The Revolver

Cocos: Investors call for standardisation, more consistency

Like for British marmite, opinions on contingent capital differ wildly – some love them for the yield and the dislocations the market offers, while others dislike them and do not even consider them as bonds. But does everyone understand these products and their complexity? And what are the risks the market faces if a trigger event or a coupon deferral occurs? What should regulators do to make contingent capital more investable? We asked investors to share their views with a short survey, and over 150 responded – coco buyers and not. The results are exciting and worrying at the same time. We present here a summary of their thinking.

Yield and **the lack of alternatives** are the two main reasons why people buy contingent convertible instruments (cocos). Only a quarter of the buyers think the instruments are fundamentally cheap relative to their risks.

What investors look at when buying a coco, in order of importance, are:
1. Fundamentals of the issuing bank
2. Distance from the trigger point
3. Whether there is risk of coupon deferral and the type of conversion, and
4. Past volatility and the liquidity of the instrument.

Systemic risk: the market is vulnerable to a coupon deferral or conversion. Investors believe the market will face a harsh test when the first coupon deferral or conversion occurs. They expect prices across the market to drop by around 9%, and to face an even stronger drop with a conversion of -15%. Roughly half of the survey respondents think that the lack of knowledge among investors, high complexity of the product and the negative convexity of the risk-return profile all pose potential risks to the whole market.

Hubris: most investors think they know the market better. We asked investors to rate their understanding of cocos relative to the rest of the market. Interestingly, hedge funds rated themselves the most knowledgeable, vs for example, pension funds. The survey showed investors are slightly guilty of hubris, with 90% of respondents rating themselves higher than the market. They cannot all be right.

Investors call for greater standardisation from regulators. Many open comments from investors called for standardisation of cocos. Many also pointed out that the unclear mechanics on coupon deferral or triggers could effectively subordinate cocos to equity, or create a situation were a "rogue bank" would be encouraged to trigger a coco in a *gamble to resurrection*. We too have flagged this concern previously in the recently published article in the *Financial Times* (Regulators must act on coco bond risks). To best represent the voice of investors, we have decided to publish their entire comments in this research report.

Our view: be long but selective. Our empirical models show that the coco market is not pricing all existing risks, particularly the risk of conversion (The Revolver | Coco Loco: The Systemic risks of contingent capital, 14 April 2014). Cocos should continue to perform well on bank deleveraging and recapitalisations, in our view, and on an improving economy in Europe. However, we think investors should be selective – preferring bonds of commercial banks (eg. BBVA, SocGen) to those of investment banks that have a high percentage of revenue from trading (eg. Barclays, DB).

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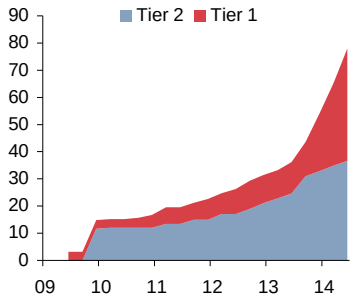
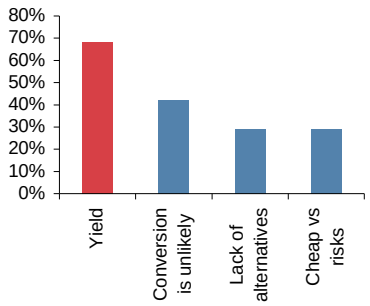
A yield gamble or an opportunity?

Getting close to €100bn
Size of coco issuance, €bn



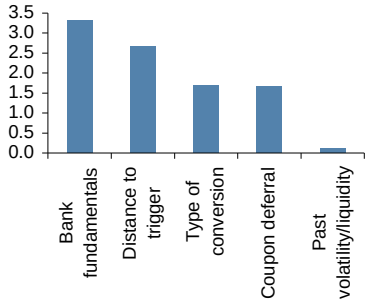
Source: RBS Credit Strategy, Bloomberg

Why are you buying cocos? Yield



Source: RBS Credit Strategy

What's most important in a coco
Investor ranking of coco features



Source: RBS Credit Strategy

"The last coco will be issued before the first one is triggered."
~ US real money manager, 2013

"There's little probability of a trigger event, therefore cocos should trade like senior."
~ European hedge fund manager, 2014.

Who is right? We decided to ask investors themselves, and over 150 clients responded. As the Romans said, vox populi, vox dei.

Contingent capital instruments are growing fast – the total size of AT1 and T2 bail-in bonds outstanding has reached just over €77bn, including the last two from UBS and Santander. Deutsche Bank is also planning an issue shortly, while other banks are likely to join the trend. For banks, new capital requirements, and in particular Basel's new leverage ratio, are a reason why cocos are attractive. They are also tax deductible, and cheaper than the return on equity required by shareholders.

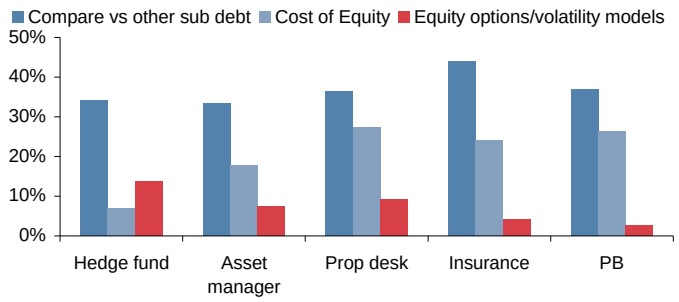
Searching for yield. For investors, cocos offer an answer to the ongoing search for returns that characterise credit markets in today's environment of zero real interest rates. Yield is in fact the main reason why investors buy cocos (left), according to our survey. Around 40% of respondents believe that a conversion is unlikely, while one-third buy cocos because of the lack of alternatives. Very few – only a quarter – buy cocos because they think cocos are fundamentally attractive relative to the risks.

The search for yield has indeed rewarded investors who bought cocos: AT1s returned around 7% to date and T2 cocos around 6%. Spread compression will continue, in our view, and high risk debt will continue to perform well. But what are the risks and features investors look at when buying cocos?

The most important features. The fundamentals of the issuing bank and the coco's distance from the trigger are the two most relevant features investors care about when buying (left). So far, this makes sense, although very few investors appear concerned about the past volatility or liquidity of these instruments. This, however, could be a surprise going forward – especially if a coupon deferral or conversion occurs.

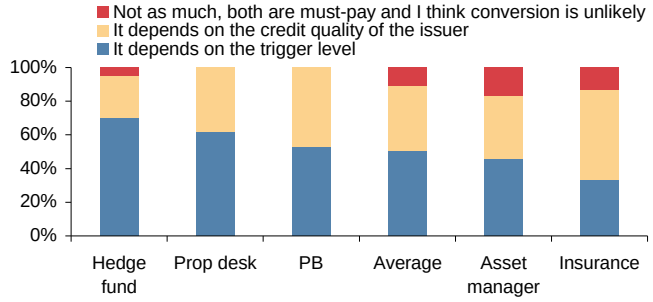
Given these features, how do investors value cocos? Our survey results suggest that investors look at cocos in very different ways. The majority use other sub debt instruments as a comparison, applying relative value analysis. Few – mainly hedge funds – use more complex models based on equity options or volatility, as shown above. Hedge funds care the most about trigger levels and the bond's characteristics, while asset managers or insurance companies seem to worry more about fundamentals, for example when differentiating between an LT2 bond and a T2 coco.

How do you value cocos?



Source: RBS Credit Strategy

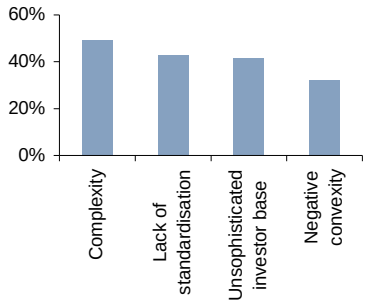
How do you differentiate an LT2 bond from a T2 coco?



Source: RBS Credit Strategy

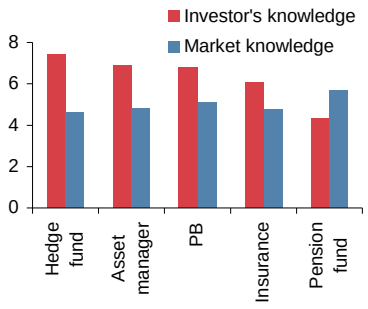
Waiting for the test of fire

Biggest risk: complexity
What's the biggest risk for the market?



Source: RBS Credit Strategy

Always smarter than you
Investors' rating the market's understanding of cocos vs their own



Source: RBS Credit Strategy

There's some hubris among coco investors: everyone thinks they're smarter than the market. Investors think complexity is the biggest risk to the market (left) and generally recognise that their knowledge of coco instruments may not be complete. When asked to rate their understanding (on a scale of 1-10, with 10 being most knowledgeable), they generally rated themselves between 6 and 8, which would get them only a pass at school, and not a top grade. Almost all respondents, however, felt they were smarter than the rest of the market (except for the pension funds). They can't all be right.

