Senior Bondholder Immunity to Losses Begins to Fade: Euro Credit

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(By John Glover

July 18 (Bloomberg) -- The shelter available to bondholders in senior bank debt is starting to fracture as the escalating cost of reinforcing Europe’s financial institutions prompts policy makers to seek to share the burden more widely.

Bank bonds that rank ahead of subordinated and junior debt for payment have been almost unscathed by the debt crisis.

Bankia SA, Spain’s third-biggest lender, has seen the value of its 4.625 percent undated subordinated bonds plummet to 28.5 percent of face value, while its 4.25 percent senior securities repayable in May 2013 trade at about 92.16 cents per euro.

Ireland was compelled by the European Central Bank to maintain payments to senior debt investors when the government sought aid to rescue its banks. Denmark, the only nation to inflict losses on senior lenders, had to water down its bank resolution law after lenders were shut out of funding markets.

Now, the ECB says its stance is “evolving,” and may allow a wider pool of investors to lose money when banks need rescuing.

“The Spanish banks don’t have nearly enough subordinated debt to absorb their likely losses,” said Matt King, global head of credit strategy at Citigroup Inc. in London. “The authorities will do whatever they think is best for stability.

Until now, that has meant not inflicting losses on senior bondholders. But that may yet change.”

Different Views

Irish Prime Minister Enda Kenny said yesterday that the issue of imposing losses on senior bondholders at troubled banks has been discussed by euro-area finance ministers.

“There were differences of opinion, so that matter is still ongoing,” he told reporters in Dublin, adding that “clearly the ECB are talking to Spain.”

At a meeting with Irish Finance Minister Michael Noonan in Frankfurt yesterday, ECB President Mario Draghi “noted that the question of burden sharing with senior bond holders is evolving at the European level,” as discussions on how best to close down failing banks proceed, the ECB said in a statement.

The ECB advocated at a meeting earlier this month imposing losses on senior bondholders at ailing lenders, according to two officials with knowledge of the central bank’s position.

Spain agreed to a 100 billion-euro ($123 billion) bailout for its banks last month, joining Greece, Ireland, Portugal and Cyprus in asking for a lifeline. Spain’s 10-year borrowing cost is 6.76 percent, up from a low this year of 4.85 percent reached on Feb. 1. Ireland’s nine-year bonds yield 6.28 percent, down by more than half from as high as 15.5 percent a year ago.

Spain contrasts with Portugal and Greece, where sovereign woes hit the banks, and Cyprus, a casualty of Greece’s restructuring. Spain is looking to learn from Ireland in dealing with lenders and the draft accord between the government and the European Union calls for holders of equity and subordinated bonds to lose money on banks taking state aid.

Failure Costs

“Bad loans have been made and the money is gone,” said William White, chairman of the Economic Development and Review Committee of the Organization for Economic Cooperation and Development in Paris. “The only interesting question right now is how the losses are to be allocated, who takes the hit. The people that lent the money imprudently should in principle, and I repeat, in principle, be the ones that pay the price.”

Stress tests by outside consultants showed Spain’s banks may need as much as 62 billion euros of capital. They have about

60 billion euros of subordinated bonds outstanding, according to Citigroup. More than 32 billion euros is from the country’s two biggest banks, Banco Bilbao Vizcaya Argentaria SA and Banco Santander SA, which don’t need bailouts.

The banks with investors at risk, including Bankia and its holding company, have about 14 billion euros of subordinated bonds outstanding between them.

Irish Experience

When Anglo Irish Bank Plc collapsed, the Irish government was forced to prop it up, said Michael McGrath, a spokesman for the opposition Fianna Fail party.

“The ECB wouldn’t allow a bank failure,” he said. “Large European institutions would have been forced to take losses, with consequences through the entire system. So the Irish state recapitalized the banks to repay senior bondholders.”

Denmark set up a framework in 2010 to force senior bondholders to bear losses. Two regional lenders then collapsed, the law was invoked, and funding for most of the nation’s banks vanished. The law was amended twice to regain market access.

“I don’t know of one big EU bank that’s gone down,” said John Whittaker, an economist at Lancaster University Management School. “The authorities are frightened to death, frankly.”

The EU is introducing a standard resolution procedure in

2018 that may mean creditors have their claims “reduced or converted to shares,” according to the draft proposal.

“Insolvency works very well for a widget maker, but not so well for a confidence-sensitive financial system,” said Satish Pulle, a fund manager at London-based European Credit Management Ltd., which oversees about $9.5 billion. Winding up banks at the expense of investors “may not be the best way forward in a systemic crisis,” he said. “You should not impose losses in a systemic crisis.”

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