Reacfin
Know-How to Risk

Seasonal Breakfast

Hybrid Capital Instruments :
Opportunities for larger and smaller financial Institutions

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Welcome

- Both the Banking and the Insurance regulatory frameworks foresee the possibility to account for some deeply subordinated debt as own funds.
- Who should consider it as an opportunity and in which circumstances?

- **Topics to be covered today**
    - What are rationale to consider hybrids?
    - What are hybrids? What are the difference between Tier 1 and Tier 2? Banks vs Insurance?
    - How are hybrids instruments considered for accounting, tax or rating purposes?
    - How can smaller institutions also issue hybrids (or how can you reduce issuance costs)?
    - What is the typical issuance process of hybrid instruments?
    - Currently prevailing market conditions and issuance activity

What are rationale to consider hybrids?

Hybrids : Somewhere between Debt and Equity

Equity :

Legal characteristics :

- Right to dividend (uncertain)
- Right to vote at GSM

Solvency characteristics :

- Permanence (perpetual)
- Loss absorption :
  - Most subordinated
  - Remuneration conditional and uncertain
  - Does not trigger bankruptcy

Economic characteristics :

- Cost of Equity
- Not tax deductible
- Impacting :
  - ROE (dilution)
  - EpS (dilution)
  - PE (indirect impact)

Hybrids :

Legal characteristics :

- Conditional right to interests
- No right to vote at GSM

Solvency characteristics :

- Permanence (long maturity or perpetual)
- Loss absorption :
  - Subordinated (various degree)
  - Remuneration subject to deferral or cancellation
  - No or reduced trigger to bankruptcy

Economic characteristics :

- Cost of Subordinated Debt
- Tax deductible
- Impacting :
  - ROE (no dilution)
  - EpS (no dilution)
  - PE (positive impact)

Debt :

Legal characteristics :

- Right to interests
- No right to vote at GSM

Solvency characteristics :

- Redeemable / repayable
- No loss absorption
- => Default triggers bankruptcy

Economic characteristics :

- Cost of Debt
- Not tax deductible
- No Impact on :
  - ROE (no dilution)
  - EpS (np dilution)
  - PE (no impact)

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What are rationale to consider hybrids?

Hybrids prove to be an efficient source of capital

- Hybrids offer some key economic benefits :
  - Hybrids may be considered as "Capital", reinforcing the solvency of the issuer
    - for regulatory purpose
    - for rating agencies
    - for equity and credit analysts or investors
  - Hybrids are cheaper than ordinary shares :
    - Cost of hybrid debt is systematically and significantly lower than the cost of equity
    - Interests are usually tax deductible
    - => tend to reduce the WACC (compared to equity issuance) and hence to improve valuation of the issuer
- Hybrid issuance favorably compares with equity issuance for control and financial metrics :
    - No dilutive impact on voting rights
    - No dilutive impact on RoE
    - No dilutive impact on EpS
    - => should positively influence PE compared to the same proceeds raised with new shares
    - *=> should positively influence rating and future cost of debt compared to the same proceeds raised with senior debt*
- Hybrid issuance allow a diversification of the investor base,

What are hybrids for Banks and Insurance companies?

Overview – Not Exhaustive

Tier 1 and Tier 2 instruments – Common features for both banks and insurance companies

Own-fund	While issued under the form of debt instrument (Notes, Loans, etc.) recognized, in all or in part, as belonging to the institution's own fund
Funding	Fully paid-up and not funded/purchased by the issuer nor its subsidiaries, etc.
Subordination	Deeply subordinated unsecured debt, ranking after all claims (but Tier 2 ranks before Tier 1)
Not Encumbered	Not connected to any other transactions (incl. no restrictions, fees, charges, etc.) and proceeds are immediately available
Callable	At the sole discretion of the issuer and subject to prior regulatory approval
Early redemption triggers	To the extent authorized by the regulatory framework • e.g. for Tax treatment & gross-up events, for regulatory events (capital qualification), for rating methodology events[†]

†) For insurance companies under Solvency II, Rating Methodology triggers will be ruled-our by upcoming revision of the Delegated Regulation approved by EU Commission on 8-March-2019 and under scrutiny until 8-June-2019

What are hybrids?

