When banks go bust: part 3

Adventures in banking:2 more Italian banks down + IMF

In the meteor shower that is Basel 3, there's been a few developments which have been of interest to us:

-2 Italian banks are undergoing forced recapitalisations after zombie-ing around for the past few years: it's either that or get shuttered by the regulator.

-The BIS issued a 73 page paper about CoCo's (aka AT1/Hybrids/T2) and this prompted some further media commentary.

Our views on how "non-viability" and bank failure and how CoCo's/AT1/Hybrids/T2 will behave are probably different enough to many investors (and the BIS) that we can spend a few pages on what we think the issues are ahead of the Christmas/New year break.

When markets (or headlines) are wrong

It's not a long time since the NYT headline below; this was in early 2016 and the commentary was dire. There were lots of headlines that Deutsche was going to be closed up and hybrids converted into equity.

Deutsche Bank's Hybrid Bonds Are in a Death Spiral

Returns don't lie(mostly)

Since then the CoCo market has staged a 17% return. That's not bad when EUR cash rates are negative. At the very least, those kind of headlines indicate that large parts of the market made a judgement error (i.e.) Deutsche Bank was close to being closed down, but it somehow survived. If you are less charitable you would conclude that it was never seriously at risk and the market was looking at the wrong things.

The rules:

Basel 3 is stupidly complex, but the rules around what happens when banks get into trouble are quite simple. Hybrids get converted to equity or written off if one of two events happen;

- If a bank's equity level fall below 5.125%.
- If the regulator considers that the bank is non-viable (which has never been specifically defined), hybrids are converted to equity or written off.

In both cases the conversion or written off outcome is dependent on what was in the offer documentation. While all the Australian bank hybrids contain conversion mechanisms, around 60% of the $500b CoCo's issued since 2009 write the instrument off (or down) if the triggers occur. So an investor gets nothing under write down compared to a bunch of shares under the conversion mechanism. This conversion/write off option is the major difference between a CoCo and a more conventional bond and the valuation of the option has been the basis for the lots of controversy in the CoCo market. When Basel III commenced in 2013, many investors thought the options were impassable roadblocks to investment. Media commentators, AMP Capital, Schroder Investment Management, Macquarie Investment Management and a number of asset consultants all commented that investors were not being compensated for the non-viability option and that the instruments were non investable. We were more of the view that, for Australian banks, the option wasn't particularly valuable and the additional yield compensation was far more than the option value, notwithstanding that it was difficult to value.

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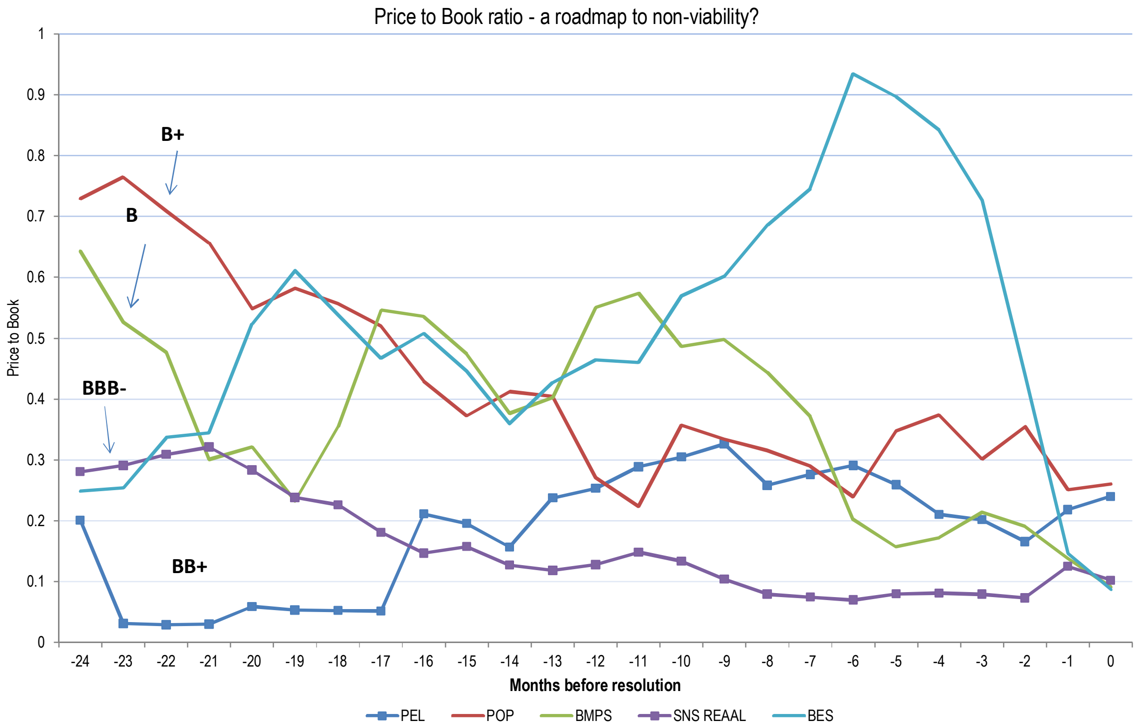
So just how do banks fail?

