Significance and characteristics of burden-sharing in the recapitalization of Spanish banks

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The burden-sharing process being implemented in the recapitalization of the Spanish banking system under the Memorandum of Understanding (MoU) signed with the EU for aid to the financial sector is unique and the first of this order of magnitude within the EU. The main objective of this exercise is to reduce the ultimate cost borne by taxpayers of the financial restructuring process and it will have a notable impact on holders of hybrid equity and debt instruments, such as preferred shares and subordinated debt.

One of Spain's commitments under the MoU signed with the EU for aid to the financial sector was to carry out a so-called burden-sharing exercise. Current estimates for the impact of the exercise point to a private sector contribution of nearly 13 billion euros, i.e., one fourth of the capital needs identified in the stress test performed under the MoU. Aside from its large scale, the process is also unique and technically complex, as a good deal of the affected hybrid instruments were placed among the retail customers of the institutions which need assistance. The FROB has set up burden-sharing guidelines for Group 1 and Group 2 banks. The ultimate impact of these measures on the nominal value of instruments for the holders of the securities in question will presumably be even greater than the stipulated haircuts, due to the mechanisms for exchange put in place to recapitalize banking institutions and the price levels to be set for the shares of the banks that are, or will be listed.

Introduction

The road map for the process of restructuring and recapitalization of the Spanish banking system set out in the *Memorandum of Understanding* (MoU) -signed by the Spanish authorities in order to receive European assistance- is being completed reasonably on schedule, as highlighted by recent progress reports published by the European Commission and by the International Monetary Fund. By virtue of the MoU, Spain committed itself to implementing burden-sharing in the restructuring and recapitalization process. This is understood to mean that all holders of subordinated debt (in addition to shareholders) issued by the banks that now need assistance should partially absorb the losses arising in these banks and thus contribute to their recapitalization. Holders would be forced to accept a portion of the burden of recapitalization in order to minimize the cost to taxpayers entailed by an injection of public funds. To this end, applicable legislation was changed in order to make the burden-sharing exercise especially coercive for holders of such

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securities (affected institutions have begun the burden-sharing process in recent weeks). Specifically, the exercise is being carried out under **Law 9/2012 of November 14th on credit institution restructuring and resolution**, which transposed some MoU commitments in law.

Absorption of losses is distributed between capital and investors in hybrids (subordinated instruments) **without strict adherence to seniority**. For example, seniority would have required preferred security holders' funds to have been depleted before holders of subordinated debt could take losses. Nevertheless, former shareholders do take prior losses on their full investment, except in some cases (namely, in listed institutions) in which they remain present with small amounts for technical reasons.

The purpose of this article is to analyze the actions being carried out in the framework of the MoU for institutions that have received public funds (Groups 1 and 2). First, we will evaluate the significance of these actions in the recapitalization process of Spanish banks. Then, we will review the characteristics of the mandatory exchanges that will be implemented in Group 1 institutions, and of the sole voluntary exchange offer that has been made to date (in Liberbank), which was combined with a subsequent mandatory exchange. Lastly, we will set forth the main conclusions of the analysis.

The role of burden-sharing in Spanish bank recapitalization

In recent weeks, both the Ministry of Economy and Competitiveness and the FROB have released more information on the conditions of exchange of hybrid instruments –preferred shares and subordinated debt– that banks which received public assistance are obligated to carry out. At the time this article was written, some of the exchanges had already been completed (in Banco de Valencia and Liberbank), while others are under way.

The basic procedure is to apply a haircut to the nominal value of subordinated securities. The size of the haircut will depend on the characteristics and nature of the securities, and holders are forced to exchange the corresponding amount for capital instruments[2], usually bank shares, but also bonds convertible into shares in some cases. The aim of these mandatory buybacks and exchange for shares is to force bondholders to take some of the banks' losses and, thus, minimize the bill for taxpayers.

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The FROB has set up a hybrid management exercise through mandatory exchanges (coercive action) in Group 1 institutions Bankia, Novagalicia Banco, Catalunya Banc and Banco de Valencia and in CEISS. In Group 2 institutions –Liberbank, BMN and Cajatres–, although the possibility was envisaged of voluntary exchanges under less onerous conditions for investors or more alternatives than a mandatory exchange, only Liberbank ultimately made use of this option. In any case, it was obliged to supplement this with coercive action for holders who did not participate in the voluntary exchange.

[2] Except in those which are not perpetual, where holders may opt for deposits or senior bonds of institutions with the same maturity as the subordinated security.