Tier One instruments

	Reacfin	Banks	Insurance Companies
	Denomination	Additional Tier One (aT1)	Restricted Tier One (rT1)
	Main European Regulation	**Capital Requirement Regulation EU575/2013** Title 1: Elements of own Funds Chapter 3 : Additional Tier One Capital	**Solvency II delegated regulation EU35/2015†** Title 1: Valuation and Risk-Based Capital … Section 1: Determination of Own Funds
Common Features	Maturity	Perpetual with no incentive to redeem allowed	
Common Features	Cancellations	Repayment/redemption and distribution may be cancelled at issuer’s discretion	
Common Features	Loss Absorbing	Must be immediately available to absorb losses on capital requirement breaches using loss absorbency mechanism (converted in equity, written down or equivalent mechanism)	
Common Features	Write-up*	With no obligations, only allowed using distributable profits and subject to maximum amount	
Common Features	Distribution	Paid out of distributable Items only, at the full discretion of the issuer, no obligation to substitute, no dividend pusher, cancellable without restrictions, etc.	
Common Features	First Call	After 5 years only	After 10 years only
	Triggers	CET1 / RWA ratio < 5.125%	Eligible Own Funds < SCR for 3 months Eligible Own Funds < 75% SCR Eligible Own Funds < MCR
	Limits	Theoretically unlimited†† Practical market standard: 15% of total Tier One	rT1 < 20% of total T1 with Total T1 > 50% of SCR and> 80% of MCR

†) Being modified by the amendments accepted by the European Commission on 8-March-2019 and under scrutiny until 8-June-2019
**) Applicable to instruments with write down mechanism only

††) see EBA Q&A: https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2013_19

Tier Two instruments

Reacfin	Banks	Insurance Companies
Main European Regulation	**Capital Requirement Regulation EU575/2013** Title 1: Elements of own Funds Chapter 4 : Tier 2 Capital	**Solvency II delegated regulation EU35/2015†** Title 1: Valuation and Risk-Based Capital … Section 1: Determination of Own Funds
Default	Non payment when due induces event of default	
First Call Date	At the earliest after 5 years	
Flexibility over repayment and distribution	-	Repayment of principal and / or payment of coupons may be delayed at issuer's discretion (with or without "Cumulative" coupons)
Maturity	Upper T2 is perpetual and ranks behind Lower T2 (>5y Maturity)	At least 10 years
(re-) Payment	-	Eligible Own Funds > 100% of SCR or MCR
Incentive to redeem	No step-ups or other incentives to redeem	Limited incentive authorized after 10 years (Step-up of max +100 bps or 50% spreads)
Regulatory Amortization	20% reduction in capital recognition in each of 5 final years to maturity	-
Eligible capital	Maximum up to 1/3 of Tier 1 *Eligible capital = T1 + Max (T2; T1 / 3)*	T2 + T3 < 50% of SCR T2 < 20% of MCR

†) Being modified by the amendments accepted by the European Commission on 8-March-2019 and under scrutiny until 8-June-2019

What are hybrids?

Principles of pricing – market practices

1-Market standard (for larger listed IG issuers): "Libor +" Proxying with other instruments

- Spreads (vs. equiv. swap rate) derived from market prices of comparable instruments recently issued by peers adapted for lump-spreads corrections to reflect structuring differences (considering then prevailing market conditions)

Illustrative examples for market standard Perp. Non-Call 10 structures issued by large A rated financial institutions

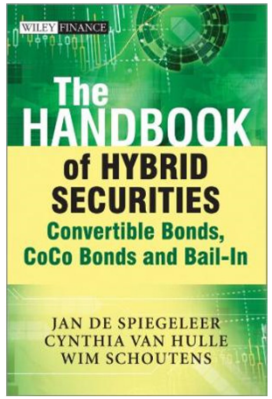
- **Maturity correction** (per year of 1st Call): 8-12 bp up to max 25bps
- **Rating Correction** (per rating Notch)**:** ~ 8-12 bp up to max 35bps
- **Liquidity Correction** (in function of size): ~2 bps per market "benchmark" size (EUR 500M)
- **First time issuer premium:** ~15-20bps (depending on issuer's size – the larger the cheaper)
- Etc.

