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INSIGHT

VIEWPOINT

Don’t Worry About It?

JAMIE FARNHAM & CHET MALHOTRA | JUNE 16, 2017

A bank failed. One of the largest banks failed, in fact the sixth largest. Spain is the sixth largest European economy and its sixth largest bank just failed. In the U.S. an equivalent failure would be PNC or U.S. Bank. However, market participants seem content that this is an isolated event and not an indicator of a wider crack in the foundation. Should they be?

Shrugged off as an idiosyncratic event, Spain’s Banco Popular was deemed ‘failing or likely to fail’ last week. Regulators implemented the failed bank resolution scheme, fully writing down all of the bank’s capital securities (common equity, AT1s and LT2s). Another of the largest Spanish banks, Santander, bought the failed bank, requiring a significant capital raise and future loss reserving to do so.

How does this happen?

Banks fail either when they make poor lending or investment decisions or when their funding dries up, forcing balance sheet shrinkage. Funding shortages may occur with a run on deposits, which was the case with Popular. The point is: Banks don’t fail out of nowhere, particularly when the following are present:

- **Economic Growth --** During a speech on April 6th, European Central Bank President Mario Draghi stated the once fragile European economy is now showing healthy and broad improvement:

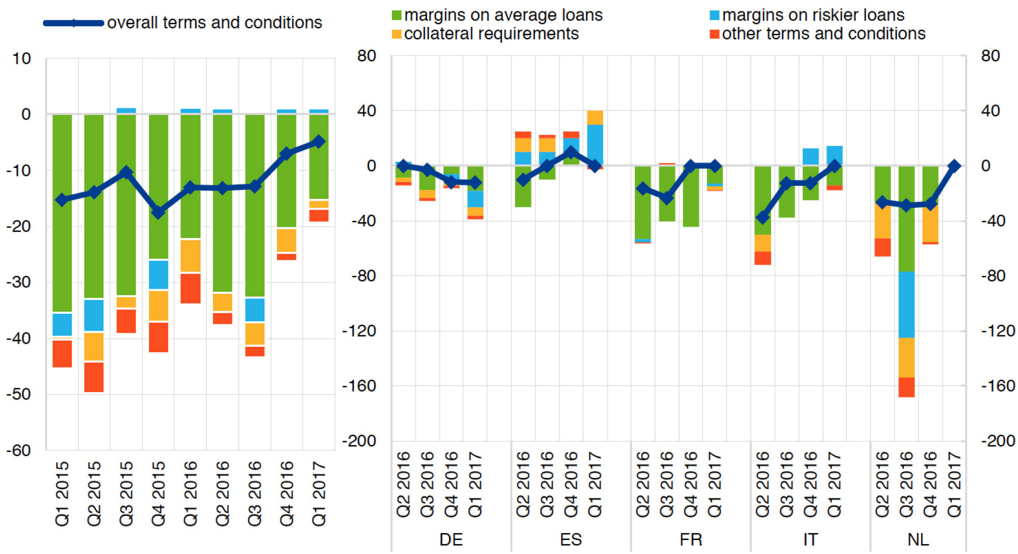
  “But things have also been clearly improving. Since mid-2014, the recovery has evolved from being fragile and uneven into a firming, broad-based upswing.”

- **Easing Financial Conditions** – Per the Euro Area Lending Survey as of April 2017, lending standards eased (i.e. better terms to borrowers) while loan demand increased across all areas including enterprises, consumer credit and housing loans. While Spain was a bit less constructive than the broader Eurozone, it still has improved significantly over the last several years.

