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CAPITAL

Eight Lessons from the European Bank Failures

June 2017 has seen three notable failures of European banks under the new bank resolution regime. The bail-in of Banco Popular in Spain came as a surprise to some, particularly to those holding the subordinated debt (tier 2) and preference shares (additional tier 1/AT1) which traded near their issue prices until very close to the end. In the case of the two failed Italian banks the subordinated securities were trading close to zero implying failure was expected. Investors seeking to avoid losses on future bank failures can takeaway eight key lessons from this month's examples. Like almost all business failures, the signs were there for those who knew what to look for.

Bail-ins work remarkably well if action is taken early enough

The biggest lesson from recent events was that the system constructed over the last eight years to enable bail-ins of failing banks can work remarkably well. For Banco Popular; taxpayers, depositors and senior creditors did not suffer losses and there was minimal impact on other banks. The process happened in a matter of days with the customers able to continue to conduct their transactions throughout.

The reason that this could occur was because (a) Popular was bailed-in before it was too late and (b) the economic environment was positive enough to allow Santander to buy the assets without requiring taxpayer funds. Had the losses at Popular been greater, or if the bail-in had taken place during a recession it is unlikely that the process would have gone as smoothly.

In contrast to the outcome at Popular, the two Italian bank failures required €5.2 billion in upfront assistance as well as €12 billion in guarantees. The problems with these banks had been present for years but they were allowed to continue to operate in a zombie state. The continual delays by Italian officials have now cost their taxpayers dearly.

Non-performing loan ratios and profitability are key solvency indicators

For the year ended December 2016 Popular recorded a €4.9 billion loss before tax. It also had a non-performing loan (NPL) ratio of 14.6%. These two indictors had the bank going backwards fast, with a high probability that the losses would continue in the years ahead. Investors looking for a simple guide should consider an unprofitable bank or an NPL loan ratio above 5% key warning signs. If both are indictors are present the risk of failure is multiplied.

The share price is a better indicator than the capital ratios

In the 2016 annual report Popular's tier 1 capital ratio was 12.13% and the leverage ratio was 5.31%. The tier 1 ratio was worse than most of its peers but the leverage ratio was better than most of the large European banks including Santander who acquired its assets. This is not unusual, Dexia was another example of bank presenting supposedly healthy capital ratios before failing.

However, the share price movements in the months leading up to the bail-in showed that Popular was a very unhealthy bank. From November 2016 onwards, Popular's market capitalisation mostly bounced around at €3-5 billion. This was well below its book equity of €11.1 billion. A robust bank will have a price to book ratio above 1. Popular's ratio of less than 0.5 showed that shareholders had substantial doubts it would survive.

Solvency and liquidity both matter, but solvency matters more

Two of the major reforms since the last crisis were to (1) require banks to hold more capital relative to their assets and (2) hold more liquid assets. There's often debates over which of these reforms is more important. The failure of Popular followed the typical pathway of a bank failure, where solvency problems lead to liquidity problems. Popular's large book of non-performing loans and substantial losses created concerns over its solvency. Creditors responded to

those concerns by withdrawing their deposits, creating a liquidity crisis. Without the solvency issues, liquidity wouldn't have become an issue.

Regulators can act before key thresholds are crossed

In the case of Popular, the regulators waited until all avenues for a solvent restructuring had been exhausted. However, they didn't wait until capital declined to the point that would have triggered the automatic conversion of preference shares to ordinary equity. The regulators determined that the solvency and liquidity issues were sufficient to trigger the non-viability clause in the preference shares and subordinated debt and bail-in those securities. The fact that there wasn't anything recovered for subordinated securities indicates that the regulators waited as long as they could.

The distinction between tier 1 and tier 2 didn't matter this time (but will sometimes)

Many commentators have concluded that as the tier 1 and tier 2 securities were both zeroed in these cases that's likely to always be the case in the future. Given the relatively thin slices that these securities form in a bank's capital structure that simplistic view has some merit. However, seeing the two types of security as of similar risk ignores the fundamental structural differences. These differences are very important for banks that hit temporary rough patches.

In the next financial crisis, investors should expect that the weakest banks will go through bail-ins like Popular or outright fail like the Italian banks. Banks that are a little stronger can remain solvent but will likely need to halt dividends on their preference shares to preserve capital. In this situation, preference shares are likely to trade below 50% of their issue price. Subordinated debt should continue to receive interest payments and this will keep the prices much closer to the issue price. If the weak performance continues for several years, subordinated debt securities could be redeemed at the issue price whilst preference shares could remain stuck with no payments and no potential to exit via redemption or conversion. This scenario is a key reason that tier 1 and tier 2 securities should continue to trade at substantially different margins.

There are more bank failures to come, particularly in Italy

Unlike the American regulators, the European regulators have been very slow to act on their troubled banks. Banks in Greece, Ireland, Portugal and Spain are still cleaning up large amounts of bad loans made before the crisis and several weak banks remain at risk of failure. Italy's €360 billion of bad loans (one-sixth of all loans) and sluggish corporate insolvency processes weigh down its banks. Monte Dei Paschi's inability to formulate a restructuring plan sees it at imminent risk of failure.

Securitisation is a better investment structure than tier 1 and tier 2 securities

Some investors in the subordinated securities of Popular are complaining that they didn't get a fair chance to realise the value of Popular's assets. They argue that if a more orderly sale process had been run, or if the bank had been allowed to wind down they would have received a better recovery. Whilst this may be true, the terms of subordinated debt and preference shares sold by banks clearly give regulators the right to intervene when they believe a bank is non-viable. When a bank's solvency becomes questionable, subordinated investors become the crumple zone to protect senior creditors, depositors and taxpayers from losses.

Securitisation investors get a much better deal when times get tough. Interest and principal are distributed according to a pre-determined order of priority ensuring investors get their appropriate share. In some cases, subordinated investors may receive no payments for a time to ensure than senior investors are fully paid. However, once senior investors have received all their principal and interest, payments can resume to subordinated investors from the remaining assets. This is a much cleaner and clearer process than second guessing a banking regulator.

Conclusion

The failure of Spain's Banco Popular and two Italian banks in June is a reminder that problems remain unresolved with European banks. The bail-in of Popular was a textbook example of how a bail-in can work. The failure and taxpayer bailout of the two Italian banks shows what happens when action is taken way too late. Investors looking to avoid losses on subordinated bank securities should focus on profitability and non-performing loan ratios. Securitisation structures are a better way to invest in loan pools, offering a cleaner and clearer process for dealing with non-performing loans.

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