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Europe

Investment Grade Credit

European Banks

Why Non-Called Tier 1 Can Count as Tier 2

Creeping caution on calls: Having long been bullish on mid-to-good-quality banks calling at the first call date, we are becoming more cautious as we look out over the medium term, driven by a number of factors.

Basel's January release was a game-changer: Although complex and having gone somewhat unnoticed, this release is key in defining the future of subordinated capital instruments dependent upon the type of resolution regime in place, and has far-reaching consequences for pre-existing Tier 1 securities, in our view.

Non-called Tier 1 to count as Tier 2 under Basel III where there is a strong resolution regime in place. While not explicitly stated in any single Basel release, when reviewing the plethora of releases, it is clear to us. At the most basic level, if banks can still issue LT2 without a step to serve as gone concern capital under Basel III, there is no reason why non-called Tier 1 cannot fulfill the same role, in our view.

A myriad of other factors suggest caution too, including all new instruments being non-step, SIFI buffers likely to be additive, growing caution from regulators on calls, less generous grandfathering buckets than expected and a gradual increase in the number of banks in the non-call camp.

Market priced to perfection, meaning that there is no room for error at current levels. There is little (if any) differentiation between low back ends and high back ends. While there are no obvious non-calls of Tier 1 likely in the short term, as we flagged in *Strategic Tier 1 Switches*, February 24, 2011, low back ends tend to underperform on any weakness or volatility.

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European Banks

Why Non-Called Tier 1 Can Count as Tier 2

We have long been bullish on major banks continuing to call their subordinated debt securities at the first call date. While we expect banks to continue to call in the short term, we see increasing risks to this continuing in the medium term. Post the January addendum from the Basel Committee, **the idea of non-called old-style Tier 1 counting as a form of perpetual Tier 2 capital (rather than simply a form of perpetual funding akin to senior debt) has received limited attention in the market.** This may be because it is not explicitly stated in the release and relies on tying together a variety of releases from the Basel Committee. **Yet, we see this as a potential game-changer over the medium term, at the very least for the performance of low versus high back-end steps.** This becomes even more of a potential risk when we consider it in light of the following:

- **All new instruments being non-step** – hence non-calls should be more commonplace going forward.
- **SIFI buffers will likely be additive** – hence banks will likely still need to maintain a certain amount of Tier 2 capital outstanding.
- **A more generous approach to grandfathering,** increasing the incentive for banks to leave non-steps outstanding.
- **Regulators becoming increasingly cautious on calls,** requiring banks to pre-finance securities coming to call.
- We would also highlight that **Deutsche has been somewhat *discretely* joined in the 'non-call club' by a host of other names**; hence, non-calls are by no means as rare as they once were. We will be returning to the above two topics in a forthcoming note.

Bottom line, we do not necessarily expect a dramatic change in call policy from the largest banks in the short term, especially as most of the securities coming to call in 2011 have high back-end steps and as regulations for new capital instruments are not currently clear as we await the draft of CRD IV in the summer. However, to us, **the direction of travel is clear and, over the medium term, there is a much greater risk of non-calls, and they are likely to become more commonplace and accepted.** Given this, and based on current pricing, we believe that the market is becoming complacent on call risk, leading us to become increasingly cautious on securities with low back-end steps (see *Strategic Tier 1 Switches*, February 24, 2011). As such, **we believe that there should be a growing (rather than narrowing) differentiation in how low back-end steps trade versus high back-end steps.**

Non-Called Tier 1 to Count as Tier 2

As we highlighted in *Basel – Loss Absorbency at the Point of Non-Viability*, January 14, 2011, and *Strategic Tier 1 Switches*, where a strong resolution regime exists (which we expect to be Europe-wide by 2014/15), **we believe that a non-called Tier 1 can continue to count as a form of Tier 2 capital.** The Basel January release lead us to this significant change in view, as we had originally expected that non-called step-up Tier 1 would not provide a bank any form of regulatory capital benefit (even as Tier 2) and thus, if left outstanding, would simply represent an expensive source of term funding. (Note that, in a similar way, non-steps would lose all capital benefit over time to be giving zero Tier 1 capital benefit by 2023.) The idea of non-called Tier 1 counting as Tier 2 capital is not explicitly stated in any of the Basel documents. Therefore, to explain our rationale for why we think this is the case, we run through the key documents issued by the Basel Committee.