Improving Lending Conditions in European Markets

Changes in Terms and Conditions for Loans or Credit Lines to Enterprises

(Net Percentages of Banks Reporting Tightening Terms and Conditions)

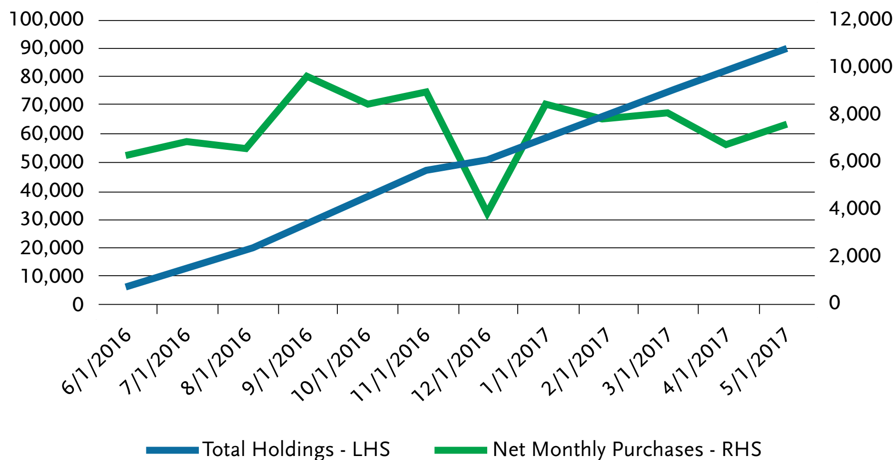


Note: “Margins” are defined as the spread over a relevant market reference rate. “Other terms and conditions” are an unweighted average of “non-interest rate changes,” “size of loan credit line,” “loan covenants” and “maturity.” “Overall terms and conditions” were introduced in the first quarter of 2015.

Source: ECB

- **Central Bank Buying** – European Central Banks have also played an active role in supporting their lending markets via such programs such as the CSPP (Corporate Sector Purchase Program). Started in 2016, the six national central banks now own over EUR92b in non-financial, investment grade-rated bonds by buying roughly EUR7.5b per month. This means that these central banks have amassed ownership of more than 7% of the European bond market in less than a year.

CSPP Holdings at Book Value, EUR Millions

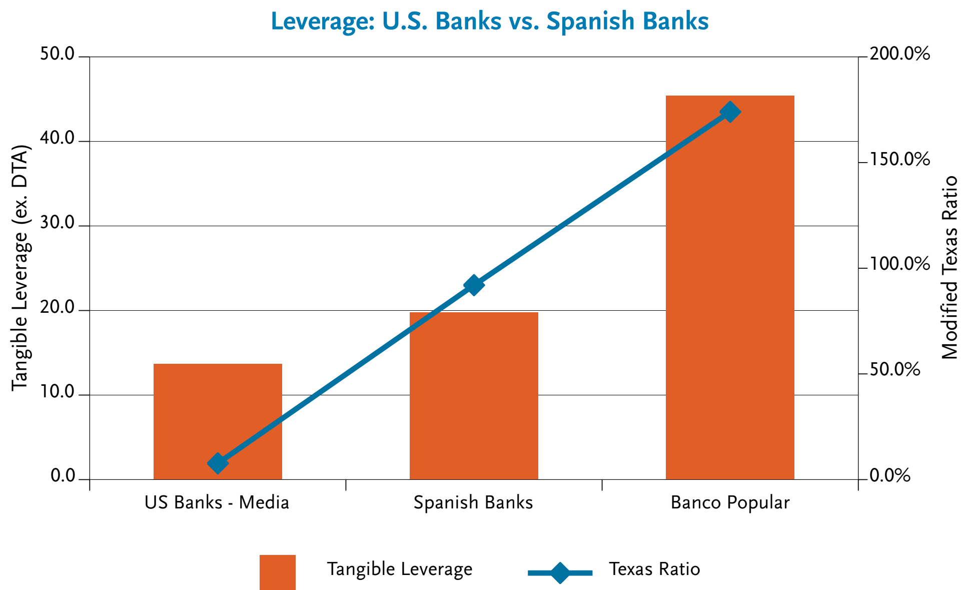


Source: ECB

Lending terms have eased, borrowing demand has expanded and European employment trends have improved. This should benefit European banks via more lending and lower credit losses with borrowers better able to service their debt.

How similar are the fundamentals?