Heavy losses for the whole market if a coupon deferral or conversion occurs. Despite their limited concerns on volatility and liquidity, many investors appear worried about the market's reaction to the first coupon deferral or trigger. On average, investors expect a 9% drop for cocos across the board on the first deferral of coupons, and a 15% drop in prices for a conversion. That said, we capped the possible answer to a 20% drop upon a conversion, and it is likely that some investors may have opted for an even steeper drop if they had the option – as can be seen from the chart on the lower right. The least worried of all were pension funds, which estimated a 7% loss on coupon deferral vs hedge funds, which forecast the highest at a 10% fall.

Open questions for regulators

Given these observations, it is clear that the market would benefit from greater standardisation of coco features and from greater clarity. There are several open issues, including:

1. Uncertainty about the coupon deferral mechanism, which could potentially put coco-holders in a worse position than shareholders.

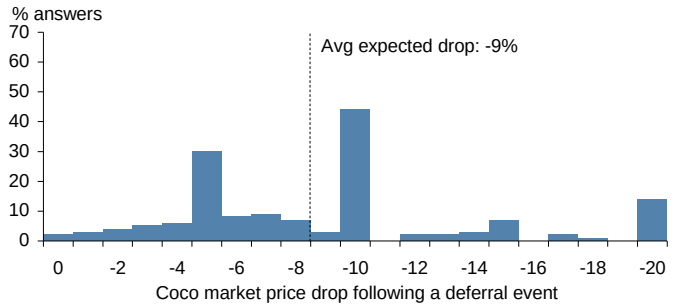
2. Uncertainty about conversion mechanisms and points of non-viability.

3. Moral hazard, especially from permanent-conversion cocos: an investor mentioned the case of a "rogue bank" triggering and hurting bondholders before raising equity.

4. Misalignment between cocos and shareholders' risk-return function: equity-convertible cocos are the most aligned, but they are also the least liked by fixed income investors, who can't hold equity. Temporary write-down instruments appear to be the best compromise – but some investors are sceptical about the mechanics and timing of a write-up, which is often at the discretion of the issuer.

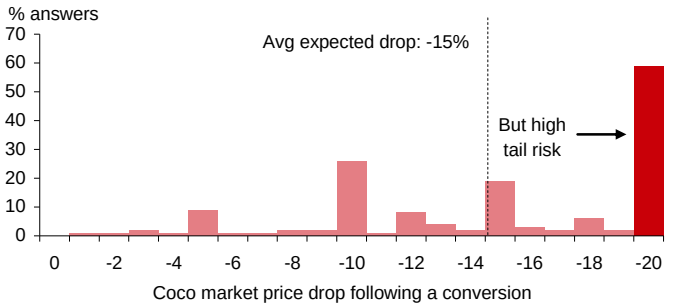
As one hedge fund manager wrote: *"Standardisation, standardisation, standardisation ... The market for cocos will dramatically improve once the issuers begin to form any remote semblance of standardisation."*

Investors expect a big drop upon the first coupon deferral…
How do you think the whole market will react to a deferral?



Source: RBS Credit Strategy

… and an even steeper drop when a conversion occurs
How do you think the whole market will react to a conversion?



Source: RBS Credit Strategy

The voice of investors: Standardisation is key

Around one-third of the investors who participated in our survey left us some open anonymous comments on how to improve the market. We have decided to publish all of them here, in the hope of encouraging further discussion across the market, as well as with regulators.

Have your say: what improvements would you like to see to the coco market over the coming months?

Increased standardisation. More registered deals.
~ Private bank/ wealth management, US, does not own cocos and not planning to buy

Standardisation is key.
~ Asset Manager, UK, holds cocos, only Tier 2

Standardisation of features.
~ Hedge Fund, US, holds both Tier 2 and Tier 1 cocos

Standardisation.
~ Asset Manager, Europe, holds cocos, only Tier 2

Regulators should standardise features. This would benefit the investors and the issuers themselves.
~ Asset Manager, Europe, planning to invest in cocos

If the product is potentially subordinated to equity then the pricing of the instrument should reflect that reality and the fact that the ROE requirement for most of the banks is >10%. The sooner one of these existing issues blows up the better, as it would bring some discipline back to the market.
~ Insurance Company, Europe, does not own cocos and not planning to buy

Standardisation of the language and improved liquidity.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation would be positive but is unlikely given the different regimes.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

Would like to see the market push for dividend stoppers outside of Swiss regime.
~ Asset Manager, Canada, holds both Tier 2 and Tier 1 cocos

The inconsistency in outcomes is highly unhelpful. For example, if there is a trigger event, some cocos could be written to zero. However in some other cases if a bank were to enter a formal administration process without previously having triggered its cocos, then they could rank at the LT2 level. So in one instance cocos effectively rank junior to equity and in the other they rank above junior subordinated instruments. It is such ludicrous state of affairs that makes the instruments needlessly confusing. To label essentially a junior equity or equity linked instrument as LT2 is highly misleading and should be outlawed.
~ IB Prop trader, UK, does not own cocos and not planning to buy

I miss hedging instruments: Coco CDS.
~ Hedge Fund, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation of language.
~ IB/ Prop trader, Europe, does not own cocos and not planning to buy

Standardisation.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation & liquidity.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation of optionalities which are quite complex to track, especially for bonds well above par which might be called. Clauses of recovery in case of temporary write-down do not seem easy to understand too as far as I have seen. Also a bit unclear are LT2 Cocos vs AT1 Cocos.
~ Hedge Fund, Europe, holds both Tier 2 and Tier 1 cocos

I would like cocos to go away. I think they mess up the capital structure of banks. I see a significant risk that some misguided regulators in some jurisdictions might institute a bail-in/write-down even before any triggers have been de facto reached.
~ Pension Fund, Europe, does not own cocos and not planning to buy

More standardisation. The biggest risk to the market is not mentioned - a "rogue" issuer skipping a coupon or converting "early", which is a one-off event but can close/suspend the market.
~ Hedge Fund, UK, holds both Tier 2 and Tier 1 cocos

I don't think you can improve them. They are structurally deficient instruments, and people are chasing them right now because of yield. They are not appropriate vehicles for bond investors.
~ Asset Manager, US, does not own cocos and not planning to buy

Bonus of the issuers' employees [should be] paid in cocos, not any more in equity.
~ Asset Manager, UK, holds both Tier 2 and Tier 1 cocos

More standardisation. By the way, I like this asset class a lot because it is difficult, challenging and appealing.
~ Private bank/ Wealth management, Europe, holds both Tier 2 and Tier 1 cocos

Issuer roundtables. Regulators talking about it more. More info on investor base (are equity investors buying?) as well as real cost and benefit of it to the issuer.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

More issuance (= positive feedback loop). A coco index.
~ IB/Prop trader, Europe, holds both Tier 2 and Tier 1 cocos

In order for my investment group to consider cocos, the issues would need to contain terms allowing forced conversion into equity with the number of shares received determined by dividing the par amount of the coco by the current market value of the equity shares. That is a treatment more in line with a classic bankruptcy type treatment. It makes no sense to buy an instrument that is essentially subordinated to the common shareholders. Why not simply buy the common stock if that is your risk appetite?
~ Asset Manager, US, does not own cocos and not planning to buy.

I want the ECB's potential QE program to target cocos.
~ Hedge Fund, Canada, holds both Tier 2 and Tier 1 cocos

Coupons paid on a monthly basis (or as frequent as possible).
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

More standardisation of the product and an improvement of the investor base.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation. Reality check on pricing of some lower quality credits.
~ Private bank/ Wealth management, UK, holds both Tier 2 and Tier 1 cocos

Coco Index + launch of more Coco-specific fund mandates.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation.
~ Asset Manager, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation and a first correction/small crash as a test.
~ Private bank/ Wealth management, Europe, planning to invest in cocos

Standardisation.
~ Private bank/ Wealth management, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation of the product.
~ Private bank/ Wealth management, Europe, holds both Tier 2 and Tier 1 cocos

Standardisation, better alignment of management with interests of coco investors.
~ Asset manager, US, does not own cocos and not planning to buy

Levels more in line with the real risk/cost of equity: banks are getting away with issuing too cheaply for themselves. Private bank retrocession/rebate for introducing/placing clients into "equity" - gets more focus and better understanding of value and risks from the client coverage. Standardisation of Basel III compliant AT1 with Asia (doesn't need contingent trigger). More standard information on Bloomberg on resets/trigger levels/types of conversion mechanism/buffer to trigger etc. to make it easier to compare. More standardisation (coming slowly but there will be some leftover pieces). More issuances.
~ Private bank/ Wealth management, UK, holds both Tier 2 and Tier 1 cocos

Standardisation of structures.
~ Asset manager, UK, holds both Tier 2 and Tier 1 cocos

Standardisation.
~ IB/Risk manager, Europe, holds both Tier 2 and Tier 1 cocos

Greater transparency and detail as regards to the Capital Buffer Proposal (CBR) to have a better idea of what the buffer to potential coupon deferral might be as the CBR begins being phased in January 2016.
~ Asset Manager, UK, holds both Tier 2 and Tier 1 cocos

