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Realm Market Review – Who will Pay? 23rd July 2012

The cycle of European governments and regulators attempting to manipulate bond valuations via liquidity initiatives has failed miserably; this has been clearly illustrated by the diminishing half-life and impact of these measures on market prices. The bond spreads of sovereigns and banks in the periphery have continued to fluctuate and widen in the absence of market and systemic confidence.

The political strain is starting to become more and more evident in the core, as the resistance to debt mutualisation without accountability grows (especially in Germany). Given all of these factors and with time running out, should European power brokers finally face the prospect of significant bank write downs playing a meaningful part in the process of European deleveraging?

Over the last week there has been an increasing amount of chatter regarding whether subordinated and senior unsecured lenders should pay a price in the Spanish bank bailout process. Until now we have seen the European Union actively intervene to shield bank lenders from the pain of haircuts. In Ireland for example the state was forced to guarantee its banking system to protect bank senior unsecured bond holders despite the fact that these same banks were clearly insolvent. The belief has been that there is an implicit guarantee on bank debt from the Eurozone governments.

This view will now need to be amended to reflect a changing reality. The introduction of a central European banking regulator could quite conceivably have a meaningful impact on the current perceptions of debt seniority. In many ways this is a natural progression of the crisis and is a good example of the types of obstacles the EU will face moving from a loose monetary union to a political fiscal union.

In the case of the GIIPS, the ability to protect national interest by shielding their banks has been compromised in the eyes of the market, as such it is logical that attention should start to turn on to the quality of the underlying banking assets. This naturally leads to a more difficult question of who will pay in the event that a large Spanish or Italian bank (for example) is found to have a solvency issue (in the absence of national support)?

Let us consider the plight of BBV and Santander, how can the market be certain that the ECB would not take a harsher view of the asset quality and current provisioning of these large domestically important institutions than the Spanish government? It would be fair to suggest that the Spanish bank stress tests were an abject failure in terms of restoring any market confidence which would indicate that the ECB will almost certainly be a harder task master? The noises coming out of Brussels at present would not be providing European periphery bond holders with much comfort with the WSJ and FT both reporting the ECB may contemplate both subordinated and potentially senior bond holders accountable as a part of any Spanish bank bailout.

At this stage the probability of subordinated debt holders participating in the event of a Spanish bank bail-out by the ECB seems to be increasing by the day. For the senior unsecured bond holders there seems to be push back against participation however this will largely depend on the extent of losses.

The problem in the Spanish example is that the holders of the subordinated instruments are in the majority of cases retail investors which the market initially felt may shield them. Depending on what happens next, the subordinated and perhaps senior unsecured debt holders across Europe could be looking at more negative revaluations as market pricing reflects the transition from implicit systemic guarantees to explicit self-reliance.

This takes some – or all – of the gloss off the recent Spanish and Italian summit triumph and leads us to question whether they have in fact delivered Berlin the ability to haircut the Spanish tax payers and savers through the back door.

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