2-RM practice & smaller institutions: Based on issuer's probabilities of default scales

- Comparable to method 1 but deriving the Maturity- and Rating Corrections from PD's rating scales (e.g. from rating agencies, implicit from asset swap, CDS, etc.)

3-Advanced (Trading & Academics): Option Pricing based

- Valuing each embedded option with the structure on the basis of option pricing models
- See for instance academic work by Pr. Wim Schoutens & Pr. Jan Despiegeleer (KUL)
  - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1795092
  - "The Handbook of Hybrid Securities: Convertible Bonds, CoCo Bonds and Bail–In", 2014, Wiley Finance



†) Being modified by the amendments accepted by the European Commission on 8-March-2019 and under scrutiny until 8-June-2019

How are hybrids instruments considered for accounting or tax purposes?

Key accounting aspects

IFRS

- **Classification challenge (Equity, Liabilities or compound instrument):**
  - Topic considered under IAS 32 ("Financial Instruments Presentation")
  - Depends on the **substance** of the instrument. Not on its legal form ➔ Key determining factors: **contractual obligations****
  - Classification as liability results in interest paid considered as expenses and charged to earnings (+ impact gearing ratio)
  - Equity = any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities
- **Key principles:**
  - Financial liability if it has contractual obligations for the issuer to deliver cash or other financial asset to the holder
  - Exception: For instruments that (could) settle in own equity instruments classification depends on whether the number of shares to be issued is fixed or variable
- **Our experience:**
  - For Tier 1, interpretation may materially differ from auditor to auditor, with the specific features foreseen in the instrument
  - Tier 2 are always considered as liabilities

Under IFRS, Tier 2 instruments are typically unquestionable liabilities. Most Tier 1 are also classified as liabilities but classification may be challenged by some auditors depending on the instrument features

Belgian Gaap

- **Usually always considered as liabilities**

How are hybrids instruments considered for accounting or tax purposes?

Key tax aspects in Belgium

Principles

- **Tax deductibility of distribution applies to debt instruments (interests) but not on equity instruments (dividends)**

- **Classification of hybrid instrument as debt or equity for tax purpose will depend on some characteristics of the financing instrument :**
  - Maturity (even if the perpetual nature does not trigger the equity classification per se)
  - Ability to repay the principal amount : the issuer must have the right to repay the principal amount of the debt. The convertibility into shares is a way to repay a loan or a bond
  - Distribution :
    - the payment has to be determined in advance and is not linked to the profitability of the issuer in order to get interest qualification
    - The payment is not at the sole discretion of the issuer
  - Accounting treatment : instrument qualified as debt according to Belgian GAAP

- **Deductibility is key to prevent withholding tax, as no withholding tax exemption is foreseen for dividend distribution**

How are hybrids instruments considered for accounting or tax purposes?

Tax treatment in Belgium

Reacfin	TIER 1	TIER 2
Subordination	=> **Acceptable**	
Accounting treatment in Belgian GAAP	Debt => **Acceptable (normal treatment)** *(NB : If treated as Equity* **=> *Attention point*** *)*	Debt => **Acceptable**
Sufficient duration	Undated => might be an **Attention point** (even if undated character is acceptable per se)	> 10 years maturity => **Acceptable**
Incentive to redeem	No incentive to redeem **=> Attention point**	Limited incentive => **Acceptable**
Opportunity to repay	After 10 years and between 5 to 10 years if sufficient solvency => **Acceptable**	After 5 years => **Acceptable**
Loss absorbency	Immediately available to absorb losses using loss absorbency mechanism (write-down, conversion or equivalent mechanism) => **Attention point**	May not be immediately available => **Acceptable**
Full flexibility over the distributions	Full discretion, no obligation to substitute, no dividend pusher, cancellable without restriction, etc => **Attention point**	Deferral allowed => **Acceptable**
In practice	***Several rulings have been obtained to support deductibility***	***Tax deductibility not challenged***

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What equity credit to expect from rating agencies?