Not sure I can really recommend improvements except that we really liked the coco market early on and now believe that the market is getting ahead of itself. Underwriters are serving their clients (the issuing banks) and allowing momentum to price new deals, but we are much less active and won't chase. So - most of my comments are effectively self-serving.
~ Asset Manager, US, holds both Tier 2 and Tier 1 cocos

Cocos demonstrate that the traditional fixed income market is stuck in a traditional technical model foundation and are unable to recognise that cocos are a balance sheet/solvency (fundamental) analysis. The fact that major fixed income players have remained outside of the only asset class that yields anything 'reasonable' today (let's face it, Euro HY is ~3.6% for goodness sake) demonstrates that they have under-served their client base and failed to adapt to one of the fastest growing credit classes in the world, supported by global regulation
~ Hedge Fund, Asia-ex Japan, holds both Tier 2 and Tier 1 cocos

Better standardisation of points of non-viability & regulators to get more involved with the write-down mechanisms.
~ Insurance company, Asia-ex Japan, holds both Tier 2 and Tier 1 cocos

I would prefer more standardisation, in bond features, regulatory regimes and approaches to write-down.
~ Private Bank/ Wealth Management, Asia ex-Japan, holds both Tier 2 and Tier 1 cocos

Standardisation of contracts to enhance comparability.
~ Private Bank/ Wealth Management, Europe, holds both Tier 2 and Tier 1 cocos

More published information.
~ Asset Manager, UK, holds both Tier 2 and Tier 1 cocos

Must avoid situations in which Coco holders are wiped out before equity or they end up paying a costlier bill than equities. Clear and strict capital structure priority/ranking. Regulators should only be able to deem a bank not viable in very extreme and limited cases. Higher standardisation is crucial.
~ Investment bank/ Prop trader, Europe, holds both Tier 2 and Tier 1 cocos

The feature required by regulators, whereby AT1 coupons can be deferred while equity dividends are paid, is appalling. The only reason we hold cocos is because they have been the least-worst option in debt restructurings - question 2 should have offered this as one of the responses. If the regulators want to see banks with cocos as part of their capital they should require 50% of bonuses to be paid as cocos. Over a few years this would build up to a meaningful capital buffer.
~ Insurance company, UK, holds both Tier 2 and Tier 1 cocos

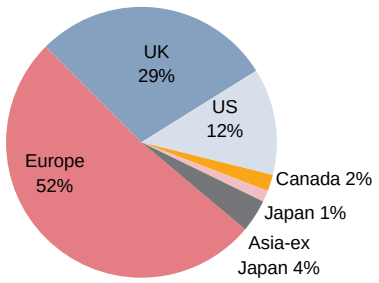
Structure with discrete call periods of 5 years rolling so that the fixed rate can be locked in again without the risk of being called at any time after it resets to LIBOR. This will improve the prospective liquidity of the secondary market as the product cycle matures. Keep all Additional Tier 1 paper OUT of the high yield indices as these are bail-in equity instruments. Tier 2 coco inclusion in high yield is more logical as they must pay coupons (until they blow up). ANY (ALL) prospective US retail structured issues should be standardised as AT1 point-of-non-viability exclusively so as to eliminate feature confusion – they should also be structured as $10par (not $25par) to specifically package the product type as being bail-in rather than the traditional gone concern products that retail is accustomed to.
~ Asset Manager, US, holds both Tier 2 and Tier 1 cocos

"Standardisation, standardisation, standardisation ... The market for cocos will dramatically improve once the issuers begin to form any remote semblance of standardisation."
~ Hedge Fund, US, holds both Tier 2 and Tier 1 cocos

The sample: Who answered our questions

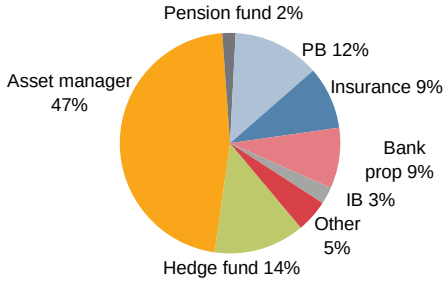
Our sample of investors was not only made up of coco buyers. Around a third were not planning to buy them. Half were asset managers and half from Europe – but a large chunk also consisted of private banks and hedge funds. Please contact us or your sales representative for a more detailed report.

Respondents by geography



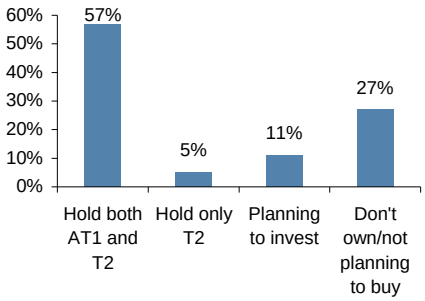
Source: RBS Credit Strategy

Respondents by type



Source: RBS Credit Strategy

Respondents by coco holdings



Source: RBS Credit Strategy

List of outstanding Contingent Convertible bonds

Contingent convertibles: Wide variation in features among different instruments

Issuer	Issue Date	Rank	Coupon	Size	Maturity	Trigger	Mechanism
Bank Of Ireland	29/07/2011	Tier 2	10%	€1bn	30/07/2016	CET1 ratio < 8.25%	Equity Conversion
Barclays	21/11/2012	Tier 2	7.625%	$3bn	21/11/2022	CET1 ratio < 7%	Permanent write-down
Barclays	03/04/2013	Tier 2	7.750%	$1bn	Call 10/04/2018	CET1 ratio < 7%	Permanent write-down
Barclays	10/12/2013	AT1	8%	€1bn	Call 15/12/2020	Fully loaded CET1 ratio < 7%	Equity Conversion
Barclays	20/11/2013	AT1	8.25%	$2bn	Call 15/12/2018	Fully loaded CET1 ratio < 7%	Equity Conversion
BBVA	30/04/2013	AT1	9%	$1.5bn	Call 09/05/2018	CET 1 ratio < 5.125%, EBA CTI < 7%, Capital Principal ratio <7%, Tier 1< 6% & the bank or group has reported losses > 1/3 of its capital & reserves in the last 4 quarters	Equity Conversion
BBVA	**11/02/2014**	AT1	**7%**	**€1.5bn**	**Call 19/02/2019**	**CET1<5.125% linked to both Group and Bank**	**Equity Conversion**
Credit Ag SA	12/09/2013	Tier 2	8.125%	$1.0bn	Call 19/09/2018	Basel III CET1 ratio < 7%	Permanent write-down
Credit Ag SA	15/01/2014	AT1	7.875%	$1.75bn	Call 23/01/2024	Credit Ag SA Group phased in CET1< 5.125% or Credit Ag Group phased in CET1 < 7%	Temporary write down
Credit Ag SA	**08/04/2014**	AT1	6.5%	€1bn	Call 23/06/2021	Group CET1 < 7%, Bank CET1 < 5.125%	Temporary write down
Credit Ag SA	**08/04/2014**	AT1	7.5%	£0.5bn	Call 23/06/2026	Group CET1 < 7%, Bank CET1 < 5.125%	Temporary write down
CS	24/02/2011	Tier 2	7.875%	$2bn	Call 24/08/2016	Basel III CET1 ratio < 7%	Equity Conversion
CS	22/03/2012	Tier 2	7.125%	CHF750m	Call 22/03/2017	Capital ratio in any interim < 5%	Equity Conversion
CS	01/08/2013	Tier 2	6.50%	$2.5bn	08/12/2023	Basel III CET1 ratio < 5%	Permanent write-down
CS	18/09/2013	Tier 2	5.75%	€1.25bn	Call 18/09/2020	Sum of (i) CET1 ratio and (ii) higher-trigger capital ratio < 5%	Full & Permanent Write-Down
CS	11/12/2013	AT1	7.5%	$2.25bn	Call 11/12/2023	Sum of (i) CET1 ratio and (ii) higher-trigger capital ratio (7% trigger) < 5.125%	Full & Permanent Write-Down
Intesa	01/10/2010	Old style Tier 1	9.50%	€1bn	Call 01/06/2016	Total risk based ratio < 6% (BOI)	Temp write-down/ write-up
KBC	17/01/2012	Tier 2	8%	$1bn	Call 25/01/2018	CET1 ratio < 7% **(on transitional basis)**	Permanent write-down
KBC Group NV	**19/03/2014**	AT1	**5.625%**	**€1.4bn**	**Call 19/03/2019**	**KBC Group NV CET1 < 5.125% (on transitional basis)**	**Temp write-down/ write-up**
Lloyds	03/11/2009	Old style Tier 2	-	£7.6bn	25/05/2020	CTI < 5%	Equity Conversion
Lloyds	**20/03/2014**	AT1	7.875%	£0.75bn	Call 27/06/2029	BIS3 fully-loaded group CET1 ratio < 7%	Equity Conversion
Lloyds	**20/03/2014**	AT1	7.625%	£1.494bn	Call 27/06/2023	BIS3 fully-loaded group CET1 ratio < 7%	Equity Conversion
Lloyds	**20/03/2014**	AT1	7%	£1.481bn	Call 27/06/2019	BIS3 fully-loaded group CET1 ratio < 7%	Equity Conversion
Lloyds	**20/03/2014**	AT1	6.375%	€0.75bn	Call 27/06/2020	BIS3 fully-loaded group CET1 ratio < 7%	Equity Conversion
Lloyds	**07/04/2014**	AT1	7.5%	$1.675bn	Call 27/06/2024	BIS3 fully-loaded group CET1 ratio < 7%	Equity Conversion
Popular	10/10/2013	AT1	11.50%	€500mn	Call 10/10/2018	CET1 ratio < 5.125% or Tier 1 < 6% (with losses in four most recent quarters)	Equity Conversion
Rabobank	19/03/2010	Snr Cont. Notes	6.875%	€1.25bn	19/03/2020	Equity Capital < 7%	Temp write-down (principal to 25%)
Rabobank	26/01/2011	Old style Tier 1	8.375%	$2bn	Call 26/07/2016	Equity Capital < 8%	Permanent write-down
Rabobank	09/11/2011	Old style Tier 1	8.40%	$2bn	Call 29/07/2017	Equity Capital < 8%	Permanent write-down
SocGen	29/08/2013	AT1	8.25%	$1.25bn	Call 29/11/2018	CT1 or phased in CET1 (after Jan 1, 2014) < 5.125%	Temp write-down/ write-up
SocGen	18/12/2013	AT1	7.875%	$1.75bn	Call 18/12/2023	CT1 or phased in CET1 (after Jan 1, 2014) < 5.125%	Temp write-down/ write-up
SocGen	07/04/2014	AT1	6.75%	€1bn	Call 07/04/2021	CET1 < 5.125% phased-in	Temp write-down
UBS	22/02/2012	Tier 2	7.25%	$2bn	Call 22/02/2017	Basel III CET1 ratio < 5%	Permanent write-down
UBS	10/08/2012	Tier 2	7.625%	$2bn	17/08/2022	Basel III CET1 ratio < 5%	Permanent write-down
UBS	15/05/2013	Tier 2	4.75%	$1.5bn	Call 22/05/2018	Basel III CET1 ratio < 5%	Permanent write-down
UBS	**06/02/2014**	Tier 2	**4.75%**	**€2bn**	**Call 21/02/2021**	**Contingent write-down at the earlier of (i) CET1<5% breach, or (ii) the point of non-viability**	**Permanent write-down**
UBS	**08/05/2014**	**Tier 2**	**5.125%**	$2.5bn	**15/05/2024**	Basel III CET1 ratio < 5%	**Permanent write-down**
Unicredit	**21/07/2010**	Old style Tier 1	**9.375%**	**€500m**	**Call 21/07/2020**	**Total risk based ratio < 6% (BOI)**	**Temp write-down/ write-up**
Unicredit	**03/04/2014**	AT1	**8%**	**$1.25bn**	**Call 03/06/2024**	**Basel 3 CET1<5.125% (either consolidated or on individual basis)**	Temp write-down
NWIDE	**11/03/2014**	AT1	**6.875%**	**£1bn**	**Call 20/06/2019**	**Fully loaded Basel 3 CET1<7% (either consolidated or on individual basis)**	**Conversion (into core capital deferred shares)**
Santander	**12/03/2014**	AT1	**6.25%**	**€1.5bn**	**Call 12/03/2019**	**Transitional CET1<5.125% (bank or group)**	Equity Conversion
Santander	**08/05/2014**	AT1	**6.375%**	$1.5bn	**Call 19/05/2019**	**Transitional CET1<5.125% (bank or group)**	Equity Conversion
Danske	**12/03/2014**	AT1	**5.75%**	**€0.75bn**	**Call 06/04/2020**	**Transitional CET1 <7%**	Temporary Write-down

