

Special Report

Burden Sharing: Who Pays Next Time?

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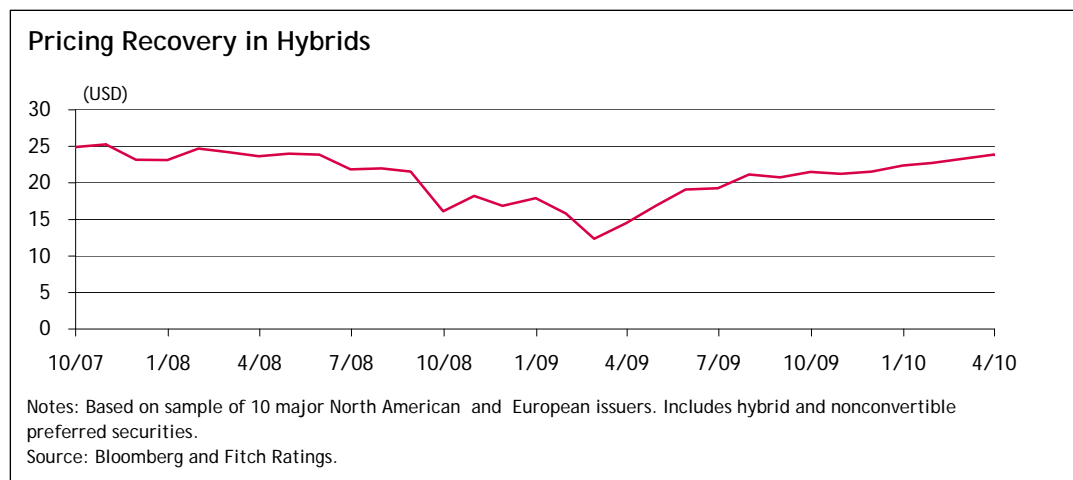
Over the past two years, Fitch Ratings estimates that major industrialized countries have provided approximately EUR1.1 trillion (or 4% of their GDP) to recapitalize the financial services sector. This public sector support, coupled with extensive liquidity-related programs, most likely prevented the collapse of numerous banking systems worldwide.

Wider economic fallout from the crisis, political concern about moral hazard, and pressures on sovereign balance sheets are motivating regulatory initiatives in several countries that would minimize the use of public sector resources to support systemically important institutions in the future. One visible and ongoing initiative is to continue to strengthen banks' equity capitalization and risk-based capital levels. Another potential solution that has been receiving increased focus is burden sharing, or the process whereby uninsured creditors must first bear losses before public sector support is provided.

While legislative uncertainties and implementation complexities make it difficult to project whether burden sharing will ultimately become a reality, this analysis applies a "what if" perspective on how burden sharing, if it were implemented, could affect the risk profile of different classes of bank obligations.

Summary

- Fitch's capital analysis of the recent crisis indicates that if burden sharing mechanisms were implemented, then lower priority debt instruments such as subordinated debt as well as hybrids would be exposed to significantly elevated credit risks in the future; senior debt would only be moderately impacted but might incur losses under more severe stress scenarios. While burden sharing might help in recapitalizing banks or the banking system, it could never replace government-sponsored liquidity guarantees and the resulting benefits to market confidence.



- This accentuated bifurcation in risks between subordinated debt and hybrids relative to senior debt is illustrated in two different backtests: comparison of the stock of hybrid and subordinated debt outstanding to the total amount of public

sector capital support provided during the crisis; and, a stress test of large global banks in which equity conversion of existing subordinated debt and hybrids would recapitalize more than half of the equity capital depleted by a severe asset loss.

- Despite potential risk bifurcation, the difference in credit spreads between banks' subordinated and senior debt, which widened considerably at the height of the crisis, has since mostly converged. Similarly, hybrids pricing, after losing almost half of its value during the height of the crisis, has almost recovered to precrisis levels (see the graph on page 1). This convergence in pricing might reflect market skepticism about the likelihood that burden sharing will be implemented, the view that implementation would affect only new issuance, or simply positive sentiment on the credit environment and the financial sector.
- While the course of future regulatory and legislative developments remains unclear, the countries most likely to implement meaningful burden sharing share some or all of the following attributes: significant costs from providing government support to the financial sector; fewer second-order market or economic effects from imposing losses on creditors; and regulatory and legislative momentum to develop resolution authority based on burden sharing. Additionally, regulators globally have been pressuring banks to strengthen their equity capitalization, which will remain the first line of defense in absorbing losses in a stress event.
- Given the uncertain outcome of current regulatory and legislative initiatives, this "what if" analysis does not in itself result in any immediate changes to criteria or ratings. Nevertheless, Fitch will continue to monitor and analyze the policy process, as meaningful weakening in the perceived likelihood of government support or accentuated risk bifurcation within bank debt structures could have rating implications for systemically important financial institutions.