We've always been interested when banks get into trouble as it gives us a guide as to how to interpret and value the "trouble" options. Under Basel 3, there have been 11 European banks (ex-basket case economies such as Greece and Cyprus) which have been closed by the regulators and there are the 2 Italian banks we mentioned above which have been given until the end of the year to raise equity or be closed. Of the 11, there have been 5, as well as the 2 "maybes" which were listed. We think market judgements are valuable. The chart below shows the path of the Price/Book (P/B) ratio (of the listed bank entities) in the 2 years before closure and the Credit Rating over that time. Price to Book is a shorthand method of valuing a bank. If a bank has a low Price to Book ratio (i.e. Market Value to Shareholders Funds), it indicates that the market thinks the bank has unidentifiable loan losses (i.e.) its book value is too high, or that it needs to do a dilutive capital raising or that it will never earn enough to justify the capital invested. Alternatively, a really high P/B ratio indicates that the market thinks there are no unidentified bad loans or that the entity earns super high returns.



So waddya know?

It's a little bit surprising just how good markets are at predicting demise. All but one of the banks that were closed had really low P/B ratios at least 12 months and in most cases 24 months before closure (the outlier, BES, was a case of fraud). The fraud discovery blew an $800m proposed capital raising by Goldman Sachs to bits: they're still trying to sue someone; good luck with that!). In addition, almost all the listed banks had sub investment grade credit ratings 24 months before closure. Of course, there were other banks that had low P/B and credit ratings that did survive, but we're less interested in the false negative/type 2 errors; they're less costly.

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And the 2 "maybe dead" Italian banks

The chart below shows the same data for the 2 "maybe dead" Italian banks and it is much the same picture: low P/B and low credit ratings. However, it looks like both banks will get capital injections. While that strikes us as brave, it looks like there are little pockets of business within each of the banks which are quite valuable, and the buyers are buying at almost option like values.

Banks and agency risk and regulators

Where we do disagree with BIS and an article by Chris Joye in the AFR last week is the importance of how agency risk works. The BIS claims, and the AFR article notes, that bank equity prices and management risk taking are heightened if a bank issues a Principal Write Off Hybrid, rather than a converting hybrid. The theory is that equity value is increased if one of the triggers (point of non-viability or <5.125% equity) occur with a write down hybrid whereas in a conversion type Coco, there is a dilution of equity. So a bank that issues a write down hybrid is only doing it to increase equity value at default. Unfortunately, the approach described above bears no relation to the (short) history of post 2013 European bank closures. The most important points about the 11 closures that have occurred to date are;

- They all occurred when the regulator declared non-viability. All the banks had equity ratios well above the 5.125% trigger at the time. We don't think the 5.125% ratio trigger will ever be used. Default will be regulator driven.
- Equity was largely wiped out. Whether or not the bank had issued a Principal Write off or Converting instrument made no difference to equity value or management tenure.
- Whether capital instruments were converted or not was entirely situational (and probably always political). In some cases, capital instrument investors got nothing. In other cases they suffered no loss.

We think that the BIS is correct to point out the issue of agency risk. However we think agency risk

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occurs earlier in the bank life cycle rather than at default. Agency risk is most dangerous when the bank is healthy and bank executives and shareholders are capable of maximising short term gains at the expense of long term risk. We think that over time more attention will be focussed on the appalling agency risk that exists in banks and bank management in Australia. APRA's activities over the past few years have been heavily concentrated in this area. When the concept of non-viability was first introduced in the early years of this decade, neither APRA nor any other regulators around the world would give any guidance as to what non-viability actually was. We initially agreed with the banks who were squawking about it but over time we think it's a case of APRA being crazy like a fox. The moment the regulators give bank management any ideas about what constitutes "non-viability", the banks will start the regulatory arbitrage process that has served them so well in the 25 years since Basel I commenced. So effective was their use of regulatory and market arbitrage in the 90s and 2000's that banks evolved from utilities which used to earn a few % points over bond rates to much riskier entities earning 15% over bond rates. That risk exploded for much of the world in the GFC. Australia missed out but in some ways it was a "there by the grace of god" moment. And as a consequence we've had a decade of bank de risking.

So how does this affect local hybrids

We've always thought of Basel III hybrids as subordinate-ish debt (*) with the conversion option attached. Our view has been that the option (for Australian banks) was, and is, deep out of the money and not very valuable. Hence we thought the credit margins, even taking into account the price of the option, were attractive. Current P/B's of domestic banks range from 1.5 to 2.2 and their credit ratings remain at AA-, 6 levels above investment grade. It looks to us that they are a long way from being considered "non-viable" by APRA. In addition, it looks like you get a few years warning before regulatory action after the bank enters the non-viability zone bearing in mind the descent into the non-viability zone takes a few years as well. If this is the case, most of the domestic hybrids look "money good". However, circumstances change and we'll watch a variety of indicators to give us some insight as whether non-viability risk is increasing.

(*) Before readers start reminding us that hybrids are deeply subordinated (not just subordinate-ish), the coupon payment must be made if the bank pays an ordinary dividend. Australian banks have not failed to pay an ordinary dividend for at least the past 50 years. We think you probably have to go back to WW2 before the major banks missed a dividend payment.

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