Source: RBS Credit Strategy, RBS Financials Trading Desk Strategy, company filings, Bloomberg

Trade map: summary of trade ideas, country/sector and bank recommendations

	Core Europe	Semi-Core	Non-EMU	US	EM	Periphery: Spain	Periphery: Italy	Periphery: Ireland	Periphery: Portugal	Periphery: Greece	Overall
Ins sub							Generali				**OW 25%**
Bank sub	Deutsche Bank, Commerzbank	SG, Credit Ag, BNP, ING, ABN, KBC Rabobank	Lloyds, Nationwide SEB, Nordea, Handelsbanken, Swedbank, Danske			Caixabank, Popular, Sabadell			BES		**OW 20%**
Bank senior	Deutsche Bank, Commerzbank, Erste, RBI	SG, Credit Ag, BNP, ING, ABN, KBC Rabobank	Lloyds, Nationwide Barclays, HSBC, SEB, Handelsbank, Swedbank, Nordea, Danske			Popular, Sabadell Santander	Intesa, Monte, Popolare UniCredit	Bank of Ireland	BES, Caixa Geral	Piraeus	**OW 10%**
Ins senior											**OW 10%**
Telecoms			Everything everywhere Telenor, Teliasonera, Ericsson								**OW 10%**
Utilities	Fortum	GDF Suez, EDF									**OW 10%**
Fins Services											**OW 5%**
Industrials	Siemens		Rolls Royce				Atlantia	CRH			**OW 5%**
Cons Services		Publicis, Casino	Compass				Lottomatica				**UW -15%**
Cons Goods		Unilever, Danone	Morrisons Nestle, Svenska Cellulosa							CCHB	**UW -15%**
Technology											**UW -50%**
Oil & Gas		Total, Shell	Statoil				ENI				**UW -50%**
Materials	Linde, BASF	DSM, Solvay	Holcim								**UW -55%**
Healthcare	Bayer	Sanofi									**UW -75%**
HY						Cirsa, Ence, Gestamp, Campofrio, Bezinc	Buzzi, Cerved, Bormioli, IVS, Ei Towers, Guala, Lecta, Zobele, Sisal		Portucel	OTE, FAGE, Frigoglass, Yioula Glassworks	**OW**
Overall	**UW**	**OW**	**OW**	**UW**	**UW**	**OW**	**OW**	**OW**	**OW**	**OW**	**OW**

Source: RBS Credit Strategy

Our views in bullets

Spreads. We expect political risks to subside, growth and budgets improve, and banks continue to rebuild capital in Eurozone. The ECB will become Europe's bank regulator in September 2014, which will favour convergence across core-periphery bank spreads. We forecast investment grade spreads will be 50bp at year-end and high yield will decline to 225bp.

Default rates. We think default rates will fall to around 1%, on improving growth, stabilisation in unemployment and lending as well as a decline in the proportion of very low-rated companies. Default rates in the US instead will remain around 2%, on higher re-leveraging and shareholder-friendly activity.

Ratings. Ratings will gradually turn upwards for sovereigns on better growth, and later on for banks on new policies from the ECB, EIB and structural reforms to the banking system. Ireland, Portugal and Spain will benefit from positive rating actions.

Financials. We are long financials. We stay long periphery banks in senior debt on improving capital and liquidity as well as negative net supply of bonds, and long senior and sub debt in UK, France, Holland and Spain. Bank sub debt will continue to outperform this year, on ECB measures to strengthen banking system and more issuance of equity. We avoid banks that are dependent on investment banking and which trade too tight in core Europe and Scandinavia – which could face increasing regulatory risk. We also avoid banks which are exposed to EM, like in Austria.

Corporates. Periphery corporates offer a good premium to those in the rest of Europe. Larger companies with diversified revenues and stronger fundamentals will benefit as investors increasingly look to the periphery to capture this yield. We would avoid tight names in core Europe, as well as names in the technology and consumer cyclical sectors, including autos and retail. We prefer corporates which still need to deleverage, rather than core IG firms which have an incentive to re-leverage over the next year.

Capital structure. Banks' capital structures will change over 2014. Banks will continue to issue more equity and coco debt, particularly given regulators' increasing focus on the leverage ratio. We think the sweet spot will be LT2 debt. We are very selective on coco and hybrid bonds.

Regions. We prefer European periphery, semi-core and the UK; we are underweight core Europe (Germany and Scandinavia), US and Emerging Markets. Euro credit will outperform US, and we forecast 2.2% and 6.7% total returns from European investment grade and high yield, respectively in 2014. We recommend switching to Yankee and Sterling credit from European issuers for higher yields and spreads after hedging rates and FX risks.

Duration. We prefer exposure to idiosyncratic and default risk vs systemic risk and volatility. Therefore, we recommend low/mid-range duration exposure to limit mark-to-market volatility, taking advantage of the positive impact of ECB liquidity and refinancing/tender activity, which is concentrated around the 3-7 year segment. This also allows investors to protect themselves from the risk of rising rates, which we see coming up in the US and the UK.

CDS-Bond basis. The positive basis collapsed to neutral across corporates during the latest rally in CDS, while it remains positive in financials. We think the CDS premium over cash could decline on positive policy risk.

Primary issuance. Issuance will remain strong on a gross basis, but flat or negative on a net basis on bank deleveraging.

Secondary volumes. Banks are derisking trading and capital markets businesses as well as deleveraging loan portfolios. This means lower secondary volumes.

