Bank Rescues – Italian banks re the latest.
For clients of Puzzle Financial Advice
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I take particular note of what is happening with bank rescues around the world, because they provide a guide to how future Australian bank rescues might look like.

You will remember, that during the Global Financial Crisis, western governments and central banks (who had been caught by surprise by the crisis) rescued many of the major banks – rescuing their shareholders, bond holders and executives in the process, because they feared global systemic failure for the financial system. Yes, there were many banks failures in that period, such as a few hundred banks in the USA, but the financial system was protected by rescuing the too-big-to-fail banks and financial institutions.

However, the central banker's central bank, the Bank of International Settlements (https://www.bis.org/ or BIS) considered this issue and provided guidelines about how future bank rescues should be structure. BIS well understood that the nature of rescue of the big banks during the financial crisis represented a major moral hazard.

- https://www.ft.com/content/947cfe24-64d7-11de-a13f-00144feabdc0?mhq5j=e3
    - 'It highlighted two main risks: first, that not enough will be done to ensure a durable recovery from crisis; and second, that the emergency action to stabilise the financial system will undermine efforts to build a safer system. The report was particularly scathing in its assessment of governments' attempts to clean up their banks. "The reluctance of officials to quickly clean up the banks, many of which are now owned in large part by governments, may well delay recovery," it said, adding that government interventions had ingrained the belief that some banks were too big or too interconnected to fail. This was dangerous because it reinforced the risks of **moral hazard** which might lead to an even bigger financial crisis in future.'
- http://www.investopedia.com/ask/answers/050515/how-did-moral-hazard-contribute-financial-crisis-2008.asp
    - 'The financial crisis of 2008 was the result of a wide range of contributing factors. One significant factor leading up to the financial crisis was the existence of moral hazards in the economy. The epicenter of the 2008 financial crisis was the financial sector, particularly related to housing. Conditions preceding the financial crisis were such that lenders faced moral hazards when evaluating the outcomes of lending and collateralizing assets.'
    - 'A moral hazard exists when a person or entity engages in risk-taking behavior based on a set of expected outcomes where another person or entity bears the costs in the event of an unfavorable outcome. A simple example of a moral hazard is drivers relying on auto insurance. It is rational to assume that fully insured drivers take more risks compared to those without insurance because in the event of an accident, insured drivers only bear a small portion of the full cost of a collision.'

In an effort to deal with this Moral Hazard, BIS has developed guidelines that seek to ensure that the costs of a bank failure are born, in order of priority, by shareholders, bond-holders and similar, and last in the chain by depositors – before taxpayers carry the cost.

We have already see an implementation of this policy in the rescue of the banks of Cypress, which is well documented here. https://en.wikipedia.org/wiki/2012%E2%80%9313_Cypriot_financial_crisis

Recently we have had the rescues of 3 Italian banks and one major Spanish bank. It is worth looking at those rescues to again see if there are any messages for future Australian bank rescues.

So before looking at the latest Spanish bank rescue and the latest 2 Italian banks rescues, it is worth looking at the front page of today's (18/7/17) Financial Review.

- http://www.afr.com/business/asics-greg-medcraft-warns-hybrids-are-ridiculous-for-retail-investors-20170712-gx9rgy
    - http://puzzlefinancialadvice.com.au/2017/AFR/170718_AFR_ASICs_Greg_Medcraft_warns_hybrids_are_ridiculous_for_retail_investors.pdf
    - 'Billions of dollars of hybrid securities issued to retail investors by the major banks will eventually cause problems for the financial system, according to outgoing chairman of the Australian Securities and Investments Commission Greg Medcraft.
    - In an interview with The Australian Financial Review to mark his six-and-a-half years as chairman, Mr Medcraft said hybrid securities were a "ridiculous" product for retail investors. He said it was notable that they had been banned for retail investors in other markets such as the United Kingdom.
    - "If a bank has any trouble they're the first line of defence," he said."If you wipe out retail and all those retail investors are superannuation investors you are robbing Peter to pay Paul.'

The recent Spanish bank rescue. There also has been a rescue of Spains fifth largest bank – Banco Popular. Chris Joye discusses this rescue here:-

