After the ‘Whatever-it-takes’ Bail-out of Eurozone Bank Bondholders

The Eurozone’s wasted opportunity for a banking union that protects sovereigns finance

Summary

Despite rhetoric to the contrary, the Eurozone’s banking crisis management choices taken in recent years have confirmed the status of bank bond investors as highly privileged. For senior unsecured bank bond investors a banking union in the sense of full insurance is not a distant project, but a reality today. Even subordinated bank bond and hybrid bank equity investors have been mildly treated in many cases of near insolvent banks. Anecdotal evidence from Spain, Ireland and Greece suggests different dynamics leading to similar results, with loss recognition speed and political willingness to bail-in playing the decisive roles.

While comprehensive bank bondholder protection was implemented, bank insolvency legislations in the Eurozone that could have rationalized these policies became delayed and remain a torso. The corresponding bail-out costs and risks have almost exclusively been underwritten by sovereign bond investors. Through the events these have become de-facto subordinated to senior unsecured bank bond investors. Contrasting with the situation of senior unsecured bank bonds, haircuts for sovereign bonds by way of collective action clauses are a legal feature from January 2013 onwards.

Asking European banks to step up to mutually fund protections for bank bondholders and eventual bail-out costs in the dimensions seen will be near impossible. Unless course is changed quickly and radically, banking union will become expected to remain a private debt transfer exercise to Eurozone sovereigns and Eurozone banks will be seen as largely government-sponsored.

By Hans-Joachim Dübel

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Introduction

Despite the sometimes opposite public pronouncements of Eurozone political leaders, their determination to protect bank bond investors in the current crisis in reality has been rather swift and pervasive. Severe sovereign bond market stress and the first steps towards sovereign debt mutualization have resulted from pushing sovereigns directly out of the market (Ireland, Cyprus) or to the brink (Spain) in connection to bank bail-outs. In Greece, currently a second sovereign restructuring is under debate as public debt is further increased to protect bank bondholders. Debt acceleration through payments to banks is without doubt a key driver of the ongoing Eurozone sovereign debt crisis.

While political rhetoric demanding bank bondholder bail-in has picked up cyclically as the fiscal tab for the bail-outs mounted, the delay and timidity of actual action speaks a different language. Schich (2012) provides an overview analysis for OECD countries suggesting that the practices of bank resolution adopted so far have rather uniformly benefited bank debt investors. The exceptions to this policy – in particular Denmark and the UK – are found outside the Eurozone. This finding can be further detailed by exploring the financial mechanisms of avoidance of bail-in in three Eurozone countries. Together with revealed legal and regulatory actions seen on the EU level so far this allows us to make some inference about the character of banking union and its backup mechanisms that is implied by current policies.

Scale of Bank Bondholder Bail-outs: Anecdotal Evidence from Ireland, Spain and Greece

Between the three countries more than a dozen large banks and savings banks so far have received officially sponsored recapitalizations. Of interest is the contribution of private investors to fill the bank capital gaps determined by regulators. Of particular interest are those investors that are first in line of taking losses, i.e. hybrid equity and subordinated bond investors[1], in short 'junior' bank bond investors.

In Spain and Ireland financial stress was caused by a largely synchronous real estate lending boom that in both cases peaked in 2007. Yet, Irish house prices already had collapsed by 2009, forcing banks to recognize losses as soon as 2010, while in Spain both price adjustment and loss recognition were dragged out into 2012.

Ireland as a result had soon created a bad bank that purchased defaulted developer loans with very high discounts and for the remaining assets remaining on bank balance sheets enforced a severe stress-test. Booking the losses upfront established a sizeable capital buffer, which stabilized the banks. With the help of swiftly passed legislation, the sovereign was able to recover EUR 5.5 billion through haircutting the original junior bond investors. This means that roughly 10% of the ca. EUR 50 billion capital gap of Irish banks has been covered through bail-in of bondholders.[2] Ireland could have achieved a far higher ratio of burden sharing if the Eurozone would have not resisted haircutting Irish senior unsecured bank bondholders.