Pulling the Basel Threads Together

The Original December 2009 Paper

One-and-a-half years ago, this document highlighted that all Tier 1 additional going concern capital should be loss-absorbing via a conversion into equity or a write-down mechanism at a pre-defined trigger point. The document highlighted that there would only be one form of Tier 2 capital under Basel III, effectively abolishing UT2. **We were somewhat surprised to see that the requirements for Tier 2 had not really changed as compared to pre-existing LT2 securities** (with the exception that step-ups/incentives to redeem were no longer permitted), given its inability to absorb losses outside of a liquidation scenario. Despite this, given that the Swiss regulator had effectively outlawed LT2 as a form of capital, the negative comments in the UK from Turner on Tier 2 and the fact that it would no longer be able to absorb regulatory deductions under Basel III, we fully expected this asset class to be significantly de-emphasised. What's more, the market was (and remains) focused on the level of a bank's core Tier 1 capital. Given this, we saw little risk of a non-called Tier 1 being left outstanding as a form of perpetual Tier 2 capital.

Equally, we should also note that this was before the discussion on resolution regimes had really gathered pace, and hence it was unclear that Tier 2 capital could actually be an effective form of gone concern capital.

August 2010 Paper: Loss Absorbency at the PONV

Following the original December 2009 Basel III paper, the Basel Committee announced a separate consultation in August 2010 on much harsher terms for subordinated debt to ensure its loss absorbency. This would require all forms of Tier 1 and Tier 2 capital to contain regulatory discretion on imposing losses at the point of non-viability ('PONV') or before a bank received any form of government capital (see *Basel Proposals on Loss Absorbency: A Brave New World*, August 19, 2010). This was a major step change as compared to the December 2009 Basel release referred to above. As no existing Tier 1 instruments contained this type of language, it was clear to us that even non-called Tier 1 would not even work as Tier 2 capital. Coupled with our expectations of a short grandfathering period, this confirmed our view that Tier 1 securities would effectively be taken out at the first call if not tendered/exchanged as, if not, they would simply represent an expensive form of senior debt conferring no regulatory capital benefit.

September Release: Short Grandfathering as Expected

The Basel Committee release from September 12, 2010 confirmed our expectations that the grandfathering period for existing, non-compliant Tier 1 (and Tier 2) securities would be relatively short, with all non-compliant securities being phased out by 2023 as compared to the pre-existing 30-year grandfathering included in CRD II. However, the majority would be phased out much sooner as anything with an incentive to redeem would lose all of its regulatory capital benefit at its 'effective maturity date' (i.e., its first call date). This was in line with our bullish expectations on grandfathering and further confirmed our original thesis that there was little point in leaving old-style Tier 1 securities outstanding, except for the very weakest banks that risk failing, where this capital could be used to absorb losses (see *Basel's Final Boost*, September 13, 2010, for more details.

December 2010 Release Provided the First Clue

The final Basel III document from December 2010 largely copied out the requirements for Tier 1 and Tier 2 securities from the original December 2009 document. However, there was a lot more detail on grandfathering of non-compliant Tier 1 and Tier 2 instruments. There are two key points of interest that we will highlight here. First, the grandfathering of Tier 1 and Tier 2 instruments is to be done on an aggregate basis for each Tier of capital rather than an instrument-by-instrument basis. As we discuss below, with the notional amount of instruments being fixed in 2013 and not being reduced as instruments lose their regulatory capital benefit, this provides scope for banks to carefully manage their subordinated debt instruments to maximise the capital benefit they are receiving over the grandfathering period. Second and of most interest is paragraph 94 (b) point 2:

"*For an instrument that has a call and a step-up on or after 1 January 2013 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward looking basis will meet the new criteria for inclusion in Tier 1 or Tier 2, it will continue to be recognised in that tier of capital. Prior to the effective maturity date, the instrument would be considered an "instrument that no longer qualifies as Additional Tier 1 or Tier 2 and will therefore be phased out from 1 January 2013*."

When we first read this, it was particularly confusing. The only instrument we could think of that would fall into this camp was the UCGIM € 9.375%. This security is effectively an attempt at a new-style Tier 1 but also contains a step-up at the call date which was outlawed by the Basel Committee. Therefore, our thinking was that this clause was included so securities like this could continue to count as Tier 1 capital after the first call date if not called. As this security contains a coupon step-up, its capital benefit would be grandfathered down by 10% per annum from 2013 to only 20% by 2020 at the first call date; but if not called then, as its incentive to redeem would disappear, and as a compliant Tier 1 security, then its capital benefit would be returned to 100%. However, as we note above, we found it odd that this clause would have been included as it would only cover a very limited number of securities, as so few banks had attempted to issue compliant Basel III Tier 1 securities containing an incentive to redeem. As we detail below, the real significance of this paragraph only truly came to light after the release from Basel Committee in January.

EC Working Paper on Resolution Regimes

In January 2011, the EC put out a working paper on resolution regimes (see *EC – More Clarity on Resolution*, January 7, 2011). While the paper focuses on supervision, prevention, recovery planning and early intervention, the real area of interest are the proposals on resolution. The overriding principle is clear that, after shareholders, unsecured creditors should bear residual losses. To achieve this goal, the ultimate aim is to create a framework for banks to be resolved/liquidated/wound up, making it easier to enforce losses on unsecured (senior and subordinated) creditors if an institution fails. While this release was expected, it was only following the January Basel announcement discussed below that we realised it had far-reaching consequences for existing Tier 1 instruments.

