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Europe

Investment Grade Credit

European Banks

Periphery Review: Tier 1

As discussed in *Reviewing Our Periphery Skew*, September 12, when we closed out our underweight in Tier 1s in June, we did so by adding a number of Italian and Spanish high-steps. With the upcoming banking sector-specific risks highlighted in our *Periphery Skew* note and valuations on our periphery recommendations at or very close to 12-month highs, it's time to sell some of our Italian and Spanish Tier 1s.

Our starting point is a 10.2% YTC on the SANTAN £ 7.3% 19NC14 LT2 (high step to l+416bp) that we kept when reviewing our LT2 recommendations in *Periphery Review: LT2*, September 17. In periphery Tier 1s, we want to definitely beat this yield by a good margin, or otherwise simply get more defensive, rather than go underweight.

Sell SANTAN £ 11.3% 14s at 101, YTC 10.6%, buy HBOS £ 6.461% at 78 (when liquidity allows), YTC of 11.5%, YTP 8.3%. Note that HBOS' step in 2018 is 5-year UKT+285bp, so not huge, but still, the optionality of a call or LME at this low-ish cash price makes these bonds still interesting, in our view. The SANTAN Tier 1s are almost the same yield as its own £ LT2s.

Sell € ISPIM 8.375% at 96, YTC 9.2% and buy ACAFP's retail € 6% at 73.25, YTP 8.6%. While it still has Emporiki, Agricole is clearly not out of the periphery woods yet, but there are confirmed bidders for Emporiki and we do not believe that it should trade close to an Italian bank.

Sell € ISPIM 8.047% at 91.75, YTC 10% and buy BPCEGP's retail €9% or 9.25%, with the 9.25% offered around 100.25, YTC in 2015 of 9.1%. Even a reg par call on January 1 would still give a good, if very short-term, yield on these. **We also like Lloyds' € 7.875%** (also in $) pref shares at 89, YTP 8.9%, although liquidity is difficult.

We'd keep high-step BBVA in £ and € Tier 1s as we still believe that the YTCs are good on these (16% and 14%) and outstrip anything we can find in LT2s by a margin – for example, low-step BBVA and SANTAN callable LT2s are trading between 6% and 7.3% YTM in €. We'd also keep ABBEY $8.963%, recognising that the call is out in 2030, giving us a nice yield and good duration. We also believe that we'd never be able to buy it back if we sold it.

Risk Factors

- Market conditions give further legs to the rally and periphery banks continue to outperform the core.
- The banking sector-specific risks turn out to be more severe than expected, meaning that maintaining an equal-weight in Tier 1, albeit with no periphery skew, is too bullish.

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Although we have a longer-term constructive view on bank credit, we have clear concerns in the short term, where the raft of bank sector-specific risks – against the backdrop of numerous political and economic events – could weigh heavily on bank debt, where valuations are currently close to one-year highs. We outlined the numerous risks in *Reviewing Our Periphery Skew*, and Joachim Fels, our co-head of Global Economics, recently commented on rising complacency in general, in his *Sunday Start*, September 23.

Risks of Increasing Complacency

According to the CRIC cycle that our strategists and economists use – Crisis, Response, Improvement, Complacency – when Complacency becomes pervasive, it usually gives way to a renewed crisis. Joachim links his view of increasing complacency to evidence including the market looking through the fact that the economy remains stuck in what he describes as the 'twilight zone'. He argues that weak advance PMI surveys out of the euro area and China last week confirmed a continuing contraction in manufacturing, and this has been borne out in further European business sentiment gauges this week. He also points to the disagreement on EBU (European Banking Union) and suggestions that Spain and Italy actually may not need ESM programmes (notably Schäuble on Spain). Joachim concludes that the current complacency reminds him of the March/April period, "when the post-LTRO improvement in markets induced governments and the ECB to relax prematurely, with well-known consequences".

While we have a more cautious short-term view, as stated above, at the same time, we also believe that liquidity in bank debt will remain very patchy and, hence, when investors want to add, it may well prove difficult. Hence, **we are simply revisiting our recent recommendations and suggesting switches into 'safer' bonds, rather than reducing our current equal-weight in bank debt down to underweight.**

Skewed Towards Italians and Spanish

The key reason for this review is that within our equal-weight on bank debt, **we have been skewing our recommendations towards Italian and Spanish banks.** We're basically long high-step Tier 1s and many with long calls/high swap gains. We'll revisit Tier 1 more broadly in a later note – here, we just focus on the periphery bonds we've added since June.

