

Novo Banco

Recapitalization with Full Protection of Small Investors and Equal Treatment of Bondholders

Adam Lerrick

The Bank of Portugal made a serious mistake in the structure of the € 2 billion recapitalization of Novo Banco. It chose five specific senior unsecured bonds out of 40 bonds of equal rank to absorb the losses required to recapitalize Novo Banco. The justification was protection of small investors because the five bonds are held entirely by large investors. Bondholders of equal rank receive unequal treatment. The result is legal challenges, claims of discrimination and of arbitrary action by bank regulators and uncertainty for investors in Eurozone bank bonds.

An alternative structure based upon the treatment of depositors in a bank restructuring will generate the necessary € 2 billion of Novo Banco capital while providing full protection of small investors and equal treatment for bondholders of equal rank. A clear set of predictable rules will be established.

Under the Bank of Portugal plan, all holders of the five selected bonds will see 100% of their holdings transferred to the bad bank and incur large losses. Under the equal treatment structure, even after full protection of small investors, less than 50% of large investor bonds will be transferred to the bad bank.

I. Bank of Portugal Recapitalization Plan

The Bank of Portugal has two goals:

1. Recapitalize Novo Banco without taxpayer funds; and
2. Protect small investors to ensure the stability of the Portuguese financial system.

To achieve these goals, the Bank of Portugal transferred five senior unsecured Novo Banco bonds governed by Portuguese law totaling € 2 billion into the bad bank BES where investors will incur large losses. The minimum denomination of the bonds is € 100,000. Thirty-five other Novo Banco senior unsecured bonds governed by foreign law and Portuguese law totaling € 3.4 billion remain liabilities of Novo Banco where no losses will be imposed.

Almost all of the bonds transferred to the bad bank BES are held by institutional investors. Many, if not most, of the bonds that stay in Novo Banco are held by retail investors. However, the Bank of Portugal plan only partially achieves its goal of protecting small bondholders. It fails to protect small investors that hold the minimum € 100,000 denomination of the transferred bonds. At the same time, the plan fully protects large institutions that hold the non-transferred bonds.

Investors with bonds of equal rank receive unequal treatment. The result is legal challenges, claims of discrimination and of arbitrary action by bank regulators and uncertainty for investors in Eurozone bank bonds.

II. Alternative Structure: Full Protection of Small Investors and Equal Treatment of Bondholders

An alternative structure based upon the treatment of depositors in a bank restructuring will achieve the Bank of Portugal goals while providing equal treatment for bondholders of equal rank.

Each investor's aggregate holdings of senior unsecured Novo Banco bonds, both Portuguese law and foreign law, will be divided into two baskets:

1. A € 200,000 fully protected amount that will remain liabilities of Novo Banco ("Protected Holdings"); and
2. The investor's holdings above the € 200,000 fully protected amount ("Non-Protected Holdings").¹

The Protected Holdings of all investors will be aggregated and deducted from the € 5.4 billion total of Novo Banco senior unsecured bonds.

€ 2 billion of the investor Non-Protected Holdings will be transferred to the bad bank BES creating the required additional capital for Novo Banco. The excess of total Non-Protected Holdings above the € 2 billion required to recapitalize Novo Banco will remain liabilities of Novo Banco.

All allocations across bond issues and among investor Non-Protected Holdings will be pro rata.

Each bondholder, whether it holds Portuguese law bonds or foreign law bonds, whether the investor is an institution or a small retail client, whether it is Portuguese or foreign, receives the same treatment:

1. Total protection up to € 200,000; and
2. Identical loss on the investor's holding above € 200,000.

The structure replicates the treatment of depositors in a bank liquidation/restructuring. The € 200,000 protection will achieve the Bank of Portugal goal of protecting all small investors. At the same time, all large investors share the cost of the required recapitalization.

There is no discrimination among investors of equal rank and a clear set of predictable rules will be established.