January 2011 Release Provided Further Clarity

The issue of all subordinated debt securities requiring PONV language was not dealt with in the main Basel III December 2010 release, with Basel simply noting that it was finalising its criteria for Tier 1 and Tier 2 capital. Basel addressed this point with an addendum to the main Basel III release from December 2010 in mid-January (see again *Basel – Loss Absorbency at the Point of Non-Viability*). Many investors have queried whether this January release supersedes the December 2010 release. This is not the case, in our view, as it very clearly states that "*These requirements are <u>in addition</u> to the criteria detailed in the Basel III capital rules that were published in December 2010."*

The release deals with the requirements for subordinated debt securities going forward, and we copy out the key part of the release below:

"*The terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by an internationally active bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event unless:*

(a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss;

(b)a peer group review confirms that the jurisdiction conforms with clause (a); and

(c)it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that such instruments are subject to loss under clause (a) in this paragraph. " (page 2, Basel Committee issues final elements of the reforms to raise the quality of regulatory capital, January 2011).

In summary, the Basel Committee followed through on its August 2010 proposals requiring all Tier 1 and Tier 2 instruments issued by internationally active banks to have write-down or conversion language at the option of the regulator on the occurrence of a trigger event (being when the regulator deems that an institution is non-viable or prior to any public sector capital injection). However, **somewhat unexpectedly, the Basel Committee included an exception to this requirement** as detailed in points (a) to (c) above.

The exception is linked to the existence of what we will term a *strong resolution regime* which has been subject to a peer review. Simply, the idea is that a jurisdiction must have statutory powers to ensure that subordinated debt securities can be written off/absorb losses at the option of the regulator before the taxpayer is exposed to losses. The aim is that where a bank reaches a point of non-viability, the end result should be the same as where a security contains contractual PONV language at the discretion of the regulator. (By means of a recap, statutory powers are enshrined in law and would give the regulator power to write down/convert all unsecured securities, as compared to contractual powers, which would only give regulators powers to write down/convert securities that contained the specific language within the bond indenture).

There are several direct implications from the January 2011 release where a strong resolution regime exists, in our view:

- Banks can continue to issue traditional LT2 securities (as long as they do not contain any incentive to redeem) as defined in the December 2010 document without any form of explicit loss absorbency (as this will be ensured by the existence of statutory powers). Based on point (c) above, for new issues, we believe that there would need to be disclosure as a risk factor of the potential risks posed by a strong resolution regime to qualify as a compliant Tier 2 security going forward (this is exactly what Barclays and ABN did in their recent LT2 deals).
- Tier 1 securities will need to contain write-down or conversion language but only as defined under Basel III December 2010 release at a pre-specified trigger point (not necessarily at the PONV as once again this is ensured via statutory powers).

However, quite clearly where there is no strong resolution regime in place, all subordinated debt securities (both Tier 1 and Tier 2) will need to contain explicit loss absorbency at the PONV, i.e., effectively contractually giving the regulator full discretion on write-down/conversion, which no securities currently do (although we accept that CS' BCNs have language approximating this). Hence, **the clear dividing line is the existence or not of a strong resolution regime in a jurisdiction.** However, as we detail in *<u>Bank Resolution Regimes – 2011 Driver</u>*, November 24, 2010, we believe that these will be in place Europe-wide by 2014/15.

Aug + Dec + Jan Basel Releases + EC Release = Non-Called Tier 1 Can Count as Tier 2

So, from all of this, how do we get to our conclusion that non-called Tier 1 can count as Tier 2? First, as we highlight above, where a strong resolution regime exists, traditional LT2 (but without a step-up) will continue to fully qualify as Tier 2 capital and not even need to be included in any form of grandfathering as it is a compliant instrument. Following this logic a step further, an old-style Tier 1 security more than meets the requirements of Tier 2 capital under Basel III, in our view. Per the Basel III requirements, Tier 2 capital must be subordinated with a minimum maturity of five years and can only have a call (without a step-up or incentive to redeem) after a minimum of five years. Comparing this to an old-style Tier 1, these are more deeply subordinated, perpetual and have no step-up *after* the first call date. While a non-called old-style Tier 1 will normally be callable quarterly after the first call date call, at issuance it must have had at least five years to the first call date (consistent with the requirement for Tier 2 capital on page 18 of the Basel III December release). The January release also required the risks relating to resolution regimes to be disclosed, but this is only in "*issuance documents going forward*"; therefore, this should not impact pre-existing Tier 1 securities. **So, while an old-style step-up Tier 1 will lose all capital benefit as a Tier 1 at the first call date, we think that it more than meets the requirements of Tier 2 capital under Basel III and thus could receive 100% benefit as Tier 2 capital.**