Spain in contrast had permitted banks for several years to keep financing new house purchases at inflated prices to sell off defaulted developer stock, with the help of rock bottom interest rates. The consequence was that in 2010 and 2011 only a partial restructuring of bank balance sheets was undertaken. The low loss recognition at that point permitted some original investors to fully recover their investments and misled new investors into investing in seemingly sound balance sheets. Through the delay, much of risk positions in banks that could have been used for bail-in in Spain was de-facto transferred from professional to retail investors[3] or was lifted in insolvency rank. Shares sold to retail investors implicitly protected bank bonds sold earlier. [4] Only 2012 saw finally both the inflated prices

1 Hybrid equity has historically been classified as core capital of a bank while benefiting from interest tax deduction and legal formulation as debt contracts. The most popular versions used in Europe have been preference shares and silent participations (concealing the identity of investors). Subordinated bonds do rank before hybrid equity but behind senior unsecured bonds in bank insolvency, and for this reason have historically been accepted as substitute capital.

2 Capital gap can be defined as the distance between the current core capital position of the near-insolvent bank, usually in negative or insufficiently low territory after loss recognition, and the core capital demanded by regulators for the going concern. A zero current core capital position already assigns zero book value to shareholder equity, and likely also hybrid equity (depending on its recognition). These positions should then not be included in bail-in ratio calculations.

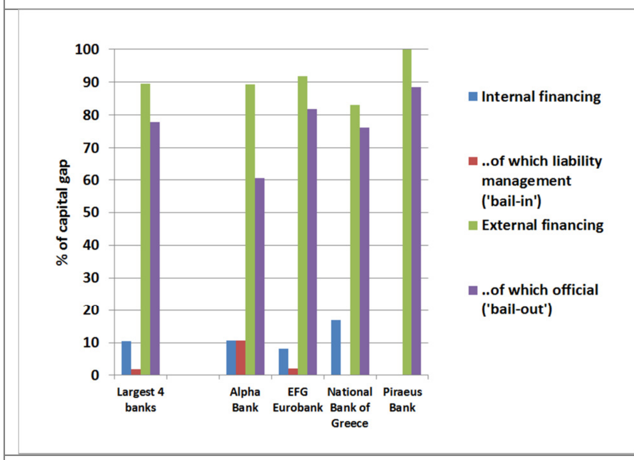
3 The investment bank UBS estimates that Spanish banks have issued between 2007, the price peak, and 2010, the year of the largest Caja mergers, EUR 32 billion in preference shares which were largely sold to retail investors.

4 An example of the tactics adopted to engineer rank improvement for junior bonds as a result of delayed loss recognition is the creation of Bankia and its holding company Banco Financiera de Ahorros (BFA). Bankia absorbed both assets and liabilities, including preference shares and silent participations, of the seven Cajas participating in its merger. However, implicitly protecting those junior bonds was the transfer of doubtful loans to the holding company BFA, which in addition initially held the ownership, i.e. first loss position, in Bankia. BFA itself issued in December 2010 EUR 4.465 billion in convertible preference shares to the public Spanish bank stabilization fund FROB, pulling the Spanish government into the risk. When BFA privatized Bankia stock to 400,000 retail investors these de-facto removed part of the risk for the Spanish government. In summary, the Spanish government and retail investors have been operating as insurers protecting the junior liabilities merged

collapse and a full bank restructuring and creation of a bad bank along the Irish model.

As a result of the rotation of investors in bank equity and junior bank bonds, Spain, in contrast to Ireland, had to be forced by the Troika of ECB, EU Commission and IMF in 2012 to adopt modernized bank insolvency legislation. Resistance to full implementation remained strong: while the recovery ratios for junior bond investors agreed on look potentially low on paper[5], for the retail investors among them it has been suggested by government that full recovery would be possible if they can prove to have been misled by the issuing bank. This special treatment has also prompted lawsuits by retail investors that felt misled into buying bank shares.

