UniCredit

27 March 2017

Credit Research
Sector Flash

Non-preferred senior bonds compared to the HoldCo/OpCo approach

- We analyze the new type of senior non-preferred bonds and compares these new bonds to the HoldCo/OpCo approach of Swiss and UK banks.
- New banking bail-in regulation (TLAC and MREL) requires banks to issue a minimum amount of debt that can be bailed-in. MREL/TLAC-eligible debt instruments must absorb losses prior to liabilities excluded from MREL/TLAC. This requirement impacts the creditor waterfall in the event of a default and thus interacts with insolvency laws.
- There are three potential ways to fulfill the requirements:
  - **Contractual subordination:** The subordination of TLAC-eligible debt to instruments that are excluded is determined in the debt contract, just as is the case for subordinated bonds.
  - **Statutory subordination:** The subordination of debt is determined by the insolvency hierarchy as stipulated in the respective country's law.
  - **Structural subordination:** The subordination of debt is determined by the structure of the bank, i.e. when the debt is issued by a holding company (HoldCo), while excluded bonds are issued by an operating entity (OpCo).
- France has decided to implement the statutory subordination solution introducing "non-preferred seniors" as a new type of senior bond , which rank below senior preferred bonds in a resolution scenario. Spain will likely follow the French approach, but as no law has been passed there yet, Spanish banks can issue non-preferred bonds based on contractual subordination in the meantime (like Santander). This approach will likely be the future European approach after the European Commission proposed the partial harmonization of the European bank insolvency creditor hierarchy by introducing a preferred/non-preferred senior solution.
- **Spread performance:** We analyze the non-preferred senior bonds issued so far by French and Spanish banks and compare their pricing to outstanding HoldCo-OpCo spreads of banks in the UK and Switzerland.
- **Our spread expectations:** In our view, the spread development among non-preferred senior bonds of banks will likely be more volatile compared to senior preferred bonds. Over time, the expected loss of senior non-preferred bonds in the event of a resolution declines as more and more volume becomes outstanding. This might lead to a slight tightening of the spread between preferred senior debt and non-preferred senior debt.
- **Supply outlook:** We expect the largest volumes of subordinated senior bonds to be issued by French, Spanish and Nordic banks. We estimate the TLAC/MREL shortfalls to be EUR 93bn for the largest four French banks; EUR 91bn for the largest six Spanish banks; and EUR 48bn for Swedish banks (all values are valid until 2022).
- **Rating approach and expected rating development:** We analyze the rating approach of the external rating agencies and the expected developments of the ratings. While S&P and Fitch might upgrade the ratings of the senior preferred bonds, Moody's might upgrade the ratings of the senior non-preferred debt when more senior non-preferred bonds are being issued.

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Regulatory background

Introduction of BRRD as EU framework on bank resolution

As part of the post-crisis regulatory overhaul, the world's banking authorities introduced various tools to deal with failing banks. In Europe, the legal framework is the Bank Recovery and Resolution Directive (BRRD), which has been in effect since January 2015. One of its main building blocks for dealing with failing banks is the co-called bail-in tool, which was implemented in each EU member state in 2016 at the latest. According to the bail-in tool, debt instruments can be converted into equity, or the principle amount can be reduced partially or in full (also known as a senior bail-in). The tool applies to all liabilities that are not exempt, such as covered deposits and covered bonds. In order to ensure that banks have sufficient debt outstanding that is not exempt from a senior bail-in, the EU introduced Minimum Requirements for own funds and Eligible Liabilities (MREL). A similar concept that applies to global systemically important banks (G-SIBs) is the minimum standard for Total Loss-Absorbing Capacity (TLAC) for G-SIBs. While there are some important differences between TLAC and MREL (which is in the process of being harmonized with TLAC rules), their conceptual ideas are the same.

MREL and TLAC requirements

TLAC requires banks to have bail-in debt outstanding in the amount of 18% of risk-weighted assets (RWA) from 2022 onwards. A phase-in period starts in 2019, with a requirement of 16% of RWA. Additional requirements regarding the leverage ratio, i.e. the ratio with respect to total (unweighted) assets, apply. Furthermore, these numbers apply at a group level, while rules are in place to regulate how these requirements are broken down to subsidiaries.