In our view, this was specifically addressed in para 94 (b) point 2 that we highlighted above from the December 2010 Basel III release. When we consider this paragraph again in light of the January release, our read is that an old-style step-up Tier 1 will be grandfathered down by 10% per annum to the first call date ("*Prior to the effective maturity date, the instrument would be considered an instrument that no longer qualifies as Additional Tier 1 or Tier 2 and will therefore be phased out from 1 January 2013*"). At the first call date, if not called, it will lose all Tier 1 capital benefit as the old-style Tier 1 securities are non-compliant with the Basel III requirements for Tier 1 (per the September/December 2010 Basel releases). However, where a strong resolution regime exists (hence PONV is not required from the January release), a non-called Tier 1 security more than meets the requirements of complying as Tier 2 capital. Therefore, it can effectively constitute 100% capital benefit as a form of Tier 2 capital ("*For an instrument that has a call and a step-up on or after 1 January 2013 (or another incentive to be redeemed), if the instrument is not called at its effective maturity date and on a forward looking basis will meet the new criteria for inclusion in Tier 1 or Tier 2, it will continue to be recognised in that tier of capital.*" Note that in the appendix to this report, we include a table detailing exactly how securities will be grandfathered and the capital benefit that banks will receive for them.

Above, we have given a somewhat detailed and technical explanation of our view of why we believe that a non-called Tier 1 could be recognised as a form of Tier 2 capital. It is easy to become bogged down in the detail, so we should also think about the issue from a very high-level perspective as it may help to add clarity. **Post 2013, the only reason that a bank can continue to issue traditional Tier 2 capital (albeit without a step-up) is because there is a strong resolution regime in place, i.e., the regulator has powers to ensure that these securities can absorb losses as a form of gone concern capital. Therefore, to the extent that a bank has non-called old-style Tier 1 capital, it seems like there should be absolutely no reason that this cannot be made to absorb losses as a form of gone concern capital in exactly the same way; therefore, it should be able to qualify as Tier 2 capital, in our view.**

CRD IV Implications

Note that everything we have noted above is on the basis of Basel III, but we cannot rule out the possibility that CRD IV (draft to be published June/July), which will be used to implement Basel III in Europe, will differ from the Basel proposals, which are not legally binding. Our feel is that some minor differences will manifest themselves, but given pressure in Europe for softer rather than stronger regulation from large parts of Europe (e.g., Germany, France), it is very unlikely that Europe will do away with Tier 2 as a form of capital (as in Switzerland), in our view. Therefore, we strongly believe that our Tier 1 becoming Tier 2 capital argument will hold. Somewhat ironically, if Europe was to be very lenient, e.g., maintain the current CRD II 30 year grandfathering, this would actually lead us to be even more cautious on calls (although we think that the idea of 30-year grandfathering remaining is very low).

Equally, we have yet to get colour on how CRD IV and EC legislation on resolution regimes will interact, specifically on what will happen if there is a one-year gap between Basel III becoming law in 2013 and the EC implementing its directive on resolution regimes. We suspect that banks would be able to issue instruments without PONV language and that the EC would bridge these qualifying as capital until the resolution regime legislation was introduced. Certainly, on January 1, 2013, when CRD IV is expected to come in, we will at that point have a cast-iron directive or regulation relating to resolution regimes; it just won't have been implemented at that point – but will very clearly be coming.

Our argument for non-called Tier 1 counting as Tier 2 is dependent upon a strong resolution regime being in place Europe-wide. We currently only have strong resolution regimes in Germany, the UK, Ireland and Denmark, and Holland is in the process of creating a regime. In the absence of a strong resolution regime, non-called Tier 1 could not count as Tier 2 as it has no PONV language. However, Europe is clearly moving towards implementing a resolution regime (see again *EC – More Clarity on Resolution*) and, as we note above, we do expect an EC resolution regime by 2014/15 and believe that banks would prefer there to be one in place, as it would mean that they did not have to issue subordinated securities with PONV language.

All New Instruments Will Be Non-Step

Historically, the majority of securities issued to the institutional market contained a coupon step-up (effectively designed as an incentive to redeem the security at the first call date and therefore, from an investor perspective, this gave the security an effective maturity date). Post the crisis, nearly every back-end step-up was so low compared to secondary spreads that they did actually not serve as a form of incentive to redeem, as the cost of refinancing was greater than the coupon step-up. However, by virtue of being a 'step-up' security and having a significant amount of reputational risk associated with it at a time of weak market confidence, many Tier 1 and Tier 2 securities have so far been called at the first call date for reputational considerations.