Rating agencies treatment and requirements

- **Rating agencies have developed their own proprietary models to assess the solvency of banks and insurers. Those models embed tools to handle hybrid capital instruments**
- **Capital recognition**
  - Like for pillar 2 regulatory capital models, prospective available capital (e.g. S&P's Total Adjusted Capital [TAC]) is compared to required capital (e.g. S&P's Risk Based Capital [RBC])
  - Proportion of hybrid accounted for available capital :
    - may, like for regulatory capital models, be capped (e.g. S&P's tolerances for intermediate equity content) and proportion that exceeds regulatory qualifying capital is excluded
    - May, unlike regulatory capital models, only be partially recognized (e.g. Equity Credit in Fitch's Risk Based Capital Assessment model)
  - Tier 1 will typically be recognized, at least partially, but capped
  - Recognition of Tier 2 instruments is not systematic

- **Other impact**
  - Hybrids will be accounted for in assessment of financial leverage (in particular concertation of maturities & call dates)

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What equity credit to expect from rating agencies?

Rating agencies have developed their own methodologies to treat hybrid debt

- Typical treatment of hybrids by rating agency

Reacfin	S&P	Moody's	Fitch
Model	Risk Based Capital Model		PRISM
Equity Credit of Tier 1	50 to 100% (structure dependant) Capped at 25% of Total Adjusted Capital	50 to 75% (structure dependant) Capped at max 30% of Adjusted Equity	100% Capped at 20% of total Tier 1
Equity Credit of Tier 2	Up to 50%	Typically 0% with room for partial recognition	Typically 0% with room for partial recognition
Rating of Tier 1	4 notches lower 1 for subordination, 1 for loss absorption and 2 for interest cancellation	3 to 4 notches lower	4 notches lower 2 for recovery risk and 2 for moderate non-performance risk
Rating of Tier 2	2 notches lower 1 for subordination and 1 for interest deferral	1 or 2 notches lower	2 notches lower 1 for recovery risk and 1 for moderate non-performance risk

How can smaller institutions also issue hybrids?

Reducing the costs by considering loans private placements

Advantage of loan format

- Possibly **faster & easier**: No need to prepare full fledged prospectus & organize formal roadshow
- No **minimum "benchmark" size** (deals as of 100M can be considered)
- **Reduced fees** to third parties (less involvement of bankers, lawyers, agents, trustee, rating agencies, exchanges, Central Security Depositories, etc.)
- **No road-show costs**
- **Less "maintenance"** requirements than a marketable security (e.g. Publicity & notices to holders, etc.)

Challenges

- Private placement (**finding the investors**)
- Market consistent **pricing**

What is the typical issuance process of hybrid instruments?

- For all hybrids
- Marketable securities only
- Private placement (e.g. loans) only

Overview of the usual issuance timeline

Main steps - high-level overview only

Total: 15-25 weeks

Feasibility assessment — 2-4 Weeks
- Defining the type of hybrid
- High level economic assessment
- Internal approval process
- Hiring lawyers

Defining the term-sheet — 3-6 Weeks
- Defining the exact structure
- Validate accounting treatment with Auditors
- Refining pricing estimation
- Go/No Go decision

Writing the prospectus — 8-10 Weeks
Hiring the agents, trustee, book runners, etc.
2-3 Weeks
incl. prep. agreements

Roadshow — 1-3 Weeks
- Meetings with investors
- Finalizing pricing

Issuance & listing — 1 Week

6-10 Weeks
- **Regulatory approval request**
- **Submission for tax ruling**
- **Requesting a rating**

High level estimation. May widely vary considering the type of structure and activity of tax authority, regulator or rating agencies