Our trades in bullets

1) Short Australia vs Europe. Australia's economy is too dependent on mining, construction and exports to a slowing China for growth, while the domestic real estate market also appears highly overvalued. Australian bank spreads do not price in these risks, in our view, and will widen as EM turmoil continues.

Buy protection on iTraxx Australia vs sell protection on iTraxx Europe.

The Revolver | Melt-up: Going all-in into year-end, 11 October 2013

2) Long Dollar bonds from European companies. These bonds offer around 40bp higher spread and 1% higher yield vs similar Euro bonds issued by the same firms. Hedge FX and rate risks.

Buy: Santander, Veolia, Soc Gen, BNP, ING, Rabobank, Telecom Italia, Nationwide, Vodafone, Daimler, Deutsche Telecom, France Telecom, Intesa, Telefonica, AB Inbev

The Revolver | 2014 Outlook: Europe's recovery, 20 November 2013

3) Long senior debt of periphery banks. Periphery spreads will continue to tighten as the region recovers and reforms and as investors reallocate to it.

Buy: Unicredit, BBVA, Popular, Sabadell, BES, Caixa Geral, Bank of Ireland

The Revolver | 2014 Top Trades: From melt-up to diet credit, 13 January 2014

4) Long LT2 sub debt of British, French, Dutch, Belgian and Spanish banks. The ECB's measures to strengthen the banking system and the banks' issuance of new CET1 and AT1 capital will help LT2 bonds compress further into senior.

Buy: Soc Gen, Credit Agricole, ING, ABN, KBC, Lloyds, Nationwide, BBVA, Caixabank, Popular and Sabadell.

5) Long mid-cap high yield periphery companies. Smaller HY periphery firms yield around 1% more than larger peers, with comparable fundamentals. Liquidity is also improving and more firms are coming to market as banks deleverage.

Buy: Campofrio, Ei Towers, Portucel, Ence, Buzzi, Gestamp, FAGE, Cerved, Cirsa, IVS, Frigoglass, Bormioli, Guala Closures, Bezinc, Lecta, Zobele, Sisal and Yioula.

6) Long single-A CLO senior tranches. European firms need to borrow but banks are still pulling back. This creates an opportunity for non-bank lending sources. CLOs are the easiest way for institutional investors to gain exposure to these loans and can provide the leverage needed to make the yields on lending attractive.

7) Sell EM-exposed corporates, buy European and US-focused firms. Sell corporates with revenues from emerging markets or EM-dependent products. Buy firms which will benefit from the US and European recovery.

Sell: Casino (COFP 3.994% 2020); Buy: Morrisons (MRWLN 2.25% 2020)
Sell: Holcim (HOLNVX 2.625% 2020); Buy: CRH (CRHID 2.75% 2020)
Sell: Telenor (TELNO 1.75% 2018); Buy: Everything Everywhere (EVEVRV 3.25% 18)

The Revolver | Credit crunch, Phase III: A postcard from EM,
5 February 2014

8) Sell EM-exposed banks, buy domestic banks. Sell banks which have sizeable operations in emerging markets and are vulnerable to a slowdown in EM growth. Buy domestic-focused banks which are exposed to the ongoing European recovery.

Sell: BBVA (BBVASM 3.75% 2018); Buy: Caixabank (CAIXABF 3.125% 2018)
Sell: Santander (SANTAN 4% 2017); Buy: Banco Popular (POPSM 2.5% 2017)
Sell: UniCredit (UCGIM 4.875% 2017); Buy: UBI (UBIIM 2.5% 2017)
Sell: HSBC (HSBC 3.125% 2017); Buy: Nationwide (NWIDE 3.125% 2017)
Sell: NAB (NAB 3.75% 2017); Buy: Lloyds (LLOYDS 1.75% 2018)
Sell: ANZ (ANZ 3.75% 2017); Buy: Lloyds (LLOYDS 1.75% 2018)
Sell: CBA (CBA 4.25% 2018); Buy: Lloyds (LLOYDS 1.75% 2018)
Sell: Westpac (WSTP 4.125% 2018); Buy: Lloyds (LLOYDS 1.75% 2018)
Sell: NAB (NAB 3.625% 2017); Buy: Lloyds (LLOYDS 6.75% 2018)

Austrian banks: A dangerous waltz with emerging markets,
21 February 2014

9) Sell EM-exposed Austrian Banks, buy domestic core banks. Switch out of EM-exposed banks into domestic banks.

Sell: Erste Bank (ERSTBK 1.875 05/13/19); Buy: BNP Paribas (BNP 2 01/28/19)
Sell: RBI (RBIAV 1.875 11/08/18); Buy: ING (INTNED 1.875 02/27/18)
Sell: UniCredit (UCGIM 3.625 01/24/19); Buy: Intesa (ISPIM 3 01/28/19)

Europe's corporates: Walking again, but not ready to run
26 March 2014

10) Sell Core IG firms with the strongest incentive to re-leverage. Sell the firms which have the greatest incentive to re-leverage, based on five factors: 3y EBITDA growth, 5y EBITDA volatility, number of ratings notches above high yield, funding costs and our estimate of their optimal amount of debt.

Sell Statoil (STLNO € 2% 2020); Sell Royal Dutch Shell (RDSALN € 4.375% 2018)
Sell Telenor (TELNO € 4.125% 2020); Sell Sanofi (SANFP € 4.125% 2019)
Sell Total (TOTAL € 2.125% 2021); Sell Unilever (UNANA € 1.75% 2020)
Sell Nestle (NESNVX € 1.5% 2019); Sell TeliaSonera (TLSNSS € 4.25% 2020)
Sell GDF Suez (GSZFP € 6.875% 2019); Sell EDF (EDF € 5.375% 2020)
Sell ENI (ENIIM € 4.125% 2019); Sell Bayer (BAYNGR € 1.125% 2018)
Sell Publicis (PUBFP € 4.25% 2015); Sell Danone (BNFP € 2.25% 2021)
Sell Compass (CPGLN € 3.125% 2019); Sell Rolls-Royce (ROLLS £ 6.75% 2021)
Sell Linde (LINGR € 1.75% 2019); Sell Fortum (FUMVFH € 6% 2019)
Sell Svenska Cellulosa (SCABSS € 2.5% 2023); Sell Siemens (SIEGR € 1.5% 2020)
Sell Ericsson (LMETEL € 5.375% 2017); Sell BASF (BASGR € 1.5% 2018)
Sell DSM (DSM € 1.75% 2019); Sell Solvay (SOLBBB € 4.625% 2018)
Sell Atlantia (ATLIM € 4.5% 2019);

Eureka! Buy the Greecovery and Greek banks
08 April 2014

11) Long Piraeus Bank senior. Greece is recovering and making progress on structural and budgetary reforms. Piraeus Bank has raised capital and is now resilient to further rises in bad loans or widening sovereign spreads.

Buy TPEIR 5% 2017

Trade performance: Open trades

Open trade recommendations

Trade	Start date	End date	Time horizon	Target Gain / Stop Loss	Total return	Revolver publication
European bank senior	6-Jul-12	Open			+1,251bp	H2 2012 Financials Outlook: Banking on Europe
European bank sub	6-Jul-12	Open			+570bp	H2 2012 Financials Outlook: Banking on Europe
Short Australia vs Europe	27-Jun-13	Open	6 months	+2/-1	+26bp	When the Fed and China sneeze again…
Buy Yankees	11-Oct-13	Open	6 months	+6/-6	+300bp	Melt-up: Going all-in into year-end
Buy periphery senior bank debt	20-Nov-13	Open	12 months	+6/-6	+746bp	2014 Outlook: Europe's recovery
Buy sub debt of British, French, Dutch, Belgian and Spanish banks	20-Nov-13	Open	12 months	+6/-6	+549bp	2014 Outlook: Europe's recovery
Buy bonds of mid-cap periphery companies	20-Nov-13	Open	12 months	+6/-6	+675bp	2014 Outlook: Europe's recovery
Buy single-A CLO senior tranches	20-Nov-13	Open	12 months	+6/-6	-	2014 Outlook: Europe's recovery
Sell EM-exposed corporates, buy European and US focused firms	5-Feb-13	Open	12 months	+2/-2	+8bp	Credit Crunch, Phase III: A postcard from EM
Sell EM-exposed banks, buy domestic banks	5-Feb-13	Open	12 months	+2/-2	+57bp	Credit Crunch, Phase III: A postcard from EM
Short Austrian Banks (EM exposed) vs Long Domestic banks	21-Feb-14	Open	12 months	+1.5/-1.5	+61bp	Austrian banks: A dangerous waltz with emerging markets
Sell Core IG releveragers	26-Mar-14	Open	6 months	+2/-2	+32bp	Europe's corporates: Walking again, but not ready to run
Long Piraeus Bank Senior	08-Apr-17	Open	6 months	+2.5/-2.5	+215bp	Eureka! Buy the Greecovery and Greek banks

Source: RBS, Bloomberg. Priced as of 9th May 2014

Note: Mid-level spreads are used in performance calculations, and are not reflective of bid-asks for entering/exiting trades

Trade performance: Closed trades

Closed trade recommendations (2012-present)

