

# Creditor Participation in European Bank Restructurings

A Corner Turned ?

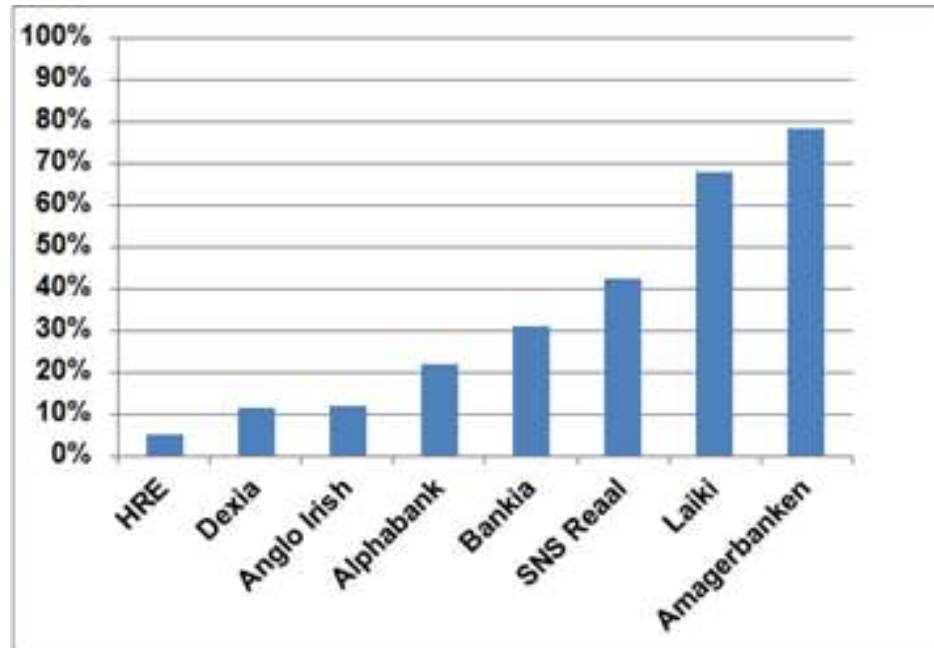
Cyprus Banking Forum  
Nikosia  
5. December 2013

Hans-Joachim Dübel  
Finpolconsult, Berlin

# What have we done?

## 8 Bank Sample

Estimated Private Sector Involvement in  
Capital Gap Financing



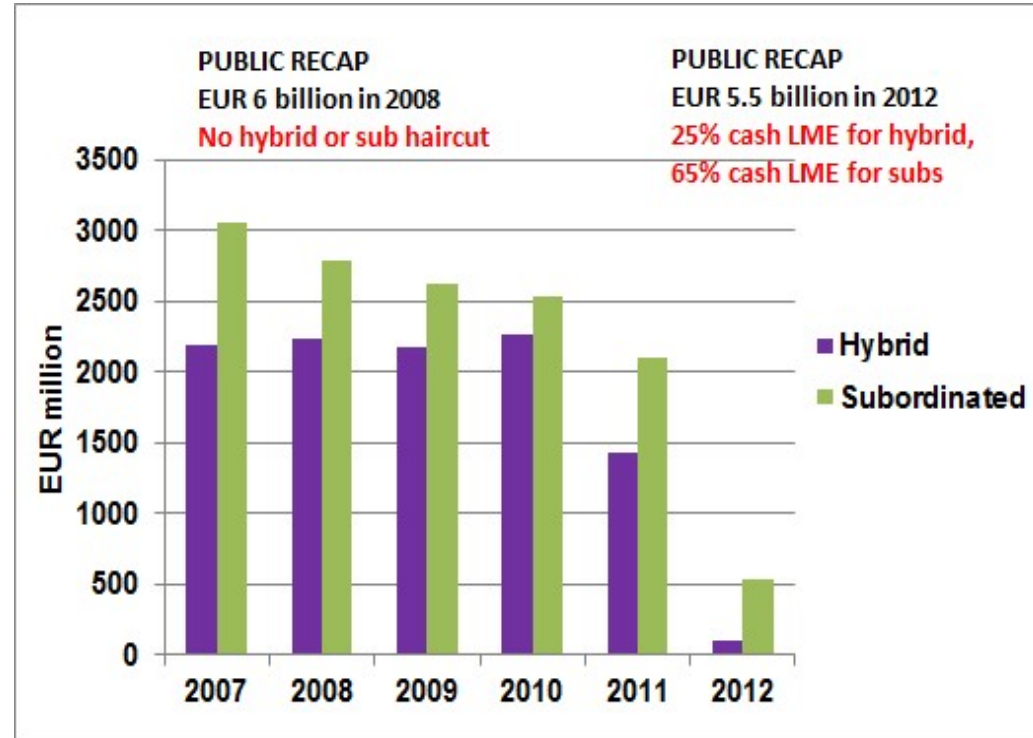
Creditor participation ratios increasing over time , however **outliers**:

- **Amagerbanken an early case** (Fall 2010) with **senior unsecured** creditor participation, Note: Ireland was not permitted to pursue same approach,
- **Dexia a late case** (Nov/Dec 2012) **bailing out juniors**, months after Spain.