Different ways to introduce bail-in-ability of seniors

TLAC-eligible instruments are, in general, all regulatory capital instruments (CET1, AT1 and T2) and particular debt instruments. TLAC-eligible debt instruments must fulfill several conditions, e.g. they must be paid-in, be unsecured and have a minimum remaining contractual maturity of at least one year or be perpetual. Moreover, TLAC-eligible debt instruments must absorb losses prior to liabilities excluded from TLAC. This requirement is a legally crucial issue, as it affects the creditor waterfall in the event of a default and thus interacts with insolvency laws. There are three potential ways for banks to meet these requirements:

- **Contractual subordination:** The subordination of TLAC-eligible debt to instruments that are excluded is determined by the debt contract, as is the case for subordinated bonds.
- **Statutory subordination:** The subordination of debt is determined in the insolvency hierarchy as stipulated by national law.
- **Structural subordination:** The subordination of debt is established by the structure of a bank, i.e. the debt is issued by a holding company (HoldCo), while excluded bonds are issued by an operating entity (OpCo).

Note that, in general, all senior unsecured bonds can be bailed in if necessary. The above-mentioned provisions just make sure that the subordinated ones are affected first. If the respective volume is not sufficient, debt that ranks higher can also be bailed in. In other words, senior bonds that are labeled as preferred can also be bailed in if necessary. They just rank senior to non-preferred ones. For more information, see our recent banking regulation update.

Implementation of bail-in differs in different jurisdictions

France has decided to implement the statutory subordination solution. The Sapin 2 law came into effect on 10 December 2016 introducing "non-preferred seniors" as a new type of senior. This new type of senior bond ranks below senior preferred bonds in a resolution scenario.

Spain will likely follow the French approach, but as no law has been passed yet, Spanish banks can issue non-preferred bonds based on contractual subordination in the meantime.

Banks in the **Switzerland and the UK** follow the structural subordination approach and Dutch banks have started to implement this approach, too. This means bail-in-able senior bonds are bonds issued by the holding company (HoldCo), while senior bonds issued at the operating company (OpCo) level are not considered as MREL/TLAC-eligible senior bonds.

The approach in **Germany** and **Italy** is different and includes preferential treatment of other senior claims against outstanding senior bond, which makes most outstanding senior bonds eligible for MREL/TLAC.

In the **Nordics** the approach is still developing. The Swedish regulator says it expects some form of subordination of seniors in the medium term. Nykredit in Denmark issued three senior resolution notes of aggregated EUR 1.5bn that are contractually subordinated. The 3 year senior resolution notes were priced at mid-swap plus 110bp compared to conventional three-year seniors, which trade at around 50bp (according to Reuters). This 60bp spread difference has declined significantly in the meantime to only to only 20bp.

BAIL-IN HIERARCHY AND SENIOR NON-PREFERRED BONDS ACCORDING TO BRRD

Secured claims	for example, covered bonds and covered deposits (i.e. deposits up to EUR 100,000)
Unsecured deposits of SMEs and natural persons	according to Art. 108 BRRD
Preferred senior liabilities	existing senior unsecured debt, derivatives and bank and wholesale deposits
Non-preferred senior liabilities	new senior non-preferred in France and Spain, senior resolution notes in Denmark
Subordinated debt	
Regulatory own funds (CET1, AT1 and T2)	