However, under Basel III, compliant subordinated debt securities will not be permitted to contain any form of incentive to redeem. Going into the detail from Basel, **it is explicitly stated that banks will not do anything that creates an expectation that a call will be exercised.** Equally, where a bank exercises a call, the instrument must be replaced "*on conditions which are sustainable for the income capacity of the bank*" (page 16: Basel III, December 2010), i.e., not at a materially higher cost, in our view, unless the bank is well above the Pillar 2 capital requirements when the call is exercised (in which case it may not even need to be replaced). **At every level, if a bank wants to exercise a call on a new security going forward, it will be subject to much greater scrutiny** and there should be no expectation that a bank will call as has been the case historically. **Given this, it also argues to an extent that existing securities may be subject to a greater level of scrutiny** and that there will be a gradual shift towards a greater acceptability of securities not being called at the first call date, as we see a greater amount of new-style instruments issued. However, we would note that no new-style instruments will actually come to call before 2015.

SIFI Buffer Should Be Additive

While we lack regulatory clarification on SIFI capital in Europe (format, amount required, ultimate purpose), we believe that the large global banks will need to have a SIFI buffer of around 2-4% of RWAs. Critically, **in our view this buffer will be additive on top of the 7% core Tier 1, 8.5% Tier 1 and 10.5% total capital ratios.** This is important, as if a SIFI has a core Tier 1 ratio of 9% and 3% of CoCos (we presume in a Tier 1 or Tier 2 host instrument as in Switzerland), then on the face of it, it will have more than exceeded its minimum capital requirements. However, if SIFIs CoCos are additive on top of minimum capital requirements, then **it would still require over 150bp of additional Tier 2 capital** to meet the regulatory minima. Equally, we would not rule out the importance of Tier 2 capital and, in many ways, we expect it to perform the same role as low trigger CoCos in Switzerland once Europe has a strong resolution regime in place.

As we note above, we lack clarity on exactly what requirements will be placed upon SIFIs. However, we believe that the SIFI buffer will be additive. First, it is designed as a surcharge on large banks, i.e., permitting SIFI capital to count within the requirement to hold 10.5% capital makes no sense as you could end up with a situation where HSBC and a tiny building society effectively had the same capital requirements, which seems totally nonsensical. Second, we already have an example of a capital surcharge, i.e., the capital conservation buffer, which is additive. Finally, if we look to Switzerland, while the big banks do not have to apply Basel III per se (as the Swiss regulator is much more severe), the requirements for low and high trigger CoCos are effectively additive.

Given this, we believe that banks are likely to have an ongoing need for Tier 2 capital going forward. Equally, **it potentially increases a bank's incentive to leave existing Tier 1 securities outstanding as perpetual Tier 2 capital to fill this capital need.** While this could potentially have a damaging impact on a bank's ability to issue new CoCos to the market, as we saw with DB, following its original LT2 non-call and subsequent Tier 1 non-call, it has not stopped the bank from subsequently issuing a bullet institutional LT2 and retail Tier 1 pref to the market.

The willingness and need of a bank to leave Tier 1 outstanding as Tier 2 as we describe above will depend on the level of core Tier 1 that banks are required to run for pillar 2 purposes. For example, if banks are required to run minimum 10% core Tier 1 capital like the Swiss banks or as the interim ICB report suggested for the UK banks, then this would largely remove the need for banks to have Tier 2 capital outstanding, especially as Tier 2 capital no longer absorbs regulatory deductions in the same way going forward as occurred historically. However, we believe that there are likely to be significant divergences regarding the level of capitalisation that domestic regulators will require banks to operate at on a pillar 2 basis. Hence, this may well play a role in driving differentials in call policies across European banks, and this is by no means priced in at current levels.

Exhibit 1

Example of Tier 1 Amortisation Schedule

£ million	90% 2013	80% 2014	70% 2015	60% 2016	50% 2017	40% 2018	30% 2019	20% 2020	10% 2021	0% 2022
Step-up bond – call 2016	1,000	1,000	1,000	1,000						
Non-step bond – call 2013	500	500	500	500	500	500	500	500	500	500
Total Tier 1	1,500	1,500	1,500	1,500	500	500	500	500	500	500
Grandfathered amount	1,350	1,200	1,050	900	750	600	450	300	150	-
Tier 1 capital benefit	1,350	1,200	1,050	900	500	500	450	300	150	-
Residual benefit to Tier 2	150	300	450	600	1,000	1,000	1,050	1,200	1,350	1,500

Source: Morgan Stanley Research; Note: Residual benefit to Tier 2 capital assumes that the step-up Tier 1 is not called.

