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Europe

Investment Grade Credit

European Banks

ECNs – Still Sellers

We see grounds for a Capital Disqualification Event to occur, permitting Lloyds to undertake a Regulatory Par Call ('RPC'). We think that the most likely upshot from this remains an LME ('Liability Management Exercise') using an RPC to encourage participation. The loss of CT1 benefit from the ECN derivative (see next page) is not an impediment to this, in our view.

ECNs are likely to face a Capital Disqualification Event ('CDE'), in our view, as we flagged last February (*Lloyds ECNs: Revisiting Regulatory Par Call Risk*). While there are some interesting quirks on the definitions (see inside for more detail), we see grounds for Lloyds to invoke a CDE, thus permitting it to exercise an RPC, if it wants to.

Prices are likely to fall ahead of an LME, in our view. If Lloyds had clarity that a CDE had occurred, we'd expect it to inform the market and this would serve to push prices down, in our opinion. For context, taking out all of the ECNs at current market levels, would imply a loss of £806 million on our estimates (based on the latest balance sheet values as at FY12). If all prices were 5 points lower, this loss would be reduced to ~£388 million.

Exchange is the most likely outcome using the RPC (tacitly or explicitly) to encourage participation, in our view. Post Basel 3, Lloyds needs ~£5 billion of AT1, so an exchange partly into AT1 and partly into vanilla Tier 2 could make sense (both lower coupons). This would lower overall interest expense, investors who could not hold AT1 could be accommodated with Tier 2, capital quality would be enhanced and this would avoid the normal Tier 2 amortisation that the ECNs will face over the coming years. **However, without the threat of an RPC, holders would be unlikely to exchange, given that the potential upside from holding onto ECNs would likely outweigh benefits from sizeable AT1** (with a 7% fully loaded trigger) and Tier 2 issuances.

Now sellers of Lloyds £ and € 15%s (bid at 144.5 and 149.75). Given these were marked on balance sheet at 141 and 145 as at FY12, taking them out at their 'make whole' (139 and 147) is not as costly as one might think and bonds would also likely suffer from volatility surrounding any talk of an RPC given their cash prices.

Trade Recommendations:

We turn a seller of *all* ECNs now and recommend selling the Lloyds £ 15% 19s at 144.5 and Lloyds € 15% 19s at 149.75.

Risk Factors:

- Price action is far worse and happens sooner than we expect due to, for example, Deutsche Bank or Credit Suisse using their own Reg Par Calls – which would be the first use of it in Europe and would cause the market to look at other potential RPC situations (ECNs). See *2013 – RAC Par Calls; 2014 – Reg Par Calls*, 12 December.
- Again, Lloyds does not necessarily have to act at all; the publication of the PRA's guidance on UK bank stress testing could make clear ECNs are not stress test capital, inciting fears of a CDE.
- Lloyds offers a generous LME to holders with a premium to the current market price.
- Lloyds does nothing and ECNs and LT2 spreads continue to compress.

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ECNs – Still Sellers

ECN Embedded Derivative

The ECN embedded derivative asset is not a major impediment to an LME, in our view. As required by accounting standards, Lloyds has recognized a derivative asset linked to the ECN conversion feature. As it forms part of Lloyds' net assets, it feeds directly into CT1. The derivative represents the **fact that Lloyds would benefit from a conversion of the ECNs (as a liability would be cancelled and equity created) and thus is recorded as an asset on Lloyds' balance sheet**. Its value is determined using the spread differential between ECNs and Tier 2.