Trade	Start date	End date	Time horizon	Target Gain / Stop Loss	Total return	Revolver publication
Buy a basket of lower tier 2 callable bonds with low market implied call probabilities (Credit Agricole, Intesa, and Lloyds).	23-Jan-12	10-Feb-12	3m	+7.5/-7.5	+721bp	Buy senior bank bonds and dirt-cheap sub bonds
Buy protection on Portuguese bank 5-year CDS. Sell protection Portuguese corporate 5-year CDS. (1x:1.1x ratio).	6-Feb-12	22-Feb-12	6m	+6/-6	+615bp	The LTRO and the Portuguese Threat
Sell protection on an equally weighted basket of US bank 5-year senior CDS. Buy protection on an equally weighted basket of 5-year senior CDS.	14-Feb-12	30-Mar-12	6m	+3/-3	+321bp	European banks: too good to be true
Buy 5-year senior CDS protection on Intesa, Societe Generale, and UniCredit. Buy a basket of cash covered bonds on the same names.	17-Feb-12	5-Apr-12	6m	+4/-4	+299bp	Liquidity today brings subordination tomorrow
Buy low-price, low-coupon bonds from cash rich firms.	5-Mar-12	12-Oct-12	3m	+3/-3	+294bp	The refinancing race is on: Buy bond tender candidates.
Buy protection on an equal weighted basket of Air France/KLM, Carrefour, Deutsche Post, IAG and Ineos. Sell protection on iTraxx Xover	12-Mar-12	2-Jul-12	6m	+2.5/-2.5	+40bp	After PSI: The threat of rising oil prices
Buying protection on BBVA, Caixabank and Santander vs selling protection on US and UK banks	19-Mar-12	29-Mar-12	3m	+2/-1	+208bp	Spain: Structural challenges deeper than liquidity can solve
Buy Bank of Ireland senior unsecured 4.625% € 2013 bonds	4-Apr-12	30-Oct-12	12m	+5/-5	+715bp	Ireland: The Celtic Tiger is coming back on track
Buy protection on BBVA 5-year senior CDS and sell protection on Santander	20-Apr-12	22-May-12	6m	+2.5/-2.5	+147bp	Stress testing Spain's champions: Sell BBVA vs Santander
Sell protection on Societe Generale 5-year senior CDS	30-Apr-12	21-Aug-12	6m	+3/-5	+325bp	France: Election fears overdone, long Societe Generale
Sell protection on iTraxx Xover. (Removed short leg of buying protection on iTraxx Sub Financials on 2-Jul-12.)	17-May-12	06-Aug-12	4m	+3/-2.5	+323bp	Greece: The fallout through the banking system
Short Australian banks against US corporates	24-May-12	31-Jul-12	6m	+1.5/-2	-229bp	The global repercussions of the Eurozone crisis
Sell protection on buy protection on Spain (1x:1x ratio)	1-Jun-12	29-Jun-12	6m	+3.5/-3.5	+336bp	Spain's near death experience
Buy short-dated bonds of downgrade-resilient periphery corporates. Sell downgrade-exposed periphery corporates	13-Jul-12	21-Aug-13	6m	+2/-2	+20bp	Investing on the edges of the market
Sell 5-year senior CDS protection on UniCredit and buy 5-year CDS protection on BBVA	20-Jul-12	6-Aug-12	6m	+3/-3	+205bp	Spain needs surgery, Italy therapy
Long European HY Corporates vs Xover	6-Aug-12	30-Oct-12	6m	+1.5/-1.5	+50bp	High yield: Still a buy, but be selective
Sell 5-year CDS protection on Fiat and buy protection on Peugeot and Renault	28-Aug-12	11-Sep-12	6m	+1.5/-1.5	+322bp	The Silk Highway: Long Fiat vs Peugeot & Renault
Short Spain vs Long Xover	3-Sep-12	30-Apr-13	6m	+2/-5	+61bp	Same problems, new mistakes: Sell Spain
Short Investment banks vs Long Commercial banks	3-Oct-12	24-Jun-13	6m	+2/-2	+14bp	Bank to basics: The future of investment banking
Buy short-dated Spanish sovereign bonds; sell short-dated BBVA senior bonds	12-Oct-12	14-Jan-14	6m	+1.5/-1.5	-81bp	Tail risk is dead. Long live tail risk
Buy BESPL 5.625% 2014 and sell PGB 3.6% 2014	17-Oct-12	08-Nov-12	6m	+3/-3	+291bp	Portugal: Long Banco Espirito Santo vs sovereign
Buy BASQUE 4.15% 2019, NAVARR 5.529% 2016, CANARY 2% 2016, CASTIL 3.85% 2016 and MADRID 6.213% 2016	29-Oct-12	7-Feb-13	6m	+16/-7	+1394bp	The Spanish regions: Mirage and oasis in a yield desert
Short LT2 bonds ISPIM 5% 2019, UCGIM 5.75% 2017, BPIM 6% 2020 and MONTE 5% 2020 vs Long iTraxx SubFin	10-Dec-12	28-Feb-13	3m	+5/-3	+115bp	Italy: Brace for political risk
Long Periphery Corporates (Cash bonds)	8-Jan-13	01-Oct-13	12m	+6/-4	+325bp	Top Trades 2013: Making money in a yield desert
Long Periphery Banks	8-Jan-13	19-Nov-13	12m	+6/-4	+487bp	Top Trades 2013: Making money in a yield desert
Long European vs US high yield	8-Jan-13	12-Dec-13	6m	+2/-2	+5bp	Top Trades 2013: Making money in a yield desert
Sell UK consumer bonds vs iBoxx 7-10 year £ BBB	29-Jan-13	16-Apr-13	7m	+3.5/-3.5	+200bp	The UK: slowly losing safe-haven status
Long Corporate Hybrid Bonds	19-Feb-13	14-Apr-14	6 m	+10/-6	+992bp	Corporate hybrids: another oasis in the yield desert
Short Italian bank sub vs Xover	14-Mar-13	28-Mar-13	6m	+2/-2	+472bp	The State of Credit Markets
Buy BESPL 2015 5.875% and CXGD 2015 5.625%	19-Apr-13	01-Oct13	6m	+3/-4.5	+104bp	Buy Portugal
Buy Mid Cap Periphery HY	23-May-13	19-Nov-13	6m	+6/-6	+438bp	High yield: Small is beautiful
Sell Monte 5% 2020 LT2	10-Jul-13	04-Oct-13	12m	+10/-10	+551bp	EC bail-in rules: It's time for a haircut
Buy top 30 deleveraging, sell top 30 releveraging credits	24-Sep-13	26-Mar-14	6m	+4/-4	+350bp	The leverage temptation resurfaces
Buy Protection on iTraxx Xover	01-Oct-13	11-Oct-13	1m	+1.5/-1.5	-117bp	Banking union: The moment of truth for Europe's banks
Long sub debt of French, Dutch and British banks	11-Oct-13	19-Nov-13	6m	+4/-4	+245bp	Melt-up: Going all-in into year-end

Source: RBS, Bloomberg. Note: Mid-level spreads are used in performance calculations, and are not reflective of bid-asks for entering/exiting trades

Recent research

Coco Loco: The systemic risks of contingent capital – 14 April 2014.The coco market will grow to over €100bn this year. Coco bonds meet many needs: on the one hand, European banks need more capital, with just around 3% over assets vs 5-6% in the US and Switzerland. On the other, fixed income investors are hungry for yield and willing to take more risk. But are they pricing these risks correctly? We show that coco prices do not fully reflect the risks of conversion. And while performance is positive for now, lack of standardisation and complexity means any deferral or trigger will shake up the investor base going forward. We think investors should be selective.

Eureka! Buy the Greecovery and Greek banks – 8 April 2014. We initiate coverage on Greek banks today, with a long on Piraeus. There are still many obstacles for Greece. Its economy lost 24% of GDP during the crisis and public debt is 176% of GDP. One out of two young workers is unemployed. But there are signs of recovery, finally – in financial markets and in the real economy too. Manufacturing, tourism and even confidence are up. The Eurogroup and Germany are showing support and have discussed a third aid package. The budget is in surplus, allowing the government to distribute a potential €450m social dividend. Banks, hurt by bad loans and sovereign losses, have consolidated and are now raising capital.

Europe's corporates: Walking again, but not ready to run – 26 March 2014. There are more signs of growth in Europe and investors are rushing to put capital back to work in the riskiest parts of the bond market: periphery, hybrid capital, and high yield. Are they getting paid for the risk? It depends on what CFOs are doing with the funds they are raising. We show most European corporates are still deleveraging and optimising costs to improve earnings. They remain very cautious on debt and ratings and continue to hoard cash, especially in the periphery. So while investors are getting exuberant, issuers are still behaving rationally. We remain long credit overall, but selectively underweight bonds of core firms that have strong incentives to add leverage.