Momentum Toward Burden-Sharing

Hybrids and subordinated debt, given their contractual subordination and qualification as regulatory capital, are expected to function as risk capital in a significant stress scenario. However, during the crisis these instruments generally did not fulfill that role, as governments provided support before liquidation would have occurred in order to maintain confidence in ongoing entities and continuity in systemically important financial services.

Given the resulting strain in sovereign balance sheets and public concern about moral hazard, political momentum is building in several countries to ensure that bank investors share in the risks of financial system stresses, for example in the U.S. and U.K. (see text box below).

Resolution of failing financial institutions "shall ensure that shareholders and unsecured creditors bear losses."

— *U.S. Financial Stability Act of 2010*

"The big question is clear enough. Can we resolve distressed LCFIs [large and complex financial institutions] in an orderly way without injecting public money? Perhaps it does not have to involve liquidation or administration. Perhaps it does not have to involve a binary shift from "going concern" to "gone concern." But it does have to involve loss for equity holders and uninsured creditors."

— *Paul Tucker, Deputy Governor, Financial Stability at the Bank of England, at the European Commission's Conference on Crisis Management (March 19, 2010)*

Why did hybrids and subordinated debt generally not function as risk capital during the crisis?

- Existing resolution authority in many countries was not equipped to impose losses onto parts of a bank's capital structure in going concern situations.
- Many hybrids, particularly those issued by European banks, are designed to defer dividends only when preset capital thresholds are breached. During the crisis, governments generally intervened before these triggers.
- Contractual terms, such as must pay features (e.g. look back clauses), prevented coupon deferral on many securities.
- Nonpayment on certain types of subordinated debt (e.g. most lower Tier II) can trigger an event of default for the institution as a whole, thus absorbing losses on a gone concern but not a going concern basis.

Although political momentum is building, policymakers face a number of conceptual and technical challenges in developing robust burden sharing mechanisms, including:

- Possible regulatory changes ensuring that a debt instrument's contractual terms do not impede the institution's ability to function as a going concern in a burden-sharing scenario. For example, burden sharing, such as forced debt-for-equity conversion, could conflict with existing contractual rights of holders of outstanding debt issuances, which might entail legislative override and could result in legal disputes. Additionally, in many jurisdictions, unsubordinated bondholders rank *pari passu* with depositors and other unsubordinated counterparties, creating potential legal difficulties were authorities to seek to impose burden sharing on one class of unsubordinated creditor and not another.
- Applying transparent and consistent rules for how risks are imposed on different classes of investor during a stress event, particularly if resolution is to result in a going concern.
- Mechanics of the burden sharing process (e.g. haircutting creditors, debt-for-equity conversion, or transfer of troubled assets to a "bad bank").
- International coordination in addressing cross-border banking groups.
- Imposing losses on creditors without panicking other, in some jurisdictions more senior, claimants (e.g. depositors) and without creating systemic risk aversion among investors in other troubled but not yet failing institutions.

These challenges are significant and will involve extensive legislative and policy efforts before burden sharing can become a reality. While it is difficult to project the ultimate outcome, there has been increasing focus on the potential implications if burden sharing were implemented. Much of the discussion to date has focused on how burden sharing might reduce the role of public sector support and, in turn, potentially increase the stand-alone credit risk of individual financial institutions. However, there has been relatively less analysis of how burden sharing might affect the risk profile of different classes of bank obligations.

Differentiated Impact for Bank Investors

The research presented in this report assesses the potential impact of burden sharing on bank investors from two perspectives:

- Stocktaking of subordinated debt and hybrids relative to capital support.
- Stress-testing of capital structures under an adverse loss scenario.

This research is based on fiscal year-end 2007 financial statement data, which enables backtesting of bank balance sheets and capital levels leading into the crisis and provides a conservative perspective, since it does not reflect the considerable strengthening in bank capitalization since the crisis unfolded.

