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The Moving Goalposts of European Bank Failures

Bondholder Implications from Recent Italian and Spanish Cases

The occurrence of a bank failure became intertwined with a consequent bailout during the financial crisis, damaging sovereign finances and raising consternation among taxpayers. Recent bank failures in Spain and Italy have tested the Eurozone's resultant bail-in regime and demonstrated that its application remains a moving target with broad ramifications for bondholders throughout the capital structure.

- *The first responses by Eurozone and national authorities in Spain and Italy avoided solutions that impose losses on depositors and senior bondholders, while customers faced minimal operational disruptions and became clients of nationally-recognized institutions;*
- *While holders of hybrid and subordinated bonds face full loss in both instances, the Italian solution involved public funds, which was not the case in Spain;*
- *Although the contrasting details raise regulatory consistency questions, there was always a high probability that Italy would find a way around stringent implementation of EU bail-in rules. In particular, its solution avoids losses to retail bond investors while minimally disrupting those Italian banks dependent on senior unsecured funding and an economy in the midst of a tepid recovery before a crucial election;*
- *Outcomes for other weak European banks may still differ from the Spanish and Italian solutions. As the composition of bank capital evolves, it will eventually become easier to impose losses on more slices of debt throughout the capital structure;*
- *Furthermore, potential "rescuer" banks will likely see greater logic in waiting for the resolution of a failing bank, making loss imposition on debt more likely;*
- *While additional regulatory developments do not preclude future bank bailouts, the sector is generally healthier when compared to its state at the onset of the financial crisis;*
- *The recent cases highlight that investment decisions based purely on a few reported capital and operating ratios are inappropriate—rather, an accurate assessment requires sound analytical knowledge of business franchises, funding structures, corporate culture, loss recognition practices, and national banking structures.*

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A Brief History: Spain's Banco Popular Español and Italy's Veneto Banca and Banca Popolare di Vicenza

Banco Popular Español was a publicly listed, mid-sized lender with a 7% loan and 6% deposit market share in Spain. In earlier decades, it had built a solid reputation as an efficient bank with a cautious credit culture, closeness to small-and-medium-sized-enterprise customers, and credit ratings in the AA range until 2008. From the early 2000s, however, Banco Popular made a big push in the construction and real estate sectors—those at the heart of the crisis in Spain starting in 2011.

Over time, the bank's insufficient recognition of loan losses and foreclosed assets led regulators to insist on a capital raising in 2016, which was ultimately insufficient. In Q2 2017, Banco Popular disclosed that 25% of its total assets had soured with a 45% loss recognition (when peers had over 50% recognition). From that point, the bank struggled to raise capital, potential suitors backed away, and meaningful deposit outflows followed. When these outflows reportedly reached €12 billion, Eurozone regulators deemed that the bank had reached the point of non-viability (PONV), and a subsequent resolution action involving Spanish authorities ensured that the bank would continue to function for its customers. After Banco Popular's existing shareholders and AT1 (additional tier 1 or Basel III compliant hybrid capital) bondholders had their claims extinguished, investors in the dated subordinated debt had their holdings converted to equity, which was subsequently valued at €1. Banco Santander S.A. (Santander) was subsequently brought in as a buyer of Banco Popular's legal entity, paying the €1 for the bank and its subsidiaries

In Italy, Veneto Banca and Banca Popolare di Vicenza were two regional lenders with a combined national market share of less than 2%, but with a more significant presence in their home Veneto region where they served many regional businesses. After the global financial crisis and the Eurozone crisis, the deterioration in the banks' credit profiles was marked by accumulating non-performing loans (some 37% of gross loans as of 2016), weak earnings, and insufficient capital levels. Given the precarious state of the banks by mid-2017, Italian authorities stepped in, citing EU rules permitting state-assisted liquidation for banks that do not pose a national systemic threat if the member state decides that standard resolution proceedings will have a serious impact on a regional economy.

