Asia Credit Research

OCBC Bank

The Spanish Resolution: Different Symptoms call for Different Remedies

Tuesday, 13 June 2017

Summary / Key credit considerations

- The resolution of Banco Popular Espanol SA has highlighted the exposure of bank capital instruments to regulator write-down powers which are over and above contractual write-down risk.
- We believe idiosyncratic factors drove the recent events and while global regulator interests and intent are the same, their actions in crises will vary depending on circumstances. Market reaction reinforces this view.
- Characteristics of banking sectors in Asia mean the remedy for banking sector stress may not necessarily be the same as for Spain.
- While still mindful of loss absorption features and the subordinated nature of these instruments, our view of the risk profile of these instruments for banks under our coverage has not changed.

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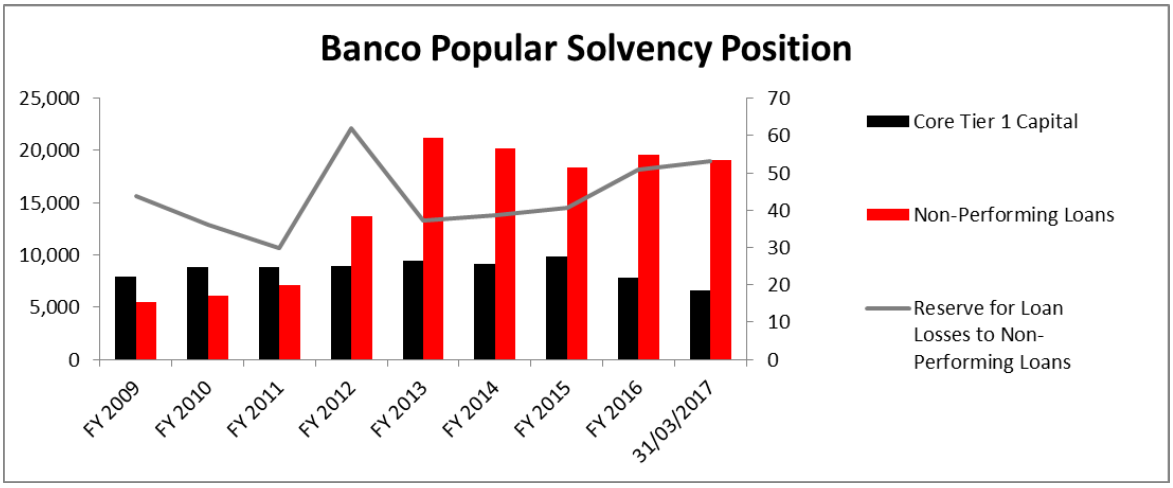
Banco Popular Espanol SA was Spain's sixth largest bank by assets with a reported 8% market share of system loans and 6% market share of system deposits as of November 2016. Revenues are predominantly generated in Spain (~90%) with a concentration on small and medium-sized enterprises.