# Bailout

## LME as a Bailout Vehicle

**Dexia S.A. Junior Debt Structure**



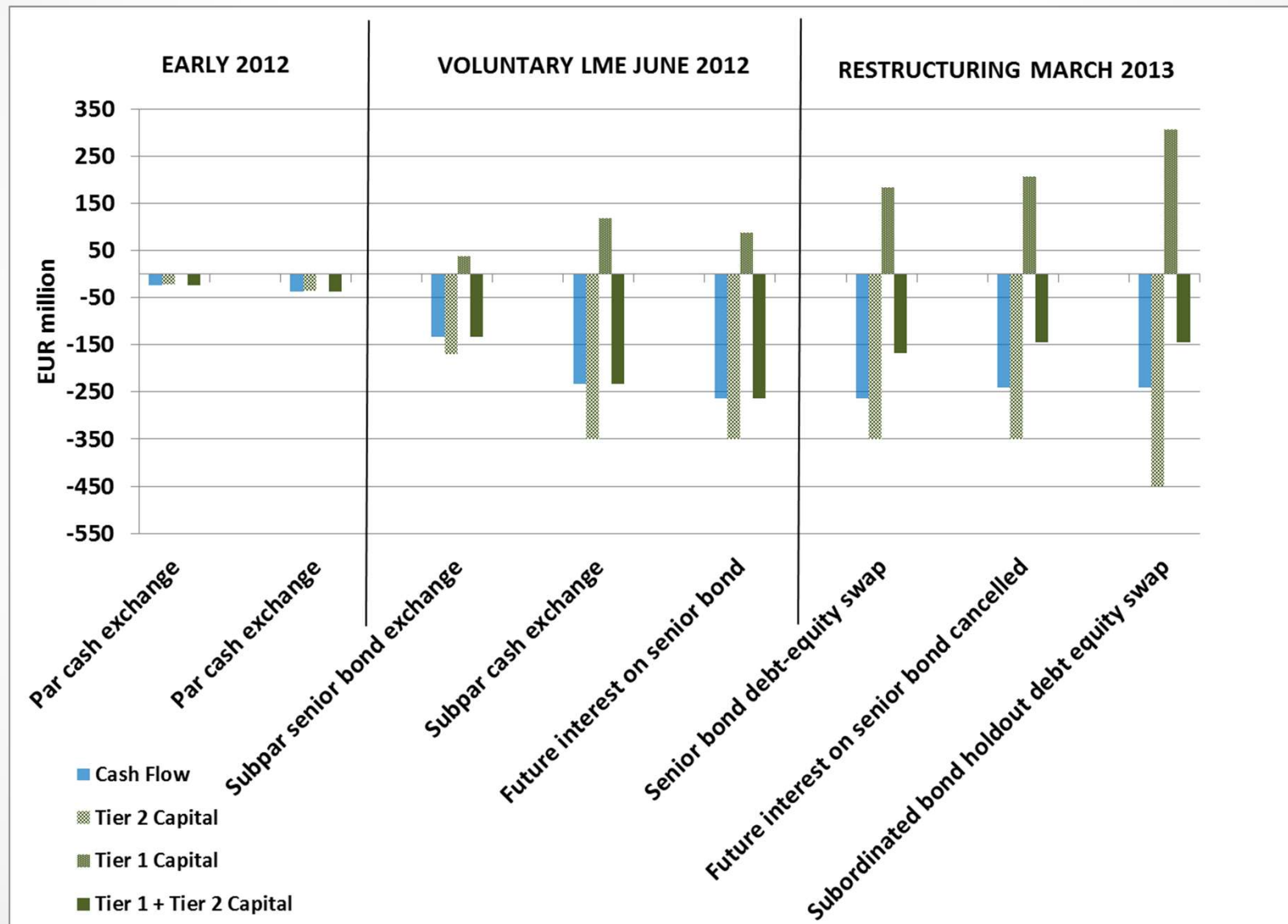
**Buybacks (LME) and calls** are popular bailout instruments.

**Understood by very few in government, high fees for investment banks.**

**Basel II->III arbitrage** (increase in core tier 1 << decrease in sum of tier 1 and tier 2).

# Bail-out and Basel III Arbitrage

## Laiki Bank Subordinated Bond LME



# Bailout

## Can Greece Afford These LME?

### Greek Bank Junior Debt Repurchases

Cash offer conditions to investors 2012, 2013

Bank Nr	2012				2013				2012	2013
	1	2	3	4	1	2	3	4	Average	
Subordinated debt Lower Tier 2	60%	50%	50%		55%	DES	55%		53%	55%
Hybrid securities Tier 1	45%	40%	40%	37%	40%	35%	DES	35%	41%	37%

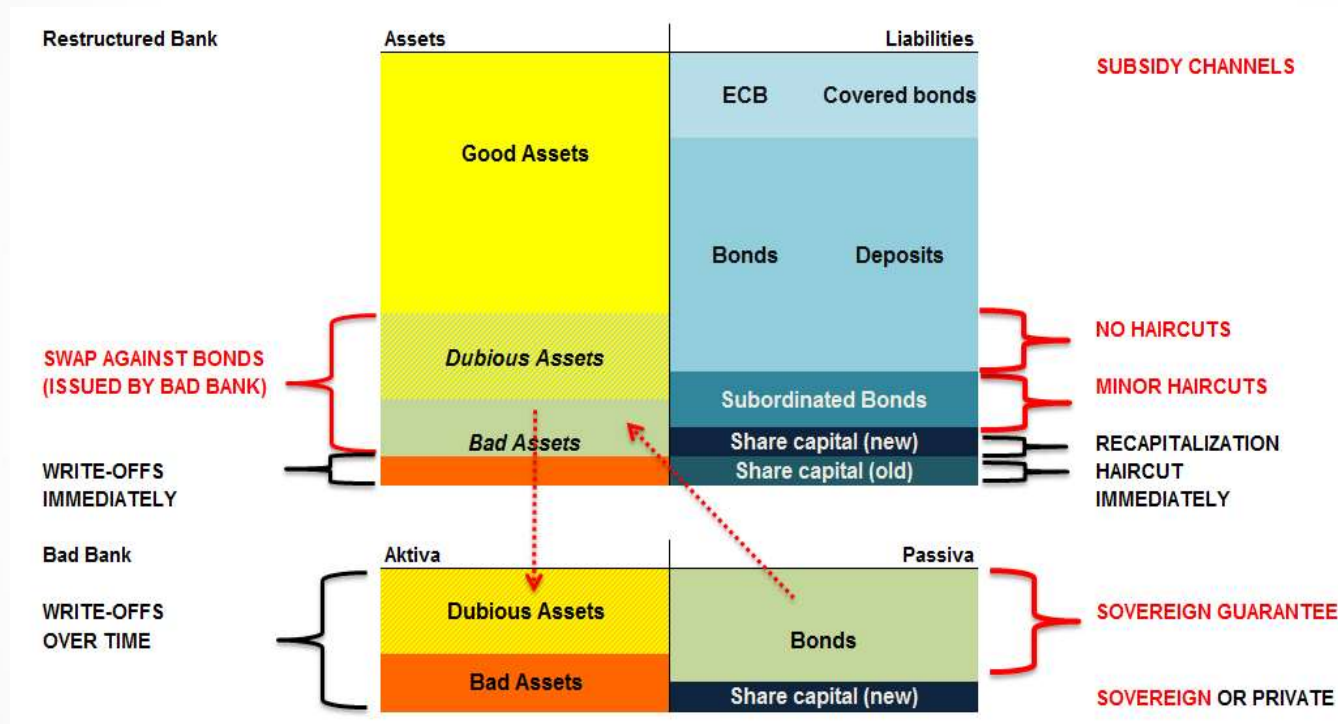
1: National Bank of Greece, 2: Alpha Bank, 3: EFG Eurobank, 4: Piraeus Bank. EFG Eurobank  
DES – debt equity swap.

