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Crédit Agricole CIB

Crédit Agricole revived a lifeless market for floating rate notes this year.

The bank solved a structural problem that had squeezed coupons on floating rate notes (FRNs) a percentage point lower than equivalent tenor fixed-rate bonds and had choked issuance from tens of billions of euros a year to almost zero.

The new structure pegged FRN coupons to forward rather than spot rates, eliminating a negative carry that had dragged down coupons in the old structure. Fourteen other issuers have since adopted the format, issuing more than €2.8 billion since November 2018.

"The floating rate note market had almost disappeared," says Amaury D'Orsay, the bank's global head of fixed income sales. "In a year of all-time low and falling rates, the development of the '10-10' structure brought it back to €3 billion in less than a year. This is not just a product. It has become a market."

Financial institutions typically use FRNs to protect against interest rate rises, principally the risk that customers withdraw savings when rates go up and leave institutions with depleted assets to match their liabilities. Crédit Agricole estimates total outstanding issuance to be about €200 billion. But volumes in the three years to 2019 amounted to no more than €3 billion.

Usually the notes pay a coupon based on the 10-year constant maturity swap (CMS) rate or three-month Euribor, plus or minus a spread. In essence, the investor buys an expensive forward rate and receives a cheaper spot rate. The negative carry delivers a lower coupon. The further the forward curve rises above spot rates, the lower the first coupon will be compared to the equivalent fixed rate.

> "This is not just a product. It has become a market"
> Amaury D'Orsay, Crédit Agricole CIB

Twenty-year investment grade FRNs today in Europe would typically pay a zero coupon if linked to three-month Euribor, explains Christophe Viard, Crédit Agricole's head of macro structuring.

Poor returns from holding FRNs were taken as fact by clients, D'Orsay says: "Everyone accepted floating rate notes were expensive. They just didn't buy them."

Through more than 200 meetings since the beginning of 2018, the bank explained its new structure to clients, culminating in an initial €100 million 20-year deal sold to a French mutual insurer in November 2018. Since then, Crédit Agricole has issued a further €600 million in 14 deals – about 25% of the FRN issuance in the new format by volume.

Christophe Viard, Amaury D'Orsay and Samy Ben Aoun

To solve FRNs' carry problem, Crédit Agricole took advantage of a structural downward slope in the forward curve after the 10-year point. That means the gap between the forward and spot curve closes. By indexing bonds to a 10y10y forward swap, the bank removed the drag on the coupon.

"The CMS 10-10 exposure will give at least the fixed rate equivalent coupon. With any other floating rate exposure, you reduce your coupon," says Viard.

The flattening of the forward curve results from the convexity of long-dated swaps and bonds, which are more sensitive to rate changes than shorter-dated bonds. At the long end, the downward pull of convexity cancels out an otherwise natural upward slope. For euro and US dollar interest rates this inflexion point falls at 10 years 80–90% of the time.

"Nobody had thought of this before," says a former finance director at the French mutual. Crédit Agricole's quantitative simulations showed 10-years was the optimum point of the curve, he says. "I realised that CMS10 in 10 years would become a kind of new market reference."

A critical step in the successful take-up was the publication of the bank's formula for calculating coupons. The formula draws a relationship between spot and forward rates, providing a "really good proxy" for the physical forward rate at any point in time.

In broad terms, a 20-year swap can be thought of as a 10-year swap and a 10y10y swap. That means you have a relationship between the 20-year, the 10y10y and the 10-year and can calculate one from the others, explains Samy Ben Aoun, global head of structured rates trading.

"If you want to develop a concept in the fixed income world you have to be completely transparent on the calculation of the coupon. If investors could not compute the coupon, they would not buy the product because they would be relying only on the fairness of the manufacturer to determine the rate." ■

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