Credit unions suffering from floating rate uncertainty

By Paul McCarville and Joe Mottley

The devastating losses suffered by investors in Irish bank shares have captured headlines throughout the past year. Less well-known, but almost as severe, have been the losses to holders of subordinated debt issued by the same banks.

This is an important market – the six government-guaranteed institutions have (at face value) about €26 billion of such debt outstanding, somewhat greater than their total equity. Significant amounts of these bonds are owned by credit unions, through which losses affect many people.

Subordinated debt is part of a bank's regulatory capital, and ranks behind depositors and senior bonds in a wind-up. It can be divided into Tier 2 and Tier 1 capital. Tier 1 debt is the most risky – as part of the core capital of a bank, it sits just above equity, it must have no firm redemption date and the issuer has broad discretion to withhold coupons without triggering a default.

Tier 2 capital divides, in turn, into Upper Tier 2 (UT2) and Lower Tier 2 (LT2). UT2 bonds are similar in nature to Tier 1, being perpetual and having the possibility of coupon (interest) deferral. LT2 instruments are the 'safest' type of subordinated debt. The best-known variants are subordinated callable floating rate notes (FRNs), which have been widely used by most Irish and European banks.

They are usually issued for a ten-year term, but may be redeemed ('called') after five years. The coupon is paid quarterly, at a floating rate specified as three-month Euribor plus a margin, typically 0.1 per cent to 0.5 per cent. If the bank's option to call after year five is not exercised, the investor is compensated by a step-up in the margin over Euribor.

In more stable times, FRNs were considered to be a near-cash investment with an attractive yield, and their market price rarely moved far from 100 per cent.

All this changed with the onset of the financial crisis in 2007, with prices having fallen almost continuously since then. The market's doubt over the creditworthiness of the issuers is, of course, the main factor at play.

However, the price weakness has been amplified by much forced selling. Many holders of these bonds have been obliged to sell them indiscriminately, either because they were leveraged and had to liquidate assets (such as hedge funds, other banks), or the bonds' downgraded credit ratings breached their investment mandates (such as insurance companies). Now, almost two years on, some prices have fallen to 50 per cent or less.

Contrary to popular belief, not all buyers of this paper have been large institutional investors. It has also been used by small, retail investors and community entities such as the aforementioned credit unions, who sought a conservative high-yielding alternative to cash. Often, they acted on the advice of intermediaries which may not have fully understood (or explained adequately) the risks involved.

Their dilemma is exacerbated by the sheer user-unfriendliness of this market. Liquidity is scant and reliable prices are difficult to obtain. The Irish Stock Exchange, despite listing these securities, has no price information on its website.

The most reliable source of market data is, surprisingly, the website of German newspaper FAZ (www.fazfinance.net).

Is there any light at the end of the tunnel? The ultimate value of these securities will be determined by a complex web of factors, some of which are not well understood and are commonly misrepresented in public comment. There are a few points to consider:

Government guarantees

The government's bank liability guarantee, introduced by finance minister Brian Lenihan last October, covers all the deposits, senior debt and dated subordinated debt of the six banks in the scheme. Other subordinated debt – Upper Tier 2 and Tier 1 – is not covered. So, FRNs maturing before September 29, 2010 are as safe as government debt itself.

The duration of the guarantee has recently been extended to cover certain new issues of senior debt with longer maturities. Given that there is no end in sight to our domestic banking crisis, it appears increasingly likely that the full guarantee scheme will have to be extended if deposits are to be retained in the system.

But it is possible that cover for subordinated debt would be scaled back, or even removed altogether. Such a discrimination might have populist political appeal, and has been called for by some commentators.

Recapitalisations are good news

If Lenihan decided to inject fresh equity and/or preference shares into troubled banks while remaining a minority investor, the buffer between LT2 debt and losses would be expanded, and FRN investors would be better off.

Nationalisation may be bad news

This is why LT2 FRN prices in Ireland and elsewhere have continued to suffer. In an outright nationalisation (or even a de facto takeover via a majority shareholding), there is a perceived risk that the government 'moves the goal posts' with radical legislation which allows them to inflict losses throughout the capital structure. Britain has done just that with the introduction of the Banking Act 2009, although those powers have yet to be used.

Brian Lenihan: introduced liability guarantee last October TONY O'SHEA

The effect of Nama

Irish LT2 FRN prices dipped lower on the announcement of the National Asset Management Agency (Nama) initiative. Establishing Nama was a wise and wholly necessary decision. However, the markets fear that it will force earlier and deeper asset write-downs on the banks, eventually leaving the government with no option other than full nationalisation of at least some of them.

Should LT2 debt investors be made to suffer?

Politically, it might seem that the easy answer is 'yes'. In the recent (and erroneous) words of one commentator: "This is a risky asset . . . bought by rich mates of the banks." But it's not as simple as that. Our economy cannot recover without the restoration of confidence in the banking system which, in turn, is linked to confidence in the financial integrity of the state. By bringing them under the umbrella of the guarantee, the government has already demonstrated very explicit support for LT2 bonds. Reneging on that commitment could be very damaging to its standing in the debt markets, triggering even higher borrowing costs for both its own bonds and the €200 billion-plus of wholesale funding (ie senior debt) needed by the banks on an ongoing basis.

What about Anglo?

Anglo was nationalised without any legal provision to inflict losses on subordinated debt holders. In fact, on January 15, Lenihan said: "Creditors (including bondholders) of Anglo Irish Bank can be assured that it will continue to service its obligations and will repay its debts at maturity." This suggests a higher level of protection commitment than provided under the general guarantee scheme.

Moreover, if the assessor appointed to determine the final value of Anglo equity decides to award any compensation, however small, to shareholders, then it would be almost impossible for the government to later allow a default on Tier 2 bonds.

Buybacks

It has always been normal practice for issuers to repurchase some of their subordinated debt on the market. Overall shortage of capital has prevented the Irish banks from doing this of late. It may be very attractive to buy back €100 of bonds for €60 (the €40 gain goes to shareholders' funds), but total capital is still reduced by €60.

Elsewhere in Europe, a number of banks (RBS, Lloyds/HBOS, UBS) have recently instigated large-scale buybacks of their subordinated debt, in the wake of government initiatives to put their capital bases on a firm footing. The prices offered have been set at up to twice their pre-announcement levels. It is likely that, when they are eventually recapitalised to an adequate extent, the Irish banks will set about tidying their balance sheets in similar manner. Irish LT2 bank debt offers good value at its depressed levels, despite the parlous state of the issuers. The best course of action for credit unions and other holders is to hold on.

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