Article by David Curmi

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CURMI & PARTNERS

A Popular Resolution

A few weeks back I wrote an article in this newspaper referring to the powers that the European Central Bank (ECB) has in the context of a bank that is failing or likely to fail. Just a few short weeks later, the ECB's Single Resolution Board (SRB) has shown its teeth and, for the first time, utilised the powers that it has to try and prevent a bank from collapsing.

The case relates to Banco Popular, Spain's 6th largest bank. Although the bank did not require state funding in the aftermath of the 2008 financial crisis, it has remained dogged by nonperforming loans to the real estate sector. In recent weeks speculation mounted that the bank was facing increasingly large liquidity difficulties. On Tuesday evening the ECB advised the SRB that Banco Popular was failing or likely to fail. It said "the significant deterioration of the liquidity situation of the bank in recent days led to a determination that the entity would have, in the near future, been unable to pay its debts or liabilities as they fell due". Consequently, the ECB determined that the bank was failing or likely to fail and duly informed the SRB. Following the receipt of this advice, the SRB acted swiftly and on Wednesday morning orchestrated the sale of Banco Popular to Banco Santander for €1. In the process of doing this, the SRB imposed significant losses on Banco Popular's shareholders as well as bondholders who held the bank's riskiest bonds. This is a timely reminder of the precarious situation that a number of banks, especially the smaller ones, still find themselves.

It is also a significant step because, ever since it was set up in 2015, the SRB has not flexed its muscles. The European Commission approved the deal on Wednesday morning and noted that both customers and depositors of the bank would continue to have access to the bank and there would be no disruption to the economy. Importantly also, no tax payers money was used in this resolution.

The move raises many questions and points to the proactive approach being taken by the SRB in resolving such matters. From the outside shareholders may perhaps feel hard done by. After coughing up some €3.5bn since 2009, the bank, though stressed did not appear to be overly weak on many of its capital ratios. Yet the need for the SRB to intervene is a manifestation of the speed at which liquidity can dry up thereby rendering banks unable to continue functioning. And, no bank can sustain a continued run on its deposits, no matter how strong its capital ratios.

From an investor's perspective this must be a wakeup call. Shareholders and the lower ranked bondholders were completely wiped out in this transaction. This is a clear example of the risk that shareholders and some bondholders are taking when buying such instruments and perhaps more than shareholders, it is the bondholders that need to sharpen their assessment of risk. Investors need to clearly understand that the risk that they have been exposed to by the new BRRD rules is not one that should be taken lightly. Locally, most bank bonds now fall under the BRRD regime. This should not be alarming in its own right since local banks tend to be well capitalised and their business models are robust. Clearly and obviously stronger institutions with resilient balance sheets are much less at risk than those that are smaller, with less access to pools of liquidity. But as shown above circumstances can change very rapidly, and in a local context investors need to ensure that their personal investment policy takes into account and reacts to such risks. The local market has come a long way and whilst buying and selling activity has increased substantially over the years, liquidity on the market can very quickly dry up.

It is also important for investors to understand better the investments they are holding. Experience has shown that many investors are too blasé about the risks of their investment. The rate of the coupon is often the only aspect that is of interest. It seems that investors get blinded by this. Whilst important it is reckless to only look at this feature. Investors need to dig deeper to understand the nature of the entity they are investing in and try and understand the risks of non payment of interest/capital and in the context of a failure, where in the ranking queue do they lie.