As a result, Intesa San Paolo SpA (Intesa) is set to receive state aid as the buyer of the "good" parts of the two banks following liquidation. The banks carried total assets of €62 billion at the end of 2016, and Intesa takes on €37 billion of performing assets, all €23 billion in deposits, all senior bonds, and interbank and derivative assets and liabilities. In turn, Italy is set to provide Intesa with €3.5 billion to ensure that its capital ratio is unchanged after absorbing the assets and an additional €1.3 billion to compensate it for charges incurred with required restructurings. Beyond direct state aid payments, Italy will have new contingent liabilities of approximately €11 billion.

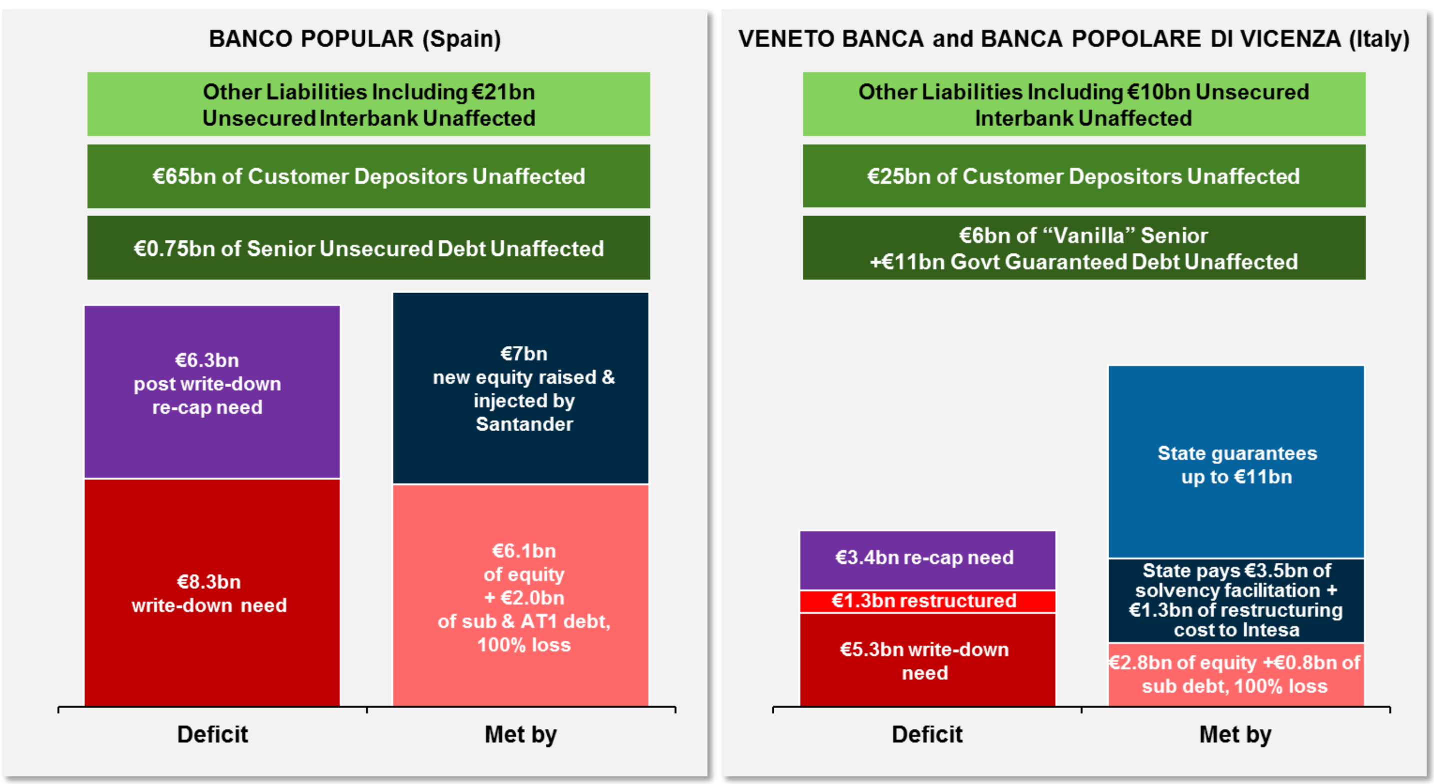
Similarities and Differences

The situations in Italy and Spain ultimately culminated around the same time, however timing is not the only shared characteristic between Banco Popular Español and the Venetian banks. In both cases, losses were imposed on equity investors as well as subordinated and hybrid bondholders (without meaningful equity conversion), **while senior unsecured holders were left unaffected—the current *pari passu* status of senior unsecured bonds with non-guaranteed depositors would have led to legal problems in imposing selective defaults on just the bonds.** Additionally, the solutions in both Spain and Italy recognized the importance of keeping the senior unsecured funding channel open in countries with a plethora of small—and sometimes troubled—banks. Given the contagion risks to the broader banking sector, any negative impact on non-guaranteed depositors was avoided by regulators overseeing the "bail-in" of Banco Popular Español and the liquidations of Veneto Banca and Banca Popolare di Vicenza.

While only a handful of differences exist between the cases in Spain and Italy, the contrast between both outcomes should not be overlooked. In the Banco Popular case, while the Spanish government facilitated the transfer of the bank's going concern to Santander, the government did not provide state aid, guarantees, or a bad bank structure. The Venetian case essentially served as an orderly government-assisted liquidation with a state-vehicle taking troubled assets and providing a subsidy to the buyer.