- Is offering between 40 and 60% in cash **‘fair burden sharing’**?  
→ **government recap** effectively **replaces some 70% of GGB losses**,
- Once government is invested in shares, subordinated debt investors expect to be paid par** → Ca EUR 2 out of 3.5 billion per Q IV 2011 get cash.

# Bailout

## Bad Banks As Bondholder Protection

### Bad Bank Model (Asset Swap Model)



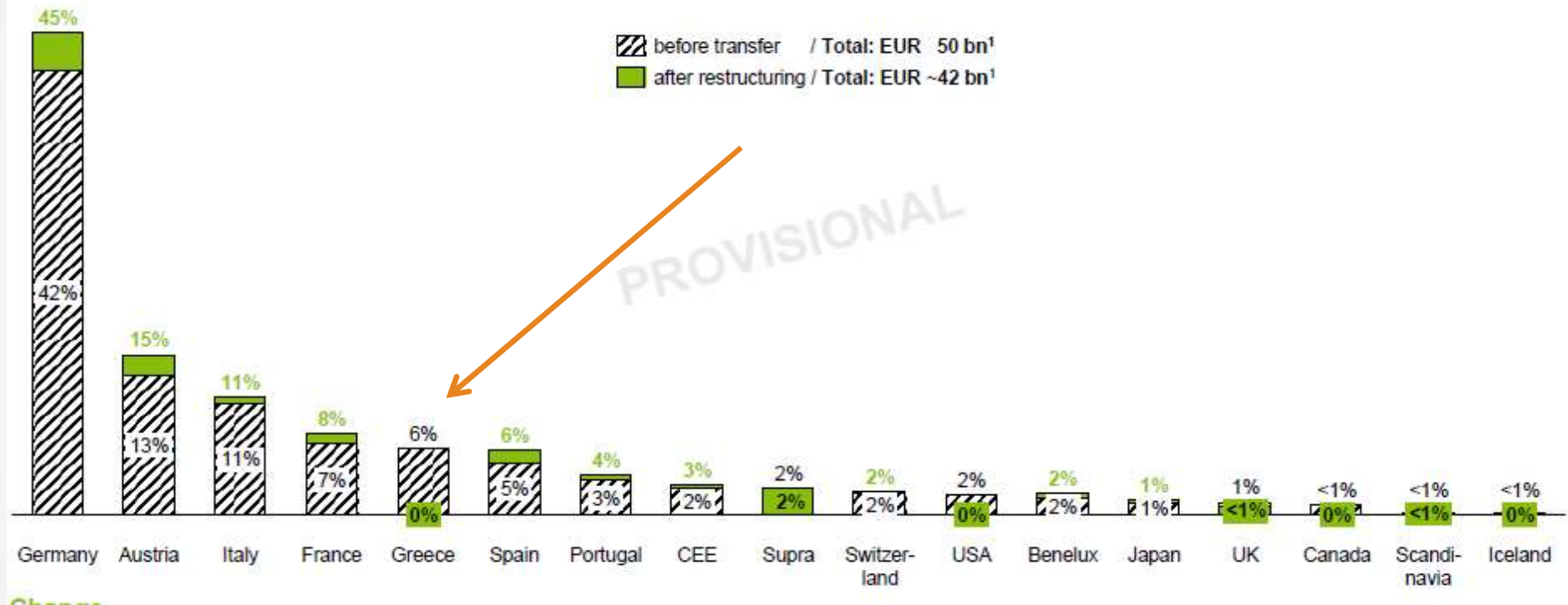
Systematically unties the fate of junior / senior unsecured **debt from the fate of assets**,