Both the stocktaking and stress-testing analyses detailed below reach similar conclusions. Namely, implementation of burden sharing would accentuate risk bifurcation, with the risk profile of hybrid and subordinated debt obligations ramping up dramatically versus a more moderate increase in risk for senior debt, which generally would be less affected but could incur losses in a more severe stress scenario.

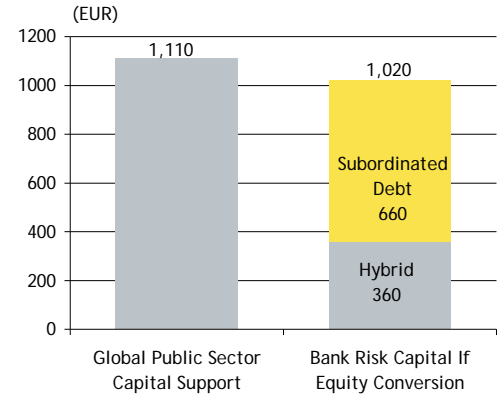
Stocktaking of Hybrids and Subordinated Debt

Coincidentally, there is a rough equivalence in the amount of direct capital support provided by governments (EUR1.11 trillion) relative to the total outstanding amount of hybrid and subordinated debt securities of the top 100 banks globally (EUR1.02 trillion

as of year-end 2007), as based on Fitch estimates (see graph at right). If burden sharing were implemented, hybrids and subordinated debt on an aggregate basis could have covered a significant portion of the amount of direct public sector recapitalization of the financial services industry during the most recent crisis.

While in the aggregate it appears that this relatively deep pool of hybrids and subordinated debt could be used to partially recapitalize the banking system in a future crisis, it is important to note that the magnitude of stress will vary by institution. The aggregate stock of hybrids and subordinated debt outstanding is of course not fungible across institutions, and, even with burden sharing in place, government-provided capital support could still be necessary to stabilize more troubled institutions.

A Partial Answer to Recapitalization in a Crisis?



Note: Based on fiscal year-end 2007 data for 100 of the world's largest banks by total assets.
Source: Fitch Ratings.

Stress Test: Impact When Converting Hybrids and Subordinated Debt

Another way of assessing the potential impact of burden sharing on bank investors is stress-testing. More specifically, by estimating banks' potential losses under a crisis scenario and then evaluating the resulting capital impact, Fitch can evaluate the ability of hybrids and subordinated debt to recapitalize depleted equity.

Based on a sample of 44 large global financial institutions (i.e. those with total assets of at least EUR250 billion), we apply a 5% loss rate to the net loans and securities (excluding derivatives) of institutions within the sample (see table below). The use of a 5% stressed loss rate roughly corresponds to the amount of government capital support provided relative to precrisis total loans and securities (excluding derivatives) to recapitalize a sample of banks hit hardest by the financial crisis and thus represents a combination of capital needed to cover actual losses and to "rebase" capital to higher levels than was the case precrisis. This assumption represents a severe scenario in that the stressed 5% loss rate is applied across all institutions within the sample.

Burden Sharing's Impact on Financial Sector Under Stress

	Prior to 5% Loss	After 5% Loss (No Conversion)	After 5% Loss (Conversion of Hybrids and Subordinated Debt)
TCE (EUR Bil.)	1,051	(249)	576
Net Loans Plus Securities (EUR Bil.) ^a	26,015	24,714	24,714
TCE/Net Loans Plus Securities (%) ^a	4.0	(1.0)	2.3
No. of Banks in Sample where TCE/Net Loans Plus Securities is Greater Than 0% ^a	44/44	15/44	40/44
No. of Banks in Sample where TCE/Net Loans Plus Securities is Greater Than 2% ^a	43/44	3/44	28/44

^aDerivatives are excluded from analysis since different accounting and disclosure practices globally create comparability challenges.
Note: Based on sample of 44 global financial institutions with total assets of at least EUR250 billion as of fiscal year-end 2007.
Source: Fitch Ratings.

These institutions as a group initially have a 4.0% ratio of tangible common equity (TCE) to net loans plus securities, excluding derivatives. By definition, the stress loss of 5% more than depletes the TCE of these institutions. While some of the better capitalized

institutions would remain solvent (i.e. positive TCE), the sample in the aggregate does not hold sufficient equity to withstand this assumed stress.