Figure 1. Bank Capital Gap: Internal vs. External Financing of Greek banks



Sources: Merrill Lynch, FROB, HFSF. Notes: other internal financing includes asset sales, tax liability management and other balance sheet management; other external financing includes shares and hybrid capital issues as well as private placements. Data as of June 2012.

As the final outcome regarding retail investors remains to be seen, what can be said is that external pressure on Spain has likely lead to a moderate contribution of junior bank bondholders to recapitalization, possibly in the range or slightly exceeding the Irish ratios for the most affected banks in 'Group 0'.[6] A bitter taste however is that as a result of Spain's insolvency delay tactics most of the investors suffering haircuts are no longer those that were historically responsible for funding the credit boom. Evidently also senior unsecured as well as covered bond investors come out completely protected.

In the case of Greek banks, loss recognition delay was not a factor in driving bail-out cost, but political resistance to bail-in was. Sovereign bond losses that initially drove bank capital gaps were determined by the external official financiers of the Greek state rather than by domestic valuation tactics.[7] The Hellenic Financial Stability Fund has not published the full bank recapitalization plans with detail on bail-in. A substitute could be Merrill Lynch (2012) analysis presented in Figure 1 of June 2012, according to which almost 80% of the capital gap of the four largest banks is funded through the Eurozone bail-out. Only two banks at that point had proposed minimal bondholder bail-in measures, limited to junior bonds.[8] By December 2012, the total junior bond debt left between the four banks is still in the range of EUR 2-3 billion.

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into Bankia. Within these junior liabilities, again over time substitution processes between professional and retail investors took place.

5 By December 2012 the settlement of the EU with Spain on Bankia, the largest near-insolvent bank, determined haircuts for hybrid equity and subordinated bonds. Strike prices for their conversion have not been published as yet, also it is unclear at what price the far larger hybrid capital position provided by the mother BFA would be converted into Bankia stock. This leaves the door open for potentially large subsidies to historic capital owners. Currently, capital market advisory firms estimate recovery ratios in the range of 25% for preference shares and of 35-40% for perpetual and term subordinated debt. Ordinary shares would be heavily diluted but not be entirely wiped out.

6 'Group 0' comprises Bankia/BFA, Banco de Valencia, NovaCaixa Galicia, and Caixa Catalunya.

7 International banks already in the summer of 2011 led by writing off 22% of the GGB book values. Zettelmeyer, Trebesch and Gulati (2012) estimate the ultimate aggregate GGB haircut by March 2012 to lie between 55 and 65%.

8 According to Merrill Lynch, EUR 100 million (EFG) and 333 million (Alpha), respectively, compared to a capital gap of EUR billion 4.9 and 3.1 billion, respectively.

A factor in the lackluster use of bail-in in Greece may be the predominant issuance of bank bonds by the largest banks through Jersey trust vehicles. These arrangements usually contain detailed contractual language enforcing later recovery unless the issuer goes insolvent. Yet, such circumstance has not deterred Ireland to cut the same type of securities severely by means of a special law, fiercely at the time attacked in the financial press and still contested in court. Also, Greece simultaneously practices a legally sound alternative to bail-in in the case of smaller banks, the Good Bank approach, which transfers junior bondholder claims together with dubious assets to the bad bank tying their future to the one of the assets.[9][10]

Even this cursory overview should permit the conclusion that in the three countries and the bank cases discussed bank bond investor contribution to financing a determined capital gap rarely has exceeded 10% of the bank capital gap. Those first in line to take losses, hybrid equity and subordinated bank bondholders have been partly left off the hook through loss recognition delay and policy-induced discretionary actions. Senior bank bondholders as well as covered bond holders have remained completely protected in all cases. Of the three countries, only Ireland actively tried to haircut both senior and junior bank bond investors.