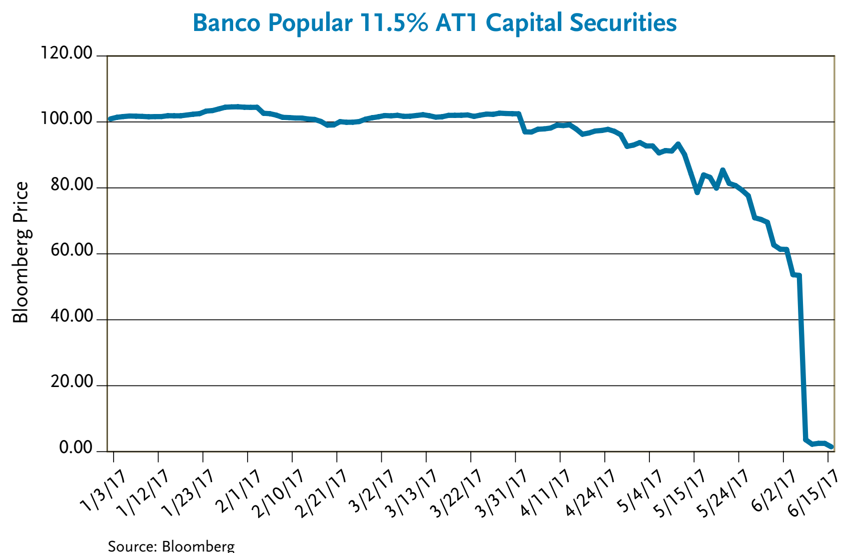
The major U.S. banks actively recapitalized their balance sheets post crisis, by raising equity capital to deleverage and by writing down troubled assets. U.S. banking regulators played a major role in encouraging and overseeing these efforts. In comparison, the progress of European banks lags considerably for both equity capital raising and troubled asset writedowns. Below is a comparison of the major U.S. banks and the 12 largest Spanish banks. It is evident that Spanish banks, including Banco Popular specifically, have a lower margin of safety given still-elevated leverage and still-present troubled assets/loans. Likely hidden during an economic tailwind, it is more likely that these cracks would become far more visible should economic or market turbulence develop.



Source: TCW, Stifel Nicolaus & SNL

Market Reaction

Market pricing for Banco Popular AT1 (Additional Tier 1) capital securities implies a quick deterioration of confidence. Quoted near par (~100) in early May and at approximately 70 at the beginning of this month, solvency doubts appeared modest until only recently.



Source: Bloomberg

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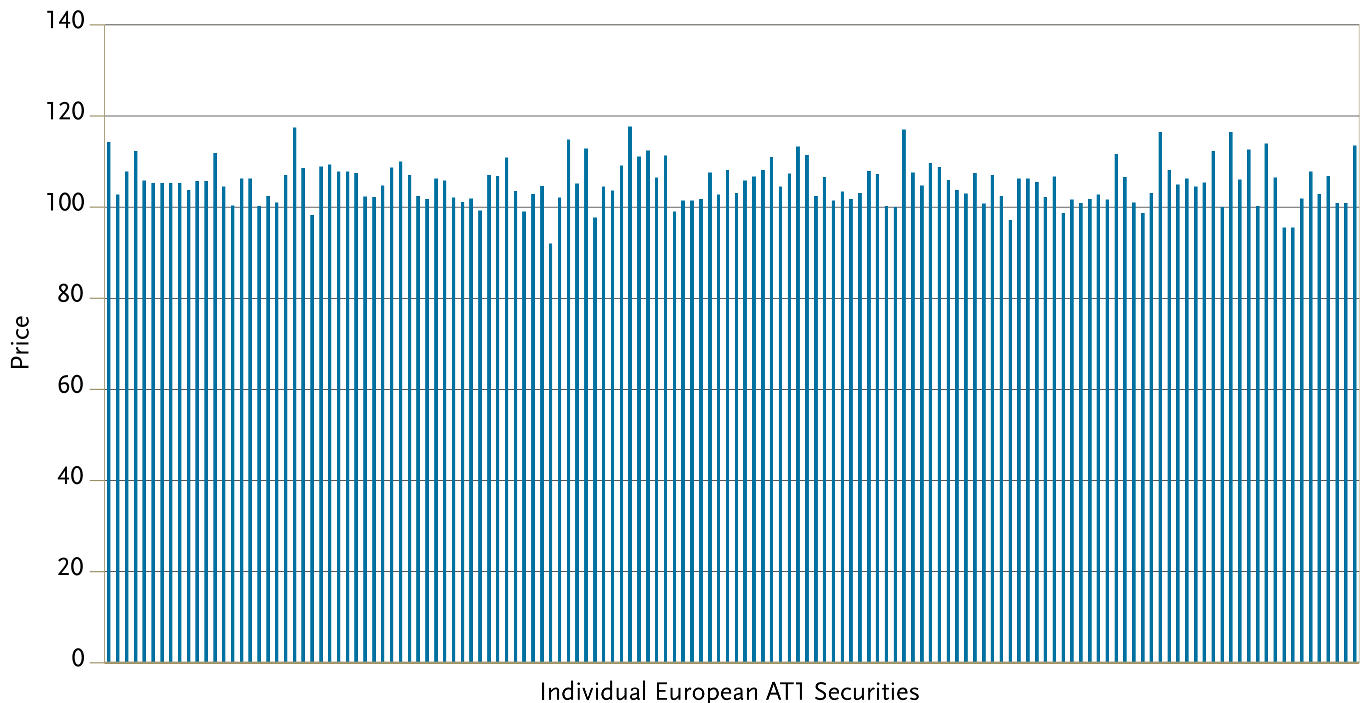
However, a survey of European bank AT1 capital securities outside of Banco Popular implies minimal extrapolation of more pervasive concern to other similar European bank AT1 capital securities.