Credit spreads: Towards the bottom in 2014 – 5 March 2014. The Ukraine-Russia crisis barely moved European spreads. Indeed, European economies now appear resilient to external shocks, as macro data continues to improve and capital comes back from riskier countries. But are investors still getting paid for the risks? Long Europe has become a crowded trade now, yet we still see positive catalysts on the horizon: ECB policy, corporate and bank fundamentals, sovereign reforms and technicals all remain credit positive. With few near-term risks, we think credit spreads will move from pricing based on volatility and tail risks to a new regime compensating primarily for default risk.

Austrian banks: A dangerous waltz with emerging markets – 21 February 2014. Emerging markets are the third leg of the credit crunch. Many have grown accumulating private leverage over the past decade, thanks to capital inflows. But these inflows are now reversing, and some EM central banks are raising rates to stop them. With higher rates, though, come higher funding costs and rising bad loans. Some European banks exposed to EM are already getting hurt. Austria's nationalised Hypo Alpe Adria is nearing resolution, as the government explores potential bail-in options. But the other Austrian banks, Erste, RBI and Bank Austria (a subsidiary of UniCredit), are also at risk of losses. We recommend selling Erste, RBI and UniCredit.

Can the demolition man rebuild Italy? – 13 February 2014. Matteo Renzi – nicknamed *demolition man* – took his next step towards becoming Prime Minister of Italy. He officially asked current PM Letta to step down this afternoon, and asserted his intention to replace him. Letta has scheduled a final cabinet meeting tomorrow at 11:30 CET and is likely to resign afterward. Renzi aims to reform the electoral system and the Senate, free up labour markets and reduce government spending. Renzi's ambition to reform could be a much-needed shot in the arm for Italy, which has so far lagged relative to the rest of Europe. He has a better chance of success than Letta did, but may still face difficulties with a divided parliament. In any case, we think Renzi as PM is positive for Italy and remain long banks and corporates.

Credit crunch, phase III: A postcard from EM – 5 February 2014. Emerging markets are the third leg of the credit crisis. They benefited from strong popularity over the past decade, but are now suffering from the same problems that Europe had three years ago: public and private debt overhangs combined with capital outflows. We have seen this movie before. EM central banks are putting their fingers in the dam by raising rates, but this has two negatives: it can rarely stop capital flight, and at the same time higher rates increase domestic borrowing costs, kick-starting a squeeze on levered corporates and consumers. Like last year, we believe many EM countries are at the start of a crunch, and that EM credit will continue to underperform.

European banks: Still too big to fail – 23 January 2014. Europe's banks are stronger but still too large, and sovereigns remain vulnerable to bank risk. Despite €3.5tn asset reduction since 2012, we estimate Eurozone banks must shrink by a further €1.8tn, and that the largest banks must raise at least €58.5bn of capital to comply with Basel III. But even with additional capital, banks will still be too big to fail. To stand on their own feet in a crisis, we estimate banks need a leverage ratio of 5.8% rather than the current 3%. This corresponds to as much as €492bn of gross additional capital. Alternatively, Europe needs larger backstops: the current €55bn SRM fund is a step in the right direction, but still insufficient. Rising capital needs mean large banks will issue €28-35bn of contingent capital this year, bringing the market to €100bn. But bank capital investors must be mindful about what they buy: we find the fast-growing coco market is mispricing conversion risk. The sweet spot in the capital structure remains LT2 debt. T1 and coco investors should be very selective.

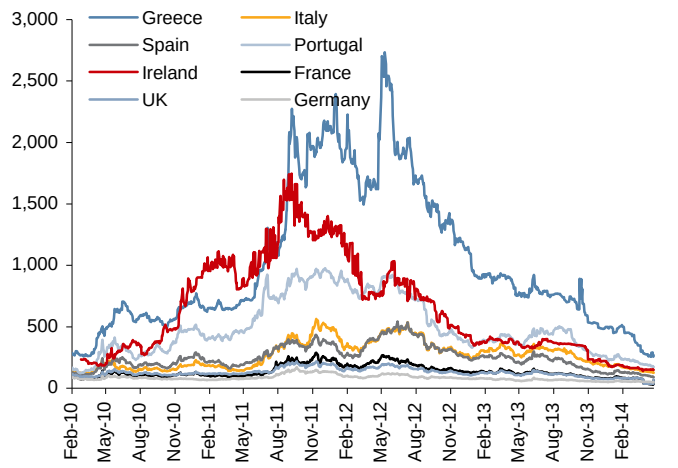
Italy: Time for bank reform – 15 January 2014. Positive signs are finally emerging in Italy: growth is returning, the government is more stable after Berlusconi's exit and it is moving towards some reforms, for example the electoral system. But as risk premia in financial markets decline, complacency remains a threat. Italy lags Spain and Ireland on reforms so far – it is now the time to press on, with reforms of the electoral system, labour markets and crucially, banks. Italy's banking sector problems are not as large as Ireland's were in 2010 or Spain's in 2012, but they are still holding back the recovery. A comprehensive bank restructuring and transparency programme, and even a bad bank, could reap large benefits in Italy, as they did in Spain and Ireland. In this piece we look at the kinds of bank reforms Italy could do.

2014 Top Trades: From melt-up to diet credit – 13 January 2014. The melt-up in credit and risk assets which we anticipated at the end of 2013 has exceeded our expectations. Now that risk premia have narrowed to pre-crisis levels investors are left with the prospect of modest returns from here. However, we think it is too early to get short credit, and that spreads will continue to narrow slightly over the course of 2014. European credit has now become something like a diet beverage: nothing too exciting but we see limited downside risks. 2014 is the year of diet credit. In this world of sugar-free bonds, there are however small niches which still offer value. These are the areas we target in our top trades for 2014.

Credit Markets Watch

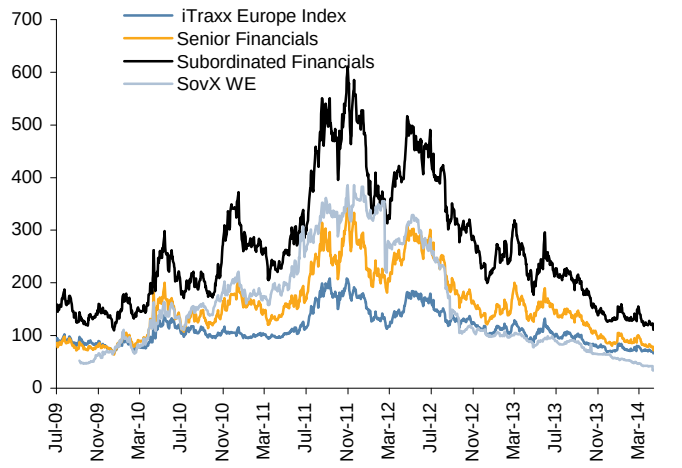
Spreads, sovereign risk, primary and secondary markets