Grandfathering Buckets: Negative for Non-Step

The issue of grandfathering buckets is also potentially negative for non-step Tier 1 securities. To explain, as we detail above, under Basel III grandfathering buckets will be calculated on an aggregate basis per Tier of capital rather than on a bond-by-bond basis. This means that banks will have a greater incentive to leave non-step Tier 1 outstanding as they continue to receive Tier 1 capital benefit for a greater period of time as it only loses 10% Tier 1 capital benefit per year from 2013. While this is not new, the way the grandfathering buckets are calculated is (from the December 2010 paper), and it is more generous for banks. **By virtue of grandfathering being calculated on an aggregate basis, there is potentially an even greater incentive to leave non-step Tier 1 outstanding.**

In Exhibit 1, we use the example of a bank that has two Tier 1 securities in issue – a step-up bond callable in 2016 and a non-step callable in 2013. As the grandfathering is calculated on an aggregate basis and the nominal amount is fixed in 2013 at £1,350 million, in 2016 when the step-up Tier 1 ceases to give Tier 1 capital benefit (whether it is called or not), the non-step Tier 1 security effectively continues to give 100% capital benefit in 2017 and 2018 despite being over five years into the grandfathering period. In this case, there would be a strong argument for the bank to leave its non-step outstanding as, even in the final year of grandfathering, it would still be getting £150 million of Tier 1 capital benefit out of an original £500 million issuance.

Note that non-steps securities were traditionally not expected to be called for reputational reasons and would only be called if it was economic to do so. However, as we have written before, we believe that the optical distinction between step-ups and non-steps has been lost to a large extent. In part, this has been driven by certain banks having now issued non-steps with greater back ends than certain of their step-up securities and calls being made on a non-economic basis for step-ups. **Therefore, even a non-call of an institutional non-step would likely have a negative read-across for a bank in the market.**

The idea of managing grandfathering buckets was also behind Commerzbank's recent LT2 exchange. Commerzbank has two LT2s coming to call in 2011 and 2012, and while we doubt its desire to call them, the securities would have lost all capital benefit under Basel III; hence, by exchanging them into a longer-dated 2019 LT2 (and issuing a 2021 LT2), Commerzbank is able to maximise its LT2 grandfathering buckets. This was also the driver of ABN's LT2 exchange where it proposed an exchange of six LT2s coming to call in 2010-13 into new 2021 and 2022 LT2. Note that even if these securities do not need to be grandfathered as Holland and Germany are deemed to have strong resolution regimes (which we expect to be the case), then by extending the maturity, the banks also push back the regulatory amortisation of these securities in the years preceding their final maturity. Equally, we would note that Credit Agricole highlighted at our recent banks conference that it would look to fully use grandfathering for its existing Tier 1s. **We highlight these as examples of banks actively managing (or suggesting that they will actively manage) their grandfathering buckets to maximise capital benefit under Basel III to show that this is a genuine focus for banks.**

We should note that when we spoke to Commerzbank, it told us that as it didn't know what the situation would be, it was taking a very conservative view of the world, for the purposes of the LM exercise, in assuming that Germany's resolution regime would not be sufficiently strong. Hence, the real motivation for its LM exercise was to maximise the amount of Tier 2 capital benefit that it would get over the grandfathering period. This contrasts to Rabobank, which issued a Basel III-compliant Tier 1 in January without PONV language as it was presumably expecting a strong resolution regime to be implemented in Holland.

Growing Caution Among Regulators On Calls

The generic theme among European regulators is that banks are going to be required to hold more capital, at least in the short term. Banks will achieve this in multiple different ways (e.g., earnings retention, rights issues), but we also believe that regulators will be increasingly strict on requiring banks to refinance calls. This has been a clear policy from the Bank of Italy for some time and now seems to be prevalent in the UK based on comments made by Barclays at our recent banks conference. Interestingly, on this point, Barclays told us recently that the FSA is comfortable with it refinancing Tier 1 with Tier 2 capital as the FSA is focused on a bank's total capital ratio rather than the split between old-style Tier 1 and Tier 2. Equally, by encouraging banks to pre-finance, it is also a way of encouraging banks to issue compliant forms of capital. Therefore, against a backdrop of tougher regulation, we cannot rule out other European regulators adopting a policy of requiring banks to pre-finance securities that banks wish to call and thus restricting banks' ability to call securities. We will return to this topic in a coming publication.

Would Tier 1 Be Cheap LT2?

On this point, we include a sample of high-quality banks in Exhibit 2 and compare the back-end spreads of their Tier 1s to the current trading levels of their LT2 securities. Note that as the Barclays securities are actually preference shares, we gross up the back-end spread for corporation tax, as this is more representative of the income that Barclays needs to make to pay the pref share dividend (we also assume that 3-month € Libor is 3.00% in 2014 and also gross this up for corporation tax). Of interest, with the exception of Barclays, the banks in our sample could all theoretically fund LT2 inside the cost of their back-end spread of their Tier 1s. Therefore, on the face of it, this would argue that it does not make sense for the banks to leave their Tier 1 outstanding as Tier 2.