As the ECN/LT2 spread differential tightens, the value of the derivative falls, reducing CT1 (as the relative benefit of having ECNs outstanding to Tier 2 has effectively diminished) and as the spread differential widens, the value increases, increasing CT1. It was worth £1,797 million as at FY09 and £1,279 million as at 1H2013 (equivalent to 46bp of CET1, or 74bp if you included the cost of buying the securities back at market levels, as compared to a 9.9% fully loaded CET1 as at 3Q13). If Lloyds were to call or LME the ECNs, it would lose the benefit of this derivative asset. However, one needs to remember:

- **The value of the ECN will trend to zero over time anyway** as the spread differential will diminish as ECNs approach maturity.
- **If Lloyds does an exchange and does not use the RPC to encourage participation or does nothing, the ECN/LT2 spread differential will likely contract anyway** and thus Lloyds will lose the benefit of this derivative asset.
- For context, with the current spread differential at ~200bp, **a 10bp reduction in the ECN/LT2 spread would reduce the derivative asset by ~£65 million** (£1,279m/200*10).

Entirely separately, on the topic of derivatives, we'd note that our understanding is that the **ECNs were not hedge-accounted for. As such, we would disregard any thoughts of additional gains from unwinding the economic hedges that are in place – as these could be realised without an LME on the ECNs anyway.**

Can Lloyds Exercise a CDE?

In our view, **the ECNs are no longer a form of going concern capital,** as they were originally designed to be. The 5% Basel 2 trigger would mean that Lloyds would need to make losses that would take it down to a fully loaded CET1 of ~1.1% (as at 2Q13) for the ECNs to trigger. From a capital perspective, **this makes them no better a form of loss-absorbing capital than traditional LT2, in our view**. However, there is a degree of definitional ambiguity in the prospectus and we'd flag the following two points.

Firstly, the CDE definition is specifically linked to ECNs ceasing to count "*for the purposes of any ''stress test'' applied by the FSA in respect of the Consolidated Core Tier 1*". However, we'd expect the forthcoming stress tests to be conducted on the CET1 ratio of Lloyds, not the CT1 ratio. Arguably, the CT1 ratio ceases to exist now the Capital Requirements Regulation has been adopted and thus there is a risk that a CDE could not be exercised.

Secondly, we'd note that the initial part of the CDE definition requires that "*ECNs would no longer be eligible to qualify in whole or in part for inclusion in the Lower Tier 2 Capital Ratio"*. In a similar way to the point above, Lower Tier 2 capital will cease to exist under the CRR, only Tier 2 capital will exist. As it will be phased out under the grandfathering requirements, this would appear to meet the requirement of ECNs not in part being eligible as Tier 2 capital.

We are not lawyers so cannot opine formally on either of the points above. However, **our feeling is that given the weakness of the structure, Lloyds could find grounds under which the ECNs do not qualify as capital for the purposes of a stress test (especially given the whole opacity of pillar 2 as a concept)**. Our sense is that the loss of treatment as Lower Tier 2 capital is less likely given that Tier 2 capital is essentially replacing Lower Tier 2.

Lloyds Does Not Need to 'Declare' a CDE

We cannot rule out a scenario where Lloyds does not explicitly use an RPC to encourage participation in an LME but does it tacitly. As such, **even in the absence of legal certainty on its ability to invoke a CDE and exercise an RPC, tacitly highlighting it as an option could still work to encourage participation in an LME.** Lloyds may not even have to tacitly suggest an RPC: imagine a scenario where the PRA publishes its decision on what type of capital would qualify in a stress test - and though it does not explicitly state that ECNs do not qualify, it's clear from the definitions that ECNs do not meet the requirements. What would happen to the price of ECNs then?

We also cannot rule out that another bank may do an RPC ahead of Lloyds. As we have written in the past, we can see scope for this with both Credit Suisse and Deutsche Bank (*2013 - RAC Par Calls, 2014 - Reg Par Calls*, December 12, 2013). This would be beneficial to Lloyds and essentially help to push the price of its bonds down in the market ahead of any LME, in our view.

Would Lloyds *Really* Take This Step?

Finally, we often hear the refrain "Lloyds wouldn't do that to us" and thus, would Lloyds risk disappointing bond holders with an RPC? This question was asked about Danske and SocGen when they had the possibility to RAC par call their bonds last year, and the consensus view seemed to be that they wouldn't take this step. The story went that as both banks had plenty of capital to issue going forward, they would be careful to treat their bondholders well. After the bonds had dropped over time due to the fact a RAC par call was a possibility, both banks took ~1 point off investors in the end, doing a tender below market (but above par), noting they would RAC par call any remaining bonds. SocGen went on to issue AT1s post this even though it used the RAC par call to encourage investors to participate in the tender.