The Banco Popular solution also involved a strong post-resolution buyer that saw the upside in acquiring the bank without state aid given the bank's above-average pre-provision profitability, its meaningful national market share, boost to economies of scale, and potential use of a more developed and active market for non-performing loans and foreclosed assets. While including state aid and assuming approximately €11 billion in liabilities may not have been the preferred result for the Italian government, it stood to lose substantially more from most other outcomes. Indeed, full imposition of bail-in rules would have led to a concentrated impact on the region's economy, and Italy already had "skin in the game" with guarantees on bonds issued by the two banks using a new facility. Additionally, the Venetian banks had a significant stock of outstanding retail targeted bonds (our estimate is that 22% of the banks' senior unsecured bonds were held by retail investors). Finally, Spanish authorities have been keen to distance the country from one requiring special case status, whereas Italy has (at least anecdotally) an effective lobby in EU institutions and is prepared to plead special circumstances.

COMPARING THE SPANISH AND ITALIAN SOLUTIONS



Sources: PGIM Fixed Income, Banco Popular Español, Banca Popolare di Vicenza, Banco Santander, Intesa San Paolo SpA, and Bloomberg

Relatively Bondholder-Friendly Outcomes Set to Become Less Likely Over Time

While the differences between the two solutions underscore that regulatory treatment for failed European banks remains in flux, changes aimed at ensuring authorities *can* resolve failed banks with loss imposition on a greater proportion of bank liabilities are clearly underway internationally and across Europe.

Internationally, the total loss absorbing capacity (TLAC) framework of the Financial Stability Board was finalized in 2015. This requires that by 2022 banks have additional amounts of explicitly bail-in eligible debt, beyond existing "Basel" requirements for solvency capital in the form of equity, hybrid debt and subordinated debt. It is applicable to the 30 largest global systemically important banks (GSIBs—14 of which are in Europe) with a clear calculation method for regulators to impose minimum levels.

In the EU, the Bank Resolution and Recovery Directive of 2014 (BRRD) stipulated that regulators set minimum required eligible liabilities (MREL) ratios that include equity, hybrid debt, subordinated debt, and any other potentially loss absorbing liabilities for all European banks, not just the GSIBs.

