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Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Banco Popular – Lessons for European Bank Capital

BACKGROUND

As the financial crisis caused by the Lehman bankruptcy spread around the globe, its form mutated, depending on local or regional factors. In Europe the financial crisis laid bare structural weaknesses in the Eurozone monetary policy - interest rates and a currency - were shared between countries but there was no pooling of solvency risk. Due to a lack of perceived currency or interest rate risk, money had flowed freely from core Eurozone countries to Eurozone countries on the periphery. These flows abruptly ended when lenders' focus moved from currency risk to credit risk. That set of circumstances led to individual countries having to recapitalize their national banking systems, and at a time of general economic weakness the bank recapitalization burden impaired government balance sheets. It did so to the extent that Greece, Ireland, Portugal and Spain required a full or partial bailout from official lenders because market confidence evaporated from 2010 onwards.

REGULATORY RESPONSE

In recent years the Eurozone has responded to the experience outlined above in two main ways. Firstly, it changed its approach to regulation. Prior to the financial crisis each Eurozone state was responsible for regulation of its own banking system. The uneven nature of national regulation and the perception of potential "home country bias" led to the ECB taking over direct responsibility for regulatory supervision of the largest banks in the Eurozone in 2014. Secondly, following political resistance to the taxpayer-funded bailouts of banks in individual countries, Eurozone regulators decided that the amount of capital in the banking system should be increased and that some bank creditors should be bailed in to increase the amount of loss absorbing capital prior to any taxpayer funded government support for distressed banks in the future.

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CONTINGENT CAPITAL

The regulatory response led to the creation of a type of bank capital instrument that became a new asset class for investors, Additional Tier One (AT1) securities, also known as contingent capital securities. AT1 securities are deeply subordinated (senior only to common equity) and can fulfill 1.5% of an individual bank's 8% minimum capital requirement. The structural change involved in AT1 securities versus previous bank capital instruments is that in the event of a breach of a pre-set capital ratio (at least 5.125%), any existing AT1 instruments of a given bank would be written down or converted to equity. The theory is that extra loss absorbing capital would be provided while the bank was still a going concern.

The structural feature allowing a write-down/conversion of AT1 securities without the simultaneous liquidation of the issuing bank has reduced the appeal of the asset class to many insurance companies and other fixed income investors. Nevertheless the current low yield environment has led to some demand for the asset class. AT1 issuance has grown to EUR 125 billion outstanding since 2013. Illustrating the global nature of the investor base issuance by currency has been USD (60%), EUR (30%) and GBP (10%). By credit rating issuance is as follows: BBB (20%), BB (65%) and the balance lower rated or unrated. Issuance of AT1 securities has predominantly come from banks in the U.K. (33%) and France/Switzerland/Spain (each 11%). In EUR following strong performance of AT1 bonds this year, the average spread over government bonds is currently 475 basis points after having started the year at 600 bps.

BANCO POPULAR

Banco Popular is Spain's sixth largest bank with assets of EUR 147 billion and Book Equity of almost EUR 11 billion at Q1 2017. Its Total Capital Ratio was approximately 12% at the reporting date. Banco Popular paid discretionary coupon payments on its AT1 securities in April 2017 indicating that the bank had not breached any capital ratio that would have led the regulatory authorities to prevent the coupon payments. Banco Popular was acknowledged to have legacy loan losses that required increased provisions: its stock deteriorated from 0.7x (Q4 2014) to 0.12x (Q1 2017) as a proportion of book value. Banco Popular's management attempted to sell the bank to allow a new owner to stabilize the situation. Some large depositors became increasingly concerned with the unfolding situation at Banco Popular and its liquidity dwindled.

On June 6 this year the ECB (the new regulator) deemed the bank "failing or likely to fail" based on the deterioration in its liquidity position; it deemed Banco Popular at the Point of Non Viability (PONV) and put the bank into resolution. On reaching the PONV judgement, Banco Popular was resolved using the "Sale of Business" resolution tool. Banco Popular was acquired by Banco Santander. In effect, by using this statutory power the ECB did not have to deem that Banco Popular breached its required capital adequacy levels. When the ECB declared a PONV event at Banco Popular, its two outstanding AT1 securities were written down to zero. The highest market values for the two AT1 securities this year were 105 and 92. The combined face value of the securities was EUR 1.25 billion. Banco Popular had reported a Common Equity Tier 1 ratio of 10% in Q1, significantly higher than the trigger levels of 7% and 5.125% in its two AT1 outstanding bonds.

KEY TAKEAWAYS

Banco Popular is the first instance of credit loss in the AT1 sector. It has been deemed a successful bank resolution because equity and junior debt (including AT1) was written down, senior debt remained intact and no taxpayer funds were used. However, there are some lessons for AT1 investors. Analysis in the AT1 sector has focused on capital ratios and the size of the buffer between a bank's current capital ratio and its minimum capital ratio that would require AT1 instruments to be written down or converted into equity. In practice the example of Banco Popular shows that if a bank is deemed to have difficulties, an acquirer (in this case Banco Santander) can wait for a PONV declaration and the subsequent bail in of the AT1 securities. The purchase price of the acquired bank can be subsidized accordingly, ignoring the published capital ratio of the acquired bank. This precedent is particularly relevant when European authorities want to demonstrate that capital markets are not being bailed out with taxpayer funds. In addition, in the event that a bank is perceived to have difficulties, there is unlikely to be a capital level that will reassure depositors; therefore, capital levels well in excess of requirements do not necessarily protect AT1 securities holders, given that any bailing in of AT1 is likely to exacerbate depositors' fears. Consequently, the structure of deposit/senior debt funding is a bigger issue for AT1 investors than considered to date.

The AT1 market has been unperturbed by its first experience of a credit loss. The fact that the manner in which the loss arose is different from what most investors originally deemed likely has not prevented further issuance from similar banks. Some holders of Banco Popular AT1 securities are expected to mount a legal challenge to the resolution process. In the meantime, in a low yield world the AT1 asset class continues to attract issuer and investor activity.

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