6-12 Weeks
Private placement & agreement on pricing mechanism

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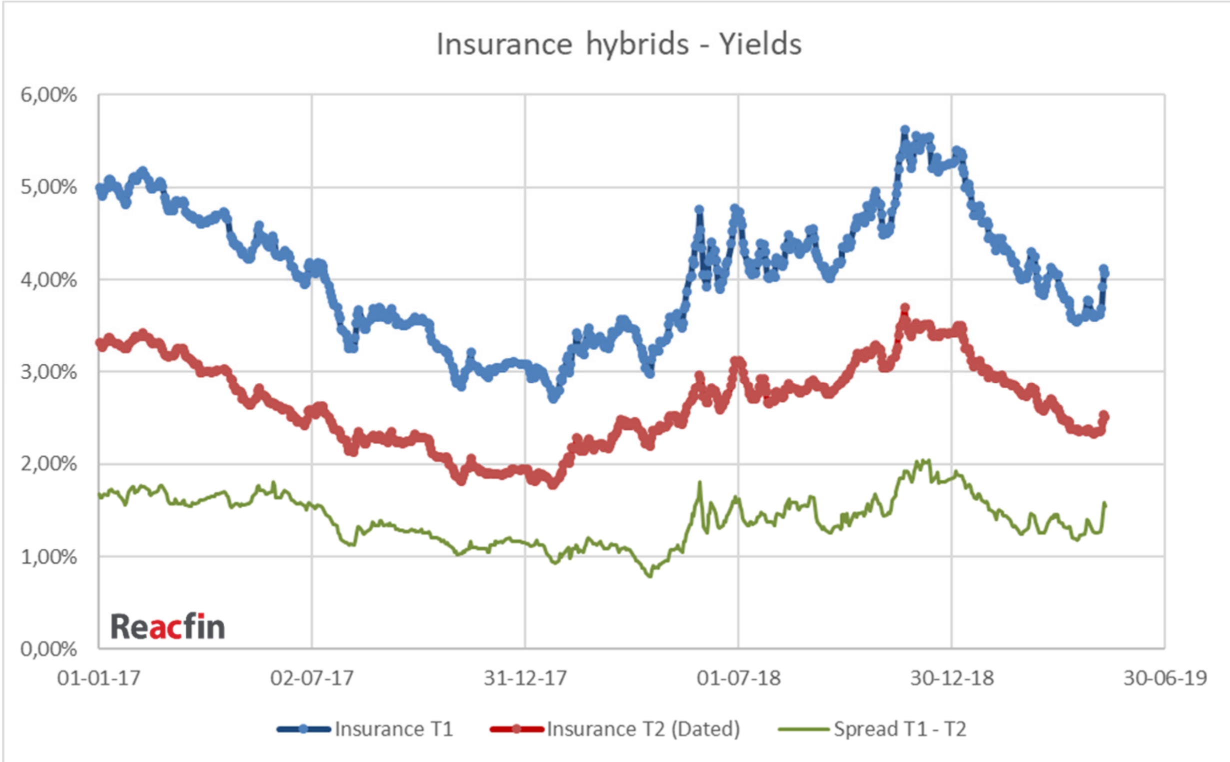
Currently prevailing market conditions and issuance activity

Insurance hybrids

- Changes in the regulatory requirements (mainly for restricted Tier 1) impact the gathering of consistent historical
- From an issuer point of view, the levels to be expected will be driven by (in order of importance) :
  - The tiering of the instrument (restricted Tier 1, Tier 2, …) as well as the specific structure and the details thereof
  - The idiosyncratic risk
  - The interest rate levels
  - The market momentum

- *<u>NB :</u> graph based on iBoxx Insurance Tier 1 (that include grandfathered T1) and dated Tier 2 yields. Bond remaining maturity is shorter than for a new issue.*
  These are general market indexes and not issuance levels



Source : Markit iBoxx

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Insurance hybrids – listed market

- Insurance Tier 1 activity has been significantly impacted by recent regulatory changes, with 12 issuances since the introduction of Solvency 2 in 2016, mainly from smaller companies. Several larger issuers recently prepared and even announced a transaction before withdrawing it
- Market has demonstrated a clear appetite, even for less known issuers and for size below benchmark