However, if burden sharing were implemented through an equity conversion of hybrid and subordinated debt, the aggregate TCE ratio would rebound from negative 1.0% to 2.3%, a shift from collective insolvency to solvency (although, based on this sample, four of the 44 institutions would remain insolvent even after the conversion). However, in the process the risk profile of hybrid and subordinated debt investors has increased dramatically, absorbing the 1.0% of loss not covered by TCE with the remaining portion now functioning as risk capital.

Performing either the stocktaking or stress-testing analyses at a more granular, institution-specific level can help in identifying idiosyncratic differences in corporate organization, capital structure, and the types of support received. For example, within holding company or complex banking group structures, capital held at the subsidiary level is in many cases trapped and thus unavailable to absorb losses across the organization as a whole. Additionally, equity conversion of existing hybrids and subordinated debt outstanding at the holding company level would not necessarily have given the holding company parent the ability to infuse additional equity into bank subsidiaries.

Potential Differences in Implementation

Since burden sharing would appear to bifurcate the risk profile of subordinated debt and hybrids relative to senior debt, an important consideration for investors is the extent to which burden sharing is implemented across different regulatory jurisdictions. Although it is difficult to predict the outcome of the political and regulatory process in each country, there are three factors most relevant to the ultimate implementation of burden sharing.

- **Severity of the impact of the crisis.** The recent crisis was global in reach, but the financial and economic impact varied from country to country. In countries where stemming the crisis required considerable public resources, whether in the form of direct recapitalization, liquidity support, or asset guarantees, there is stronger political will to shift the burden for future crises to bank investors. Additionally, for countries facing more severe economic challenges and strained sovereign balance sheets, the capacity to fund future support programs has been limited by the resource costs of the crisis. In these cases, achieving burden sharing might be both a political and fiscal necessity.
- **Second-order effects of implementing burden sharing.** As a fundamental public policy shift, a move to burden sharing could result in negative externalities for domestic constituencies and financial markets. For example, smaller economies that are highly dependent on continued external market access for both private and public sector financing are less likely to take actions that increase risks to foreign investors, given the potential for capital flight. These risks also pertain to banking systems that rely on more volatile financing, such as wholesale deposits. Secondary effects also can arise from high exposure of domestic retail and institutional investors to bank debt. For example, if such debt is widely held by important domestic constituencies, imposing losses on those constituencies could have both economic and political repercussions. All else being equal, countries where these potential secondary effects are limited will be more likely to pursue burden sharing policies.
- **Regulatory and legislative momentum.** In responding to the crisis, certain countries have already made some progress in developing new resolution mechanisms based on burden sharing, while others have taken few if any concrete steps in this direction. Additionally, in some cases, while there may be political will

to move to burden sharing, significant implementation obstacles could hamper future progress.

Broader Implications

Implementation of burden sharing could impact a broad range of market participants, including investors, issuers, and regulators.

For investors, burden sharing will most likely accentuate the bifurcation in risks between junior and senior investors. Hybrid and subordinated debt investors facing a heightened risk profile will likely expect higher compensation (e.g. in the form of higher credit spreads) relative to holders of senior debt.

Interestingly, the difference in credit spreads between banks' subordinated and senior debt widened considerably at the height of the crisis, but has since mostly converged (see graphs on page 7). Additionally, hybrids pricing has almost recovered to precrisis levels after halving in value during the depths of the crisis. One interpretation of this recent convergence is that investors are not fully differentiating between the elevated risks of hybrids and subordinated debt, which would become more equity-like under stress if burden sharing were implemented, versus the more moderate increase in risks to senior debt.