**Transfer pricing** chosen **may be right or wrong**.

# Bailout

..very wrong, indeed

Public Sector cover pool / by regions  
Nominal, 06/2010



## Bad Bank of Hypo Real Estate

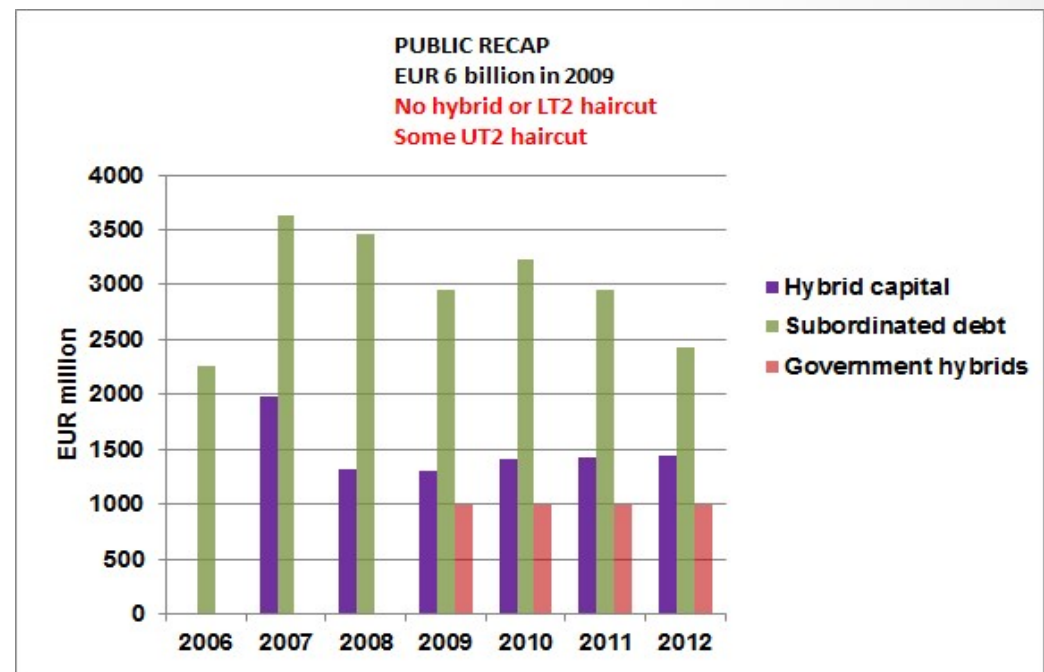
- By October 2010 **with entire Greek exposure at PAR !!**
  - **No transfer of junior debt (despite law):**
- = **de-fact third – and most expensive - public recapitalization.**

# Bailout

## HRE left with large Junior Debt Exposure

### HRE Junior Debt Structure

- **Junior creditors got** almost entirely **protected**, except
  - **Hybrid capital coupons** (KOM rule)
  - **UT2 haircuts** (held by retail),
- **Full cash payout** expected with reprivatization.
- **By 2013 we can still not intercept subordinated debt coupon payments outside insolvency !**