To sum up, from the prospectus one can deduce that there's a likelihood of Lloyds being able to use – or at least having the potential to use – a RPC on ~£9.0 billion of Tier 2 bonds currently costing it ~£750m a year in interest payments. The derivative 'CT1 benefit' will diminish over time no matter what Lloyds does. All banks in Europe want AT1, in our view, as it saves equity. All banks want to pay the lowest cost for Tier 2 capital.

Ultimately, it may well be that Lloyds simply does nothing – and a Deutsche or Credit Suisse reg par call, or the PRA paper on what does indeed count as stress test capital – does them a favour and causes a significant ECN price drop, whereby Lloyds *then,* at a far lower market price, can do a 'not too nasty' LME, without even mentioning its RPC.

Appendix 1

Relevant Definitions from the ECN Prospectus

A **‘‘Capital Disqualification Event**’’ is deemed to have occurred (1) if, at any time LBG or, where LTSB is a or the Guarantor, LTSB is required under Regulatory Capital Requirements to have regulatory capital, the ECNs would no longer be eligible to qualify in whole or in part (save where such non-qualification is only as a result of any applicable limitation on the amount of such capital) for inclusion in the Lower Tier 2 Capital of LBG or, as the case may be, LTSB on a consolidated basis; or (2) if as a result of any changes to the Regulatory Capital Requirements or any change in the interpretation or application thereof by the FSA, the ECNs shall cease to be taken into account in whole or in part (save where this is only as a result of any applicable limitation on the amount that may be so taken into account) for the purposes of any ‘‘stress test’’ applied by the FSA in respect of the Consolidated Core Tier 1 Ratio.

‘‘**Lower Tier 2 Capital**’’ has the meaning given to it by the FSA from time to time.

‘‘**Consolidated Core Tier 1 Ratio**’’ means the ratio of the Core Tier 1 Capital of Lloyds Banking Group to the risk weighted assets of Lloyds Banking Group, in each case, calculated on a consolidated basis.

‘‘**Core Tier 1 Capital**’’ means core tier one capital as defined by the FSA as in effect and applied (as supplemented by any published statement or guidance given by the FSA) as at 1 May 2009”.