Price Distribution - Bloomberg European Bank AT1 Universe



Source: Bloomberg

More than eight years into a financial and economic recovery, how likely is it that, absent fraud, such a major bank failure isn't indicative of financial system fragility? Investor confidence permits such conditions to persist, however fundamental cracks can quickly deteriorate into more severe fractures. In the case of Banco Popular, ECB Vice President Vitor Constancio stated the following last week, implying tenuous stability of even the nation's sixth largest bank:

"The reasons that triggered that decision were related to liquidity problems. There was a bank run. It was not a matter of assessing the developments of solvency as such, but the liquidity issue."

Investors should respect such tremors and be particularly cautious investing in banks that either didn't adequately repair balance sheets since the Global Financial Crisis or have significantly leveraged balance sheets while benefitting from peak earnings/cash flow. ■

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Mr. Farnham is Director of Credit Research and a Specialist Portfolio Manager in the U.S. Fixed Income group. Mr. Farnham joined TCW in 2009 during the acquisition of Metropolitan West Asset Management LLC (MetWest). Similar to his role at MetWest prior to the acquisition, he leads a team of credit analysts and oversees the firm's proprietary credit research process within the corporate, high yield, and leveraged loan markets. Prior to joining MetWest in 2002, he was a private equity investor at Primus Capital after working as an investment banker at Merrill Lynch in New York, focusing on new issue origination of equity and fixed income securities, as well as mergers and acquisitions. Mr. Farnham holds an AB in Economics from Princeton University and an MBA from the UCLA Anderson School of Management.

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Mr. Malhotra joined the TCW Fixed Income Group as a Credit Analyst in 2016 and is responsible for credit research in the financial sector. Prior to joining TCW he was a Managing Director and Senior Credit Analyst for the hedge fund DA Capital LLC where he put together various strategies within his sectors including high yield debt, leveraged loans, and public equities. Prior to joining DA Capital LLC he served as a Director and Senior Credit Analyst for Crédit Agricole Indosuez/ Calyon's CLO group from 2002 to 2005 where he covered the automotive, industrial, homebuilding, aerospace, and equipment rental sectors. Prior to joining Indosuez in February 2002, Mr. Malhotra was a Vice President in the Corporate Finance Group for ORIX USA Corporation from 1995 to 2002, where he covered credits in the telecommunications, consumer products, high-yield structured products, cable, homebuilding, gaming, and paper sectors. He was also responsible for the structuring and ongoing day-to-day management of the $547 million Astron CBO Ltd. Mr. Malhotra has over 20 years of investment experience. Mr. Malhotra received a BA in Economics from The American University in Washington, DC.

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