

The future for Irish bank senior bonds

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The economic reality

1. The Irish banks would be illiquid and insolvent if it were not for the Irish State and Irish Central Bank.

The reality facing bondholders

2. The capital structure, and not the State, is there to absorb losses.
3. Subordinated bondholders should clearly share the burden of the Irish banking crisis.
4. The general consensus is that the senior unsecured bondholders should also share the burden of the Irish banking crisis.
5. However it should not be forgotten that at the time these investment decisions were made, senior bonds ranked pari-passu to deposits, which are also part of the capital structure. Senior bondholders would have expected to share losses with depositors.
6. The rules have subsequently been changed by the Irish government with the establishment of the ELG scheme essentially making deposits senior to senior bonds and the establishment of the Credit Institutions (Stabilisation) Bill.
7. Senior bondholders should share the burden of losses to help lessen the sovereign's burden but there should be no illusion; the rules have been changed mid-game.

Subordinated bondholders

8. There is approximately €7.3bn subordinated bonds remaining in the Irish banking system.
9. An across the board coercive buyback at 30cents would see approximately €5.0bn in equity accretion to the Irish banks.

Senior unsecured bondholders

10. There is approximately €17bn in senior unsecured bonds in the Irish banking system.

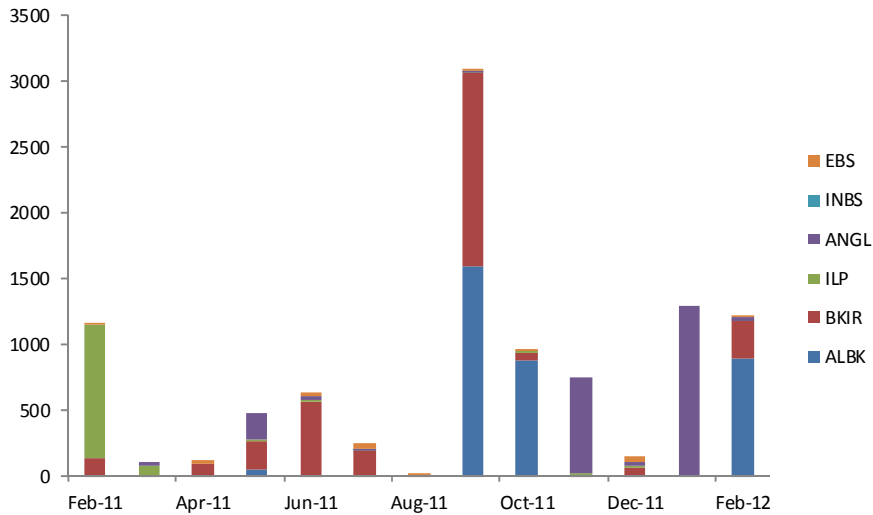
Table 1: Debt securities by institution on Bloomberg, €mn

€mn	Allied	Bank of Ireland	ILP	Anglo	INBS	EBS	Total
Senior secured	11,450	4,713		5,051			21,214
Govt guaranteed	8,757	15,110	1,408	2,985		1,025	29,285
Senior unsecured	5,865	5,160	1,650	3,158	632	520	16,985
Senior subordinated	2,041	2,018	1,137	147	173	213	5,729
Junior subordinated	766	729			100		1,595
Total	28,879	27,730	4,195	11,341	905	1,758	74,808

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Chart 1: Chart 1, senior unsecured bond redemptions occurring in the next year €mn



11. Potential equity accretions for the Irish banking system are outlined in the table below for various buyback rates assuming that they occur in the month of June, giving the new government time to digest the stress tests and make a decision. AIB and Bank of Ireland have a combined €3bn maturing in September 2011, so any decision on restructuring senior unsecured debt really needs to be made before September.

Chart 1: Senior debt outstanding end of May 2011, €mn

	Outstanding	30% of par	50% of par	70% of par
ALBK	5821	4074.7	2910.5	1746.3
BKIR	4710	3297	2355	1413
ILP	536	375.2	268	160.8
ANGL	2934	2053.8	1467	880.2
INBS	632	442.4	316	189.6
EBS	474	331.8	237	142.2
Total	15107	10574.9	7553.5	4532.1

12. For the equity accretions to be really meaningful the discount to par needs to be large. While there are differences between the clearly non-viable banks (Irish Nationwide, Anglo Irish) and the other banks it is still likely that any action on this front would need to be coercive for all banks.

