder. Additionally, the issuer may potentially be able to make dividend distributions given that dividend stoppers will not be active. In our opinion, the sum total of these proposals may make such write-down hybrids even more subordinated than equity.

Figure 1: German Bank Capital: Write Up/Down Mechanism



Source: J.P. Morgan.

Figure 2: FSA Proposals: Write Up/Down Mechanism



Source: J.P. Morgan.

Equity downside risks require equity returns, at the very least

In our opinion the net result of FSA proposals in terms of the convertible and write-down hybrid structures is one where the relative attractiveness of the asset class is severely undermined for credit investors. While we fully understand the concern of regulators that hybrid instruments should share in losses in order to be deemed effective regulatory capital, we also think that the risk/reward profile is being altered to such an extent that it may potentially make the asset class non-investible. To this extent we note FSA concerns that "*the addition of write-down or conversion mechanisms could potentially limit the traditional investor base for these instruments*". In terms of maintaining a relative attractiveness for credit investors, we think that the yields will have to be closer to the shareholder return yields. We think that these considerations are important given that they will have an impact on how issuers manage their existing hybrid instruments during the transition to the new regulatory capital regime. Our base case is that it will be costlier to issue compliant instruments and access to the traditional investor base may be problematic.

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Grandfather Time

'In order to avoid disruption of markets and to ensure continuity in overall levels of own funds it is appropriate to provide for specific transitional arrangements for the new regime on capital instruments.'[1]

'The objective of grandfathering provisions discussed above is to limit any potential disruption to a firm's capital planning or the capital markets.'[2]

'These proposals will help ensure that banks move to a higher capital standard that promotes long term stability and sustainable growth. Appropriate grandfathering and transitional arrangements will be established which will ensure that this process is completed without aggravating near term stress.[3]

Given the nature and impact of the proposals, grandfathering is required in order to ensure a smooth transition given the uncertainty with regard to the investability of new structures

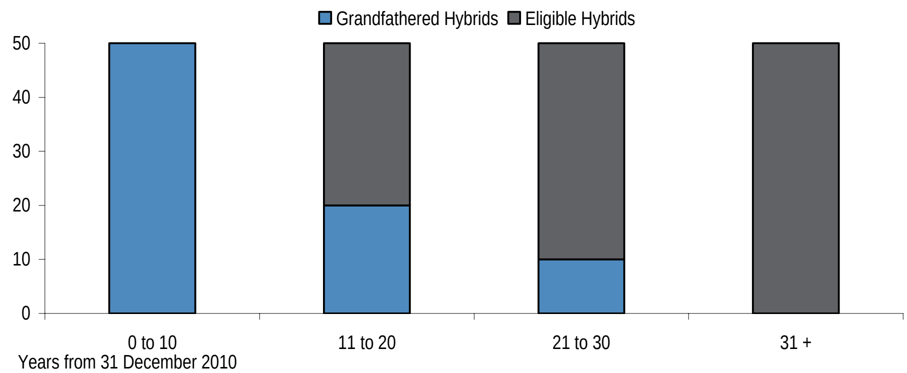
Within the context of regulatory capital development over the last two decades, we think that the current reform proposals are potentially the most challenging undertaken given their scope and impact on the banking sector. Therefore given the non-trivial nature of these changes it is reasonable to expect that the shift towards a more stringent regulatory regime should be undertaken with some caution in order to ensure a smooth transition and minimize market volatility and uncertainty. In our opinion this concern has been quite clearly flagged by some of the consultation documents produced to date, particularly within the context of the CEBS process which has already found echo in some of the member states regulatory reform proposals. To this extent we highlight that the FSA proposals are very granular with regard to the provisions for grandfathering and reflect very much the recommendations which have been initially tabled by CEBS. Specifically, we highlight the proposals according to which non compliant instruments will be eligible for a period of up to 30 years.