- In *Closing Out Our Tier 1 Underweight*, June 14, we added a number of high-coupon/high swap-gain Tier 1s, including £ BBVA 9.1%, £ SANTAN 11.3%, € ISPIM 8.375%, € BBVA 8.5% and € ISPIM 8.047%.
- In *Revisiting Swap Gains*, July 13, we confirmed our preference for ABBEY's $ 8.963% Tier 1s, even post the tender on July 3 at 103 (6 points above market).

We continue to like high-step Tier 1s due to the increased certainty of call, and the long-dated calls, where we have a constructive view on the credit and the swap gains will always help, as will the fixed coupons for some time. However, many of these Tier 1s we added back in June have come an extremely long way, and while back then many looked cheap versus LT2s, this is no longer the case. Four of the bonds have been cash tendered at premia of up to 6 points above market price since mid-June, and they are all now trading above those tender prices.

When reviewing these Tier 1s, a good starting point is to bear in mind the YTC of 10.2% on SANTAN's £ LT2 7.3% 19NC14 (steps to l+416bp), a bond which we recommended to continue to hold when we reviewed our periphery LT2s in *Periphery Review: LT2*. With this in mind, we'd recommend now selling SANTAN in Tier 1, with a YTC of just 10.6% and the same 2014 call.

- **Sell SANTAN £ 11.3% at 101, YTC 10.6%, buy HBOS £ 6.461% at 78 (when liquidity allows), YTC of 11.5%, YTP 8.3%.** Note that the step in 2018 here is 5yr UKT+285bp, so not huge, but still, the optionality of a call or LME at this low-ish cash price makes these bonds still interesting to us.

Although it's at its highs, **we'd keep ABBEY $8.963%,** recognising that the call is out in 2030, giving us a nice yield and good duration. We also believe that we'd never be able to buy it back if we sold it.

Exhibit 1

Periphery Tier 1 Bonds – Now at, or Very Close to, 12-Month Highs

Ccy	Ticker	Cpn	Next call	Step	Amt o/s (m)	Bid	Offer	YTC* (%)	YTP/M (%)	Zsprd	12m high	12m low	Recommendation
$	ABBEY	8.963	30/06/2030	L+282.5	366	107.0	109.0	8.4	7.6	585	109.0	90.0	Keep
£	BBVASM	9.1	21/10/2014	L+570	251	86.5	88.5	16.1	10.1	2,032	94.5	68.0	Keep
£	SANTAN	11.3	27/07/2014	L+766	679	101.0	102.5	10.6	10.8	971	103.0	85.0	Selling
€	ISPIM	8.375	14/10/2019	L+687	742	96.0	97.5	9.2	9.6	781	98.0	57.5	Selling
€	BBVASM	8.5	21/10/2014	L+574	645	89.75	90.75	13.9	9.3	1,328	91.0	73.0	Keep
€	ISPIM	8.047	20/06/2018	L+410	580	91.75	92.75	10.0	8.1	881	93.0	54.5	Selling

Source: Bloomberg, Morgan Stanley Research; indicative levels as of September 25, 2012, *YTC, YTP and z spread use bid side if recommendation is 'Selling', offer side otherwise

We'd keep BBVA high-step £ 9.1% and € 8.5% in Tier 1s as we still believe that the YTCs are good on these and outstrip anything we can find in LT2s by a margin – for example, low-step BBVA and SANTAN callable LT2s are trading between 6% and 7.3% YTM in € (YTCs are much higher, but we are cautious on calls, particularly SANTAN, which has been clear about its economic call policy). We'd also note that the BBVA £9.1% is the only bond here not within a hair's breadth of its one-year highs.

In terms of the ISPIM Tier 1 recommendations in Exhibit 1, again, although we like high-steps, they've come a very long way, and now with YTCs at 9.2% and 10.0% – and nearly 40 points off the year's lows – it makes sense to switch here. We got more constructive last week on Agricole in *Credit Agricole: Greece and Beyond*, September 20, and hence:

- **Sell € ISPIM 8.375% at 96, YTC 9.2%, and buy the ACAFP $8.375% Tier 1s,** offered at 100, with a YTC of 8.4%, with a step in 2019 to l+698bp, **or, staying in €, buy ACAFP € 7.875% at 98** (we recommended this in last week's Agricole note), with a YTC of 8.3% and a step to l+642bp in 2019. While it still has Emporiki, Agricole is clearly not out of the periphery woods at all – but we do not believe that it should trade this close to an Italian bank.
- **Sell € ISPIM 8.047% at 91.75, YTC 10% and buy the Agricoles above or look at the retail Tier 1 sector for ACAFP's € 6%** (again, recommended last week) at 73.25, YTP 8.6%. We actually prefer BPCEGP to ACAFP so, if they're available, **we'd buy BPCEGP's retail €9% or 9.25%, with the 9.25% offered around 100.25, YTC in 2015 of 9.1%.** Even a reg par call on January 1 would still give a good, if very short-term, yield on these. **We also like Lloyds' € 7.875%** (also in $) at 89, YTP 8.9% and, as a pref share, these have the tax-disadvantage of paying coupons out of post-tax income, increasing the likelihood that Lloyds will want to be rid of these at some stage.

Note that retail bonds here enjoy a similar YTP to the YTCs of the high-steps we're recommending to sell. However, the retail bonds are normally of course lower cash, and have the optionality of a call at some point.

An Aside on SANTAN and BBVA Language

Spanish bank Tier 1 coupons can be cut if a bank makes a loss at the non-consolidated parent company level. Disclosure is weak and only in Spanish for the non-consolidated accounts of BBVA and Santander. While 2012 coupons are not at risk, given earnings in 2011, there is a potential risk for 2013 coupons, given the additional provisions required under Royal Decree ('RD') 1 and 2.

Santander has a lot of headroom to keep paying Tier 1s, in our view, despite €2.9 billion of additional provisions to take in 2012 (after tax and the €900 million gain on the group's Columbian disposal). After adjusting for the provisions to be taken by Banesto (circa 40% of RD1 and 2), and normalising 2012 earnings (using 2011 as a proxy) for the RD1 provisions taken in 2011, we estimate that Santander will have an after-tax charge of €1.95 billion versus a net profit of €3.2 billion. Equally, with a two-year dividend stopper, we are convinced that Santander would wish to avoid this.

For BBVA Tier 1s, where we are keeping our recommendations, there is lower headroom, but we believe that they are still certainly very likely to pay coupons. BBVA has an after-tax cost of €2.8 billion for RD1 and 2 compared to a 2011 net profit of €2.7 billion, suggesting a shortfall and thus greater risk to coupons. However, with increased dividends from subsidiaries and affiliates, BBVA should have sufficient earnings to pay Tier 1s, and we doubt it would want to skip paying, particularly if Santander continues to pay.

A specific part of the Spanish Law means that if a bank that makes a loss in 2012 due to the Royal Decree cannot pay its Tier 1 coupons, then it can choose to defer the non-cumulative coupon and pay two coupons in the following year. Clearly, however, this would rely on the goodwill of the issuer.

We Prefer BBVA from a Risk/Reward Perspective
All things considered, from a purely risk perspective, we would have a preference for Santander Tier 1s, given the greater headroom, diversification and earnings capacity. However, considering where these trade versus their own LT2s and versus BBVA (including our view that, although less certain than Santander, BBVA will still pay coupons), we prefer BBVA from a risk/reward perspective.

and Smaller Italian Bank Tier 1s

We spent some time on Monte dei Paschi (MONTE) and Banco Popolare (BPIM) recently when we published *Periphery Review: Too Many Headwinds at MPS – Buy CDS*, September 13. As these banks' Tier 1s optically look interesting from a low cash price point of view, it's worth noting our thoughts in this broader piece on periphery Tier 1s, even though we don't recommend the bonds. Neither appears compelling to us, considering that coupon pushers will expire early next year for BPIM, and that MONTE is standing ahead of taking state aid and a potential EC decision on this which could include optional coupon bans. Naturally, in the face of LME, we would not recommend shorting cash bonds (hence the CDS recommendation).

Exhibit 2

BPIM and Monte Tier 1s – Unattractive Risk/Reward. Indicative Levels Only

Ticker	Ccy	Cpn	Next call	Amt o/s (m)	Step	Offer	YTP
BPIM	EUR	6.156	21/09/2017	78	L+228	68.0	8.1%
BPIM	EUR	6.756	21/06/2017	140	L+188	69.0	7.8%
BPIM	EUR	6.742	30/06/2015	373	L+525	81.5	9.5%
MONTE	EUR	6.675*	07/11/2012	243	L+630	63.75	10.4%

* Old 7.99; not called at first call date (February 2011), now floating coupons
Source: Morgan Stanley Research, Bloomberg