III. Result for Investors under the Bank of Portugal Plan and the Equal Treatment Structure ²

Novo Banco required capital infusion: € 2.0 billion

Total Novo Banco senior unsecured bonds: € 5.4 billion ³

¹ The € 200,000 protection limit should be applied to the aggregate of the investor's holdings across all bond issues. However, it may be necessary to set the € 200,000 protection limit based upon the investor's holdings per bond issue because of the mechanics of the settlement and clearing systems.

² The analysis is based upon estimates of 31 December 2015 amounts derived from the Novo Banco 30 June 2015 interim financial statements.

³ As of 30 June 2015, total senior unsecured bonds were € 6.6 billion. Between 30 June 2015 and 31 December 2015, € 1.2 billion of senior unsecured bonds were redeemed and no senior unsecured bonds were issued. It is assumed that repurchases of bonds plus movements in bond values equal the € 33 million of the previous period.

Total Protected Holdings: € 1.2 billion ⁴

Total Non-Protected Holdings: € 4.2 billion (5.4 – 1.2)

Transfer of Non-Protected Holdings to Bad Bank BES: € 2.0 billion

Excess of Non-Protected Holdings above € 2 billion required capital infusion: € 2.2 billion (4.2 – 2.0)

Share of Non-Protected Holdings transferred to Bad Bank BES: 48% (2.0/4.2)

Share of Non-Protected Holdings retained in Novo Banco: 52% (2.2/4.2)

A. Bank of Portugal Plan

Investor holds bonds selected for transfer to bad bank BES: 100% of holdings transferred to bad bank BES; 0% of holdings remain in Novo Banco; Investor suffers loss on 100% of holdings.

Investor holds bonds not selected for transfer to bad bank BES: 0% of holdings transferred to bad bank BES; 100% of holdings remain in Novo Banco; Investor has no loss.

B. Equal Treatment of Bondholders with Full Protection of Small Investor Structure

1. Small Retail Investor

Investor holding: € 100,000

Protected Holding remaining in Novo Banco: € 100,000

Non-Protected Holding: € 0

Non-Protected Holding transferred to Bad Bank BES: € 0

Non-Protected Holding remaining in Novo Banco: € 0

Total holding remaining in Novo Banco: € 100,000 or 100% of original Novo Banco holding

Total holding transferred to Bad Bank BES: € 0 or 0% of original Novo Banco holding

2. Large Retail Investor

Investor holding: € 400,000

Protected Holding remaining in Novo Banco: € 200,000

Non-Protected Holding: € 200,000 (400,000 – 200,000)

Non-Protected Holding transferred to Bad Bank BES: € 96,000 (0.48 x 200,000)

Non-Protected Holding remaining in Novo Banco: € 104,000 (200,000 – 96,000)

Total holding remaining in Novo Banco: € 304,000 (200,000 + 104,000) or 76% of original Novo Banco holding

Total holding transferred to Bad Bank BES: € 96,000 or 24% of original Novo Banco holding

3. Institutional Investor

Investor holding: € 10,000,000

Protected Holding remaining in Novo Banco: € 200,000

Non-Protected Holding: € 9,800,000 (10,000,000 – 200,000)

Non-Protected Holding transferred to Bad Bank BES: € 4,704,000 (0.48 x 9,800,000)

Non-Protected Holding remaining in Novo Banco: € 5,096,000 (9,800,000 – 4,704,000)

Total holding remaining in Novo Banco: € 5,296,000 (200,000 + 5,096,000) or 53% of original Novo Banco holding

Total holding transferred to Bad Bank BES: € 4,704,000 or 47% of original Novo Banco holding

⁴ Novo Banco debt securities held by clients (including large clients) is used as an estimate of Protected Holdings. On 30 June 2015, client holdings were € 1.5 billion. Between 30 June and 31 December 2015, € 1.2 billion of senior unsecured bonds or 19% of the total € 6.6 billion were redeemed. If bank clients received their proportionate share of redemptions, bank clients held € 1.2 billion of debt securities as of 31 December 2015.