Source: UniCredit Research

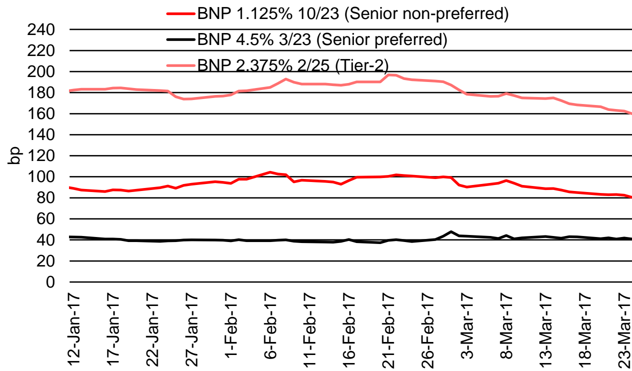
Pricing of senior non-preferred bonds

Spread performance of senior non-preferred bonds

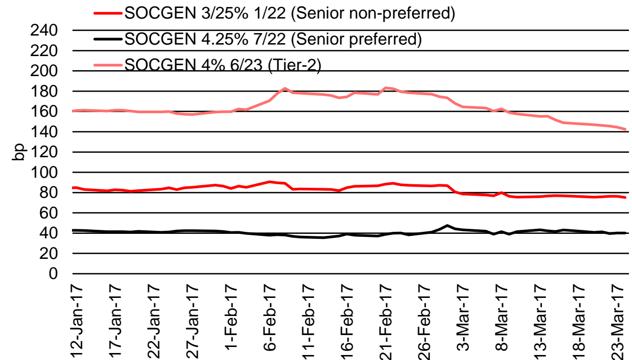
This section will look into the spread difference and performance of the new senior non-preferred bonds relative to senior preferred and Tier-2s. So far most of the new type of non-preferred seniors have been issued by French banks. As of 27 March 2017, the spread of senior non-preferred debt is around 35bp to 63bp wider than the spreads of comparable, preferred senior debt issued by French banks (see charts below). The spread difference has tightened significantly from its levels of early February. The spread difference between non-preferred and senior preferred debt issued by Santander is around 54bp. Santander issued a contractually non-preferred senior bond in January 2017, when the spread difference was still above 60bp. In our view, the spread development of non-preferred senior bonds will likely be more volatile than that of senior preferred bonds; This has already been seen in the last two months among French non-preferred senior bonds.

SPREAD DIFFERENCE OF SENIOR NON-PREFERRED RELATIVE TO OUTSTANDING PREFERRED SENIORS AND TIER-2s

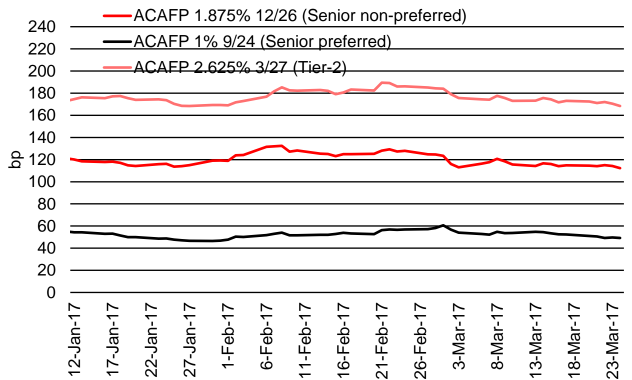
BNP PARIBAS



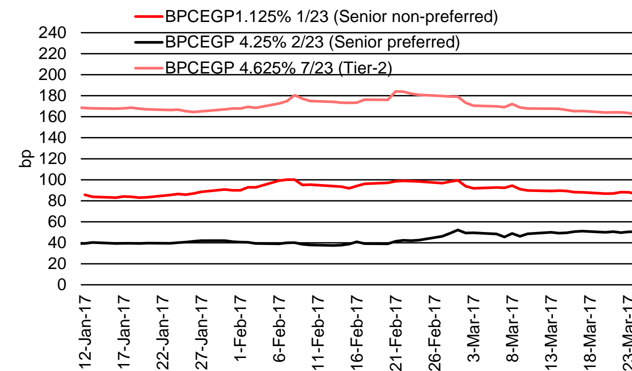
SOCIETE GENERALE



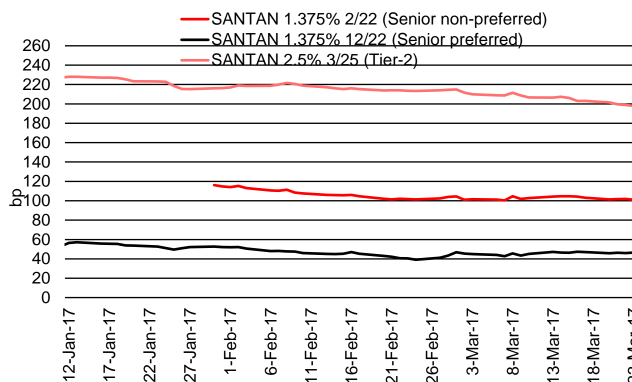
CREDIT AGRICOLE



GROUPE BPCE



SANTANDER



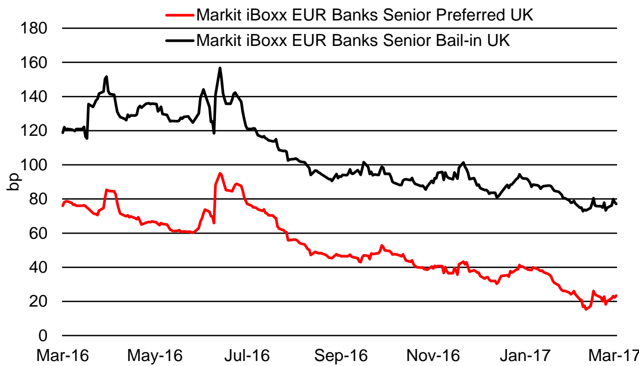
Source: UniCredit Research

Comparison of spread difference with HoldCo-OpCo spreads in the UK and Switzerland