European Insurers alternative Tier 1 Market

Issuer	Currency	Amount (Mln)	Issue Date	Maturity	Initial Coupon	Coupon post call	Loss Absorbtion (*)	Interest deferral (**)	Call upon Tax, Regul or Rating Event	Substitution & Variation (***)
Gjensidige	NOK	1.000,00	08-09-16	Perp NC5	3M Nibor + 3,60%		WD with R	Non Cum - M & Opt	Yes	Abs
RSA	SEK	2.500,00	27-03-17	Perp NC5	STIBOR + 5,25%		CoCo	Non Cum - M & Opt	Yes	Opt - ex post
RSA	DKK	650,00	27-03-17	Perp NC5	*CIBOR + 4,85%*		CoCo	Non Cum - M & Opt	Yes	Opt - ex post
ASR	EUR	300,00	19-10-17	Perp NC5	4,625%	*5ys swap +* 3,789%	CoCo	Non Cum - M & Opt	Yes	Opt
Direct Line	GBP	350,00	07-12-17	Perp NC10	4,750%	*5ys swap + 3,394%*	CoCo	Non Cum - M & Opt	Yes	Opt
SCOR	USD	625,00	13-03-18	Perp NC11	5,250%	*5ys TB +* 2,370%	WD with R	Non Cum - M & Opt	Yes	Opt - ex post
IF P&C	SEK	1.000,00	22-03-18	Perp NC5	STIBOR + 2,75%		WD with R	Non Cum - M & Opt	Yes	Opt - ex ante
Phoenix	GBP	500,00	26-04-18	Perp NC10	5,750%	*5ys swap +* 4,169%	Permanent WD	Non Cum - M & Opt	Yes	Opt - ex post
Tryg	SEK	700,00	26-04-18	Perp NC5	3M Stibor + 2,5%		WD with R	Non Cum - M & Opt	Yes	Opt - ex post
VIVAT	EUR	300,00	19-06-18	Perp NC7	7,000%	*5ys swap +* 6,463%	Permanent WD	Non Cum - M & Opt	Yes	Abs
CNP Assurance	EUR	500,00	27-06-18	Perp NC10	4,750%	*5ys swap +* 3,914%	WD with R	Non Cum - M & Opt	Yes	Abs
Rothesay	GBP	350,00	09-12-18	Perp NC10	6,875%	*5ys swap +*	Permanent WD	Non Cum - M & Opt	Yes	Opt - ex post
Aegon	EUR	500,00	28-03-19	Perp NC10	5,625%	*5ys swap +* 5,210%	CoCo	Non Cum - M & Opt	Yes	Opt

(*) CoCo = Contingent convertible
WD with R = Write down with conditional discretionary reinstallment
Permanent WD = Permanent write down with no possible reinstallment

(**) Non Cum = non cumulative
M = Mandatory coupon cancellation
Opt = Discretionary coupon cancellation

(***) Opt = optionnal substitution
Ex ante = before an event
Ex post = at or after an event

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- Tier 2 market is deeper than restricted Tier 1, with more regular issuance activity
- Most recent Belgian public deal comes from Ageas with a benchmark 30NC10 deal and a coupon set at 3,25%

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Bank hybrids – listed market

- Bank hybrids are a larger and much diversified universe, but its evolution is relatively comparable to the evolution of the Insurance hybrid market, with relatively similar increase in regulatory requirements, inducing changes in the standard structures, in the evolution of investors' appetite and in the pricing of the structures

- From an issuer point of view, the levels to be expected will be driven by (in order of importance) :
  - The tiering of the instrument (additional Tier 1, Upper Tier 2, Lower Tier 2,…) as well as the specific structure and the details thereof
  - The idiosyncratic risk
  - The interest rate levels
  - The market momentum