Not unexpected but still a surprise

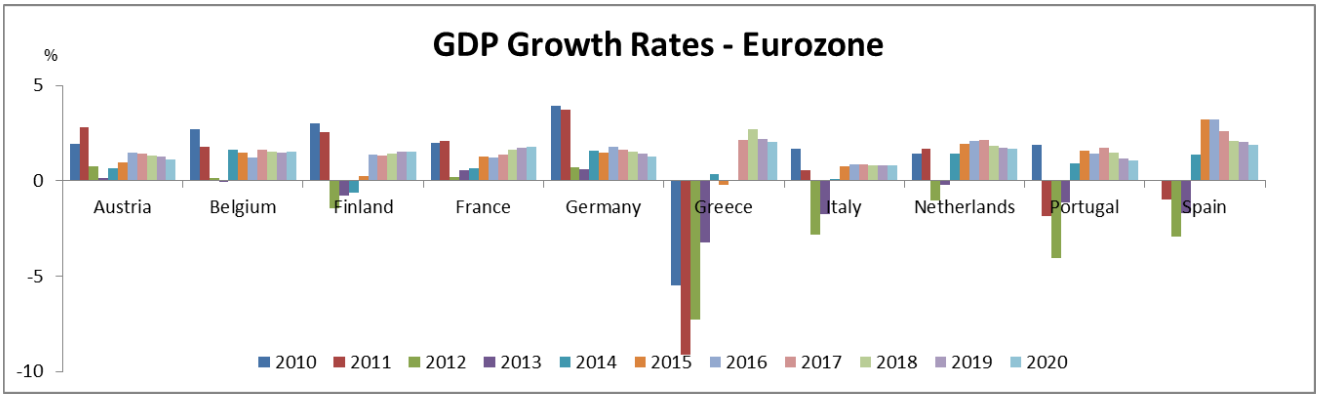
On June 7th, 2017 European regulators put Banco Popular Espanol SA (Banco Popular) into resolution, wiping out the bank's common equity and Additional Tier 1 capital. The bank's Tier 2 capital was also effectively written down to zero through conversion into equity before selling the bank to Banco Santander SA for EUR1. While this event was not unexpected given Banco Popular's strained solvency position (refer Graph 1 below) and weak credit profile, the pace at which Banco Popular's liquidity position was worsening due to negative news flow (weak 1Q2017 results, slow progress in restructuring announced mid-2016, negative revisions to audited statements, resignation of recently appointed CEO) and customer confidence in the bank was dissipating necessitated the European Central Bank to quickly determine that Banco Popular was likely to fail from a diminished ability to raise capital for provisions to accelerate disposal of its problem assets. This led to the European Banking Union's resolution authority, the Single Resolution Board, implementing a resolution scheme to resolve the bank at an accelerated pace to contain any systemic impacts to the Spanish and European banking sector.



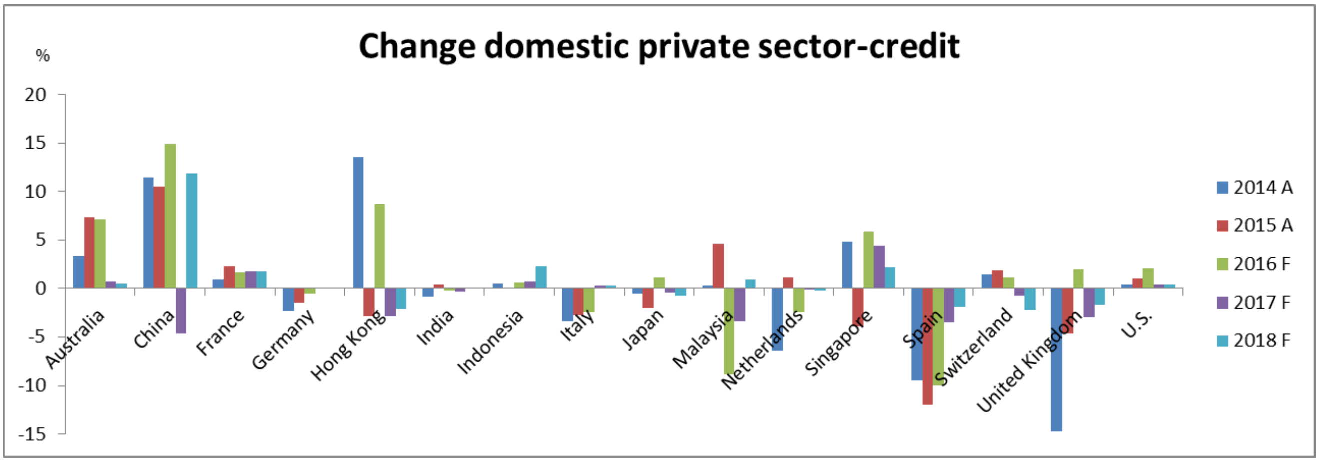
Source: Bloomberg

Things were looking up

Banco Popular's resolution comes against the backdrop of generally positive operating conditions for Spanish banks. Spain's economy has been recovering following the Global Financial Crisis with better economic growth rates in the past few years than the rest of the Eurozone. Economic restructuring, material system deleveraging and a recovery in the property market has led to improved domestic consumption while the general recovery in the Eurozone has improved external conditions and led to a rise in Spanish export volumes.