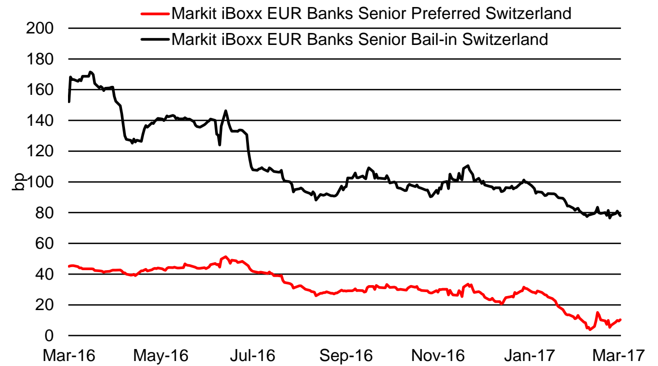
We analyzed the spread difference between senior bonds issued by HoldCos and OpCos in the UK and Switzerland using iBoxx data. As of 1 February 2017 there are now two new iBoxx indices that differentiate between these two bond categories: Senior Bail-In and Senior Preferred. As of 27 March 2017 the spread difference was 68bp for Swiss banks and 54bp for UK banks. While the spread difference has been constant over time in the UK, it has declined in Switzerland from levels above 100bp in early 2016.

SPREAD DIFFERENCE HOLDCO-OPCO SENIORS

HoldCo-OpCo Spread UK



HoldCo-OpCo Spread Switzerland



Source: UniCredit Research

Spread development expectation

Spread development expectation

Investor interest in the new asset class senior non-preferred/“Tier-3” bonds has been strong. Initial spreads have often settled in roughly twice as high as spreads associated with old-style senior unsecured bonds. However, some investors still deem initial senior non-preferred/“Tier-3” bond spreads as too similar to spreads associated with old-style senior unsecured bonds. For similar reasons, the focus remains largely on the primary market, and some investors have even taken up short positions. This has been further driven by Santander’s relatively generous spreads and expectations of significant future supply. Nevertheless, overall primary issues have been relatively well sought after.

In our view, the spread development of non-preferred senior bonds of banks will likely be more volatile compared to senior preferred bonds. The expected loss of senior non-preferred bonds of French and Spanish banks in the event of resolution will decline over time, as more volume is issued and outstanding and the Loss Given Default (LGD) decreases as it is distributed over this larger volume. This might lead to rating upgrades of senior non-preferred bonds and a slight tightening of the spread between preferred seniors and non-preferred seniors.

Relative value ideas

Regarding monetizing on the new investment landscape, we have developed three different coordinate systems along different axes:

1. Relative value between issuers from **countries with different approaches,** such as **(1)** the senior non-preferred/Tier-3 approach in France and Spain vs. **(2)** the HoldCo approach in the UK and Switzerland, and increasingly among Benelux names such as KBC, ING vs. **(3)** the approaches in Germany (general statutory subordination of senior unsecured bonds) and Italy (general depositor preference).
   - **HoldCo issues** may be more attractive given expected **larger volumes that reduce future Loss Given Failure (LGF) among HoldCo debt** (especially from HSBC, Credit Suisse, Barclays and UBS). This is because all OpCo debt will likely be switched into HoldCo debt, either by replacing maturing debt or via tenders.
   - This stance could by supported by expected less supply, as issuers may want to **wait for legal clarity and the anticipated new EU-wide legislation (likely in 2018, in our view) regarding an EU-wide new category of subordinated senior unsecured bonds.**