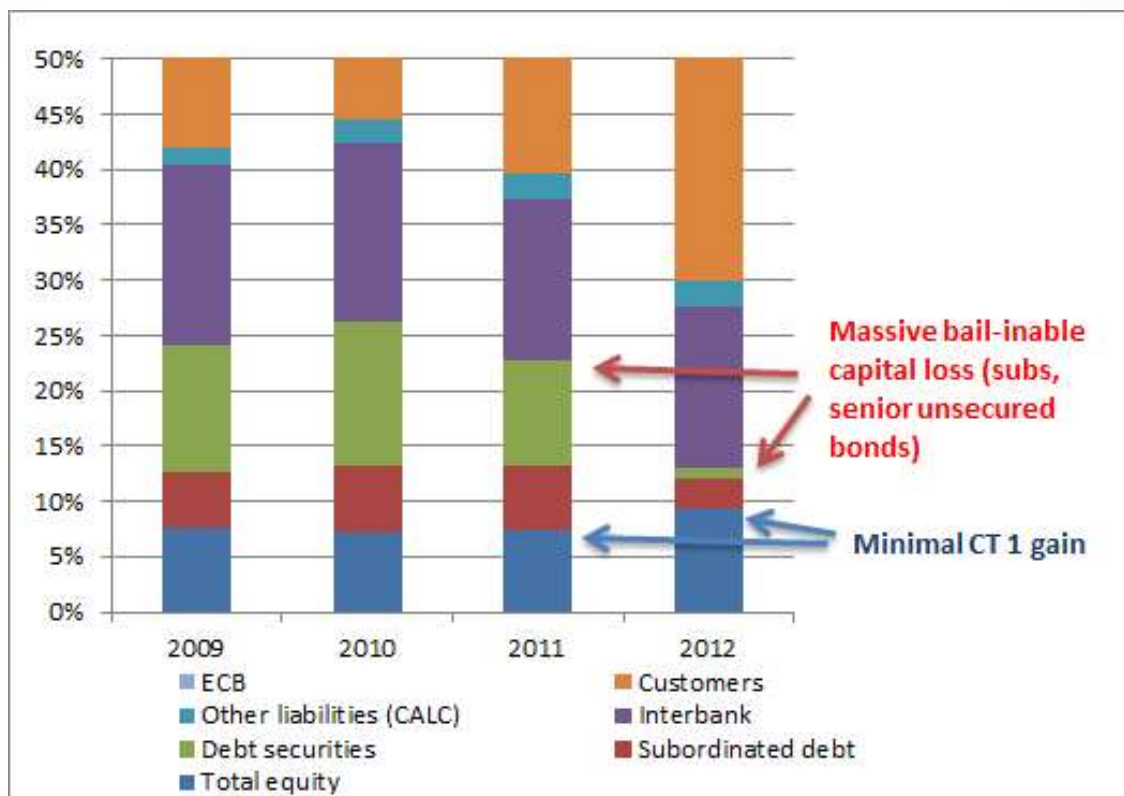




# Bailout

## Slovenia – the LME - Bad Bank Connection

**Novo Ljubljanska Banka Liability Structure**

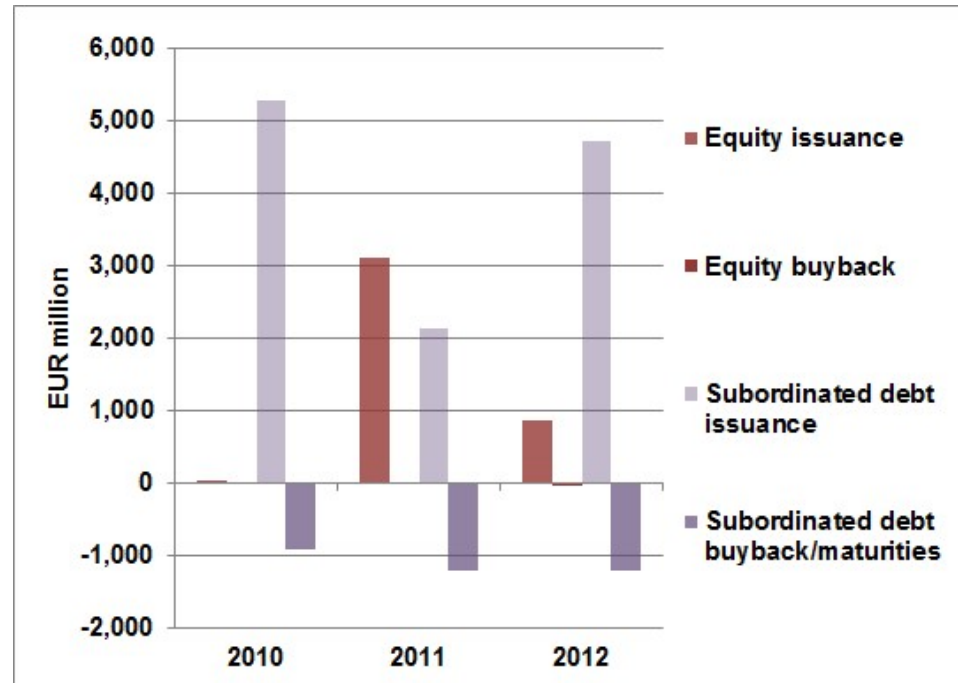


**Large LMEs of the two largest Slovenian banks during 2012 in parallel to creation of bad bank (Swedish involvement).**

**2013 - insufficient subordinated and senior unsecured debt, ex deposits, by restructuring date to support bail-in.**

# Bail-out Followed by Bail-in Creditor Rotation in Spain

**Bankia Cash Flow**

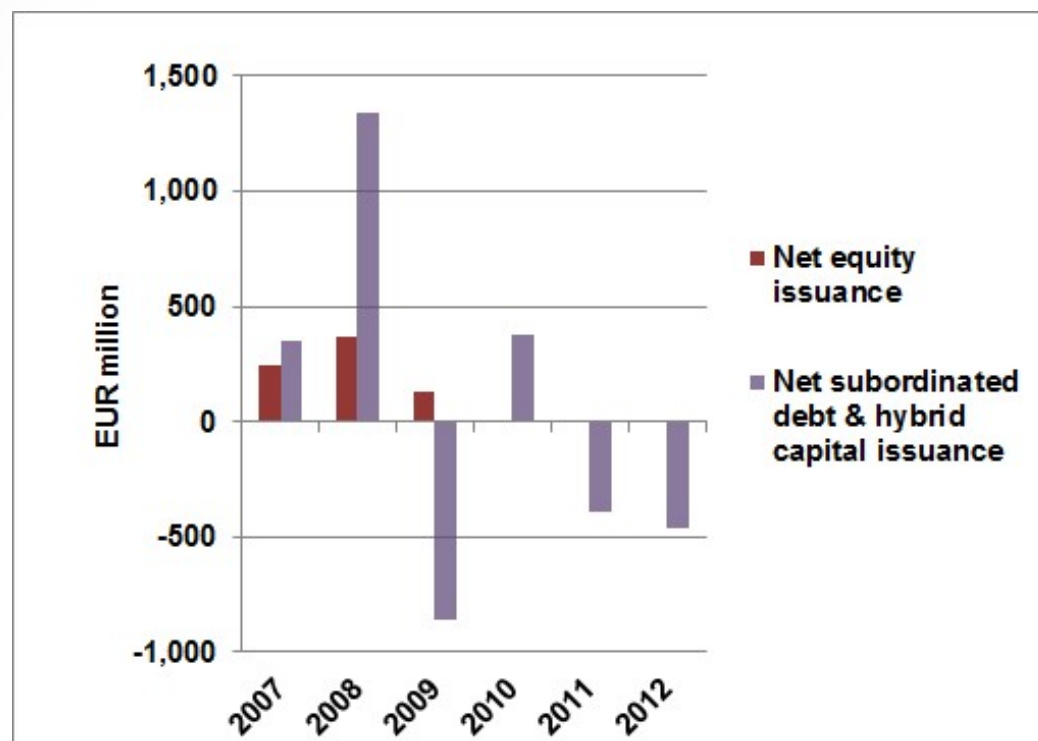


- **Cash payments** to (largely professional) subordinated investors **in 2010 and 2011 of ca. EUR 2 billion**,
- In parallel **new subordinated debt and equity was issued**, at this time **mostly to retail investors/households**,
- 2012 cash paid had to be reinvested in equity (LME). But Bankia **bought back common stock** !

# Bail-out Followed by Bail-in

## Creditor Rotation in the Netherlands

SNS Reaal Cash Flow



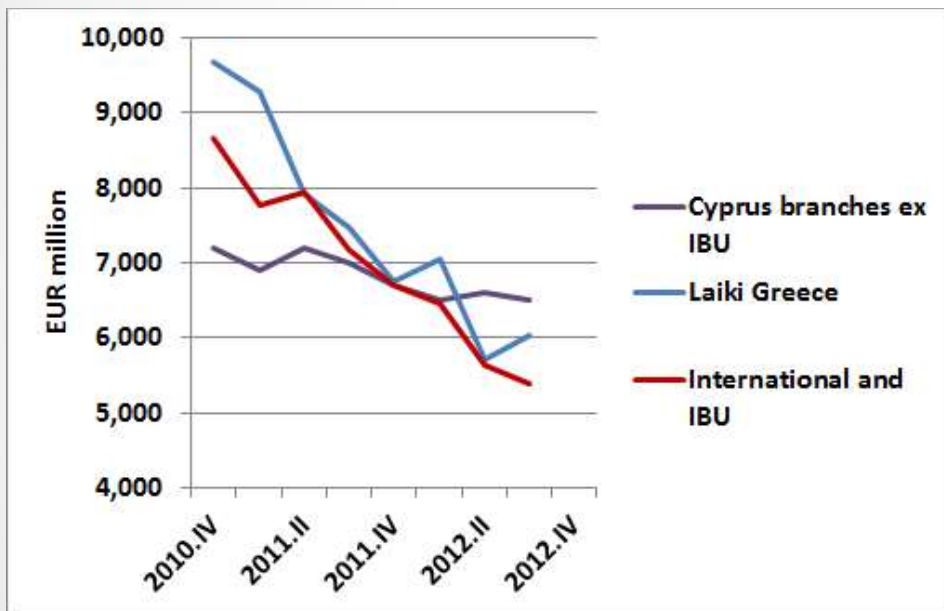
**2008 public** (senior) hybrid **capital injection**, followed in **2009** by **large buy backs**  
In **2010**, SNS Bank placed a **new EUR 500 million subordinated bond**,

**2011 large cash LME** over EUR 420 million of old subordinated debt,  
**2012 first possible call of 2003 issued hybrid capital securities** exercised.