Source: IMF



Source: S&P, Banking Risk Indicators April 2017 Update

Better economic conditions have had a flow on effect on Spain's banking sector with investor optimism for the health of Spanish banks supporting strong demand for recent TLAC issues by Spanish banks to meet rising capital requirements. According to The Financial Times, Spanish banks sold USD18.4bn of bonds by May 4th 2017, higher than the whole of 2016 and the fastest start to a year since 2014. Indeed, the more conducive operating environment was expected to be supportive of Banco Popular's future performance along with progress of the bank's restructuring strategy announced mid 2016 which was expected to reap benefits in the next 12-18 months. The banking system's liquidity and funding position has also improved with deleveraging and stable deposits reducing the sector's reliance on wholesale funding. The stock of non-performing loans continues to reduce as the property market recovers and unemployment falls (albeit from elevated levels).

Regulator Intent the Focus

Banco Popular's resolution mechanism was not a breach of minimum capital ratios (Banco Popular's total capital ratio was 11.91% as of March 31st, 2017 against the bank's reported 2017 Pillar II supervisory review and evaluation process minimum total capital requirement of 11.375%) but under the regulator's discretionary right to resolve under Point Of Non-Viability (PONV) Language. This mechanism is one of the Financial Stability Board's 'Key Attributes of Effective Resolution Regimes for Financial Institutions' [1] and exists in several jurisdictions including Singapore. With use of this discretionary trigger hard to quantify (discretion by definition speaks to the freedom to decide what should be done in a particular situation) compared to standard capital ratio based triggers, the issue then becomes one of understanding regulator intent. In general it is safe to assume that all regulators intend to do the same thing, which is ensure the health of the banking sector through effective monitoring of compliance with banking regulations. This then begs the question of whether regulators

[1] **http://www.fsb.org/wp-content/uploads/r_111104cc.pdf**

in Asia with similar discretionary powers would follow a similar course of drastic action under their respective PONV language, possibly highlighting a previously under considered risk for capital instrument investors.

However while intent is somewhat consistent, we believe the mechanism to achieve system stability will vary depending on the specific circumstances of the situation and that regulators will look at the best way to achieve their objective based on the circumstances presented. We see four key factors at play in Spain which led regulators to choose resolution as the best way forward:

1. Spain's banking sector is somewhat fragmented with the top three banks having a market share of less than 40%. Only Germany has a materially lower contribution to total market share of its top three banks in the Eurozone but German banks are exposed to a much healthier German economy. Banco Popular itself was the sixth largest banking group at the time of its resolution, somewhat lowering its systemic importance which was deteriorating anyway given the run on deposits.
2. Excess capacity: Spain's banking sector was damaged by the GFC and has previously been characterised by over capacity due to a period of excessive credit growth prior to the financial crisis. Coupled with material deleveraging of the economy, the banking sector has been consolidating with branch numbers reducing by 30% and staff levels reducing by 25% to 2015 from its peak in 2008. The regulator also has a track record of assisting in consolidating the industry merging smaller, weaker players with larger ones to improve the competitive landscape and sector fundamentals with 250 credit institutions in the Spanish banking system at the end of 2016, down from 362 in 2008[2].
3. Banco Popular’s credit profile was fundamentally weak with recurring operating income performance subdued from low interest rates, low credit demand from weak growth and deleveraging, and a higher cost to income ratio including extra-ordinary restructuring charges. More importantly, a heavy bad loan burden which was double the system average resulted in high loan loss provisioning costs and bottom line losses. Banco Popular’s ability to raise capital internally to resolve its bad debt issues was becoming increasingly constrained. That said, the bank had a solid and growing market position in domestic lending to small and medium enterprises (17.7% as of December 2016) which generate higher margins but also carry higher risk than mortgages.
4. Banco Santander S.A.’s (Santander) already solid credit profile stood to benefit from the acquisition, notwithstanding the large amount of non-performing loans Santander would acquire. Banco Popular’s existing business would solidify and expand Santander’s leading domestic market position through access to small and medium enterprises in line with its strategy and complement its geographically diversified businesses.

