

# EUREKA *report*



## EU bonds' silver lining

By Elizabeth Moran  
October 31, 2011

### **PORTFOLIO POINT: From Europe's troubles, there is good value on offer in senior bank debt.**

Uncertainty in Europe spells opportunity in bond markets. Understandably, investors are nervous about risks they don't fully appreciate. As I explained in my last column (see *ANZ's euro tempter*), just as European investors don't necessarily understand the risks involved in ANZ (thus the opportunity in the high-yielding ANZ € Tier 1s), Australian investors don't fully appreciate the value in European bank senior debt.

Unlike Australia and the US, senior debt in Europe ranks equally with deposits in a liquidation scenario. That means for a senior debt bondholder to lose money, mum and dad deposit holders must also lose money. It's just not politically palatable for everyday citizens to accept direct losses for failed banks, as the Irish work-out has shown.

### **Irish banks – no senior debt holders have been forced to take losses**

Not so long ago, the EU rescued the Irish banks and the government by injecting €85 billion, of which €35 billion went to the banks: Bank of Ireland, Allied Irish, Anglo Irish, EBS Building Society and Irish and Permanent Life. The bailout of the banks was politically damaging and the Irish government wanted senior debt holders to share the pain.

However, recognising this could have a significant negative impact on the cost of senior debt across all European banks, the EU prevented the senior debt holders taking a haircut (loss). In fact, the reasons for the EU's interjection included:

- A significant portion of the senior debt was already guaranteed by the government.
- Senior debt ranked *pari passu* (equally) with deposits.
- Preventing a loss was thought to give the banks the best chance of returning to the debt markets as soon as possible; in other words, keeping faith with investors.
- There was no obvious mechanism to impose the haircuts.

So, while making senior debt investors responsible for some of the loss made economic and political sense, they have been protected. Anglo Irish was the worst-affected bank and is now essentially a work-out entity, yet senior debt holders have not borne any loss and the banks' deposits have been transferred to other banks.

Junior debt holders have not been so fortunate. For example, in May Allied Irish announced a cash tender offer for all of its outstanding Tier 1 and Tier 2 securities, close to where they had been trading in the market. The Lower Tier 2 (dated subordinated debt securities) offer was 25% of par for most issues, and Tier 1 (hybrid/perpetuals) offer was 10% of par. The bank also put forward a resolution at the time that securities not tendered would be redeemed at close to zero.

Investors need to assess whether buying the subordinated debt is worth the additional risk in terms of potential loss involved if the bank becomes insolvent.

### **Conclusion**

We continue to see fantastic value in European bank senior debt. Taking the time to assess all the risks and mitigating factors will help in making investment decisions.

BNP Paribas has a senior debt Australian-dollar bond maturing in January 2014 with a yield to maturity of about 6.90%; and Royal Bank of Scotland, again an Australian dollar senior bond with a slightly longer maturity of March 2014, paying a yield to maturity of about 7.75%. Both of these bonds can be bought in

\$50,000 face value parcels but are only available to wholesale clients.

The other bond that I think represents very good value is a Societe Generale Australian-dollar senior debt bond with a yield to maturity of about 8.40% and a maturity date of October 2014. However, this bond is only available in \$500,000 face value parcels, again to wholesale clients.

All prices and yields are a guide only and subject to market availability. FIIG does not make a market in these securities.



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