BPIM – LME Pusher Over

BPIM carried out an any and all cash tender offer on 12 subordinated securities at an average 5.3 points premium in February 2012. Amid the Tier 1s, BPIM € 6.156%, BPIM € 6.756% and BPIM € 6.742% had a 72%, 50% and 26% participation rate, respectively. **2012 coupons of all three bonds (annual, payable in June) have been pushed by this LME, yet the pusher is limited to redemption of pari/junior securities done within 12 months prior to the coupon payment, so that this catalyst stops in February 2013.** All three bonds have dividend pusher language, but our equity analysts do not expect dividends for the next two years. We'd note here that BPIM chose not to pay coupons on Banca Italease Tier 1s (XS0255673070) when that subsidiary reported a loss at the non-consolidated level (making coupons optional), and our equity analysts are forecasting a loss of €102 million for Banco Popolare in FY2012.

While BPIM is facing the same structural challenges as other mid-cap Italian banks, its asset quality seems to have been deteriorating at a lower rate than its peers. Indeed, BPIM is the only Italian bank we follow that saw flat LLP YoY at 1H12, when its peers registered significant increases. This may partly be due to its higher exposure to Northern Italy as opposed to Central/Southern Italy for Monte, for example. However, we'd highlight that BPIM has a historically lower coverage ratio than peers (28.7% at 1H12).

Monte – Still Too Many Uncertainties

As we went through in more detail in our September 13 note, we are cautious on Monte in the near term. Monte also LME'd its subordinated debt in June 2012, offering to exchange nine securities into new 3-year senior unsecured bonds (€ 7.25% July 2015s) at an average premium of 4.2 points. Looking at its Tier 1 (the old 7.99), participation was low at 31%, and unlike BPIM's Tier 1s, coupons were not pushed by the LME. We'd note that **Monte has so far been rather bondholder-friendly with its Tier 1s, paying coupons throughout the crisis and increasing the coupons' spread over Libor from 390bp to 630bp when it did not call the bonds in February 2011.** At that time, the Bank of Italy was requiring banks to pre-finance calls and buybacks, but it revised these rules at the start of the year – hence the many tenders since then. With the bonds still trading at a low cash price and Monte looking at ways to raise additional capital, we'd not rule out another try at buying back more bonds, though we note that participation was low in June.

An interesting point here is that **Tier 1 coupons are pushed if payments are made on parity/junior securities** (there is no mention of additional share issuance being a pusher). **The new government-sponsored capital securities ('GSCS') Monte is to take are set to compensate the state even if Monte records a loss, in which case they pay in shares.** At first look, this could potentially mean that, going forward, Tier 1s will have to be paid in any case, while until now coupons were optional if the bank had not paid an equity dividend or had insufficient distributable reserves (unconsolidated net profits of the prior year). However, the Tier 1 prospectus stipulates that dividend pushers would not include dividends on ordinary shares that consist solely of additional ordinary shares. While GSCSs are not ordinary shares, the prospectus does not tackle a situation where parity/junior securities would be paid with shares, so it is unclear how GSCSs would be treated in this case. As an aside here, we'd note that even though Commerzbank's buy-back of silent participations earlier this year looked like it ought to have pushed coupons on other Tier 1s, the bank simply noted that its legal advisors said that it did not. We would not have been able to tell this at all from the prospectus, hence we're not filled with confidence about opining on Monte's language either.

We'd finally highlight that Monte's Tier 1 coupons are not mandatory if "the bank is otherwise prohibited under applicable Italian banking laws or regulations from declaring a dividend or making a distribution on any class of its equity capital". This is to some extent (although we appreciate it is less strongly worded) similar to NORD/LB's (NDB) $10.25 bond language, whereby coupons were prohibited if the bank was under a dividend ban (see *NDB's Coupons in Question*, July 12). Given that the EC had yet to approve the state aid NDB had recourse to, and the EC historically imposing a two-year dividend ban on banks taking state aid, we were cautious on NDB Tier 1 bonds ahead of the ruling. However, even though the EC did impose a two-year dividend ban on NDB, it has been somewhat more flexible with the Landesbank than other banks which took state aid, in our view. Indeed, it accepted NDB's request to modify its Tier 1 bond documents and amend the sentence saying that it could not pay coupons if it was under a dividend ban. We suspect that this higher degree of understanding as regards to the bank may come from the fact that NDB did not need additional capital under regular stress tests or Basel 2.5 ratios; it only needed to reach the (somewhat arbitrary) 9% EBA ratio. We'd note that Monte is in a similar situation as its €3.3 billion shortfall under the EBA stress tests came solely from the sovereign buffer component of the tests.

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