Legal issues with coercive actions

13. There are legal implications arising from a coercive action when equity remains and when depositors are present. The Credit Institutions (Stabilisation) Bill enacted in 2010 could be used to circumvent legal issues surrounding a coercive action.

The ECB doesn't want seniors touched

The major issue with all of the above is that the EU/ECB is against such a move for fear that it would drive up funding costs for other euro area banks and consequently push up reliance on the ECB for funding just as it is trying to lessen banks reliance on short term ECB funding. As an aside we think these fears are overblown.

So where does this leave the next Irish government?

1. Go against the wishes of the ECB/EU and unilaterally undertake a coercive buyback of all Irish senior unsecured bank debt. Below we outline the two extremes for a possible ECB/EU reaction.

Possible ECB/EU reaction:

- a. *Publicly ECB/EU turns cold towards Ireland but privately acknowledges that it was an understandable step and therefore continues to support Ireland.*
- b. *The ECB no longer permits the Irish Central Bank to give funds out under the Emergency Liquidity Assistance scheme and the EU/IMF loan deal is frozen pending a review.*

Consequences in case b if rapid solution not found to fund Irish banks....Irish banks collapse, the Irish economy spirals downward once again, the ECB takes huge losses on its main refinancing operations with the Irish banks, the ECB takes losses on its Irish government bonds, a Euro area banking crisis is reignited.

Hmmm, it seems unlikely that the ECB will play such hardball if it came down to it, but the key consideration for Ireland and it's political leaders is how far do you push the ECB as the biggest loser would ultimately be Ireland if the ECB held their line.

2. Convince the ECB/EU that the sovereign cannot shoulder the burden of further write-downs by continuing the status quo of sovereign capital injections.

Possible ECB/EU reaction:

- a. *The ECB/EU accedes and agrees that senior unsecured debt restructuring should form part of the new Government's plan for the banking system.*
- b. *The ECB/EU acknowledges the difficulties facing the Irish sovereign in relation to the banking sector, but is still against senior debt restructuring. Instead they are willing to fund a non-core bank (NAMA 2 like vehicle).*

Irish banks could deleverage and decrease deposit/loan ratios if a non-core bank was created and loans were transferred at book value i.e. not incurring any further write-downs. Such a vehicle, however, could only realistically be funded by instruments which were either eligible for repo at the ECB or instruments with a supra-national backing e.g. EFSF, IMF.

- c. *A lowering of the interest rate on the EU/IMF is offered as a carrot not to restructure banking debt.*

The cumulative saving for a 1% drop in the average rate of the entire EU/IMF loan package would be an undiscounted €4.7bn versus the €10.6bn present value of having to draw down the funds to inject into the banks today as opposed to using bond buybacks.

It would therefore likely have to be accompanied by an agreement on allowing the Irish State to do a coercive buyback with respect to Anglo/INBS which could accrete save the state approximately €2.5bn if the buyback occurs at 30 cents in the dollar.

This would also avoid the legal minefield surrounding coercive buybacks at AIB and Bank of Ireland where there are deposits as well as equity.

So what is the most likely outcome for senior unsecured debt?

This is a political animal and the ball is ultimately in the ECB/EU court, but our current thinking is that

- Subordinated debt will be bought back at a discount in all the institutions except Irish Life and Permanent, where it is less clear cut.
- A non-core (NAMA like) vehicle will be established with the input and backing of an supra-national organisation
- The EU/ECB will, like the Irish State, make a distinction between viable and unviable banks and allow senior debt restructuring in the latter.
- Anglo Irish and Irish Nationwide senior unsecured debt will not be repaid in whole, with either a coercive debt buyback or gradual repayments as and when assets are realised.
- The government will not move coercively against Bank of Ireland senior unsecured debt.
- Quite frankly with regard to AIB it is too difficult to take the view that the senior unsecured debt won't be moved against. AIB is already 93% owned by the State and requires a further €4.7bn even before the next stress test has been carried out. We believe the new government would like to move against the senior unsecured bondholders in AIB, but it may be a bridge too far for the ECB/EU.

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