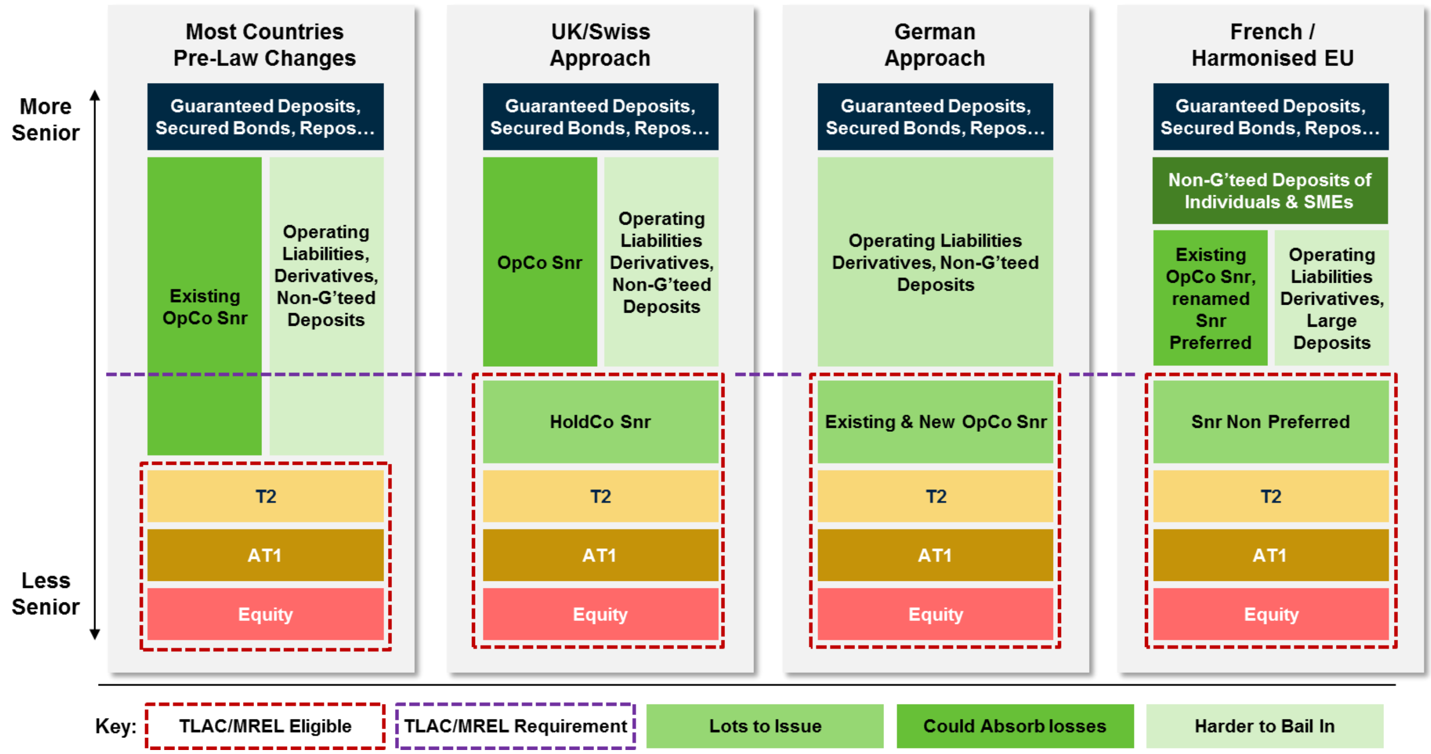
However**,** progress on establishing a critical mass of explicitly bail-in eligible debt in Europe has been patchy.

Switzerland and the UK have been at the forefront of early international discussions on bail-in and burden sharing. Historically, both countries had non-operating holding companies (HoldCos) as the ultimate parents for the largest banks. Regulators in both countries have guided the larger, non-mutual banks to use these entities (and if necessary set them up) as issuers of debt (including senior) that would be structurally subordinated to senior debt issued by their main operating companies (OpCos). Thus, a bail-in of HoldCo debt should be possible without affecting the operations of the OpCos.

