Debt-to-equity Swaps in Eurozone's Banking Sector: Minor Short-term Pain for Substantial Long-term Gain

Rui Soares*

Introduction

It is generally accepted that any solution for the eurozone debt crisis has to encompass a comprehensive write-down of banks' bad assets – including sovereign debt haircuts – followed by a massive recapitalisation of the European banking sector. Only then, will we see again (i) a properly functioning European interbank market and (ii) credit flowing to the 'real' economy (read small and mid-sized companies). Without it, a lost decade '*a la* Japanese' will be unavoidable for many eurozone countries, starting with the periphery – at best. At worst, the collapse of entire national economies and the end of the eurozone as we know it will occur.

The recapitalisation proposals being put forward have different forms and shapes, ranging from mergers in the banking sector (followed by recapitalisation of the newly merged entities) to the implementation of a bad bank/good bank model (followed by recapitalisation of the newly created entities). However, all the proposals have one thing in common: the recapitalisations will be financed with taxpayers' money. Either entirely or partially, depending on how much equity banks will be able to raise money from private investors.

The questions we must then ask ourselves are: why should the taxpayer provide any of the required financing? Why not simply force debt-to-equity swaps in the banking sector?

* HPR, London. This contribution reflects the personal opinion of the author. It does not necessarily correspond to the views of the HPR London.

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Under a debt-to-equity swap framework, the relevant supervisory authority forces banks to write off their bad assets as well as making sure that they are written off to their realisable value (i.e. their market price when there is a liquid market; otherwise the price for which they can realistically be disposed off – if necessary assessed with the help of external independent advisors). In case there is not enough equity left to comply with the minimum capital requirements, banks are given the chance to raise the requested funds in the market. For those not able do so within a short time frame, the supervisory authority takes control of them, depositors are protected, trading in the shares suspended and the recapitalisation done *via* debt-to-equity swaps. Shareholders end up being (at least partially) wiped out, bondholders become the new (major) shareholders. Shares are returned to normal trading as soon as the swaps are concluded. No taxpayers' money is used to recapitalise the banks.

What are the potential arguments against debt-to-equity swaps?

1. Debt-to-equity swaps would create major market turbulences. True. Then again, in case no one has noticed, we are already experiencing recurring massive market turbulence. Once the debt-to-equity swaps were concluded and the banks recapitalised, market turbulence would be over and the entire banking system would be on a sound footing. So the question is: is it better to have recurring market turbulence every 3 to 6 months or a major market turbulence that lasts for 3 to 6 months and is then over for good?
2. Banks at risk of suffering debt-to-equity swaps would be cut off from market financing. So what? Banks cut-off from market financing could receive liquidity injections from the ECB. Given that once the debt-to-equity swaps were concluded the banks would be sound and solvent, there is no risk that the ECB would not get its money back.
3. Banks would never again gain access to market financing. Nothing could be further from reality. If this were true, it would mean that investors are

happy to lend money to banks that have an equity-to-total-non-risk-weighted-assets ratio of 3 percent, but not to banks that have a ratio of, for example, 10 percent, which is what could happen once the debt-to-equity swaps were concluded. In other words, which investor would not be willing to lend money to sound and solvent banks?

4. Banks' cost of capital would rise. How can the cost of capital for well-capitalised banks be higher than for banks with a thin equity buffer? Are investors irrational and unable to access risk? If they are not, than the only explanation for a higher cost of capital would be that bondholders are currently pricing in an unlimited taxpayers' protection in case of bank losses. Even if this were the case, aren't well-capitalised banks, with a substantial equity buffer, the best protection that bondholders can wish for? This is especially true given that in extreme economic distress situations, the sovereign tends to be insolvent? If so, then this must mean that even if there was a spike in the cost of financing, it should be short lived. Investors would soon bring it down after realising how favourable the risk-return profile of excessively high yielding bonds of well-capitalised banks' was; especially when compared with alternative investments of similar (low) risk.
5. Investors in general and pensioners in particular would be faced with substantial losses. Fixed income funds and many pension funds would have to sell the shares their bonds were swapped for, as they are not allowed to hold equities. This would create a massive turmoil in financial markets in general, and equity markets in particular, leading to substantial losses for investors. The answer to this argument can only be: yes. And no. Firstly, and as already mentioned above, the turmoil would be limited in time. Once the sell-off was finished the markets would rebound, as financial assets – and especially bank shares – would be undervalued. It would be a purely technical reaction. Secondly, fixed income and certainly pension funds could renegotiate the investment mandates with their clients to deal with the special situation that large scale debt-to-equity swaps would create. For exceptional circumstances, exceptional investment mandates. Why shouldn't investors and pensioners agree to let fixed income and pension funds hold bank shares resulting from debt-to-equity swaps for a 3 to 5 year period? It would be in their own best interest to avoid forced selling of shares translating into a selling price below fair value. By holding the shares for a 3 to 5 year period, investors would most likely make good money with them: shares of well capitalised banks in a recovering economy should actually do very well. In short, fixed income investors and pensioners would only be likely to lose money with the newly issued bank shares if they wanted to.

What would be the advantages of debt-to-equity swaps?