The potentially highly distortive horizontal and vertical equity impact of these policies should be noted and explored in further research. For instance, Greek senior unsecured bank bond investors have received drastically better treatment than Greek sovereign bond investors, even though the difference in underlying asset quality was rather marginal (partial and intermediated vs. full and direct investment in Greek government bonds). This has hit e.g. Greek pension funds hard who according to OECD data had dramatically enhanced sovereign bond and symmetrically lowered bank bond exposure in 2009 and 2010. Going forward, the official creditors of Greece might be forced to take losses as a result of the generously calibrated bank bail-out of 2012 for the largest banks.[11] To the extent that bank bond investors receive high or full recovery in this way, sovereign bond investors are potentially hit harder. The policies chosen thus generate a de-facto subordination of sovereign bond investors to unsecured bank bond investors, whose extent depends on the scale of banking problems.

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9 The example of ATEbank is reported in the Greek press as a case where the good bank concept is followed. Under this approach, the healthy parts of the bank are sold, in the specific case with the likely participation of the three systemic groups of National (including post-merger EFG Eurobank), Alpha and Piraeus. The alternative is stand alone and later going public. The bad bank under this concept is the residual, i.e. contains dubious assets as well as equity, hybrid equity and subordinated bonds after the balance sheet is split 'horizontally'. This approach is most likely to ensure bank bondholder participation. Importantly, it provides a potential upside for junior bond investors if dubious assets perform better than expected, which improves the legal resilience of the procedure. To ensure burden sharing, senior unsecured bank bonds could be assigned to the residual bad bank pro-rata. Residual bad banks could be pooled across failed institutions in an economy.

10 While the official argument used for recapitalizing the large banks with large amounts of Eurozone funds is their greater economic viability (as opposed to smaller banks), future access to debt for the large network banks and in particular their national champions character for Greece seem to form an important subtext of the decision. Two of the four banks – Alpha Bank and EFG Eurobank – have strong market positions in South Eastern Europe that Greece does not want to give up to preserve regional status. One – National Bank of Greece – is dominating the important domestic Greek real estate finance sector.

11 Of the EUR 43 billion in Eurozone funding cleared in December 2012 and adding to Greece's sovereign debt, EUR 23 were earmarked for protecting bank bondholders (EUR 18 billion for recapitalizing four large Greek banks, 5 billion for a buffer for future recapitalizations held by the Hellenic Financial Stability Fund).

The Legal Basis for Bail-in Remains a Torso

Beyond factual empirics, the lack of willingness to let bank investors bear losses could not be more clearly demonstrated by the delay in passing bank resolution and restructuring legislation on both national the EU level. 5 years into the financial crisis, by the summer of 2012 inside the Eurozone only Ireland and Germany had adopted legislation permitting regulators to force bank bondholder participation prior to insolvency. Countries with significant banking sector issues including Greece, Cyprus, France and Austria had not taken major legal reform action. Spain had to be forced to take action, as shown; however, the law contains numerous clauses that may be abused for increasing investor bail-out. [12]

Failure to act on the national level may have been related to the fact that investors in junior bank bonds frequently are national or even local, and often intimately tied to politics on that level. This is certainly a good description for European regional banks, including the Spanish Cajas, where even prior to selling those bonds to retail many local institutions and governments were invested in them. Conversely, a factor in Ireland's quick decision to haircut junior bonds may have been their exceptionally wide distribution of such debt to international investors. The motive to protect national investors first in line to take losses likely has been a central driver of calls for a delinking of the banking risk from sovereign risk through direct recapitalizations by the Eurozone. The same delinking result clearly could have been achieved through consequent bail-in policies.

With support from many Member States running low for such reasons it is unsurprising that the European Crisis Management Directive (CMD) designed to facilitate bank resolution and contain public rescue costs remains in limbo while action in the sovereign bond market sphere has been rather fast. By June 2012 a CMD proposal assigning the bail-in option even of senior unsecured bank bond holders was published by the Commission. It stands in direct contradiction with the current rescue policies. First drafts circulating as late as January 2012, after years of delay, still had only named bail-in as one of many options and avoided putting any pre-insolvency pressure on creditors. The Directive was initially supposed to be applicable only from 2018 onwards and currently is scheduled for 2015, in both cases beyond the time frame necessary for current bank crisis management. In contrast, haircuts for sovereign bondholders through collective action clauses have been legally enabled by EU legislation in early January 2013. Not just from a de-facto empirical, but also from a legal-technical perspective, in the Eurozone sovereign bonds are now riskier than senior unsecured bank bonds.