However, we would flag that non-called Tier 1 would be perpetual Tier 2 capital, unlike a bullet LT2, which also amortises in the last five years of its life. Equally, the absolute spread levels on the Tier 1s are relatively low and therefore represent a floor for the cost of Tier 2 capital. Therefore, it also represents a cheap option to leave outstanding – we cannot rule out LT2 spread levels rising as we look ahead, given that we expect senior spreads to be under pressure from the onset of resolution regimes, increased covered issuance and a potential change in ranking of senior versus deposits. Equally, to be fair, we should really compare the back end of the Tier 1 to the cost of issuing a new Tier 2, and so we would need to add anywhere from 20-25bp to the levels above, which would bring the spread levels of Tier 2 into line with the back-end steps on Tier 1. **Bottom line, for low back-end Tier 1s, it is far from clear that it makes economic sense to call Tier 1s and replace these with new issued LT2.**

A Shifting Tide, No Big Bang Necessarily Expected

Above, we make the case for growing caution on calls. However, to be clear, we are describing this as a general trend that will come into focus over the medium term; we are not necessarily expecting a big bang with a major bank not calling in the near term (although we cannot rule this out).

A Lack of Near-Term Catalysts in Tier 1

In Exhibit 3 overleaf, we detail the institutional Tier 1 securities that are coming to call over the rest of 2011. Looking at the list, we are not expecting to see any surprises. Of the major banks, we have securities from Barclays, DNB, Fortis Bank Belgium (BNP), BNP, Soc Gen and Credit Suisse, and we have already seen these banks make non-economic calls in recent years. We would also note that for the most part, the back-end steps are actually relatively elevated. We were potentially concerned about Intesa having to refinance, but given its €5 billion rights issue, we believe that this will more than meet the refinancing requirements for this security. Separately, we know that Dexia and HBOS will not be able to call their securities as they are both already under restrictions from the EC. **Overall, while a shock non-call is by its very nature almost impossible to foresee, based on the limited number of Tier 1s coming to call from high-quality issuers with big back-end steps, we are not expecting any shock non-calls over the short term to serve as a catalyst for a sudden repricing of low back-end Tier 1s.** We will come back to more likely problem of LT2 non-call (given the volume of bonds outstanding) in a future piece.

Exhibit 2

LT2 Secondary Trading Levels Compared to Tier 1 Back Ends

ISIN	Bonds	Back end	Tax adjusted back-end	Z-sprd	ISIN	Z-sprd bullet LT2	Maturity	Tier 2/back end
XS0214398199	Barc 4.75% 14s	105	226	510	XS0525912449	250	21	111%
XS0205937336	Barc 4.875% 20s	71	182	522	XS0525912449	250	21	137%
FR0010248641	Cred Ag 4.13% 15s	165		355	XS0550466469	148	21	89%
FR0010456764	BNP 5.109 17s	172		298	XS0320303943	125	17	72%
FR0010031138	BPCE 5.25 14s	184		454	FR0000188625	143	14	78%
XS0176823424	DB 5.33 13s	199		493	DE000DB5DCW6	150	20	76%
FR0010136382	Soc Gen 4.196 15s	153		379	XS0383634762	135	18	88%

Source: Morgan Stanley Research; Note that we gross up the back end for the Barclays securities above using a corporation tax of 23% and assume a level of 3-month € Libor of 3.00%. Pricing from Bloomberg as of April 14, 2011.

Exhibit 3

Tier 1 Securities Coming to Call in 2011

Next call	Issuer parent	Currency	Structure	CPN	Step-up
15-Jun-11	Barclays plc	USD	T1	8.55	3m $Libor+300bp
27-Jun-11	Unione di Banche Italiane Scpa - UBI Banca	EUR	T1	9	3m€Libor+540bp
27-Jun-11	Banca Monte dei Paschi di Siena SpA - MPS	EUR	T1	FRN	3m€Libor+465bp
29-Jun-11	DnB NOR ASA	USD	T1	7.729	3m$Libor+272bp
02-Jul-11	Banca Popolare di Milano Scarl	EUR	T1	8.393	3m€Libor+470bp
06-Jul-11	Dexia SA	EUR	T1	6.821	3m€Libor+230bp
12-Jul-11	Intesa Sanpaolo SpA	EUR	T1	6.988	3m€Libor+260bp
10-Aug-11	Caixa d'Estalvis de Terrassa	EUR	T1	8	
15-Sep-11	Barclays plc	USD	T1	6.625	
26-Sep-11	Fortis Group	EUR	T1	6.5	3m€Libor+237bp
18-Oct-11	NIBC NV	USD	T1	7.625	
23-Oct-11	BNP Paribas SA	EUR	T1	6.625	3m€Libor+160bp
07-Nov-11	Credit Suisse Group	EUR	T1	6.905	6m€Libor+320bp
09-Dec-11	HBOS plc	EUR	T1	7.627	3m€Libor+287.5bp
15-Dec-11	SocGen	USD	T1	6.302	3m$Libor + 192bp
15-Dec-11	Barclays plc	USD	T1	7.375	3m$Libor+233bp