1. Fairness, compliance with the basic principles of a market economy and democracy. Investors chose freely to invest in banks. Taxpayers didn't. As the investors they are, banks' shareholders and bondholders knew that there were risks associated with their investments – just like with investing in any other type of company. So, if they had the freedom to decide in what to invest, how come they don't have to bear the consequences of their freely made decisions? Don't freedom and responsibility go hand in hand with each other? Is this not a basic principle of a democratic system and a market economy?
2. More stringent capital requirements and higher capital ratios possible, which should be implemented swiftly. Availability of public money to recapitalise banks is limited. Debt-to-equity swaps would make it possible to set much higher capital ratios for the banking industry and thus contribute to make over-indebtedness and financial crisis much more unlikely to occur in the future.
3. More resources left to finance public investment. With bank recapitalisation carried out without the use of public money, governments would have more resources available to finance projects with a direct impact on the economy's supply side, i.e. productivity enhancing: infrastructure, technology, education, R&D.
4. More efficient future capital allocation. Let us say that besides shareholders, bondholders ultimately ended up losing money with the debt-to-equity swaps as well. What would be the problem? This is why bonds issued by banks offer a higher yield than government bonds and bank deposits. Bank bonds have interest rate and credit risk. If credit risk materialises, bondholders have to accept the consequences. Complaining when faced with losses is an absurdity as investors are paid for taking the credit risk. It is simply the market economy at work. Realising that there are no free lunches in a market economy would make investors more vigilant in the future and encourage them to request larger capital buffers and more top management

accountability. The probability of creating an overblown financial system, over-leveraged economy and asset bubbles would be greatly reduced. A more efficient allocation of resources in the economy would be the outcome. This is hardly something we should not whish for or be unhappy about.

5. Generation of positive momentum to create a pan-European supervisory authority. Given the high level of coordination among member states that a fully-fledged recapitalisation of the entire eurozone banking system would require, and even more so if achieved *via* debt-to-equity swaps, the need to create a pan-European supervisory authority would become obvious. The pressure and political willingness to push ahead with this initiative would gain traction. Given that a stable monetary union without a centralised pan-European bank authority is a logical impossibility, this would be very good news indeed.
6. Structural reforms made easier. With banks' bad assets (including sovereign debt haircuts) written-off and the eurozone banking system recapitalised, return to economic growth would be easier to achieve as the credit crunch would basically be over. With economic growth returning, the structural reforms needed in the peripheral countries would be easier to implement.
   Note: structural reforms won't be enough. The competitiveness of (most) EU's peripheral countries is unlikely to be fully restored even at the end of a comprehensive implementation of structural reforms, i.e., (smaller) current account imbalances are likely to remain in place even if the structural reforms are wide-ranging and successfully implemented. However, with structural reforms in place, good quality infrastructure, lower labour costs, a well-educated young workforce and the right incentives in place, these countries could start to attract significant export-oriented foreign direct investment. This would have an immediate impact on GDP growth (*via* private investment) and employment; in the mid-term, once the projects became fully operational, a positive impact on the current account balance and consequent elimination (or major mitigation) of current account imbalances would be the result. Expecting that the peripheral countries with the largest external imbalances (Ireland, Portugal, Spain and Greece) will be able to correct their external imbalances without substantial foreign direct investment while remaining in the euro is unrealistic anyway.
7. More balanced generational burden sharing. If the entire banking system ends up being bailed out by the taxpayer, it will be the younger generations that will bear the heavy burden of the crisis. They are effectively the taxpayers. These generations will also have to suffer the consequences of the slow government debt deleveraging process over many years (remember: overall public debt in the EU would increase if taxpayers had to finance the recapitalisations): slower economic growth today, less spending on education, R&D and infrastructure, smaller productivity gains, lower potential economic growth in the future. If debt-to-equity-swaps are implemented to recapitalise the eurozone banking system, it will be the older generations (and especially the baby boomers) that will bear most of the costs. They are, directly or indirectly, the banks major shareholders and bondholders.

The ultimate question then is: is this fair? The answer can only be: yes. Firstly, because the younger generations (i.e. the taxpayers) have mainly financed the bailouts to date; and secondly, because it is the older generations who have benefited the most from the credit induced economic boom over the past 25 to 30 years and enjoyed higher salaries, higher asset prices and higher pensions. Thirdly, this concept is fair because it would be the wealthiest members of the older generations who would primarily bear the burden, as they are the main owners of bank shares and bonds. Fourthly, because the losses they would have to bear would just account for a small fraction of their net financial assets – their standards of living would not be significantly impaired. Fifthly, because over time they would be very likely to recover from their losses with the appreciation of the newly issued bank shares, and finally, because it is neither fair nor economically sustainable that the younger generations, who came late to the credit induced economic party, now have to do all the day-after cleaning by themselves. With the eurozone's average unemployment rate of under 25 year olds at 22 percent – over 50 percent in Spain and Greece, around 30 percent in Italy and Portugal – this should be very clear in the minds of European authorities. Generational burden sharing is necessary and will have to happen. In one form or another.

Conclusions

In this paper, it is argued that

1. The recapitalisation of the European banking system is a necessary condition to solve the eurozone

debt crisis and restore high and sustainable economic growth.

2. That no taxpayers' money should be used to recapitalise the eurozone's banking sector. It should be banks' shareholders and bondholders who foot the bill *via* debt-to-equity swaps.
3. The potential arguments against debt-to-equity swaps tend to be myopic as they are only valid for short-term time horizons. At best. In the mid-term they seem to be irrelevant.
4. The advantages of debt-to-equity swaps are significant in terms of (i) fairness, (ii) economic efficiency, (iii) future stability of the eurozone's financial system, (iv) economic growth and (v) generational burden sharing.
5. Generational burden sharing will have to happen. At stake is nothing less than the future of Europe.

The time to act is now.