# Bailout followed by Bail-in

## Central Bank Governance

Laiki Bank Deposits by Source 2010-2012



Source: Central Bank of Cyprus, Finpolconsult computations.

ELA – Emergency Liquidity Assistance,  
IBU – International Business Unit.

Large ECB **ELA borrower**, at peak **EUR 9.8 billion** (33% of assets),

**Some 50%** can be estimated to have used to pay out mostly large deposits (IBU), senior and subordinated bond holders,

Asmussen: 'did not reach **2/3 majority** in **Gov Council** to block Laiki ELA',

→some tightening of **ELA rules Oct 2013** (reporting on borrower/collateral).

# Central Bank Governance in the U.S.

## A Model for Europe

“It was unlikely that WaMu would survive unless it started borrowing from the Federal Reserve Board’s discount window.

However, **Fed lending .. is heavily collateralized.** Meaning that **the more a bank borrows** from those sources, **the more expensive it becomes for the FDIC to resolve.**

For that reason, **the law prohibits the Fed from lending to a failing institution,**

and **as a matter of courtesy, the Fed typically consults with us before lending to a troubled bank**

**and does only so with our consent.”**

# Bail-in Techniques

## Debt Equity Swap vs. Haircuts

### Spain (Bankia)

#### - Haircut & DES

- Group 1 – mandatory SLE,
- Group 2 – first voluntary, then mandatory SLE.

#### - Pricing approach:

- “market price” (first law draft permitted 10% over) vs.
- liquidation value,
- Ultimately ‘negotiated’.

### Netherlands (SNS Reaal)

#### – Expropriation

- 100% haircut,
- liquidation value.

**Both approaches lead to same desired Core Tier 1 effect.**

Debt equity swap leaves **possible economic upside** on the table for investors, tied to asset performance.

**Important for real estate related stress.**

#### **Parallel to Coco debate:**

- 0-1 (insurance) instruments carry significant legal risk, esp. if triggers are regulatory.

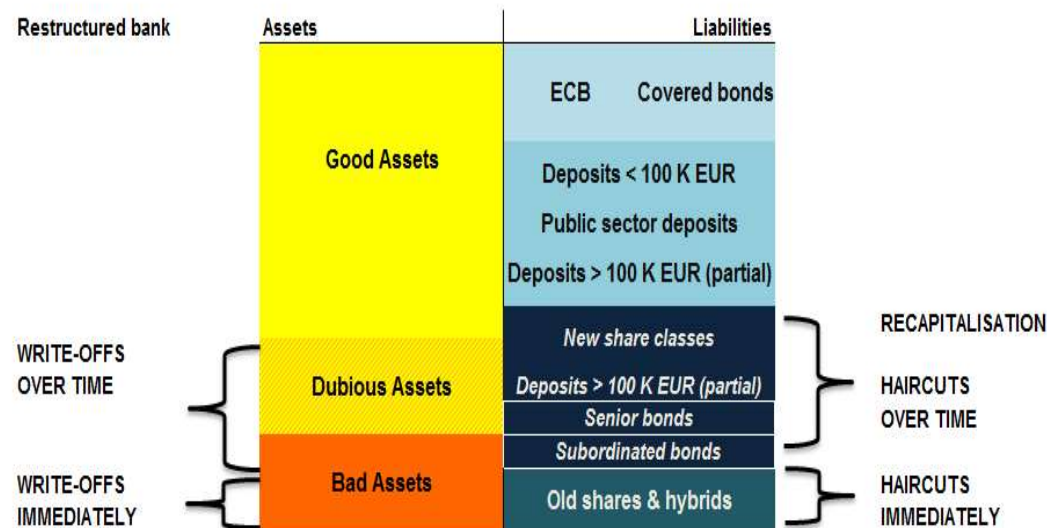
#### **Alternatives?**

- **CDS written** by bond investors **on initial bank portfolio**,
- Example: KfW **credit-linked notes** program.

