EUROPEAN BANK FUNDING IN A BAIL-IN WORLD

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This is the perception many investors have of bail-in bonds
Eurozone jobless rate surges to record

"Lost generation" to suffer years of unemployment

"Finance for big projects cut as banks are squeezed"
- Money for airports and hospitals down a third
- Hope of infrastructure boost for economy hit

"Funding gap puts infrastructure projects in peril"
- There may be a significant shortfall in bank financing for the global economy in the coming years. Unfortunately if you start having to slowdown infrastructure work for any reason, it will have a negative effect on growth
- Where there is broad ranging regulatory reform, there are likely to be unintended consequences – and unfortunately bank lending to projects will be among the areas to suffer
- Historic sources of debt have dried up and we are likely to continue to see pressures in the short term
The world as we knew it


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iTraxx Europe Senior Financials On the run (5Y)  
iTraxx Europe Non-Financial On the run (5Y)  
iTraxx Europe SovX Western Europe On the run (5Y)

Source: DataQuery, 2 May 2012. CDS mid-level
Onset of the financial crisis

CDS spread evolution, July 2007 – December 2009

Source: DataQuery, 2 May 2012. CDS mid-level
The world turned upside down

![CDS spread evolution, January 2010 – present](image)

Source: DataQuery, 2 May 2012. CDS mid-level
Transformation of the investor base for European banks

<table>
<thead>
<tr>
<th>Pre-Crisis</th>
<th>Today</th>
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<tbody>
<tr>
<td><strong>CP</strong></td>
<td>Money market funds (2a7)</td>
</tr>
<tr>
<td><strong>Term Senior</strong></td>
<td>Bank liquidity / treasury portfolios / limited real money participation</td>
</tr>
<tr>
<td><strong>ABS</strong></td>
<td>SIVs and bank treasuries / ABCP conduits / money market funds</td>
</tr>
<tr>
<td><strong>Covered</strong></td>
<td>Real money accounts / rates accounts</td>
</tr>
<tr>
<td><strong>Lower Tier 2</strong></td>
<td>SIVs / bank prop desks</td>
</tr>
<tr>
<td><strong>Tier 1</strong></td>
<td>Real money accounts / hedge funds bank prop desk / retail (private banks) / depositors</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td>Real money accounts / hedge funds / strategics (levered)</td>
</tr>
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<thead>
<tr>
<th>Tenor</th>
<th>Pre-Crisis</th>
<th>Today</th>
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</thead>
<tbody>
<tr>
<td>2006</td>
<td>Fixed 4%</td>
<td>Floating 16%</td>
</tr>
<tr>
<td></td>
<td>Floating 86%</td>
<td>Fixed 84%</td>
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<tr>
<td>2006</td>
<td>5–10yrs: 15%</td>
<td>5–10yrs: 50%</td>
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<tr>
<td></td>
<td>10yrs+: 8%</td>
<td>10yrs+: 16%</td>
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</tbody>
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Investors and bail-in

- Investors differentiate between financial, corporate and sovereign risk, however uncertainty attracts a significant additional risk premium
  - The special status of a bank (versus corporate) in liquidation is acknowledged

- Consequently, the key area of debate in the bank space is the appropriate risk premium
  - Pandora’s box has been opened but uncertainty around when and how the proposed Crisis Management Framework will be implemented remains high
  - There has been a wide range of estimated risk premia: from a minimal 50bps, to 87bps (J.P. Morgan Investor Survey, 14 October 2010) to 345 bps (J.P. Morgan Research, 23 March 2012)

- Misapprehension that investors need to buy European bank paper
  - The assumption that investors will buy an asset category because they "always" have has been proved wrong
  - The investor base that European banks historically relied on has transformed
  - The sovereign debt crisis has illustrated that the fear of “buyer strikes” can be self-fulfilling and dramatic even in the “safest” of asset categories

- Investors accept and sympathise with the concept of bail-in of senior debt
  - Not a concept to be utilised when a bank is a going concern, but rather when it has “failed”
  - Should only be operated within the confines of a strict statutory resolution framework
  - The liquidation hierarchy needs to be rigorously respected

- Grandfathering of debt and exempt asset classes (and therefore encumbrance and bias towards short term funding) as well as the implementation timetable are contentious issues
European banks face a significant funding challenge

Source: ‘The 2.8 Trillion Question’, 23 March 2012