'Current tier one instruments that do not comply with the new requirements as at 31 December 2010 will be allowed to maintain their current tier one capital eligibility for ten years after implementation of the new rules. During that ten-year period, instruments that are refinanced would cease to be grandfathered. So, any new instruments issued would have to meet the new requirements in order to count as tier one capital. Further, the eligibility of tier one instruments that do not meet the criteria mentioned in the earlier sections will be gradually reduced over a period of 30 years,' [4]

[1] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 Para 5,
[2] Financial Services Authority – Consultation Paper 09/29 – Para 3
[3] Basel Committee on Banking Supervision – Consultative Document
[4] Financial Services Authority - Consultation Paper 09/29 - Para 3.58 and 3.59

Figure 3: Limits for non-compliant instruments

% of Total Tier I after deductions



Source: FSA

We think that grandfathering proposals will condition how issuers manage their outstanding hybrid instruments

We think that the proposed timeframe for grandfathering will influence issuer behavior and will condition decisions to issue or redeem outstanding capital instruments. In fact the proposed timeline for implementation of such proposals is the single most important driver in how we see value in the Tier I market, given our perception of how issuers will call or extend Tier I instruments. In addition we highlight that the impact of grandfathering on issuer behavior is also recognized by the FSA in the impact study on the implementation of a new capital regime. By their own admission, the refinancing of hybrid instruments will only occur incrementally between 2020 and 2040 as issuers seek to maximize the benefit of grandfathering proposals given the incremental cost of issuing more expensive, compliant hybrid instruments. To this extent we analyze how the major UK banks will likely manage their hybrid capital bases in line with the benefit which will accrue from extending existing instruments versus refinancing with more costly, compliant hybrids.

Or base case assumption is that existing hybrid instruments will not be called as long as they benefit from grandfathering provisions

For the purposes of this analysis we assume that the absolute level of overall Tier I capital remains constant and we look at how the outstanding volume of hybrid Tier I instruments will evolve according to the increasing restrictions on grandfathering over a 30 year time line from initial implementation. The limits which we consider are the proposals for grandfathering over a 30 year period for non-compliant instruments, as well as the 15% limit on instruments which contain moderate incentives to redeem such as coupon step-ups or principal stock settlement. This analysis gives us greater clarity on how UK banks will look to manage their outstanding hybrid Tier I instruments, with our base case assumption being that existing hybrid instruments will not be called as long as they can benefit from grandfathering provisions given the increased cost and difficulty in issuing new generation hybrid capital. We highlight FSA proposals whereby instruments will cease to be grandfathered, unless these instruments are compliant with the new regulatory capital regime. Hence refinancing will bring with it additional costs for the issuer.

Barclays

Based on the volume of existing hybrid capital instruments, Barclays will have an excess of £4.2bn over the grandfathering limit beyond 2020

In our analysis Barclays is the only large UK bank where proposed grandfathering provisions may be insufficient to ensure that it receives maximum benefit from existing hybrids beyond 2020, at which point the amount eligible for grandfathering will be reduced from 100% to a maximum of 20% of total Tier I. We think that this reflects the reality of an institution that has not been active in undertaking liability management to the same extent as more troubled domestic peers in a bid to improve their solvency. We assume that issuers behave in an entirely rational manner and will only call bonds when these are no longer eligible under grandfathering provisions. This assumption is based on the fact that the opportunity cost of refinancing under the new regime will be higher than the locked-in cost of existing outstanding instruments.

Calling the BACR 14% £19 will avoid high step in coupon and reduce the excess over the grandfathering limit

Specifically, we assume that issuers will only call instruments if the economic incentives are compelling such as a relatively high back-end spread. Hence, within the context of the outstanding instruments we highlight the economic rationale for Barclays to call the BACR 14% £19 given the fact that in the event that this instrument is not called it will revert to £Libor+1,340bp. We expect that under normal conditions and even with a higher cost of issuing CEBS compliant instruments, that this instrument will be relatively expensive to maintain outstanding. In addition we highlight that the calling of this instrument prior to 2020 will also reduce the extent to which Barclays will exceed the grandfathering limits for Tier I instruments. With the call of the BACR 14% £19 in 2019, the issuer is able to reduce the excess of Tier I instruments over the 20% of total Tier I from £7.2bn to £4.2bn. In addition, the calling of this instrument will also allow the issuer to maintain the proportion of grandfathered innovative Tier I below the 15% limit for instruments for instruments with incentives to call.

Liability management remains an attractive alternative for Barclays in right-sizing its hybrid capital base in order to maximize grandfathering benefits

As a result of having an excess of non-compliant Tier I instruments beyond 2020, when the limit on grandfathering provisions is reduced to 20%, we believe that this opens up the possibility of the issuer undertaking liability management in order to optimize its capital base. We think that the most efficient method of right-sizing the capital base and to maximize the potential for grandfathering would be for Barclays to undertake liability management which would target the excess of £4.2bn which will lose its regulatory benefit post-2020. Liability management would also reduce any pressure on the issuer for future calls as we have seen for issuers such as BBVA and Santander.