- Consequently, as **old-style senior unsecured bonds are likely to remain a potential future funding source, LGF is likely to be spread across a somewhat smaller volume of senior non-preferred bonds** from the respective issuer, reducing the likelihood of more favorable relative ratings.
- On the other hand, the so-far positively viewed argument of **larger expected volumes** of HoldCo debt could be reversed, potentially leading to **relative pricing pressure for HoldCo debt.**
- **Outstanding German senior unsecured bonds** are a special case, as – since January 2017 – they have been subordinated to various types of other senior debt and to all deposits. Assuming that this debt will be generally **"grandfathered as subordinated debt"**, this debt would likely become less attractive if new EU-wide legislation (likely in 2018) regarding a new EU-wide category of subordinated senior unsecured bonds were to again allow senior preferred debt.
- **A similar case cannot be made for Italian debt, as the general depositor preference is only set for 2019** and there would therefore likely be no need to deal with outstanding subordinated debt as in Germany – assuming the new EU-wide legislation regarding a new EU-wide category of subordinated senior unsecured bonds occurs in 2018. .
- Another argument in favor of HoldCo debt is that many US investors are familiar with this concept (as witnessed in the Deutsche Bank earnings/investor call, for example) as opposed to the other models and that **portfolio mandate restrictions and ECB eligibility** often only allow for senior debt to be eligible, which may hence allow for Holdco, but potentially not for senior *non-preferred* /"Tier-3" debt.

Overall, we have a slight preference for HoldCo debt from this coordinate system perspective.

2. Relative value between issuers from countries with similar approaches, such as **(1)** between countries that have the senior non-preferred/ Tier-3 approach (France and Spain) or **(2)** between countries that have the HoldCo approach (e.g. the UK and Switzerland and increasingly Benelux names, such as KBC and ING), or **(3)** between countries that have some form of statutory (or to that effect economic) subordination of senior unsecured bonds (e.g. Germany with a general statutory subordination of senior unsecured bonds & Italy with a general depositor preference).
   - This approach could be characterized by arguing in favor of **Spanish names vs. French names,** given the relatively generous and lower expected supply compared to French names, for example, especially **BNP**.
   - On the other hand, assuming a constructive approach regarding the upcoming French presidential election, one could **"go long" France** - and here we like BNP (please see coordinate system 3 below) – **vs. tighter regions, such as Nykredit or the UK.**
   - Yet another, more conservative approach, would be to choose **Swiss names as safe-havens among the HoldCo countries vs. not only French names, but also issuers from the UK,** given looming Brexit uncertainties and ongoing litigation/conduct and restructuring issues .
3. Relative value between issuers from within the same country, focusing on idiosyncratic fundamentals.

   France is currently in the spotlight due to the uncertain outcome of the French presidential election and the significance and size of France for Europe's future. While it could be argued that the large expected volumes of announced senior non-preferred bonds compared to French peers could put pricing pressure on outstanding senior-non-preferred bonds, larger volumes of senior non-preferred bonds would reduce the LGF for such bonds, likely leading to better ratings. Also, regardless of the outcome of the presidential elections, **BNP is the largest French bank, whose solid fundamentals would, in our view, likely weather short-term market volatility.**

Supply outlook senior non-preferred

French, Spanish and Nordic banks will be large issuers of subordinated seniors

We expect the largest volumes of subordinated senior bonds to be issued by French, Spanish and Nordic banks. We estimate the TLAC / MREL shortfalls to be EUR 93bn for the largest four French banks, EUR 91bn for the largest six Spanish banks and EUR 48bn for Swedish banks (all values until 2022). As of 27 March 2017, a total of EUR 16.7bn of senior non-preferred debt had been issued by French banks, and EUR 1.85bn had been issued by Santander.

French and Spanish banks

The four largest French banks are all classified as G-SIBs and therefore have to fulfill TLAC requirements. In Spain, only Santander is classified as a G-SIB. The 16% TLAC requirement has to be met as of 1 January 2019. Therefore, large issuance is to be expected from French banks and Santander in 2017 and 2018. The following table outlines our estimate based on data from year-end 2016. We estimated that the four largest banks will face a TLAC shortfall of EUR 93bn until 2022 and that Santander would face a TLAC shortfall of EUR 45bn over the same period. Including other large Spanish banks, which have to fulfill MREL, we estimate the TLAC/MREL shortfall of Spanish banks to be EUR 91bn.