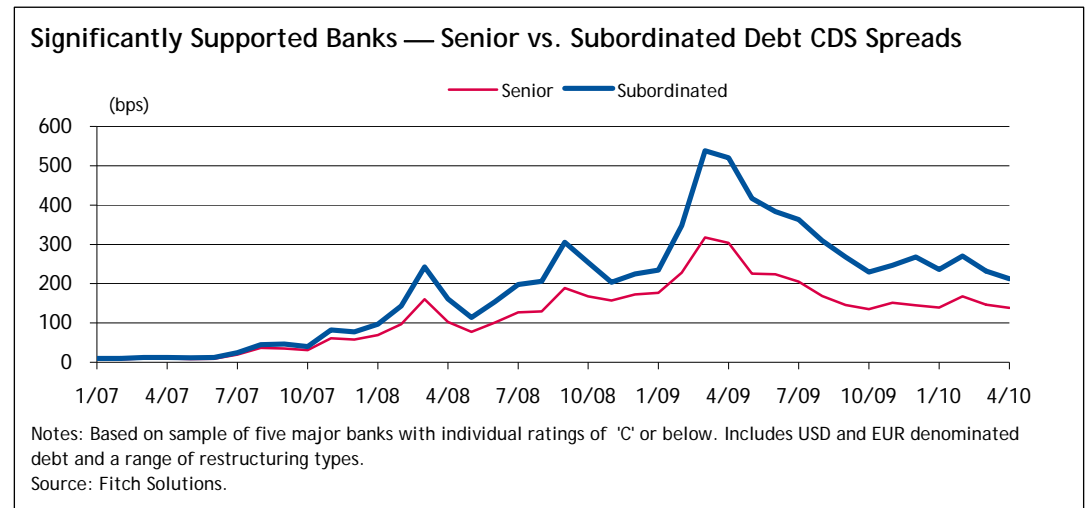
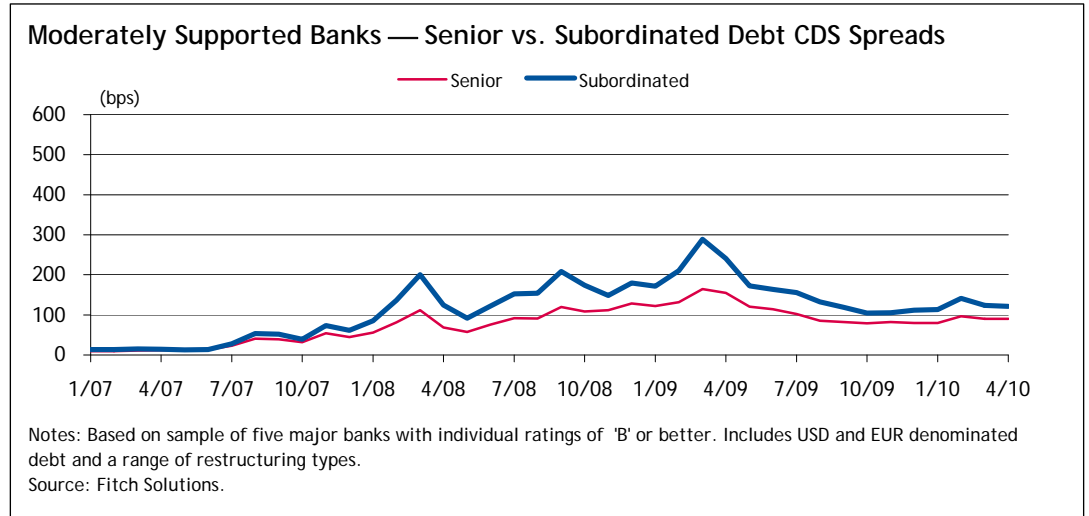
However, it is striking that the spread convergence has been much stronger for the sample of moderately supported banks than for the sample of significantly supported institutions (as defined in the graphs on page 7). From this perspective, convergence is at least partly a function of the overall risk profile of both the financial institution and the sector more broadly. Spreads thus converge when investors view the risk horizon as benign, but then bifurcate as a bank's financial strength erodes, whether due to institution-specific or systemic factors.

Burden sharing could also affect the capital management strategies of financial institutions. For one thing, it would become costlier to issue hybrids and subordinated debt. Financial institutions might be able to mitigate these costs by holding larger buffers of common equity, as might be expected given current regulatory pressures. Additionally, the implementation of clear mechanisms for hybrids and subordinated debt to be converted to common equity under stress might effectively function like and thus supplant contingent convertible securities, which have been widely discussed as a potential form of regulatory capital but have yet to gain market traction.

For regulators, burden sharing promises to enhance the role of market discipline in monitoring banking risks, since the informational content of subordinated debt pricing should more closely align with the underlying risk profile of each institution. This risk signaling would depend on both the credibility of burden sharing and liquidity in the underlying subordinated debt issuances.

Ultimately, it is unlikely that burden sharing, if implemented, would fully obviate future public sector support, particularly when a financial sector crisis is systemic in nature. For example, burden sharing might lessen the need for government-funded recapitalization, but liquidity support and asset purchase programs will likely remain essential components of the overall solution to a crisis. While there have been complementary efforts to shift the costs of support back to the financial sector (e.g. proposals for levies on banks to create an emergency fund), there is no private sector alternative for both the resources and confidence needed to stem a financial panic.

Stronger Banks, Tighter Convergence



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