Source: Morgan Stanley Research

Why We Are Changing Our View

As we detail above, our original view as to why Tier 1s would be called was linked to the idea that regulators were exclusively focused on core Tier 1 at the exclusion of all other types of capital, the importance of reputational risk and as non-called Tier 1 would not represent a cheap form of senior debt. We believe that the January release from the Basel Committee, coupled with the EC project to create an effective resolution regime in Europe, has changed this. As a result, Tier 2 capital and the amount of a total capital that a bank has outstanding will become an important source of capital for regulators in the future. What's more, non-calls are by no means as rare as they once were, and new instruments will have no form of incentive to redeem going forward. When we couple this change in approach from the regulators with current valuations where there is no room for error (i.e., calls are fully priced in for the most part), then this makes us much more cautious on low back-end Tier 1s.

To be clear, we still believe that the strongest banks will continue to call for the time being; we are more concerned about a shock non-call from a mid-sized issuer, most likely in LT2, which could impact the trading levels of the whole market – and in Tier 1s, these trading levels are on the whole fully priced to the call date. Again, we will return to this topic in a follow-up note.

Appendix

Phase-In Arrangements (Shading Indicates Transition Periods) (All Dates Are as of January 1)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum common equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
Phase-in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Source: Bank for International Settlements

Treatment of Subordinated Instruments under Basel III

In a strong resolution regime	Call pre-January 1, 2013	Call post January 1, 2013
Tier 1 step	If not called, will continue to count as Tier 1 capital until January 1, 2013. Then, will lose all Tier 1 regulatory capital benefit from January 1, 2013 but give 100% capital benefit as Tier 2 capital.	Normal grandfathering from January 1, 2013 of 10% per annum; will lose all Tier 1 regulatory capital benefit from first call date if not called but will count 100% as Tier 2 capital.
Tier 1 non-step	If not called, will continue to count as Tier 1 capital until January 1, 2013, then normal grandfathering from January 1, 2013 of 10% per annum as Tier 1 capital, amortised amount (i.e., residual amount not counting as Tier 1) to count as Tier 2 capital.	Normal grandfathering from January 1, 2013 of 10% per annum as Tier 1 capital; amortised amount to count as Tier 2 capital.
Tier 1 preference shares	Per Basel, prefs still qualify as Tier 1 capital but expect EC and FSA to be super-equivalent; in this case, will be same treatment as Tier 1 non-step above.	
UT2	If not called, will continue to count as Tier 2 capital.	Normal grandfathering from January 1, 2013 of 10% per annum as Tier 2 capital; if not called will give 100% regulatory capital benefit as Tier 2.
LT2 – callable	If not called, 20% amortisation per annum as per normal.	Normal grandfathering from January 1, 2013 of 10% per annum as Tier 2 capital; if not called, 20% amortisation per annum as per normal.
LT2 – fixed	20% amortisation per annum as per normal five years prior to maturity.	20% amortisation per annum as per normal five years prior to maturity.

In a weak resolution regime	Call pre-January 1, 2013	Call post January 1, 2013
Tier 1 step	If not called, will lose all Tier 1 regulatory capital benefit from January 1, 2013.	Normal grandfathering from January 1, 2013 of 10% per annum; will lose all Tier 1 regulatory capital benefit from first call date if not called.
Tier 1 non-step	If not called, will continue to count as Tier 1 capital until January 1, 2013, then normal amortisation from January 1, 2013 of 10% per annum as Tier 1 capital.	Normal grandfathering from January 1, 2013 of 10% per annum as Tier 1 capital.
Tier 1 preference shares	Per Basel, prefs still qualify as Tier 1 capital but expect EC and FSA to be super-equivalent, in this case, will be same treatment as Tier 1 non-step above.	
UT2	If not called, will lose all regulatory capital benefit from January 1, 2013.	Normal grandfathering from January 1, 2013 of 10% per annum as Tier 2 capital; if not called, will lose all regulatory capital benefit.
LT2 – callable	If not called, will lose all regulatory capital benefit from January 1, 2013.	Normal grandfathering from January 1, 2013 of 10% per annum as Tier 2 capital; if not called, will lose all regulatory capital benefit.
LT2 – fixed	Normal grandfathering from January 1, 2013 of 10% per annum, with five years left to maturity; expect the LT2 to get capital benefit, which is the lower of the cumulative 10% grandfathering and the normal 20% amortisation per annum from five years prior to maturity.	Normal grandfathering from January 1, 2013 of 10% per annum; with five years left to maturity, expect the LT2 to get capital benefit, which is the lower of the cumulative 10% grandfathering and the normal 20% amortisation per annum from five years prior to maturity.

Source: Morgan Stanley Research

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