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Table 1: Barclays - Impact of FSA Grandfathering Proposals

£ mn

Preference Shares	Crncy	Amt outstanding	GBP eqv	Cpn	Fixed/Post Call Spread	Call Date	Type
US06739F3901	USD	750	459	6.625	Fixed	15/09/2011	Non-innovative
US06739H7769	USD	1,375	842	7.1	Fixed	15/12/2012	Non-innovative
US06739H5110	USD	1,150	704	7.75	Fixed	15/03/2013	Non-innovative
US06739H3628	USD	2,650	1,623	8.125	Fixed	15/06/2013	Non-innovative
XS0222208539	GBP	750	750	6	142bp	15/12/2017	Non-innovative
US06738C8284	USD	1,000	612	6.278	155bp	15/12/2034	Non-innovative
XS0205937336	EUR	1,000	880	4.875	105bp	15/12/2014	Non-innovative
XS0214398199	EUR	1,400	1,232	4.75	71bp	15/03/2020	Non-innovative
Total Non-innovative Tier I			7,102				
XS0110537429	EUR	850	748	7.5	295bp	15/12/2010	Innovative
XS0117441922	USD	1,250	765	8.55	300bp	15/06/2011	Innovative
XS0129959978	USD	750	459	7.375	233bp	15/12/2011	Innovative
XS0269453139	USD	1,350	827	5.926	175bp	15/12/2016	Innovative
XS0322792010	USD	1,250	765	7.434	317bp	15/12/2017	Innovative
XS0397801357[1]	GBP	3,000	3,000	14	1,340bp	15/06/2019	Innovative
XS0305103482	GBP	500	500	6.3688	170bp	15/12/2019	Innovative
XS0248675364	GBP	500	500	5.3304	199bp	15/12/2036	Innovative
XS0150052388	GBP	400	400	6	89bp	15/06/2032	Innovative
XS0155141830	USD	1,000	612	6.86	173bp	15/06/2032	Innovative
Total Innovative Tier I			8,577				
Total Tier I instruments			15,679				
Total Tier I		42.6bn					
Innovative 15% limit		6.4bn					
Tier I 20% limit		8.5bn					
Tier I 10% Limit		4.3bn		Grandfathering Schedule			
				2010	2020	2030	
				100%	20%	10%	
Total Innovative Tier I as % of Total Tier I				20.1%	13.1%	13.1%	
Excess over 15% limit of Innovative Tier I				2,183	n/a	n/a	
Non-grandfathered Tier I as % of Total Tier I				n/a	9.7%	19.7%	
Excess over Grandfathering Limit				n/a	4.2bn	8.4bn	

Source: J.P. Morgan estimates, Company data. [1] We assume that instrument will be called at first call date given the high back-end spread.

Lloyds

Given grandfathering limits we assume that Lloyds can benefit from extending existing instruments over next 30 year period

Given the scale of liability management exercises which have been undertaken previously by Lloyds, we note that the issuer is unlikely to experience any pressure with regard to having excesses above the grandfathering limits. Hence, given the grandfathering proposals included in the most recent FSA consultation paper we conclude that Lloyds can continue to benefit from having these instruments outstanding, rather than refinance at predictably higher opportunity cost. The additional benefit of having undertaken liability management is the lack of pressure to call hybrid Tier I instruments at subsequent call date.

