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January 7, 2011

Europe

Investment Grade Credit

European Banks

EC – More Clarity on Resolution

Regulators picking up the pace on resolution. As expected, the EC issued its working paper on bank recovery and resolution which will form the basis for its draft legislative proposals that will be tabled in June 2011.

Content largely consistent with previous releases but more details were provided on the key elements of supervision, prevention, recovery planning, early intervention and resolution. See *Bank Resolution Regimes - 2011 Driver*, November 24, 2010, for the basics of the new proposals.

Wide ranging resolution tools including selling a business, transfer to a bridge bank, asset separation or **as a last resort the debt conversion/write-down tool**. The bottom line is that banks will be allowed to fail and regulators will have the toolkit to ensure that creditors (including seniors) will take losses in the future.

Write down of debt going forward. While debt write-down is 'not envisaged' to apply to debt currently in issue, we see this as a cold comfort for the markets as in many ways this largely mimics the approach of the SDRM (Sovereign Debt Recovery Mechanism) that will also only apply in the future (from 2013), but which was taken badly by the sovereign debt markets.

Peripheral concerns will be the biggest driver as we look into 2011 and will override Basel technicals, as we've stated for some weeks now. Regulatory change on bank resolution is further negative news for the sector, supporting our current underweight recommendation (see *Reversal of Fortune - European Banks in 2011*, November 30, 2010, and *Position for a Volatile 2011*, January 6, 2011).

Bank seniors safe in the short term and the defensive trade amid peripheral concerns. We expect continued decompression of spreads at weaker banks as sub debt is increasingly at risk of taking losses. However, medium term, we expect a compression of senior/sub in stronger names as high quality seniors are not priced for regulatory change on bank resolution.

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European Banks

EC – More Clarity on Resolution

EC Framework for Bank Recovery and Resolution

As expected the EC issued its working document entitled 'Technical Details of a Possible EU Framework for Bank Recovery and Resolution'. In conjunction with an impact assessment, this will likely form the basis for the EC legislative proposals that are expected to be tabled in June 2011; however, the details are subject to change. The content of the release was largely in line with what had previously been announced and fleshes out the EC paper on crisis management from October 20, 2010 (see again *Bank Resolution Regimes – 2011 Driver* for more details). The legislative proposals will lead to an EC Directive, but we find it unlikely that will become law before mid-2012 at the earliest.

Resolution Tools

The document is split into several parts dealing with scope of application, supervision, prevention, early intervention and resolution. While the whole document is of interest, we focus our attention on the section dealing with resolution. **The core underlying principle is clear, banks should be allowed to fail and shareholders and unsecured creditors should take losses going forward** while insured depositors and taxpayers are protected. The objectives do also specifically reference maintaining financial stability and preventing contagion. In terms of resolution tools, the document proposes a variety of solutions. These are as follows:

Sale of Business Tool
This would enable resolution authorities to effect a sale of a credit institution in whole or in part without requiring the consent of shareholders or complying with normal procedural requirements.

Bridge Bank Tool
This would enable resolution authorities to transfer all or part of the credit institution to a bridge bank. This would be a publicly owned institution and the ultimate objective would be to facilitate the sale of the bridge bank. The operations of the bridge bank should be temporary and should be terminated within one year, although this may be extended by up to one year. Note that if the bank has not been sold before the maximum period has expired, then it should be wound up.

Asset Separation Tool
This is effectively a good bank/bad bank split.

Debt Write-Down Tool
This is a mechanism that would permit resolution authorities to write down or convert into equity unsecured creditors of a failing institution. Note that it is not envisaged that this will apply to debt currently in issue. This is only designed to be used as a last resort and aimed at large, complex institutions that are deemed too big to fail. We go into this option in more detail below.

Page 10 of the document gives a useful pictorial representation of the order in which resolution tools should be applied to failing institutions. The first option should always be an ordinary liquidation, if this is not possible, then a bank should be wound down in an orderly manner; this may include the selling of the business, the creation of a bridge bank or the creation of a good bank/bad bank. Only if this is not possible should a bank be restructured as a going concern which may require the use of the debt write-down tool. We would reiterate that this tool is to be only used as a last resort and note that in all of the options described above, we believe that existing creditors could lose money.