Table 1

Expected capital increase through hybrid management exercises (billion euros)

	billion euros	Oliver Wyman capital shortfall	Capital augmentation through SLEs*	SLEs management (%)
Group 1	BFA-Bankia	24.743	6.593	26.6%
	Catalunya Banc	10.824	1.553	14.3%
	Novagalicia Banco	7.175	2.027	28.3%
	Banco de Valencia	3.462	0.426	12.3%
		46.204	**10.599**	**22.9%**
Group 2	BMN	2.208	0.182	8.2%
	Liberbank	1.197	0.714	59.6%
	CEISS	2.062	1.196	58.0%
	Caja3	0.779	0.036	4.6%
		6.246	**2.128**	**34.1%**
Group 3	Banco Popular	3.223	0	0.0%
	Ibercaja	0.225	0	0.0%
		3.448		**0.0%**
	TOTAL	**55.898**	**12.727**	**22.8%**

**SLEs – subordinated liability exercises.*

Source:Afi, "Spain: Financial Sector Reform: Second Progress Report" of the IMF.

One may wonder, firstly, about the significance of these hybrid management exercises in the recapitalization process. It is estimated that such actions will contribute to Spanish banks the sum of nearly 13 billion euros, which is more than 1% of Spain's GDP and one fourth of the banks' estimated total capital needs, as shown in Table 1. This exercise has no parallel in Europe, both because of its scale and especially because of its characteristics, as it affects not only institutional investors, but also a majority of retail investors who are these banks' customers. It should also be noted that the recapitalization under way will require a further capital contribution of nearly 40 billion euros in public funds, over and above sums injected at previous stages, a total that is triple the amount contributed by holders of subordinated and preferred debt.

A second matter of interest is related to whether it would have been possible to reduce even further the aforementioned injection of public funds if larger haircuts had been applied to securities holders prior to the exchange for capital instruments. The answer is no, although it would have given the State a larger relative stake in the affected banks and, consequently, a larger share in future profits if the banks returned to profitability.

Would it have been possible to reduce even further the injection of public funds if larger haircuts had been applied prior to the exchange for capital instruments? The answer is no, although it would have given the State a larger relative stake in the affected banks and, consequently, a larger share in potential future profits.

While one might assume that this would reduce the net cost borne by taxpayers in the form of public assistance, certain adverse effects have been noted. In particular, against such a view, arguments have been made based on the adverse commercial impact of larger haircuts on customers, given a significant number of affected banks' dual role as deposit institution/customer and retail investor. This could negatively affect the future profitability of the bank and, hence, ultimately prevent any reduction in the net bill for taxpayers of State aid. In short, as the IMF report acknowledged, it is not clear what the actual final balance sheet for public coffers would have been if large haircuts had been applied. As pointed out in the following sections, the effective haircuts will, in general, be quite substantial[3].

Mandatory exchanges

As published in the Restructuring Plans submitted by the banks and approved by the European Commission, the standard methodology defined for calculating haircuts is as follows:

- Calculation of the net present value (NPV) of hybrid instruments through discount factors arising from yields ranging from 10% to 20%, depending on the instrument and assuming that there will be no coupon payments in those securities whose specific conditions allow for it (e.g., no coupon payment in preferred shares when the institution is not expected to yield a profit).

- The NPV could be increased by an additional premium of up to 30% for those instruments which will be exchanged into shares.

- In any event, a global restriction would apply: the conversion rate into shares or another capital instrument will not exceed 90% of the nominal value.

- For the specific case of dated subordinated debt, holders may choose between an exchange for: (i) bonds or deposits with the same maturity with a discount on the principal of 1.5% per month from December 1st, 2012, until maturity of the issue and; (ii) shares, at the highest conversion value between the value obtained through point (i) of this paragraph, and the methodology used for preferred shares and perpetual subordinated debt.

The FROB released the average haircuts on the nominal value it will apply in these mandatory exchanges of Group 1 with application of the described methodology. They will be 28% on average, with a 42% haircut for preferred shares and 38% for perpetual subordinated debt.

It should be borne in mind that, in share exchanges, the adverse impact of such haircuts for the holder of hybrid instruments may be amplified. This is especially true in cases where the economic valuation of banks is still negative after the absorption of losses by the original shareholders through a capital decrease. The injection of capital from both the exchange of hybrids under the aforementioned terms and from the contribution made by the FROB should, in practice, absorb the remaining negative economic value (not covered by the original shareholders) with a final effect in the share price if it is listed. We will now analyze each case:

- Related to Bankia, with an economic valuation of -4.148 billion euros, in addition to the announced haircuts on the notional value of the preferred shares and subordinated debt to be taken by investors in buybacks, the shares from the exchange must absorb the remaining negative economic valuation –that is not covered by the capital reduction that affects the original shareholders- in proportion to their stake

[3] We will leave aside herein the final outcome of ongoing claims in arbitration or judicial proceedings filed by retail holders affected by the improper sales practices of hybrid instruments.

Table 2

Preferred share and subordinated debt buyback and exchange: Bankia *

(billion euros).

billion euros	Preferred shares	Undated subordinated	Dated subordinated	Total	FROB injection
Pre-haircut balance	3.246	0.394	3.271	6.911	
Average haircut (%)	**38%**	**36%**	**13%**	**26%**	
Post-haircut balance	2.013	0.252	2.846	5.110	10.700
Economic valuation	**-4.148**				
Shares received after absorption of losses	1.485	0.186	2.099	3.770	7.893
Effective haircut	54%	53%	36%	45%	

** Assuming that all subordinated issues with a maturity are exchanged for shares. In fact, the FROB initially estimates an exchange for shares of 4.84 billion euros and not the 5.11 billion euros shown in the table.*

Source: Afi, FROB, restructuring plans of institution.

in the recapitalized bank, through an issue premium.