Table 2: Lloyds - Impact of FSA Grandfathering Proposals

%

ISIN	Curncy	Amt(m)	GBP eqv(m)	Coupon	Fixed/Post Call Spread	Call Date	
XS0408828803	GBP	11	11	6.088	131bp	12/05/2015	Non-innovative
XS0265483064	GBP	0	0	6.369	128bp	25/08/2015	Non-innovative
XS0408826427	GBP	3	3	6.367	136bp	17/06/2019	Non-innovative
GB00B3KSB568	GBP	70	70	6.475	Fixed	15/09/2024	Non-innovative
XS0406095637	EUR	173	152	7.875	Fixed	29/11/2013	Non-innovative
XS0406095041	USD	424	259	7.875	Fixed	29/11/2013	Non-innovative
GB00B3KS9W93	GBP	300	300	9.25	Fixed	NA	Non-innovative
GB00B3KSB238	GBP	56	56	9.75	Fixed	NA	Non-innovative
XS0156372343	USD	343	210	6.9	Fixed	NA	Non-innovative
USG5533WAA56	USD	375	229	6.413	150bp	01/10/2035	Non-innovative
US539439AD11	USD	372	228	5.92	130bp	01/10/2015	Non-innovative
US539439AF68	USD	434	266	6.657	127bp	21/05/2037	Non-innovative
Total Non-innovative Tier I			1,785				
XS0255242769	EUR	39	35	4.939	173bp	23/05/2016	Innovative
XS0353590366	GBP	14	14	9.54	675bp	19/03/2018	Innovative
XS0107222258	EUR	18	16	7.375	233bp	07/02/2012	Innovative
XS0107228024	GBP	5	5	7.834	5y T + 350bp	07/02/2015	Innovative
XS0218638236	EUR	88	77	4.385	168bp	12/05/2017	Innovative
XS0408620135 [1]	GBP	9	9	13	5y T + 1,400bp	22/01/2019	Innovative
XS0408623311[1]	EUR	46	40	13	1,400bp	22/01/2019	Innovative
XS0408620721[1]	GBP	591	591	13	5y T + 1,340bp	22/01/2029	Innovative
XS0156923913	EUR	261	230	6.35	250bp	25/02/2013	Innovative
XS0125681345	GBP	150	150	7.286	5y T + 365bp	31/05/2016	Innovative
XS0125686229	GBP	150	150	7.281	5y T + 410bp	31/05/2026	Innovative
XS0109138536	GBP	250	250	8.117	5y T + 385bp	31/05/2010	Innovative
GB0058322420	EUR	415	365	7.627	288bp	09/12/2011	Innovative
XS0139175821	GBP	600	600	6.461	5y T + 285bp	30/11/2018	Innovative
XS0109139344	GBP	150	150	7.754	5y T + 420bp	31/05/2021	Innovative
GB0058327924	GBP	245	245	7.881	5y T + 440bp	09/12/2031	Innovative
XS0165483164	USD	1,000	612	6.85	Fixed	NA	Innovative
USG43648AA57	USD	750	459	6.071	190bp	30/06/2014	Innovative
Total Innovative Tier I			3,998				
Total Tier I instruments			5,783				
Total Tier I	48.1bn						
Innovative 15% limit	7.2bn						
Tier I 20% limit	9.6bn			Grandfathering Schedule			
Tier I 10% Limit	4.8bn			2010	2020	2030	
				100%	20%	10%	
Total Innovative Tier I as % of Total Tier I				7.0%	7.0%	7.0%	
Excess over 15% limit of Innovative Tier I				n/a	n/a	n/a	
Non-grandfathered Tier I as % of Total Tier I				n/a	n/a	0.7%	
Excess over Grandfathering Limit				n/a	n/a	335m	

Source: J.P. Morgan estimates, Company data. [1] We assume that instrument will be called at first call date given the high back-end spread

RBS

Similar to Lloyds, RBS is also in the position of having almost the entirety of its existing hybrid instruments grandfathered under the FSA proposals for a period of up to 20 years, with the issuer only having an excess of £750mn up until 2030. Beyond 2030 and assuming that the limit for grandfathering will step down to 10% of total Tier I, RBS will have an excess of £7bn over the eligible limit for grandfathering. We note that this analysis is based on the assumption that banks will maintain their core Tier I capital base constant over the period which is admittedly unrealistic given the current trend towards reinforcing core Tier I. As a result and assuming a trend towards higher core Tier I, it is possible that institutions will be able to increase the benefit of grandfathering by increasing the absolute amount of Tier I. Banks would then get a double benefit of capital raised, given that core equity would increase and they would also enjoy the benefit of a higher grandfathering limit.

