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Asset Management

Banco Popular Post Mortem: Implications for the AT1 Market

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On June 7, the Single Resolution Board, the resolution entity within the European Banking Union, in co-operation with the Spanish National Regulatory Authority, decided to transfer all the shares and capital instruments of troubled Banco Popular Español S.A. (Popular) to Banco Santander S.A. (Santander), for €1. This regulatory action was due to Popular's "recent stressed liquidity situation," which caused the European Central Bank to determine that Popular was "failing or likely to fail." Popular had suffered from weak loan quality for several years. As part of this resolution, Popular was "bailed-in", whereby additional tier 1 (AT1) securities were converted to common equity and then cancelled — effectively written down to zero — the first time an AT1 security has been wiped out. Its tier 2 (T2) subordinated debt was converted to common equity, but because this equity was purchased by Santander for €1, the conversion implies a *de facto* total loss, the same outcome for the AT1 securities. Furthermore, Santander will issue €7 billion of common equity, which will be used to help fund a €7.9 billion loan loss provision to strengthen Popular's reserves. Over the next few months, Popular will be merged into Santander, which should materially improve its market position in Spain and Portugal, especially with small and medium-sized enterprises, a Popular strength. None of Popular's senior creditors or depositors will incur losses under the bank's resolution. Had Santander not taken over Popular, these claimants could have very well experienced losses.

Key Takeaways

- Popular had two AT1s: one with a 5.125% common equity tier 1 (CET1) "low" trigger to convert into equity, and one with a "high" 7% trigger. In the end, the trigger differential did not matter regarding loss content.
- Popular's capital was above these triggers and regulatory minimums when it failed. In last year's regulatory stress test its CET1 ratio under the base case was 13.45% and 7.01% under the adverse scenario, and the bank was not targeted for any regulatory action – only Italy's Banca Monte dei Paschi di Siena was targeted. Since then, Popular's operating environment improved, but yet it failed. This would indicate that the European stress tests are best viewed as tools for regulators to make banks recapitalize or otherwise follow regulatory directions, rather than objectively determine the likelihood of bank failure.
- No AT1 coupons were skipped. All were paid on time until now. Thus, the skipping of AT1 coupons to preserve "going-concern capital" (one of the design characteristics of the AT1 instrument) did not occur.
- Despite the different seniorities, both AT1 and T2 subordinated debt securities suffered the same losses. In addition, the conversion of Popular's AT1 securities to equity (thus producing going-concern capital for a stressed bank) to aid a bank without a regulatory resolution, did not happen. For Popular, conversion to equity was simultaneous with the cancellation of the equity. Thus, the AT1s acted as "gone-concern" capital, rather than as going-concern capital, as they were designed.
- There is no apparent contagion to the AT1 or T2 securities market, other Spanish banks, other European banks or the financial system in general. Banco Popular's problems are viewed as specific to that bank.

The regulators doubtless view the resolution of troubled Banco Popular as a good result, as it did not cause any senior debt or depositor losses, or systemic disruption. However, the market will need to reconsider the going-concern versus gone-concern characteristics of various junior bank securities, as well as their relative loss content, the timing of the realization of that loss content, appropriate spreads among instruments, and the information content of regulatory stress tests and capital adequacy measures.

Popular's bail-in (failure) underscores how well banking resolution regulation supports the functional soundness of Europe's banking system, while avoiding any taxpayer-led bailout. The broader AT1 and banking market have emerged unscathed, as regulators acted swiftly and decisively. That AT1 holders suffered total losses at a failed bank is not a surprise. This was a bank-specific problem with a well-advertised litany of woes. **Spectrum has not held any Banco Popular securities.**

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