- http://www.afr.com/markets/equity-markets/lessons-from-spains-big-bank-failure-20170622-gwwntz
    - http://puzzlefinancialadvice.com.au/2017/AFR/170624_AFR_Chris_Joye-Lessons_from_Spains_big_bank_failure-Banco_Popular.pdf
    - 'In this context, I have been asked by a range of investors about the forced resolution of Spain's fifth-largest bank, Banco Popular, which is roughly the same size as Macquarie Bank, earlier in the month. This was a globally noteworthy event for several reasons.
    - **First**, no taxpayer funds were expended with Europe's Single Resolution Board cancelling all shares and Additional Tier 1 (AT1) capital hybrids, and converting all Tier 2 (T2) subordinated bonds into equity, which was sold to the acquiring bank, Santander, for merely €1.
    - **A second insight** was that senior bond holders avoided any bail-in despite European regulations allowing for this possibility.
    - **Another takeaway** was that the "non-viability" clauses in the T2 bonds and AT1 hybrids, which allow the regulator to write them off, were triggered when Banco Popular's risk-weighted total capital ratio was 11.9 per cent, or miles above the 5.125 per cent capital ratio level that is normally perceived to be the threshold at which write-off/equity conversion occurs.
    - **In Banco Popular's case, the capital structure worked exactly as it should**: equity bore the first losses, followed by hybrids and then subordinated bonds. It just so happened that the gap between assets and liabilities was wide enough to warrant all securities being wiped out concurrently. Whether this happens in other bank busts depends on the magnitude of the capital shortfall (or the size of the ex ante buffer). There have certainly been other cases where higher-ranking securities, including hybrids and T2 bonds, have been spared with only equity incurring losses.
    - **This supports the emphasis savvy investors place on non-risk-weighted equity (or leverage) ratios.** Whenever a bank and/or regulator assumes away the value of an asset using the artificial risk-weighting method, there is always the possibility that this write-

down proves wrong. When large numbers of loans start going sour, sophisticated investors focus on the true dollar value of a bank's buffer that protects liabilities from assets.
    - **With this in mind, APRA's boss Wayne Byres recently highlighted that "overall [Australian bank] leverage has not materially declined" since the GFC.** "The proportion of equity that is funding banking system assets has improved only modestly, from a touch under 6 per cent a decade ago to just on 6.5 per cent at the end of 2016," Byres rightly warned.

The recent Italian bank rescues.

- http://puzzlefinancialadvice.com.au/2017/AFR/170627_AFR_Italy_rescues_two_failing_banks_after_trying_to_keep_them_afloat.pdf
    - 'The decision to let Italy dispose of the two banks under national insolvency law was crucial in shielding senior debt from losses. The EU's bank-failure law, known as the Bank Recovery and Resolution Directive, puts investors, including senior creditors, on the hook for losses if necessary to fund restructuring. The BRRD is part of the EU's attempt to prevent the public bailouts seen during the financial crisis.'
- http://www.afr.com/business/banking-and-finance/italy-pays-17b-to-wind-up-two-veneto-banks-after-20b-monte-dei-paschi-bailout-20170625-gwycfk
    - http://puzzlefinancialadvice.com.au/2017/AFR/170626_AFR_Italy_pays_EURO17b_to_wind_up_two_Veneto_banks_after_EURO20b_Monte_dei_Paschi_bailout.pdf
    - 'Economy Minister Pier Carlo Padoan said the total funds "mobilised" by the state would be for up to €17 billion - three times more than had initially been estimated to recapitalise the banks with public money.
    - The deal, approved by the European Commission, allows Italy to solve a banking crisis on its own terms, ensuring the two Veneto lenders are not wound down under potentially tougher European rules. The cost for taxpayers, however, is hefty.
    - The decree effectively means that the Veneto banks' branches and employees will be part of Intesa Sanpaolo by Monday morning, a move designed to avoid a potential run on deposits that could have spread chaos across the whole banking industry.
    - Under the plan, the banks' soured loans, as well as legal risks stemming from a mis-selling scandal, will be moved to a bad bank, partly financed by the state. Junior bondholders and shareholders in the two banks will suffer losses, but senior bonds and depositors will be protected.
    - The European Central Bank, which supervises the two lenders based in the country's rich north-eastern Veneto region, had declared on Friday that they were "failing or likely to fail", setting in motion the process that led to them being wound down. After months of tense negotiations between Rome and EU regulators, **Italy has been allowed to use national insolvency procedures rather than EU rules designed to prevent the use of state money to deal with bank crises. Those EU rules could have imposed losses on senior bondholders and large depositors**, a politically unpalatable prospect ahead of national elections next year given that Italian households hold a large chunk of bonds issued by banks.'
- http://www.afr.com/news/world/europe/veneto-banks-to-be-wound-up-under-italian-insolvency-rules-20170625-gwy408
    - http://puzzlefinancialadvice.com.au/2017/AFR/170625_AFR_Veneto_banks_to_be_wound_up_under_Italian_insolvency_rules.pdf
- http://www.afr.com/news/world/europe/the-european-central-bank-moves-to-wind-down-two-italian-banks-20170625-gwy29n

- http://puzzlefinancialadvice.com.au/2017/AFR/170625_AFR_The_European_Central_Bank_moves_to_wind_down_two_Italian_banks.pdf
- ‘They become the second and third banks to be declared effectively dead by the central bank, which acquired power to supervise eurozone banks at the end of 2014. The first, earlier this month, was Banco Popular, Spain's fifth biggest bank.
- Shareholders of the two Italian banks will lose their money, as will investors in junior bonds that are intended to absorb losses first. But deposits in the bank will be protected, as will investors in senior bonds.’