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Table 3: RBS - Impact of FSA Grandfathering Proposals

£ mn

ISIN	Crncy	Amt(m)	GBP Eqv (m)	Coupon	Fixed/Post Call Spread	Call Date	
US7800978048	USD	200	124	7.65	Fixed	31/03/2007	Non-innovative
US7800978790	USD	300	186	7.25	Fixed	31/03/2004	Non-innovative
XS0121856859[1]	GBP	200	200	7.387	Fixed	31/12/2010	Non-innovative
US780097AE13[1]	USD	1,000	620	9.118	Fixed	31/03/2010	Non-innovative
US7800977883	USD	850	527	5.75	Fixed	30/09/2009	Non-innovative
GB0006227051	GBp	140	140	9	Fixed	Perpetual	Non-innovative
US6385398820	USD	300	186	7.76	Fixed	09/04/2002	Non-innovative
US7800977966	USD	925	573	6.4	Fixed	30/09/2009	Non-innovative
XS0205935470	EUR	1,250	1,124	5.5	Fixed	31/12/2009	Non-innovative
US7800977701	USD	1,000	620	6.35	Fixed	30/06/2010	Non-innovative
DE000A0E6C37	EUR	1,250	1,124	5.25	Fixed	30/06/2010	Non-innovative
US7800977628	USD	550	341	6.25	Fixed	31/12/2010	Non-innovative
US7800977545	USD	675	418	6.75	Fixed	30/06/2011	Non-innovative
US7800977479	USD	650	403	6.125	Fixed	30/12/2011	Non-innovative
US7800977396	USD	950	589	6.6	Fixed	30/06/2012	Non-innovative
US7800977131	USD	1,599	991	7.25	Fixed	31/12/2012	Non-innovative
US780097AU54	USD	1,500	930	7.64	232bp	29/09/2017	Non-innovative
XS0323734961	EUR	1,300	1,169	7.0916	233bp	29/09/2017	Non-innovative
XS0323839042	GBP	750	750	8.162	233bp	05/10/2012	Non-innovative
US780097AS09	USD	564	345	6.99	267bp	05/10/2017	Non-innovative
Total Non-innovative Tier I			11,361				
US780097AH44	USD	762	472	7.648	250bp	30/09/2031	Innovative
XS0149161217	EUR	391	352	6.467	210bp	30/06/2012	Innovative
XS0159056208	USD	486	301	6.8	Fixed	31/03/2008	Innovative
US749274AA41	USD	322	200	4.709	187bp	01/07/2013	Innovative
US74927PAA75	USD	394	244	6.425	194bp	03/01/2034	Innovative
US74927QAA58	USD	357	221	5.512	184bp	30/09/2014	Innovative
US74927FAA93	USD	470	291	1.0506	80bp	30/09/2014	Innovative
XS0237530497	EUR	166	150	4.243	169bp	12/01/2016	Innovative
XS0277453774	GBP	93	93	5.6457	169bp	08/06/2017	Innovative
CA780097AT83	CAD	600	362	6.666	276bp	05/10/2017	Innovative
Total Innovative Tier I			2,685				
Total Tier I instruments			14,046				

Total Tier I (Pro Forma)	62.3bn
Innovative 15% limit	9.3bn
Tier I 20% limit	12.5bn
Tier I 10% Limit	6.2bn

	Grandfathering Schedule		
	2010	2020	2030
	100%	20%	10%
Total Innovative Tier I as % of Total Tier I	4.3%	4.3%	4.3%
Excess over 15% limit of Innovative Tier I	n/a	n/a	n/a
Non-grandfathered Tier I as % of Total Tier I	n/a	1.2%	11.2%
Excess over Grandfathering Limit	n/a	750m	7.0bn

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

Relative Value IG Tier I

We think that the Tier I market is increasingly priced for perfection with the market pricing in a higher degree of probability of call and ignoring the obvious benefits of grandfathering

We see limited value in Investment Grade Tier I given the current pricing levels and the greater likelihood of these instruments extending beyond first call once issuers find themselves in a new bank capital regime which will be more onerous than the current. In our opinion the market appears to be pricing in a much higher probability of calling at the first call date, which we think is quite optimistic given the implications of existing grandfathering proposals. In our opinion the Investment Grade Tier I market is increasingly priced to perfection which may leave investors with downside risk in the event of large scale extension beyond call. We have no qualms about buying instruments which may be perpetual in nature, as long as the yield to worst sufficiently compensates investors for that eventuality. With yields approaching 6% we do not think that investors are being sufficiently compensated. At the margin we only see scope for the Tier I instruments with calls over the next

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two-year period to be effectively called given that issuers should be able to refinance these instruments using cheaper current generation Tier I which will be grandfathered if they are outstanding by December 31, 2010. As such we would expect a potentially active primary pipeline in Tier I in the event that issuers which to maximize the benefits of grandfathering.