The Debt Write-Down Tool: Not Envisaged to Apply to Existing Debt

There is a separate annex on debt write-down as an additional resolution tool. The paper is clear that it relates to possible future legislative changes which would be subject to full assessment and appropriate transition provisions and periods to avoid market instability or unintended consequences. It notes that it is not envisaged to apply measures adopted to debt currently in issue. We take a negative view of the proposal as we explain in more detail below and believe that the EC could have used stronger language in support of existing creditors than simply 'not envisaging' that this will impact them. We certainly do not take this as a guarantee that existing creditors will be protected going forward. The document acknowledges ongoing work on contingent capital by regulators and notes that debt write-down/bail-in debt and contingent capital can be complimentary.

The paper notes that regulators should get a statutory power to write off all equity and either write off subordinated debt or convert it into equity. However, citing the example of RBS in 2008, it notes that this may not always be enough and seeks to give regulators additional powers to make a broad range of senior creditors "face the real risk associated with bank failure". The document describes two possible approaches as to how a debt write-down tool might be implemented.

1. Comprehensive Approach

This would be a statutory power to write down by a discretionary amount or convert all debt into equity to return a bank to solvency. This would only apply to new issued debt but would include senior debt and notes that this feature should be contractually recognised within the bond documentation in the future. It does note that certain exclusions might be necessary, this may include: swap, repo and derivatives counterparties and other trade creditors; short-term debt (defined by a specified maximum maturity); retail and wholesale deposits and secured debt (including covered bonds). Without dwelling on the matter, we note that there could be multiple technical problems with this, e.g., how tapped bonds would be treated, encouraging banks to fund themselves with short maturities to avoid having to issue debt with write-down language, the risk of subverting the normal ranking of bank bonds etc.

2. A Targeted Approach

This approach would require institutions to have a fixed volume of a bail-in debt in issue which could be written down or converted via a statutory trigger. This would need to include a contractual term that would specify that the relevant resolution authority could use a statutory power to write down debt when an institution meets the trigger conditions for entry into resolution. This could include a fixed minimum for all institutions, e.g., as a percentage of total liabilities.

The document is not drawn on what should be the trigger for write-down but acknowledges that holders would want the trigger to be as transparent, objective and predictable as possible. Further, the document also notes that a bank might have difficulty in getting liquidity after it has been through a resolution procedure and hence to increase the availability of funding to a bank immediately post resolution, the EC raises the idea of new funding being 'super senior' on a temporary or permanent basis.

Following the discussion of resolution tools, there is a section on resolution powers on page 56 in the document. In this section, it details a list of powers that the resolution authorities should have in place to be able to apply their resolution tools. It specifically notes that the resolution authority should have the power to write off claims of unsecured creditors of an affected institution and the power to convert debt instruments into shares. This makes sense in relation to the debt write-down tool. However, there is an ambiguous footnote that notes that these powers should be available in connection with any of the resolution tools. We presume that this only relates to new issued instruments as described above, but it is unclear.

Overall, the EC is attempting to draw a line in the sand between current outstanding instruments and new instruments that may be able to be written down. Although we find that the language that it uses is relatively weak in support of existing instruments with the EC simply "not envisaging" that these powers will be used on debt currently in issue. We believe that this is reminiscent of the SDRM (Sovereign Debt Recovery Mechanism) put forward by Germany to include collective action clauses from 2013 that had a significant impact on the sovereign debt markets. **Ultimately, the EC is creating a framework to permit banks to be resolved/liquidated/wound up and making it easier to enforce losses on unsecured creditors (both senior and subordinated) in the event that an institution fails). As a result, bank creditors will no longer be able to get a free ride as they did in 2008 and 2009 again.**

Despite comments on write-downs only applying to new issue debt, there can be no guarantees that this would be the case if an institution were to fail; for example, we are seeing new precedents being set with new Irish laws. Ultimately, actions of governments in the UK, Ireland and Germany have already shown that rules can be changed swiftly if need be in any case. In our view, what this paper shows (and showed last October) is that any investor still under the impression that debt is somehow safe, should think again.

Further, the idea of creating 'super senior funding' could further subordinate creditors even if they do survive a restructuring. When this is coupled with the possibility of making depositors rank senior to senior unsecured debt (this was previously raised by the EC in its October 2010 paper), this is generically negative for bank credit. **Taken together with our concerns linked to peripheral Europe, this supports our view of staying close to home in 2011, focusing on the most defensive names and our underweight stance on Tier 1 (see again *Position for a Volatile 2011,* January 6, 2011, for detailed recommendations).**

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