Appendix 2: Lloyds ECNs – Implied Cost of an at Market Tender

ECNs	Coupon	Issuer	Currency	Amount issued in Ccy	Amount issued in £	FY12 BS Value	Implied FY12 BS mark	Current market price	Share of ECN derivative to allocate	Total cost - market tender
XS0459093794	7.875	LBG CAPITAL NO.1 PLC	USD	985,636	606,359	608,000	100	109	92,659	149,864
XS0471767276	8	LBG CAPITAL NO.1 PLC	USD	1,258,631	774,304	662,000	85	109	118,323	302,250
XS0496068429	7.875	LBG CAPITAL NO.2 PLC	USD	407,578	250,740	267,000	106	110	38,316	47,586
XS0471770817	8.5	LBG CAPITAL NO.1 PLC	USD	276,658	170,199	147,000	86	110	26,008	67,078
XS0459091582	7.625	LBG CAPITAL NO.2 PLC	GBP	151,422	151,422	144,000	95	108	23,139	43,053
XS0459086749	7.8673	LBG CAPITAL NO.1 PLC	GBP	331,070	331,070	332,000	100	109	50,591	79,458
XS0459089255	15	LBG CAPITAL NO.2 PLC	GBP	775,158	775,158	1,093,000	141	147	118,453	161,060
XS0459088109	9.334	LBG CAPITAL NO.2 PLC	GBP	207,563	207,563	230,000	111	112	31,718	33,151
XS0459088877	11.04	LBG CAPITAL NO.1 PLC	GBP	736,211	736,211	847,000	115	118	112,502	137,912
XS0459086582	7.5884	LBG CAPITAL NO.1 PLC	GBP	732,276	732,276	703,000	96	108	111,900	203,420
XS0459093364	7.869	LBG CAPITAL NO.1 PLC	GBP	596,665	596,665	591,000	99	109	91,177	150,542
XS0459086822	7.975	LBG CAPITAL NO.1 PLC	GBP	102,051	102,051	99,000	97	107	15,595	25,789
XS0459089685	15	LBG CAPITAL NO.2 PLC	GBP	67,853	67,853	108,000	159	165	10,369	12,969
XS0459090188	9.125	LBG CAPITAL NO.2 PLC	GBP	147,591	147,591	157,000	106	110	22,554	27,904
XS0459090691	11.125	LBG CAPITAL NO.2 PLC	GBP	38,589	38,589	44,000	114	117	5,897	7,142
XS0459091079	12.75	LBG CAPITAL NO.2 PLC	GBP	57,230	57,230	73,000	128	121	8,745	4,708
XS0459091665	9	LBG CAPITAL NO.2 PLC	GBP	96,731	96,731	98,000	101	111	14,782	24,637
XS0459091749	8.125	LBG CAPITAL NO.1 PLC	GBP	4,056	4,056	4,000	99	107	620	960
XS0459091822	14.5	LBG CAPITAL NO.2 PLC	GBP	79,450	79,450	113,000	142	132	12,141	3,618
XS0459092127	9.875	LBG CAPITAL NO.2 PLC	GBP	57,390	57,390	66,000	115	114	8,770	8,194
XS0459092390	11.25	LBG CAPITAL NO.2 PLC	GBP	95,100	95,100	113,000	119	117	14,532	12,799
XS0459092473	10.5	LBG CAPITAL NO.2 PLC	GBP	68,740	68,740	76,000	111	116	10,504	14,930
XS0459092556	11.875	LBG CAPITAL NO.2 PLC	GBP	35,274	35,274	45,000	128	125	5,390	4,306
XS0459092804	9	LBG CAPITAL NO.2 PLC	GBP	107,439	107,439	112,000	104	111	16,418	24,212
XS0459092986	8.5	LBG CAPITAL NO.2 PLC	GBP	104,316	104,316	105,000	101	110	15,941	26,210
XS0459093281	16.125	LBG CAPITAL NO.2 PLC	GBP	61,350	61,350	95,000	155	146	9,375	3,793
XS0459088794	6.385	LBG CAPITAL NO.2 PLC	EUR	661,955	537,432	493,000	92	107	82,126	166,865
XS0459088281	6.439	LBG CAPITAL NO.1 PLC	EUR	710,523	576,864	542,000	94	107	88,151	165,559
XS0459090774	7.375	LBG CAPITAL NO.1 PLC	EUR	94,737	76,916	78,000	101	108	11,754	16,630
XS0459091236	7.625	LBG CAPITAL NO.1 PLC	EUR	226,172	183,626	181,000	99	109	28,060	46,294
XS0459087986	8.875	LBG CAPITAL NO.2 PLC	EUR	125,330	101,754	113,000	111	113	15,549	18,040
XS0459089412	15	LBG CAPITAL NO.2 PLC	EUR	486,527	395,004	571,000	145	151	60,361	84,830
XS0459090931	3.763	LBG CAPITAL NO.1 PLC	EUR	53,040	43,062	37,000	86	94	6,580	9,844
					8,369,784	**8,947,000**			**1,279,000**	**2,085,607**

Source: Morgan Stanley Research; company accounts. Indicative pricing levels; Note No1 is ultimately guaranteed by the group, No 2 by the bank (where the Tier 1s were originally issued from). Note that the share of ECN derivative to allocate simply represents the total ECN derivative asset shared on a pro-rata basis across the ECNs linked to the total volume outstanding. As we note above, the ECN derivative will disappear over time as the ECNs approach maturity anyway.

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