Two capital increases have been planned: (i) the first one, amounting to 10.7 billion euros, would be subscribed almost totally by the FROB, while (ii) the second one, for 4.84 billion euros, would allocate capital to holders of hybrid instruments. In both cases the nominal price is 1 euro per share, a price to which an issue Premium is added to cover the negative value. Obviously, a price lower than this reference would imply an effective loss greater than these percentages (at the time this article was written the shares were trading at 0.65 euros per share).

Based on a similar analysis, the losses for hybrid debt bondholders in the cases of Novagalicia Banco and Catalunya Caixa would be greater than the published haircuts. Our estimates for effective haircuts at these banks are shown in Tables 3 and 4.

Unlike other Group 1 institutions, management actions of hybrid instruments and subordinated debt carried out in Banco de Valencia involved substantially higher haircuts (85% for subordinated debt and 90% for preferred shares). In this case, the exchanges were into mandatory convertible bonds (CoCos) or ordinary shares, depending on whether the investor profile was retail or institutional, respectively. These haircuts, which are substantially larger than the previous ones, were justified by the following:

- The unique features of BVA.
- The attempt to appropriately distribute the costs of resolution.
- The minimization of public support.

Voluntary exchanges

Liberbank is the first and only Group 2 institution so far to have made an exchange offer in this sense within the policy framework for managing hybrids. Retail investors had exchanged their preferred shares and subordinated debt for either new Liberbank shares or for a combination of new Liberbank shares (between 20%-30%, depending on the debt security held) and different issues of mandatory convertible bonds CoCos- (between 70-80%). Institutional investors could only exchange them for new Liberbank shares.

The average haircuts on the nominal value applied by Liberbank in the voluntary hybrid management

Table 3

Preferred share and subordinated debt buyback and exchange: Novagalicia Banco *

(billion euros).

billion euros	Preferred shares	Undated subordinated	Dated subordinated	Total	FROB injection
Pre-haircut balance	1.174	0.211	992	2.377	
Average haircut (%)	**43%**	**41%**	**22%**	**34%**	
Post-haircut balance	0.669	0.124	0.774	1.568	5.425
Economic valuation	**-3.091**				
Shares received after absorption of losses	0.374	0.069	0.432	0.875	3.027
Effective haircut	68%	67%	56%	63%	

** Assuming that all subordinated issues with maturity are exchanged for shares.*

Source: Afi, FROB, restructuring plans of institutions.

Table 4

Preferred share and subordinated debt buyback and exchange: Catalunya Caixa*

(billion euros).

billion euros	Preferred shares	Undated subordinated	Dated subordinated	Total	FROB injection
Pre-haircut balance	0.510	0.102	1.327	1.939	
Average haircut (%)	**61%**	**40%**	**15%**	**28%**	
Post-haircut balance	0.199	0.061	1.128	1.388	9.080
Economic valuation	**-6.674**				
Shares received after absorption of losses	0.072	0.022	0.409	0.503	3.291
Effective haircut	86%	78%	69%	74%	

** Assuming that all subordinated issues with maturity are exchanged for shares.*

Sources: Afi, FROB, restructuring plans of institutions.

offer have been between 7% and 10%, depending on the choice investors made. The offer was accepted by 87.3% of bondholders (below the 90% set by the FROB as a minimum level) so the FROB ordered a mandatory loss assumption exercise for the remaining 12.7% under more onerous conditions for investors, with haircuts ranging between 10% and 54%, depending on the instrument type and the exchange type chosen with the same methodology described above for mandatory exchanges.

Liberbank shares have been valued at 1.11 euros per share, in line with the valuation of the FROB performed on Liberbank. Nevertheless, following the bank's float on May 16th, the entity's shares have fallen to levels near 0.50 euros per share, resulting in significantly greater effective losses than previously mentioned. However, the three shareholder savings banks of the bank (obviously not Liberbank) have agreed on a mechanism, charged against their own capital base, to compensate retail holder customers if the share

price falls below the benchmark used for the exchange within a two-year time horizon.

Conclusion

Although large haircuts, in theory, are to be applied to hybrids prior to their exchange for shares or other capital instruments, the final impact on holders will presumably be far greater because of the mechanisms put in place to recapitalize banking institutions (especially banks with a

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negative economic valuation). In fact, holders of hybrid instrument will likely end up taking a global net loss of more than 50% of their investment. This will largely depend on the price levels eventually set for the shares of banks that are now or will be listed: such prices will very likely be a benchmark for setting the price of unlisted banks, for which the Deposit Guarantee Fund (FGD) is expected to be a supplier of liquidity[4].

References

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