For the most part, this structure has not been practical in the rest of Europe considering HoldCos rarely existed and are difficult to establish. After passing a law in 2015, Germany has initially proceeded with a solution that "demoted" existing senior unsecured bondholders by subordinating "plain vanilla" senior unsecured bonds to all deposits and operational liabilities from January 1, 2017. This eliminated the need for its major banking groups to insert a HoldCo as the ultimate parent or to create a new liability class. It also means the banks have avoided the need to issue significant amounts of new bonds at what would have been notably wider spreads.

Most other continental European countries appear to be heading down another route that is likely to become the main approach within the EU. Most countries want the possibility for banks to access both a new tier of explicitly bail-in eligible capital and retain a form of unsecured non-deposit debt funding that would be more senior. **France** legislated for an alternative approach in December 2016, which created a new class of senior non-preferred bond (SNP, variously also referred to as non-preferred senior, NPS, or "tier 3"), thus re-designating the existing form of senior unsecured as senior preferred. Other European countries are about to follow suit.

DIRECTION OF TRAVEL IN EU CREDITOR HIERARCHY



Source: PGIM Fixed Income. Note: MREL = Minimum Required Eligible Liabilities, the equivalent of TLAC applicable to all EU banks regardless of G-SIB status

Future Implications for Bondholders

Upon looking at the cases in Spain and Italy in the context of an evolving regulatory backdrop, some key investment implications for bondholders emerge.

Recovery assumptions through equity conversion and triggers on contingent convertible bonds (CoCos) now seem less relevant. For regulators, the tipping point regarding Banco Popular was depositor flight and not the developments in the reported common equity tier 1 (CET1) ratio (10.0% as of March 31, 2017). Triggers based on CET1 ratios that AT1 bondholders focused on (5.125% and 7.0% in Banco Popular's case) hardly mattered. Equity ownership failed to materialize for those explicitly convertible bonds and holders of tier 2 debt given authorities' reluctance to create—through debt conversion—new minority shareholders that a potential post-resolution buyer would have to contend with.

There can be significant benefits for stronger banks that absorb failed institutions. In the Banco Popular case, Santander raised €7 billion in equity, leaving it with unchanged CET1. This was raised easily as the additional return it will have from this "in-market" acquisition should be at least as high as its prospective 12% ROE. In the Venetian case, the transaction is also capital neutral for Intesa thanks to the facilitation payments from state, while the cleaned out bank transfer reduces its NPL ratio and boosts its franchise in a wealthy region.

The potential benefits could mean reduced likelihood that future buyers of a distressed bank would want to move before a resolution order. The recent cases have shown that, after bondholder losses have been imposed, a "pre-pack" resolution or liquidation arrangement with a standby buyer can be arranged by the authorities. Investors that buy or continue to hold bail-in eligible debt—in the hope that the franchise of a troubled bank is valuable to a strategic buyer—would seem to be taking bigger chances than before.

Even as bail-in rules gain greater clarity, the common regulatory failure regarding a lack of tighter rules for valuing troubled assets still exists. The ECB made a valiant attempt to address this shortcoming when it assumed regulation of Eurozone banks in 2014, but this implementation proved too difficult to repeat and update in subsequent stress tests. In the recent bank failures, the write-downs needed to mark troubled assets to clearing levels amounted to CET1 ratio swings of -17%.

The cases in Spain and Italy demonstrate the limited utility in purely focusing on solvency ratios when investing in bank bonds. After the regulator-encouraged rights issue in mid-2016, Banco Popular had a CET1 ratio of 15.3%. At this point, some investors would likely have been interested in the bank's subordinated debt and hybrids. Those who ignored warning signs on the bank's history of aggressive expansion post-2004 and its reluctance to mark troubled assets down to levels similar to its peers would have been surprised by its latest admission of massive write-down needs. They would have also found an unreceptive market had they attempted to liquidate positions.

While full depositor preference is not immediately on agenda, it may eventually arrive with an uncertain impact on bondholders. It could be argued that the depositor flight that led to the urgent need to resolve Banco Popular could have been avoided if it was clear to all non-guaranteed depositors that they rank higher than all bondholders. However, Popular, (amongst other banks), did not have enough explicitly bail-in eligible bonds outstanding with which to bear losses. Critical mass of these bail-in eligible bonds may take some time to develop along with the belief that depositors would be unaffected by a bank undergoing resolution.