ESTIMTAED TLAC SHORTFALLS FOR FRENCH AND SPANISH G-SIBs

	BNP Paribas		Credit Agricole		BPCE		Societe General		Santander	
	2019	2022	2019	2022	2019	2022	2019	2022	2019	2022
Total requirement (TLAC w/o buffer)	16.0%	18.0%	16.0%	18.0%	16.0%	18.0%	16.0%	18.0%	16.0%	18.0%
Buffer requirements	4.5%	4.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Total requirement (EUR bn)	20.5%	22.5%	19.5%	21.5%	19.5%	21.5%	19.5%	21.5%	19.5%	21.5%
Risk weighted assets (EUR bn) as of 4Q16	641	641	521	521	391	391	355	355	588.1	588.1
Total capital (EUR bn) as of 4Q16	91.0	91.0	96.5	96.5	72.3	72.3	63.3	63.3	81.6	81.6
Current total capital ratio as of 4Q16	14.2%	14.2%	18.6%	18.6%	18.5%	18.5%	17.9%	17.9%	13.87%	13.87%
Estimated TLAC shortfall in %	6.3%	8.3%	0.9%	2.9%	1.0%	3.0%	1.6%	3.6%	5.63%	7.63%
Issuance gap to fill (EUR bn)	**40.4**	**53.2**	**4.7**	**15.1**	**3.9**	**11.7**	**5.7**	**12.8**	**33.1**	**44.9**

Source: companies' financial statements, UniCredit Research.

Issuance plans for French and Spanish banks

The following table summarizes the announced senior non-preferred issuance plans for 2017 and 2018 of the four French banks and Santander.

PLANNED ISSUANCE VOLUME OF SENIOR-NON-PREFERRED IN 2017 AND 2018

Bank	2017	2018
Credit Agricole	EUR 3bn	EUR 3bn
BNP Paribas	EUR 10bn	EUR 10bn
Societe Generale SA	EUR 3bn	EUR 3bn
BPCE	EUR 2.5bn	EUR 2.5bn
Santander	EUR 12-14bn	EUR 10-12bn
Sum	EUR 30.5-32.5bn	EUR 28.5-30.5bn

Source: company presentations, Bloomberg, Reuters, UniCredit Research

TLAC / MREL shortfall Nordic banks

Banks in Sweden are to become another large issuer of subordinated senior debt. The Swedish National Debt Office (SNDO) is the Swedish bank resolution authority and in charge

of the MREL-regulation.

The SNDO published its proposal in February 2017 stating that MREL-liabilities should be subordinated. The SNDO has decided to take the TLAC agreement and the implementation proposals presented by the European Commission in November 2016 into account in its policy positions on MREL. Swedish MREL requirements will include two components:

- The loss absorption amount (going-concern): component to cover potential losses, which has to be met with capital instruments. Loss absorption amount shall be equivalent to the firm's total capital requirements without taking account of the Basel I floor, excluding the combined buffer requirement and, where applicable, macro-prudential elements within the pillar 2 requirement.
- The re-capitalisation (gone-concern) component to re-capitalize the bank once the losses have been absorbed, which has to be met with MREL-eligible debt instruments. The recapitalization amount shall be equivalent to a bank's total capital requirements, excluding the combined buffer requirement.

The MREL requirements will take effect during a five year transition period. The exact amount of MREL will be determined in 4Q17. Starting 1 January 2018 banks must progressively build up the volume of subordinated liabilities required to meet the minimum requirement by 2022.

We estimate the funding requirement of the four largest Swedish banks to be approximately EUR 48bn (see table below, calculated with 4Q16 data). This implies that there is a high issuance requirement of subordinated senior bonds in the next years. We estimate Swedish banks have a sufficiently large existing debt stock, but need to replace existing senior unsecured debt with subordinated senior debt in order to meet the MREL eligibility criteria over time. The banks will probably issue senior non-preferred debt, although the SNDO proposal did not give much detail on the requirements besides referring to the subordination requirement.

The SNDO discussed the three possible ways to subordinate senior liabilities (structural, statutory or contractual subordination). The SNDO has not specified the type of subordination it recommends, as there are obstacles to all three possibilities.

- Structural subordination cannot be achieved without a major reorganization of Swedish banks, because none of the major Swedish banks is currently organized in a holding company structure.
- Statutory subordination entails a special debt category that by law is subordinated or has lower priority than ordinary non-prioritized debt, but has higher priority than own-funds instruments and other subordinated liabilities (such as non-preferred seniors in France). The SNDO stated that introducing such a special debt category is not currently possible under Swedish law. However, this solution is likely to be introduced in the longer term in order to be aligned with the proposals of the European Commission to harmonize insolvency hierarchies in Europe.
- Contractual subordination refers to contractual conditions in the debt instruments stating that they are subordinated to other liabilities. The ability to issue contractually subordinated liabilities is currently limited because the contractual terms of some existing Tier 2 capital instruments prevents the issuance of subordinated liabilities with a higher priority than these Tier 2 instruments.

