hit risk hierarchy

News analysis

Debate is heating up over how bondholders are treated if a bank fails in Europe, says **Mary Watkins**

Shocked by Cyprus, astonished by SNS Reaal and angry over Anglo Irish – recent bank bailouts have left some creditors shortchanged and others questioning whether capital structure is being subverted.

Cypriot depositors waking up on Saturday were livid to discover a one-off tax would be levied on their bank accounts as part of a €10bn bailout of the debt-burdened Mediterranean island and its banking system.

Before this weekend, depositors had never been expected to accept losses in a eurozone bailout. The situation was made worse by the fact that the levy was being applied to all depositors, including insured depositors below €100,000 – a move that risks exacerbating deposit flight in other countries next time there is a flare-up in the eurozone.

The controversial Cypriot rescue plan, while likely to be moderated, shows how eurozone policy makers have taken increasingly aggressive and swift action to impose losses. Recent decisions have broken new ground and appear to pre-empt planned new European regulations governing who shoulders losses when a bank fails.

The Cyprus rescue package "sends a message about the willingness of the EU to change the rules retrospectively", says Paul Griffiths, head of fixed income at Aberdeen Asset Management.

"Does it change the hierarchy of risk? It seems to. Does it undermine the sense of security? Yes. Will it be enough to destroy the equity market rally? That's much harder to say," says Mr Griffiths.

It is notable that senior unsecured bondholders are not being forced to shoulder losses in Cyprus given that depositors normally rank pari passu with senior bond investors, meaning they should receive equal treatment in a bailout.

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Under the current plan, junior bondholders face losses while holders of senior debt are unaffected.

In part this is likely to be because Cypriot banks are more dependent on deposits and what little debt there is held largely by local investors and governed by English law, making it trickier to "bail in".

However, policy makers have already shown in the Netherlands and elsewhere that they are wary about hitting senior unsecured bondholders, fearful of the corrosive impact such moves would have on markets.

Steve Hussey, head of financial institutions credit research at AllianceBernstein, says it is difficult to read across from what is happening in Cyprus to other countries, given that there is not much senior or subordinated debt to write off. Yet, how investors and depositors are treated when a bank fails does fit into a wider debate in Europe.

Recent action in the Netherlands and Ireland shows a more assertive stance being taken by governments that may accelerate the 2015 implementation of the EU's resolution and recovery directive governing how investors are dealt with when a bank collapses.

Last month Jeroen Dijsselbloem, Dutch finance minister and chair of the eurogroup of finance ministers, announced that as part of the multibillion-euro package to rescue SNS Reaal, subordinated bondholders – and bank shareholders – would be wiped out.

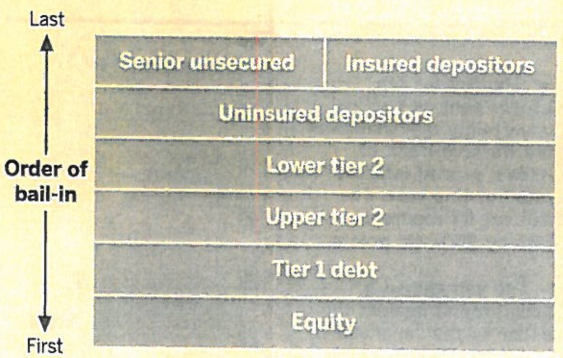
In other recent bank rescue deals, there has been some recovery for subordinated bondholders, but in this case lower tier two and tier one bondholders were written down to zero.

The stance taken on SNS Reaal reflects a broader trend in Europe, whereby shareholder rights are coming under pressure, says William Porter, head of European credit research at Credit Suisse.

"There is a sense that the frontier of market power is being rolled back aggressively."

Following events in Cyprus, he says it is clear too that euro-area officials, led by Mr Dijsselbloem "are more risk-prone" in the ways they seek to minimise bailout costs to their taxpayers.

Position in 'bail-in'



Sources: Thomson Reuters Datastream; RBS

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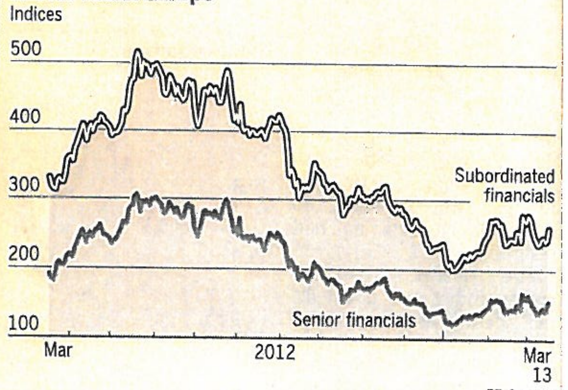

FT Graphic

"With this hindsight, SNS Reaal as an event is free to raise risk premiums in the sector in a way it did not do so originally," says Mr Porter.

Investors expect senior unsecured and subordinate financial debt to underperform non-financial, sovereign and secured financial debt.

Analysts say while they are realistic about sharing losses, recent rescue deals raise concerns. "I'm certainly not in the camp that says bondholders have always been treated unfairly. It's unfair that taxpayers have been bailing out banks for the past six years. But specific outcomes have been perverse," says Tamara Burnell, head of sovereign and financial credit analysis at M&G.

"In SNS, should creditors in the holding company have been treated in the same way as bank creditors when the holding company still had some solvent assets?"

Investors may also have underestimated the implications of Ireland's last-minute scramble to liquidate the assets of the former Anglo Irish Bank, says Alberto Gallo, head of European macro credit research at RBS.

Legal challenges are expected over Dublin's decision to liquidate one of its failed banks as part of a deal to restructure €28bn in debts, amid claims the bank's assets were undervalued when taken over by the Irish central bank.

Mr Gallo says what Ireland and Cyprus show is that eurozone policy makers are taking a "surgical" approach to enforcing losses. This reinforces a "who fails pays philosophy" of targeting stakeholders of failing institutions, "rather than socialising losses across the system".

Ultimately recent measures are likely to accelerate EU moves to implement a common framework for bank bail-ins. That at least, might create some certainty over the outcome of future bank rescues but new regulations will also push more of the burden of a bank failure on bondholders.