The Precedent Could Limit Banking Union to a Eurozone Subsidy Vehicle for Private Bank Creditors

The conclusion from the evidence available so far that the famous 'whatever-it-takes' approach, discussed publicly primarily in the context of the sovereign bond market with reference to future action of the ECB, is today an empirical reality for most of the Eurozone bank bond market. This material precedent raises serious issues for the future of the Eurozone banking system.

To start, there is the issue of credibility: whatever new legislation will be passed on the EU or national level to enable bail-in, will next time really be different? The underlying politics are unlikely to change:

[12] For example, Chapter VII of Law 9/2012 of November 14 on the Restructuring and Resolution of Credit Institutions leaves the outcome for hybrid equity and subordinated bonds largely to the discretion of the Spanish bank resolution fund FROB. FROB inter alia can use 'market prices' for such paper as benchmarks for investor payouts. It is not difficult to see that the higher the bail-out, the higher will be the 'market price' of junior bonds.

the information asymmetries of banking, especially in the Eurozone's large regional banking sector, will keep risk capital tied to local or national investors, which will keep lobbying for using the Eurozone balance sheet to bail them out in a crisis as they did in recent years. If a stabilization of the battered Eurozone sovereign finance market could be reached in the near future, as e.g. global investor attention migrates towards the United States, the relative 'success' of the precedent could have reduced the likelihood of even a modernized Eurozone bail-in legislation framework to be ever put to the practice test.

How would then a formalized guarantee structure for bank debt look like that is consistent with the empirical precedent? Routinely realized high bail-out volumes will deter more prudently run banks or banks operating in safer lending environments from joining mutual bank debt guarantee schemes be they in the form of deposit insurance scheme or of a bank resolution fund (which implicitly protects senior unsecured bank bonds, beyond insured deposits). The signs for deep resistance are already on the wall as e.g. the politically powerful German savings banks have declined to join a mutually funded Eurozone deposit insurance scheme. If mutual schemes would finally come into existence, they would be unlikely to make fully actuarially priced assessments on member banks consistent with the current bail-out precedent, i.e. keep relying mainly on the fiscal resources of the Eurozone.

This would leave the option of a 'banking ESM', i.e. a vast Eurozone sovereign substitute insurer for chronically underfunded mutual bank debt protection schemes. We seem to be well underway on this route, given that national sovereign guarantees backing up current ESM (or EFSF) funding for bank recapitalizations will be removed in conjunction with ECB supervision of banks by 2014. With a domination of sovereign over mutual private bank debt protection, the Eurozone would reach a stage of 'government-sponsorship' that has been characteristic for the state guarantees historically afforded to German Landesbanken, the implicit guarantees provided to Fannie Mae and Freddie Mac in the United States, or for large private 'too-big-to-fail' banks globally. These institutions are widely held to have contributed to the global financial crisis as their setup allowed them to socialize losses and privatize profits. This outcome would be the opposite of a meaningful banking union project based on effective control of bank management associated with permitting private investments in banks to fail and keeping banks small.

The more sensible alternative would be cut down systematically on the bail-out financing for bank capital gaps in crisis management through consequent and fast loss recognition and systematic use of bail-in. Such a strategy could already be adopted at short notice, e.g. in Cyprus in early 2013, to break with the 'whatever it takes' approach. Only a credible risk mitigation strategy would turn an explicit and partial pan-European guarantee for deposits and unsecured bank bonds that could be attractive for the banks mutually financially feasible. And only if such private sector mutuality foundations are laid and the public sector is limited to truly catastrophic risk backup functions, will fiscal responsibility be preserved and a repetition of the current catastrophic outcome for the sovereign bond market be avoided.

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