In principle, the SNDO's position is that structural and statutory (insolvency law) subordination are preferable solutions compared to contractual subordination. This is because the former two have advantages, both in terms of legal status and market functionality.

We view this amount as manageable for the banks. For instance, the outstanding volume of seniors of the four banks in the iBoxx is EUR 219bn and the EUR 48bn would require to refinance over the next five years around on fifth of the outstanding senior debt with new type of senior subordinated bonds.

ESTIMATED TLAC/MREL SHORTFALL FOR SWEDISH BANKS

	Nordea	SEB	Svenska Handels-banken	Swedbank	
Total capital requirement in % of RWAs as of 4Q16	22.4%	21.6%	27.4%	27.0%	
Total capital ratio as of 31 Dec 2016 in %	24.7%	24.8%	31.4%	31.8%	
Systemic risk buffer as of 4Q16	3.0%	3.0%	3.0%	3.0%	
Countercyclical capital buffer as of 4Q16	0.6%	0.7%	0.9%	1.0%	
Capital conservation buffer as of 4Q16	2.5%	2.5%	2.5%	2.5%	
Estimated recapitalization amount (requirement of MREL liabilities in % of RWAs); total capital requirements, excluding the combined buffer requirement	16.3%	15.4%	21.0%	20.5%	
Risk weighted assets (RWAs) in bn EUR as of 4Q16	133.2	63.7	47.9	33.0	**Sum**
MREL shortfall in bn EUR	**21.7**	**9.8**	**10.1**	**6.8**	**48.4**

Source: companies' financial statements, Swedish National Debt Office, Finansinspektionen, UniCredit Research.

In Norway and Denmark, no final decision has been made yet as to whether or how much of eligible MREL instruments will need to be subordinated. Therefore, the expected supply is difficult to estimate. However, we expect to see at least some subordination requirements and upcoming issuance of subordinated seniors in these two countries as well.

External ratings of senior non-preferred bonds

S&P's ranks senior non-preferred bonds one notch below the stand-alone credit profile

In S&P's view, holders of senior non-preferred bonds face a higher default risk than holders of senior preferred notes and of other senior liabilities, as senior non-preferred notes would be bailed-in before more-senior creditors in the event of a resolution under the BRRD. Therefore, S&P's ratings differ for senior preferred and senior non-preferred debt. According to its bank hybrid criteria, the ratings of senior non-preferred debt are usually one notch lower than a bank's stand-alone credit profile (SACP) as long as the SACP is in the investment-grade category (bbb- or higher). This reflects that senior non-preferred bonds are subordinated (even if they are not labeled as such) to more senior obligations. In addition, S&P believes that non-preferred senior notes would be subject to a possible conversion or a write-down only in a resolution. In particular, S&P is of the opinion that the proposed notes would be excluded from any burden-sharing under state-aid rules. Therefore, no further notching from the SACP is applied – because S&P believes that senior non-preferred notes do not carry any additional default risk relative to that represented by the SACP assessment. Finally, senior non-preferred bonds are eligible for inclusion in S&P's calculation of a bank's additional loss absorbing capacity (ALAC), which is part of S&P's rating methodology and consists of certain bank hybrid capital instruments and other liabilities (such as non-operating holding company debt in some jurisdictions) that can absorb losses of a bank at or near non-viability, e.g. in the event of a bank resolution, in a way that reduces the risk of the bank's defaulting (according to S&P's definitions) on its senior unsecured obligations.

S&P'S CURRENT STANDARD RATINGS

	BNP Paribas	Societe Generale	Credit Agricole	BPCE	Santander
Senior unsecured	A	A	A	A	A-
ALAC support	none	one notch	one notch	one notch	none
SACP	a	a-	a-	a-	a-
Senior non-preferred	A-	BBB+	BBB+	BBB+	BBB+

Source: S&P, UniCredit Research.

Moody's currently rates senior non-preferred debt one notch below its baseline credit assessment

Moody's rating approach is centered around an expected-loss methodology. Aside from the probability of failure, it also incorporates the severity of a loss when failure occurs. Moody's takes into account three factors for its rating of senior non-preferred bond issues: **1.** the adjusted baseline credit assessment (BCA) of the issuer; **2.** the agency's advanced LGF analysis, which evaluates the estimated severity of a loss in the event of the bank's failure; **3.** Moody's assumption of a low probability of government support for this new instrument, resulting in no rating uplift. As most issuers have only just started to issue these types of bonds, and as no large outstanding stock is available, the LGF analysis indicates a high loss severity for these instruments in the event of a bank's failure, leading it to assign a one-notch lower rating than the bank's adjusted BCA (see table below).