Table 4: Euro Investment Grade Tier I - Relative Value at 8%

Name	ISIN	Cpn	Call Date	Ratings	Cash Price	FV @ 8%	YTC	YTM
Credit Suisse Group	XS0112770127	7.974	Jun 10	BBB/A1 /*-	106	88	3.9	7.1
UniCredito Italiano SpA	USU90400AA73	8.048	Oct 10	BBB+/A2	104	87	5.6	7.2
Sanpaolo IMI SpA	XS0120282610	8.126	Nov 10	A-/A1 /*-	103	89	6.0	7.3
Barclays Bank plc	XS0110537429	7.5	Dec 10	BBB+/Baa2	100	82	8.3	7.1
Banca Monte dei Paschi	XS0121342827	7.99	Feb 11	BBB-/A3 /*-	108	102	7.9	7.9
Credit Logement	FR0010301713	4.604	Mar 11	A/A1 /*-	86	64	24.0	6.1
Mizuho Finl Group	XS0246184989	5.02	Jun 11	BBB/Baa1 /	91	67		6.2
Banca Intesa	XS0131944323	6.988	Jul 11	A-/	104	83	6.8	6.6
Fortis Bank	BE0117584202	6.5	Sep 11	BBB+/Baa1	98	78	9.0	6.6
BNP Paribas	XS0135791217	6.625	Oct 11	A/Baa1	102	74	6.6	6.6
Credit Suisse Group	XS0138429575	6.905	Nov 11	BBB/A1 /*-	104	87	5.5	7.1
BNP Paribas	XS0141843689	6.342	Jan 12	A/Baa1	99	83	7.2	6.4
HVB	DE0008512021	7.055	Mar 12	/A3 /*-	97	86	11.7	7.3
Credit Lyonnais SA	XS0146942189	7.047	Apr 12	A-/Aa3 /*-	104	86	7.8	6.8
HSBC Holdings Plc	XS0110562534	8.03	Jun 12	A-/A3	108	98	6.5	7.6
BNP Paribas	XS0160850227	5.868	Jan 13	A/Baa1	97	78	7.0	6.7
Societe Generale	XS0365303329	7.756	May 13	BBB+/A1 /*-	105	97	8.0	7.7
BNP Paribas	FR0010661314	8.667	Sep 13	A/Baa1	112	104	5.8	7.7
Deutsche Bank AG	XS0176823424	5.33	Sep 13	BBB+/Aa3	87	73	10.3	7.1
Societe Generale	XS0179207583	5.419	Nov 13	BBB+/A1 /*-	89	73	9.3	6.8
Banco Com. Portugues	XS0194093844	5.543	Jun 14	BBB-/Baa1	81	77	12.4	8.0
Banco Espirito Santo	XS0171467854	5.58	Jul 14	BBB/A3 /*-	87	82	10.2	7.9
CNCE	FR0010031138	5.25	Jul 14	BBB-/A2 /*-	79	73	12.3	7.9
Fortis Bank	BE0119806116	4.625	Oct 14	BBB+/Baa1	84	68	9.3	6.9
Barclays Bank plc	XS0205937336	4.875	Dec 14	BBB+/Baa2	76	63	11.7	6.8
Societe Generale	FR0010136382	4.196	Jan 15	BBB+/A1 /*-	81	68	9.1	6.6
UBS	DE000A0D1KX0	4.28	Apr 15	BBB-/Baa3	82	67	9.7	6.9
Banca Pop di Lodi	XS0223454512	6.742	Jun 15	/Baa1	92	108	9.7	9.7
CNCE	FR0010117366	4.625	Jul 15	BBB-/A2 /*-	74	67	11.8	7.7
BBVA	XS0229864060	3.798	Sep 15	A-/A2 /*-	91	63	5.9	5.8
Banco Com. Portugues	XS0231958520	4.239	Oct 15	BBB-/Baa1	79	68	9.7	7.3
BFCM	XS0218324050	4.471	Oct 15	BBB+/A2 /*-	84	68	8.4	6.8
Credit Agricole	FR0010248641	4.13	Nov 15	A-/Aa3 /*-	83	64	8.2	6.5
Svenska Handelsbanken	XS0238196942	4.194	Dec 15	A-/A1 /*-	90	64	6.3	6.0
HSBC Holdings plc	XS0188853526	5.13	Mar 16	A-/A3	95	74	7.0	6.4
Raiffeisen Zentralbank A	XS0253262025	5.169	May 16	BBB-/Baa1	61	74	16.7	10.3
BBVA	XS0266971745	4.952	Sep 16	A-/A2 /*-	92	71	6.9	6.4
Banco De Sabadell	XS0267456084	5.234	Sep 16	BBB-/Baa3	69	74	12.8	8.9
Erste Bank	XS0268694808	5.294	Sep 16	/A2 /*-	68	75	13.3	9.5
BNP Paribas	FR0010456764	5.019	Apr 17	A/Baa1	89	71	7.7	6.6
CNCE	FR0010535971	6.117	Oct 17	BBB-/A2 /*-	77	79	10.8	8.6
Societe Generale	XS0336598064	6.999	Dec 17	BBB+/A1 /*-	99	90	7.3	7.4
UBS	XS0336744650	7.152	Dec 17	BBB-/Baa3	100	91	8.0	7.8
Credit Agricole	FR0010603159	8.2	Mar 18	A-/Aa3 /*-	116	112	6.6	7.9
Intesa Sanpaolo	XS0371711663	8.047	Jun 18	A-/A1 /*-	107	105	7.7	8.0
BNP Paribas	FR0010638338	7.781	Jul 18	A/Baa1	113	100	6.5	7.2
Barclays Bank plc	XS0214398199	4.75	Mar 20	BBB+/Baa2	70	62	10.3	7.3