# Bail-in Techniques

## Bank of Cyprus – A Model?

### Bank of Cyprus – Debt Equity Swap

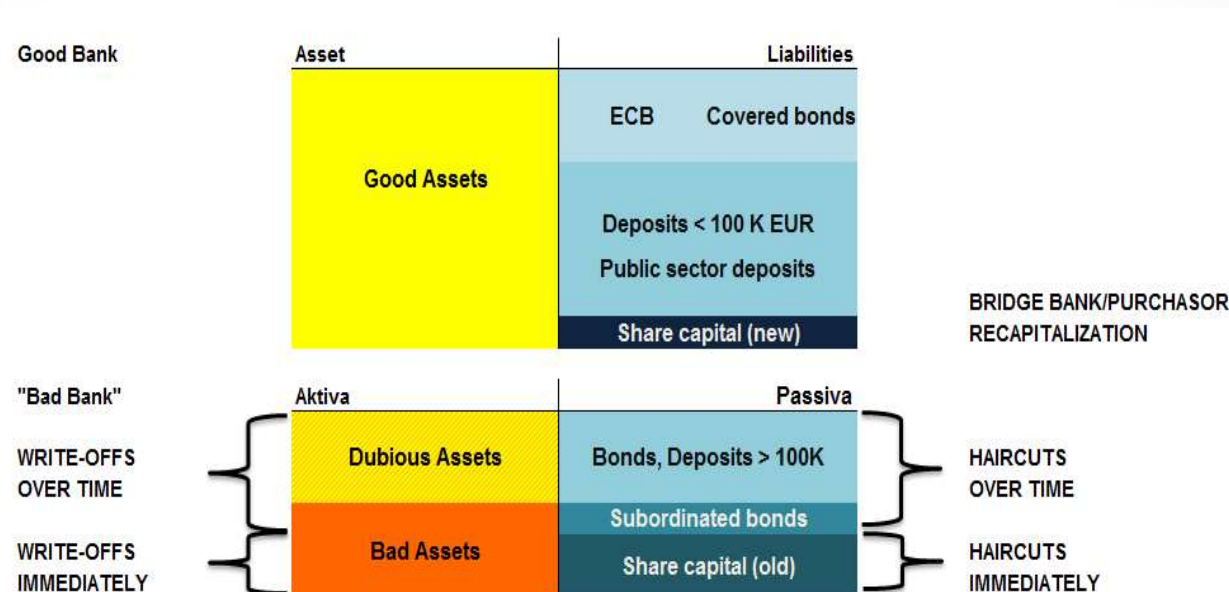


- **No initial haircuts** of debt !! → swap.  
Preferable in the presence of high uncertainty over losses (**NL vs. Spain**).
- Allocation of sub, senior unsec, large deposits to **thin equity classes**,
- **High interest rates** for preferred shares **if bank performs** (de-facto Coco),
- Current **main shareholder is** Laiki Bank **unwinding vehicle** (18%),
- **Issue: permitting ad-hoc seniority** - Cyprus public sector and ECB - **destroys incentives**.

# Bail-in Techniques

## Good Bank Model (FDIC Standard)

### Laiki - Good Bank, Purchase and Assumption (P&A)



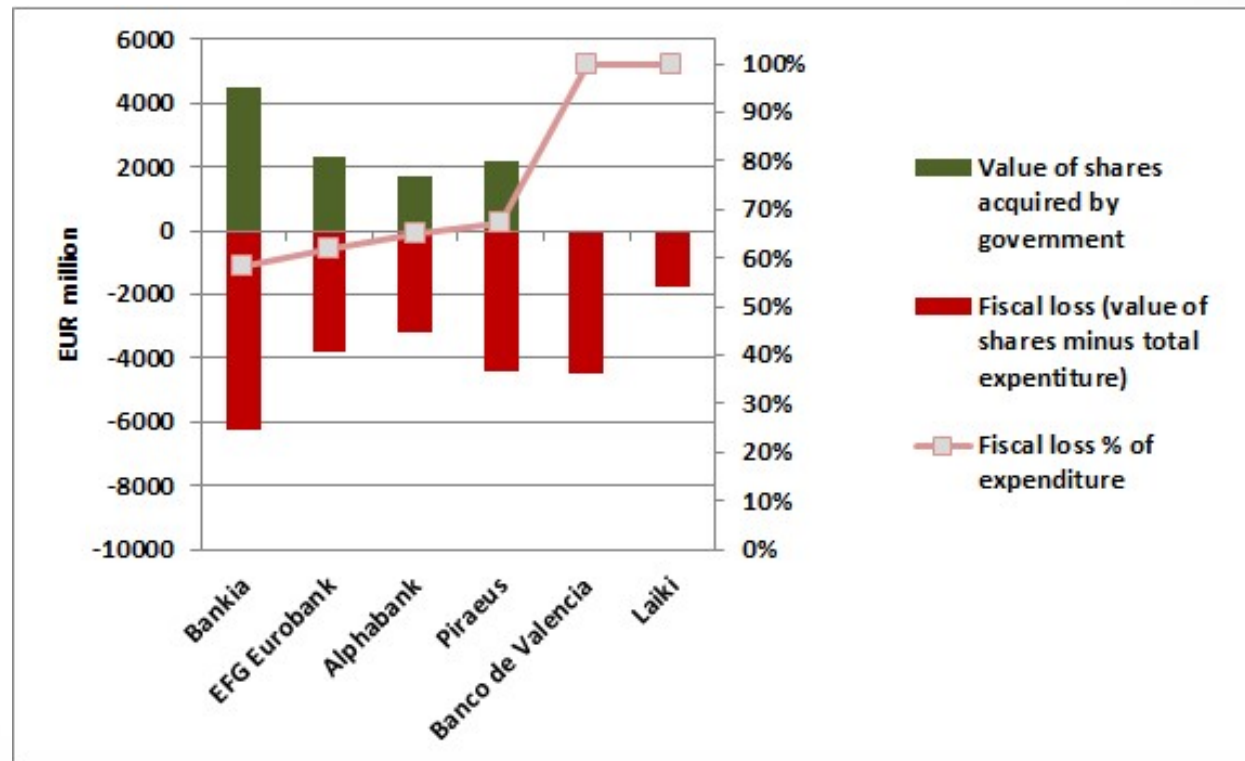
- Laiki Bank, **Good Bank & P&A** combined with **super-seniority of insured deposits**.
  - Denmark** (Amagerbanken), **Greece** (ATE, Hellenic Postbank).
- Problem** is **determination of sales price during stress** (WaMu, Laiki).
- Response: Iceland - bridge banks** to be sold later. Requires public bridge funding, European bank P&A market.



# Fiscal Outcomes

7 cases = 30%-35% of ESM capital

**Fiscal Loss Based on 2012 Book Value**



What share value does government acquire with a given expenditure?

High PSI cases show high government losses, as initial recap is given up (rational).

# Deterrents to Bail-in, Summary

## Bad reasons

- **First government recap often followed by second rather than bail-in**  
→ avoids stigma of wasting taxpayer money (HRE, Dexia),
- **False going concern hopes**  
→ protection of investors for the going concern,
- **Fiscal capacity**, program vs. non-program country  
→ anything goes?
- **Investor lobbyism**: many junior bond investors in Europe are politically well plugged in, small country syndrome.