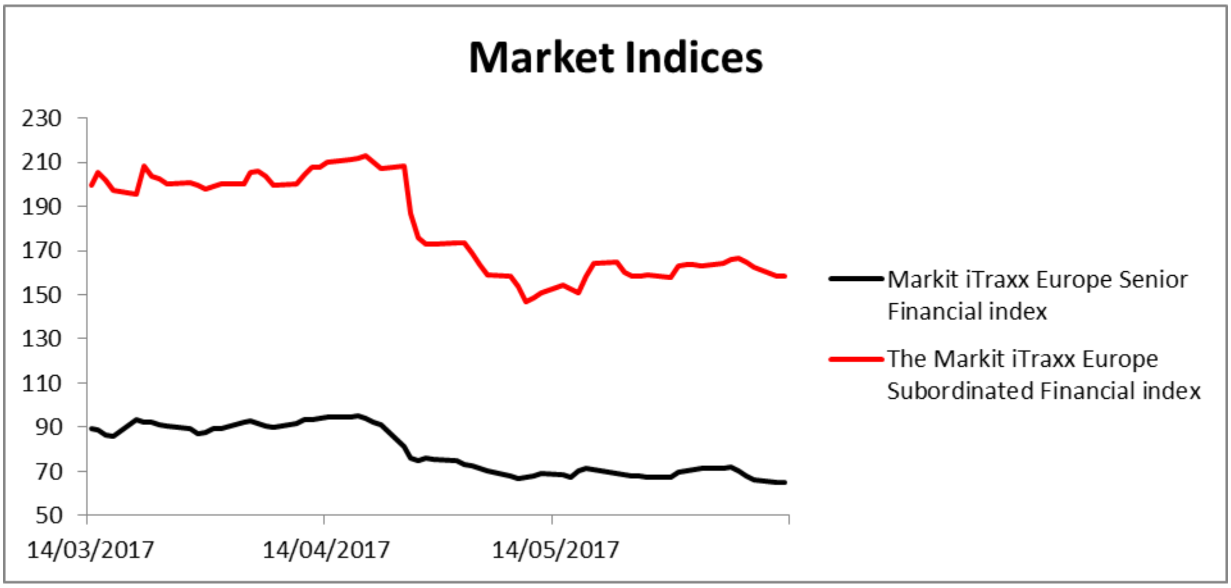
While the Spanish economy has been recovering at a pace better than the wider Eurozone, underlying fundamentals remain somewhat fragile. Unemployment remains high, system leverage remains elevated (albeit is improving) and the banking sector is still working through a high level of non-performing real estate exposures while capital buffers above minimum requirements remain lower than peers. We think the previous factors sufficiently incentivized regulators to resolve the bank given the minimal likely impact on system stability rather than expose the fragile recovery to any contagion risk from prolonged stress at Banco Popular. Positive investor perception remains important for Spain’s banking sector given the need to raise additional capital by Santander to comply with TLAC and an expected rise in the funding gap for Spanish banks as credit demand recovers along with further improvement in economic growth.