Country average corporate credit spreads, bp



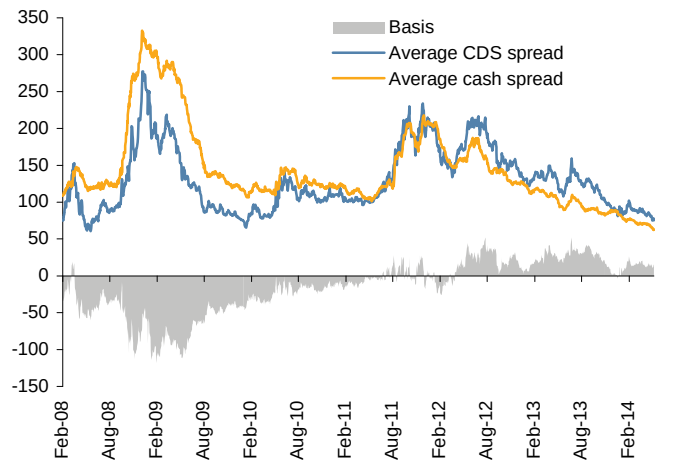
Source: RBS Credit Strategy, Bloomberg

iTraxx index spreads, 5-year on-the-run, bp



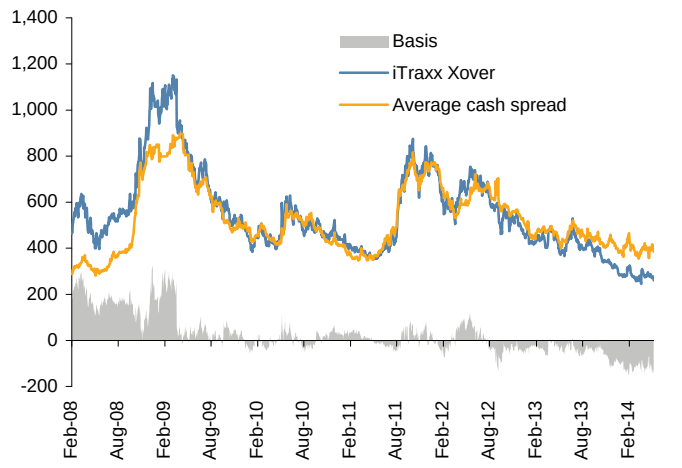
Source: RBS Credit Strategy, Bloomberg

iTraxx Main cash and CDS spreads and basis, bp



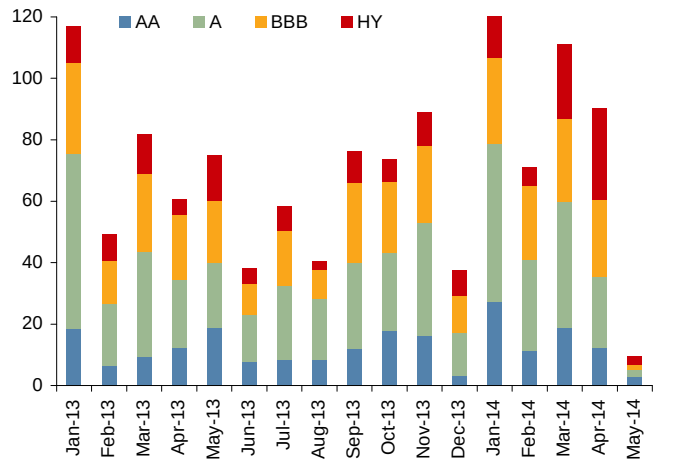
Source: RBS Credit Strategy, Bloomberg

iTraxx Xover cash and CDS spreads and basis, bp



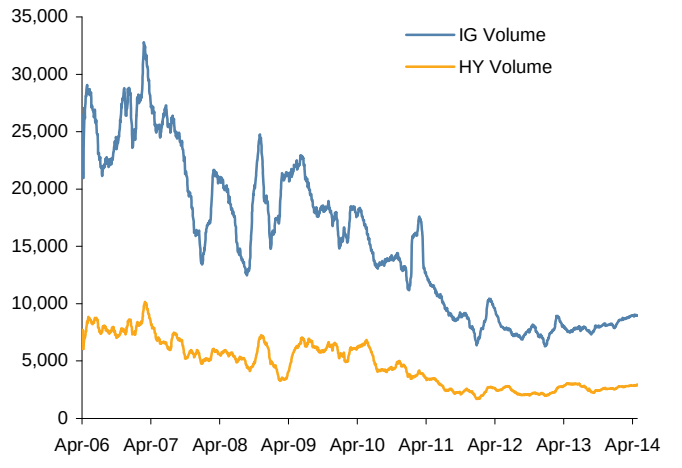
Source: RBS Credit Strategy, Bloomberg

Investment grade and high yield issuance, €bn



Source: RBS Credit Strategy, Bloomberg

TRACE 2-month trailing average daily trading volumes, $m

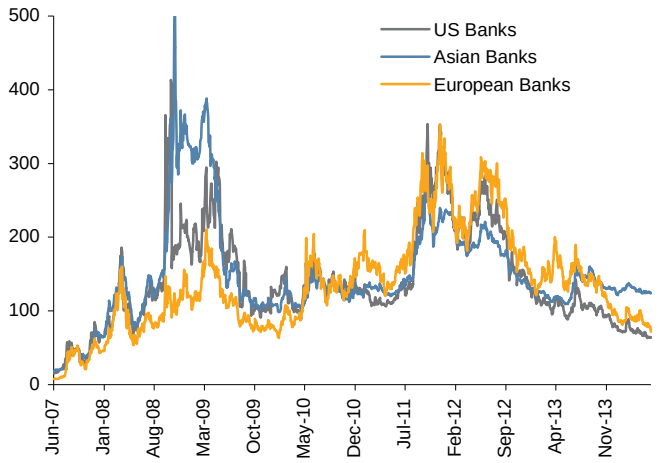


Source: RBS Credit Strategy, Bloomberg

Financial Stress Watch

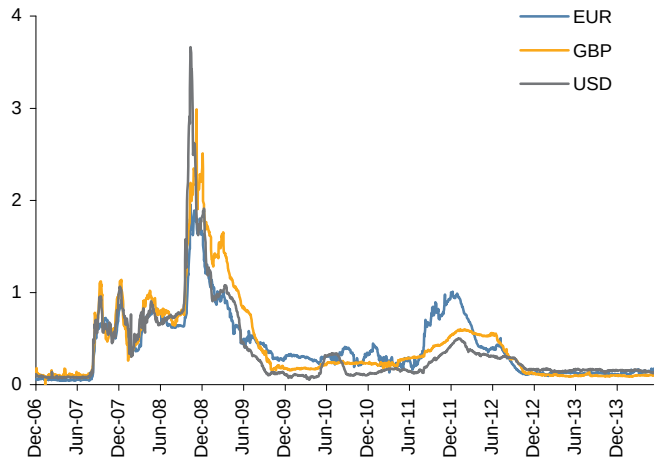
Bank spreads and risk in the financial system

Average bank spreads by region, bps



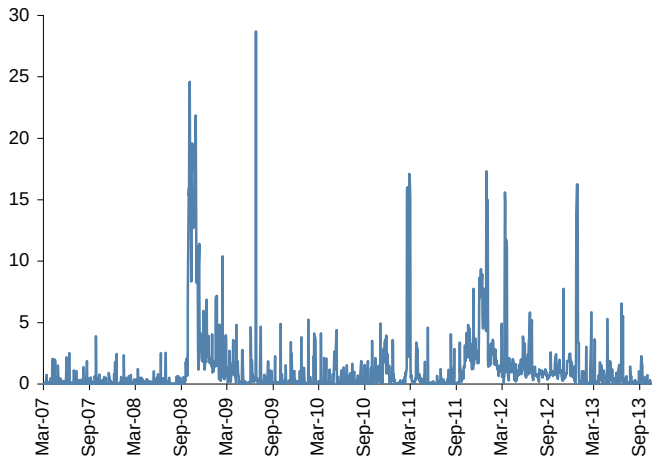
Source: RBS Credit Strategy, Bloomberg

Libor-OIS spreads, %



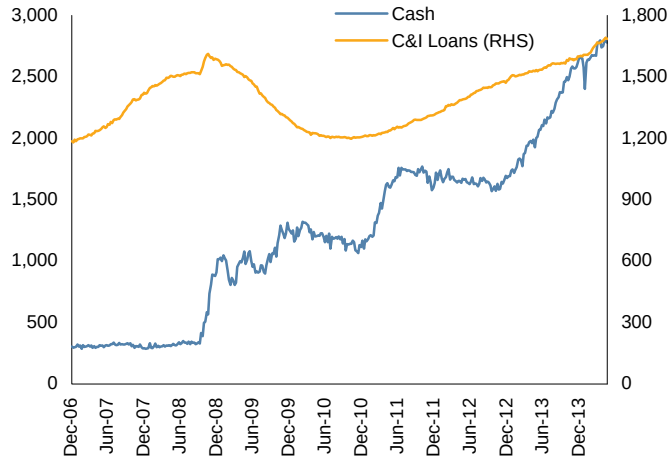
Source: RBS Credit Strategy, Bloomberg

Use of the ECB marginal lending facility, €bn



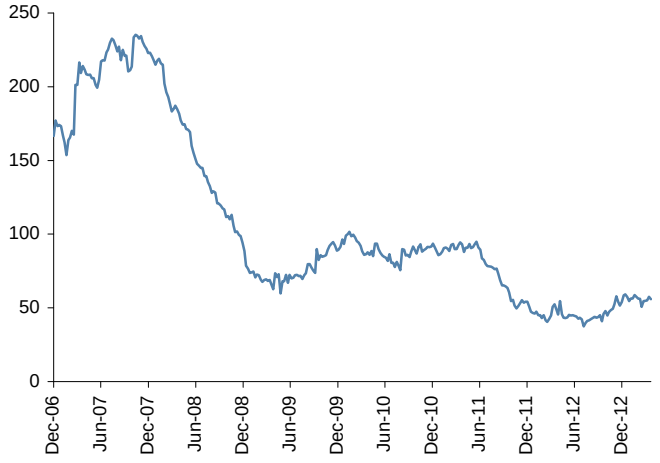
Source: RBS Credit Strategy, Bloomberg

Cash and C&I loans on banks balance sheets, $bn



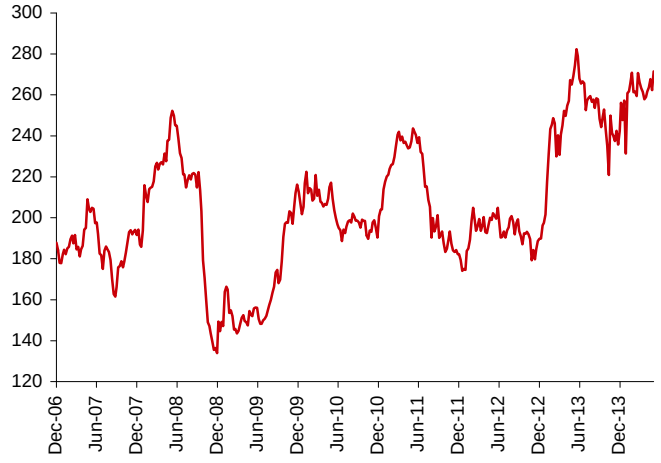
Source: RBS Credit Strategy, Bloomberg

US primary dealer corporate bond inventories, $bn



Source: RBS Credit Strategy, Bloomberg

US commercial paper outstanding from foreign issuers, $bn



Source: RBS Credit Strategy, Bloomberg

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