CURRENT MOODYS'S RATINGS

	BNP Paribas	Societe Generale	Credit Agricole	BPCE	Santander
Senior Unsecured	A1	A2	A1	A2	A3
Adjusted BCA	baa1	baa2	baa1	baa2	baa1
Senior Non-Preferred	Baa2	Baa3	Baa2	Baa3	Baa2

Source: Moody's, UniCredit Research

Fitch equalizes the senior non preferred bond's rating with the issuer default ratings

The ratings assigned to banks reflect the specific components of bank credit. Viability ratings (VRs) capture a bank's intrinsic creditworthiness, while its support rating (SR) and support

rating floor (SRF) reflect the likelihood of its receiving external support if need be. A bank's issuer default ratings (IDRs) and issue ratings are derived from the VR and SRs. Fitch usually rates senior unsecured debt similarly to the IDR. The rating agency currently rates senior preferred and senior non-preferred debt at the same level. Fitch believes the difference in default risk between preferred and non-preferred senior debt will initially be very small, and this does not justify Fitch's differentiating between its ratings. This view might change once a bank has larger buffers of non-preferred senior and junior debt.

CURRENT FITCH RATINGS

	BNP Paribas	Societe Generale	Credit Agricole	BPCE	Santander
Senior unsecured	A+	A	A	A	A-
VR	a+	a	a	a	a-
IDR	A+	A	A	A	A-
Senior non-preferred	A+	A	A	A	A-

Source: Fitch, UniCredit Research.

Expected rating development

S&P takes senior non preferred debt into account for its ALAC calculation. A build-up of a significant amount of ALAC material might lead to upgrades of the senior unsecured rating over the medium term. One indicator is the positive outlook assigned to the senior debt of Santander in February, when S&P referred to the planned build-up of EUR 22-26bn of second-ranking, senior unsecured debt instruments by the end of 2018. This issuance of ALAC material over the next two years will likely be substantial and reduce the default risk of more-senior obligations in case of a resolution. BNP Paribas will be another candidate for an upgrade of its senior non-preferred debt, although not in the next 12 months and more likely over the medium term. The other three French banks have already incorporated a one-notch ALAC uplift.

Moody's LGF approach will usher in one-notch upgrade potential over time for senior non-preferred bonds. According to Moody's advanced LGF notching guidance, and compared to the adjusted BCA, the volume of the outstanding senior non-preferred bond is one factor that determines notching relative to the adjusted BCA. In its LGF analysis, Moody's currently takes into account only the planned issuance of senior non-preferred debt for the next 12 months. Moody's however issued a request for comment in March (*Request for Comment on Forward Looking Loss Given Failure,* published on 23 March 2017) and plans to extend the forward looking period to a two-to-three-year horizon. If these proposals were to be introduced, a one-notch uplift of the current senior non-preferred ratings for rated G-SIBs would be possible already shortly.

Fitch expects its ratings of senior preferred debt to be upgraded by one notch over time. Fitch requires a high burden of proof to adjust its ratings of senior debt one notch higher than a bank's IDR. A build-up of senior non-preferred notes could result in a level of protection for senior preferred notes, justifying a one-notch higher long-term rating than the bank's IDR and non-preferred senior-debt ratings. For the senior preferred notes to achieve a one-notch uplift, the buffer of qualifying junior debt and non-preferred senior debt would need to exceed Fitch's estimate of a "recapitalization amount". This amount is likely to be around, or above, a bank's minimum Pillar-1 total capital requirement.

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Company	Date	Rec.	Company	Date	Rec.	Company	Date	Rec.
ACAFP	03/02/2017	Marketweight	BPCEGP	10/01/2017	Restricted	SOCGEN	03/11/2016	Marketweight
ACAFP	28/12/2016	Restricted	BPCEGP	11/05/2016	Marketweight	SOCGEN	16/08/2016	Restricted
ACAFP	12/05/2016	Marketweight	NYKRE	13/05/2016	Marketweight			
ACAFP	07/04/2016	Restricted	SOCGEN	03/02/2017	Marketweight			
BPCEGP	03/02/2017	Coverage in transition	SOCGEN	14/12/2016	Restricted			

Overview of our ratings

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