Overall, the whole effort to make European banks less of a problem for sovereigns in any subsequent crisis is beginning to yield results, as observed in the following table. When assessing the sector's general status, other points worth considering include the legal basis for a bail-in, the potential for reduced contagion risk from a bank failure by switching from OTC to collateral backed exchange trading, tighter limits on large exposures, and greater emphasis on governance standards.

AGGREGATE RATIOS FOR THE TOP 60 BANKS IN EUROPE AT END 2016 VS. AT END 2006

	2006	2016
Loss absorbing capital indicators		
Common equity tier 1 capital (*) to tangible assets (*)	**2.2%**	**4.7%**
Dated subordinated capital to tangible assets	1.6%	1.5%
Hybrid capital to tangible assets	0.5%	0.7%
All solvency capital (*) to tangible assets	4.2%	6.9%
Explicitly bail-in eligible senior debt to tangible assets	0.0%	0.4%
Total solvency plus bail-in capital to tangible assets	**4.2%**	**7.3%**
Comparable liquidity indicators		
Loans/deposits (higher the less liquid)	116%	103%
(cash + interbank assets - interbank liabilities) / assets	-3%	7%
Comparable asset quality indicators		
Impaired loans to gross loans	1.7%	3.8%
Provision coverage of impaired loans	87.6%	56.1%
Non-provided portion of impaired loans / CET1 capital	3.8%	18.3%
CET1 capital to tangible assets at the 87.6% impaired loan coverage ratio seen in 2006	2.2%	4.1%

Source: PGIM Fixed Income via Fitch Ratings (for 2006 data) and SNL for 2016 data.

With that being said, it is difficult to ignore the now-bigger tail risks from the recognized "known unknowns." For example, it is possible that the unwind of some unprecedented asset bubbles (e.g. housing in hot-spot cities) could be worse than predicted by any stress tests. In addition, litigation payments and regulatory penalties from around the world—often from authorities with little concern on the impact of their actions on foreign banks—have all mounted. Cyber risks are almost impossible to quantify. Furthermore, analysis of ratios in aggregate can conceal clusters of very weak banks in a concentrated area or in multiple countries. ***Thus, at this point, it would be unwise to categorically state that sovereigns will not need to step in with during the next major crisis.***

Conclusion

For many observers, the recent failures of three European banks may have rekindled a systemic question: whether banks might again burden stretched European sovereigns and taxpayers "in the next crisis." Thanks to an ongoing regulatory push, the European banking sector has, on average, significantly better loss-absorption capacity than prior to the great financial crisis, but the improvement likely conceals clusters of weakness, and there are different, novel types of tail events to now consider. Therefore, it is too early to remove the potential for sovereign aid from the calculus of bank failures.

Still, we expect that over the next few years, regulators will be more willing—and in a better position—to impose losses on any bond class that has been placed primarily with institutions. This will include the new "tier 3" class of senior non-preferred bonds as well as senior unsecured bonds issued by non-operating holding companies.

While the emphasis on greater loss-absorbing capacity builds, existing investors in explicitly bail-in eligible debt have multiple implications to consider: once a bank enters a spiral of descent, conversion features and trigger levels for new style hybrids and CoCos can be rendered meaningless; in a failed bank situation, the ultimate recovery for both hybrid and subordinated debt is likely to be zero; and authorities will likely be reluctant to convert any debt instruments to equity in a bank that is still a going concern so as not to deter potential buyers of a troubled bank.

The ongoing regulatory push and the implications for investors in bail-in eligible debt underscore that merely investing on headline solvency ratios and comparing them to likely triggers at which regulators may impose losses is inadequate. Rather, more comprehensive analysis requires evaluation of business models, risk management practices, funding risks, national banking structures, and firm wide governance and culture standards.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income, July 2017.

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