- *NB : graph based on iBoxx Bank Tier 1 (that include grandfathered T1) and dated Tier 2 yields. Bond remaining maturity is shorter than for a new issue.*
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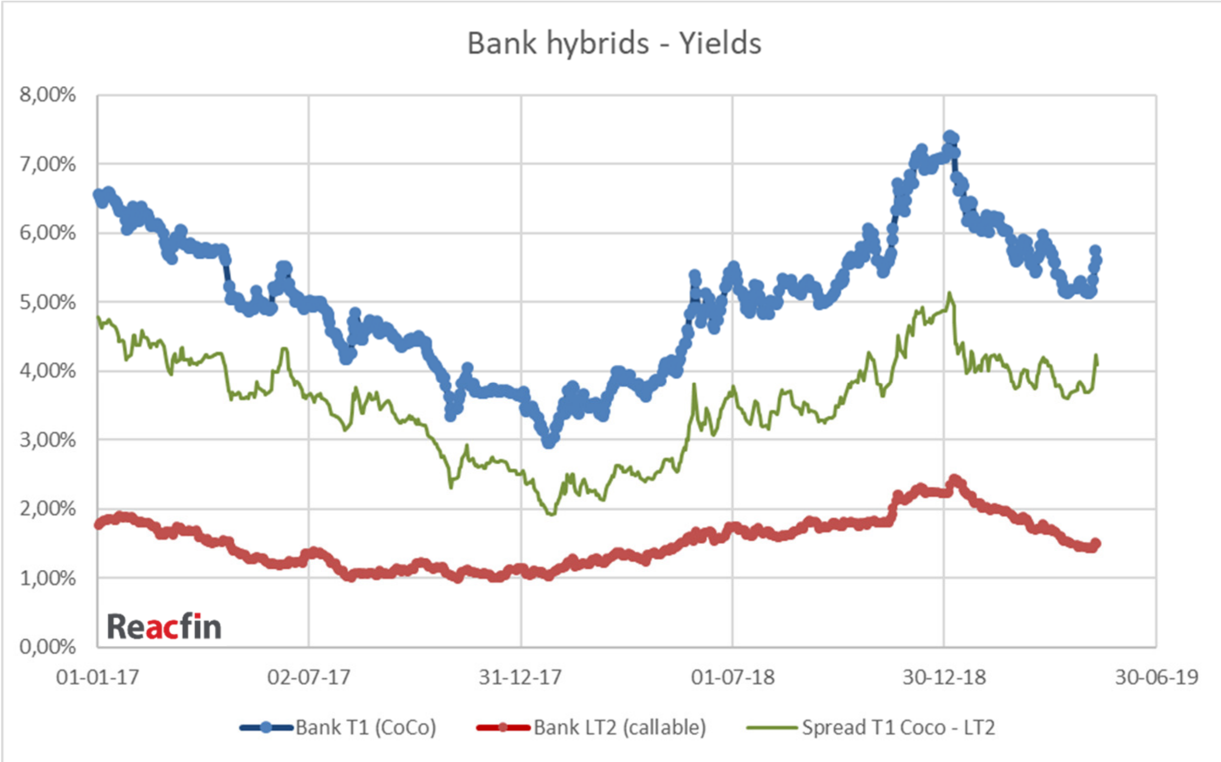

Source : Markit iBoxx

Typical attention points of investors

Investors’ perception of the market

- Hybrid debt market is a large market with diversified investors’ profiles
- It has experienced several evolutions :
  - Increased requirements for loss absorbing capacity
  - Doubts about the evolution of tax treatment in some countries (Netherlands, UK)
- The low interest rate levels have sustained the demand for Tier 1 and Tier 2 debt

- **Attention points for investors** include :
  - Overall market sentiment
  - Idiosyncratic risk :
    - Solvency
    - Rating (explicit or implicit rating)
  - Structuring :
    - Bond or loan, public or private placement
    - Currency, size and market (retail vs professional)
    - Maturity and call
    - Loss absorption mechanism
    - Deferral / cancellation mechanism and treatment
    - Dual trigger (for subsidiaries within FIG groups)

Reacfin’s support

Efficient solutions aligned with your best interest

What we do…

- Feasibility assessments and defining the solution
- Structuring your hybrid instrument and translating the solution into detailed term-sheets along market standards
- Pricing the structure
- Project management for your issuance process
- Accompanying you in your discussions with authorities (NBB, FSMA, CSSF, tax, etc.), auditors, exchanges, etc.
- Negotiating your arrangements with agents, trustees, book-runners, lawyers, etc.

… and why you should consider it

- Experienced staff with hands-on knowledge and proven track record, incl.

Pr. Jean Dessain: Former head of Capital & Funding at BNP Paribas Fortis, over 25 years structuring experience, professor at the IESEG (Paris & Lille)

Pr. François Ducuroir: Former head of Capital Solution at BNP Paribas Fortis and Director of Structured Solutions at Barclays, > 20 years experience, Prof. at the Univ. of Louvain and Namur

- Largely networked within the industry
- Working in your best interest as independent consultant
- At the cheaper cost of technical consultants

Giving you an access to best market practices for an affordable price

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