Source: J.P. Morgan.

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For Investment Grade Tier I we highlight that the asset class looks fully valued, with our analysis of the fair value cash price providing an indication of the potential correction in the market value of these instruments, should they extend beyond first call date. We note that one of the reasons why investment grade Tier I may remain better bid could be due to the fact that for traditional real money investors, there is now a smaller pool of investable assets in deeply subordinated debt, given the scale of the downgrades over the last 12 months. We also think that there are potentially investors who have missed out on the strong rally during H2'09 and are now chasing the market. At the very least, this would look like picking up pennies in front of the steam roller.

Table 5: Sterling Investment Grade Tier I - Relative Value at 8%

Name	ISIN	Coupon	Call Date	Ratings	Cash Price		YTC	YTM
Danske Bank A/S	XS0279056419	5.6838	Feb 17	BB+/Baa1	86	79	9.6	7.6
Banco San. Cen. Hispano	XS0307728146	7.005	Jul 12	A-/A2 /*-	80	69	17.4	7.0
Barclays Bank plc	XS0248675364	5.3304	Mar 36	BBB+/Baa2	72	67	7.9	7.4
Barclays Bank plc	XS0222208539	6	Dec 17	BBB+/Baa2	82	73	9.4	7.4
Barclays Bank Plc	XS0305103482	6.3688	Dec 19	BBB+/Baa2	83	77	9.2	7.7
Barclays Bank plc	XS0150052388	6	Jun 32	BBB+/Baa2	78	73	7.9	7.4
BBVA	XS0308305803	7.093	Jul 12	A-/A2 /*-	82	69	16.2	6.8
BNP Paribas	FR0010348557	5.954	Jul 16	A/Baa1	96	79	7.3	6.8
BNP Paribas	FR0010306787	5.945	Apr 16	A/Baa1	93	75	8.5	6.7
Credit Agricole	FR0010291997	5.136	Feb 16	A-/Aa3 /	90	75	8.4	6.9
DNB NOR Bank ASA	XS0285087358	6.0116	Mar 17	BBB/A2 /	90	75	7.9	7.0
HSBC Bank plc	XS0189704140	5.862	Apr 20	A/A2 /*-	93	78	7.5	7.1
HSBC Bank plc	XS0179407910	5.844	Nov 31	A/A3 /*-	88	73	7.0	6.8
National Australia Bank	XS0177395901	5.612	Dec 18	A+/Aa3 /	86	74	8.0	6.9
Rabobank	XS0203782551	5.556	Oct 19	AA-/Aa2	91	70	6.8	6.4
Standard Chartered Bank	XS0129229141	8.103	May 16	BBB+/Baa1	114	110	6.5	7.7
UniCredito Italiano SpA	XS0231436667	5.396	Oct 15	BBB/A2 /	84	74	9.5	7.4

Source: J.P. Morgan.

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