Market reaction has been muted

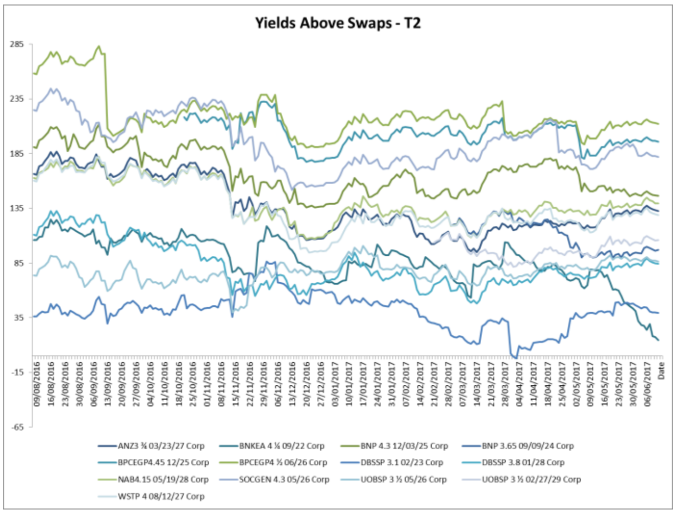
Despite the somewhat significant developments of the resolution, market reaction has been muted with both The Markit iTraxx Europe Senior Financial index and iTraxx Europe Subordinated Financial index tightening following the announcement. In general, market views have been positive given the relatively smooth and expedient resolution process which had previously been untested and worked as it should in containing systemic risk.

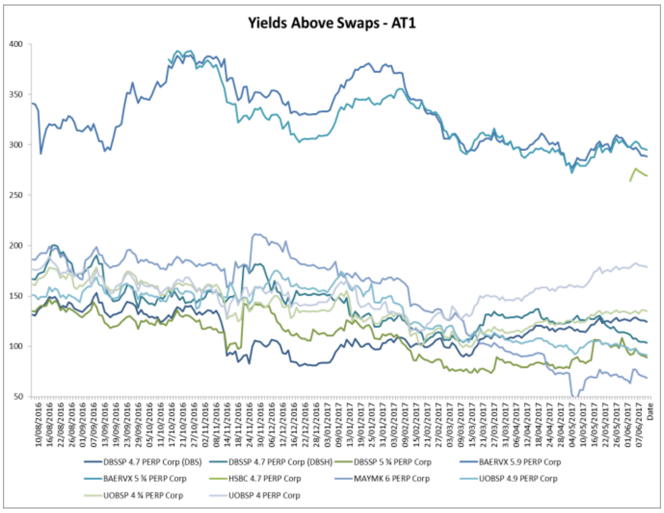
In the SGD space, the spreads on AT1 and T2 instruments for both Asian and European names also tightened towards the end of the week. Market reaction implies that the stress at Banco Popular is likely more idiosyncratic.

[2] **Moody’s Investor Services: Banking Spain Macro Profile: Strong-, 10 May 2017**



Source: Bloomberg as at June 13th, 2017





Different circumstances call for different measures

Although the events in Spain call into question whether local regulators will also exert their discretionary powers to resolve in the same way, we think that local regulators will act differently, but still in a way that preserves the health of their respective banking systems. This is given the somewhat more concentrated nature of banking sectors regionally, which increases each bank's systemic importance and heightened difficulty in putting any such stressed banks through a resolution scenario. Fundamentals for banks under our coverage also remain sound with strong market positions and relatively low non-performing loan burdens translating to solid earnings capacity and maintenance of strong capital buffers above regulatory minimums. Finally, government's still remain supportive of banking sectors with limited bail in regulations in existence aside from Hong Kong.

We see local regulator's discretionary trigger as a way to intervene earlier should weakening trends develop in the credit profile of major regional banks, acting as prevention rather than a cure. As such, our view of the risk profile of these instruments for banks under our coverage has not changed following the recent events. We expect regulators to use their resolution tools differently depending on the idiosyncratic circumstances in play.

Italy is an interesting case in point with systemic risk within Italy's banking sector elevated for some time. That said, resolution has not yet occurred given the potential to amplify contagion risk, rather than limit it. Circumstances hindering resolution include a high amount of retail investors in bank capital instruments, less desirable balance sheets and the lack of a strong acquirer for the weaker Italian banks have instead forced European regulators and the Italian Government to negotiate a rescue plan for Banca Monte dei Paschi di Siena. That said, negotiations continue and if common ground cannot be found, then regulators now have an example to follow.