## (Semi) good reasons

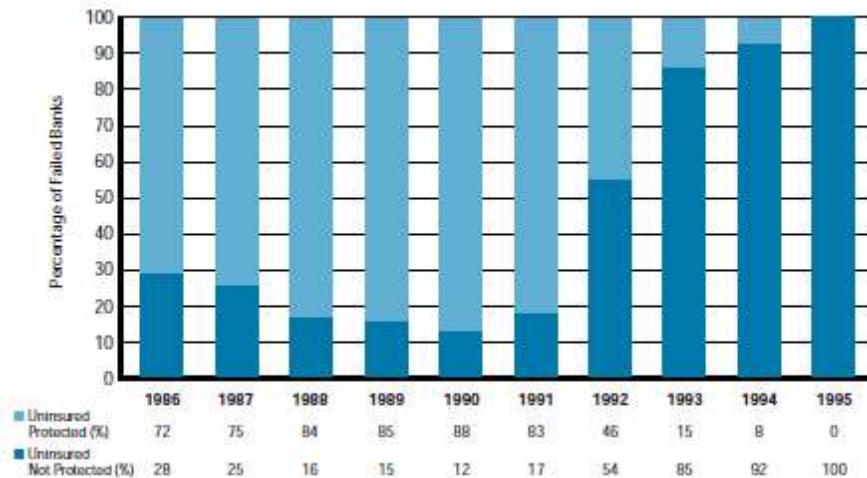
- **Restructuring delay**, may hit the wrong creditors (Bankia, SNS Reaal),
- **Retail investor protection after misselling**, Spain's sacrifice for the European common good (any reaction in Brussels?).

# Bank Restructuring & Resolution Law

## U.S. has gone through this before

### FDIC Least Cost Resolution Game Changer 1991

Uninsured Depositor Treatment  
1986-1995



Source: FDIC Division of Finance, *Failed Bank Cost Analysis, 1986-1995*.

### 1991 FDIC Improvement Act

- **Abolition of 'Open Bank Assistance'**  
(no 'direct recapitalization'),
- **Least Cost Resolution Approach**
- **ALL deposits became super-senior**
- **FDIC became only required to transfer insured deposits** in a P&A.

# Bank Restructuring & Resolution Law

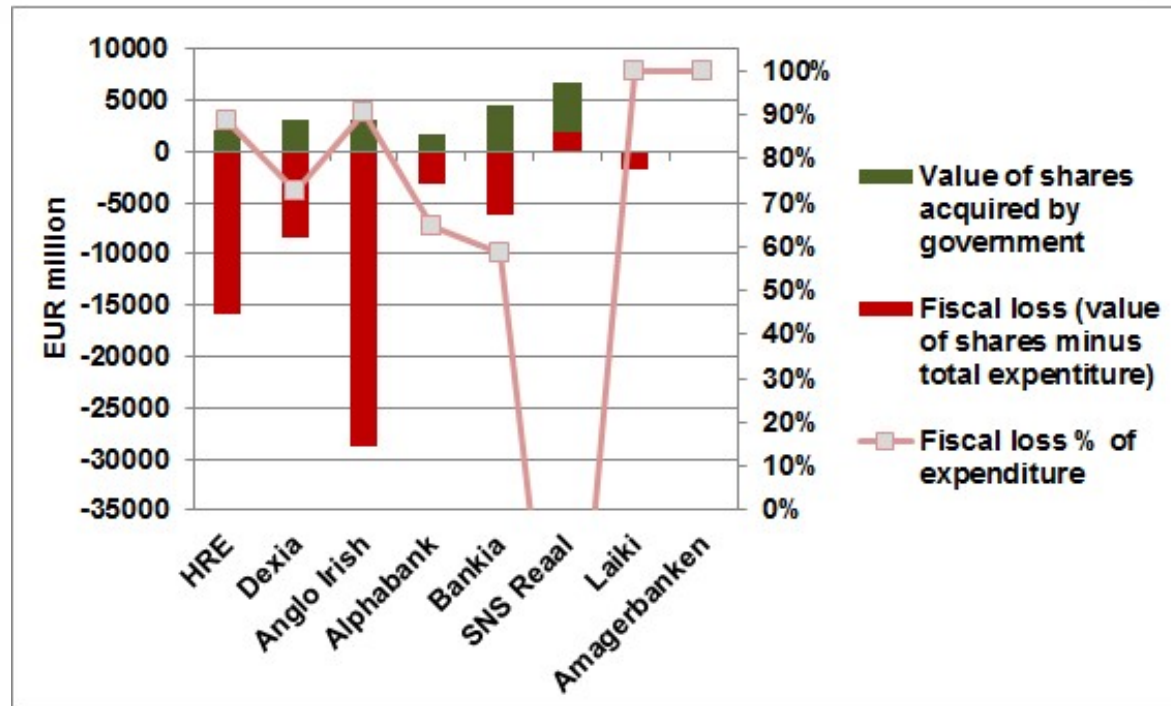
## Europe Should Accelerate

- **A European Directive by 2018 is too late !**
  - 10 years after Lehman – **exempts all likely current cases**,
  - State aid **rule** (Aug 1, 2013) **less effective without the Directive** (Nava '65%').
- **Observe sequencing, minimize exceptions**
  - **Always at least junior bond bail-in, no 'precautionary government recapitalizations'** Draghi)?
  - Include **Covered Bonds** overcollateralization → 'Germany pays',
  - **Close 'systemic risk' backdoor** → main systemic risk is fiscal collapse.
- Banking Union architecture
  - Build the **European version of U.S. FDIC**  
→ shorter time to restructuring and deeper creditor participation,
  - **ECB has conflicts of interest** as de-facto bank bond investor  
→ **shared supervision.**

# Fiscal Outcomes

## LGD – Fiscal Cost/Exposure

Fiscal Loss Based on 2012 CT1 Book Value



- **High PSI cases** (Laiki, Amagerbanken) show high loss for government as government 'gives up' initial recapitalization to bail in juniors/senior unsecured,
- **Overall losses are maximized for low PSI cases** (HRE, Anglo Irish).