EUROPEAN BANK FUNDING IN A BAIL-IN WORLD

ILF Conference, 3 May 2012

David Marks,
Chairman of FIG Debt Capital Markets, J.P. Morgan

J.P.Morgan

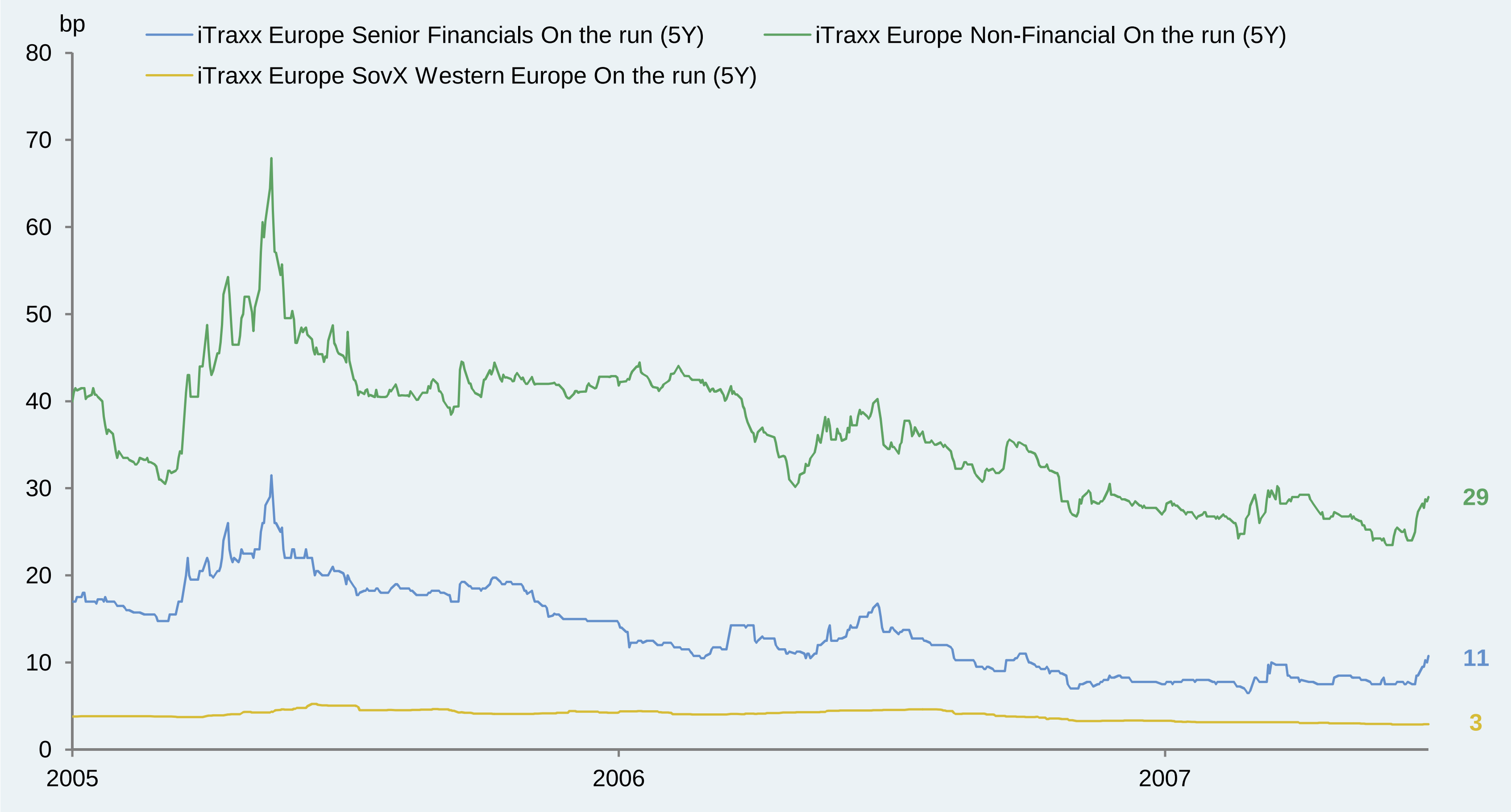
This is the perception many investors have of bail-in bonds

Today's Financial Times headlines

- 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

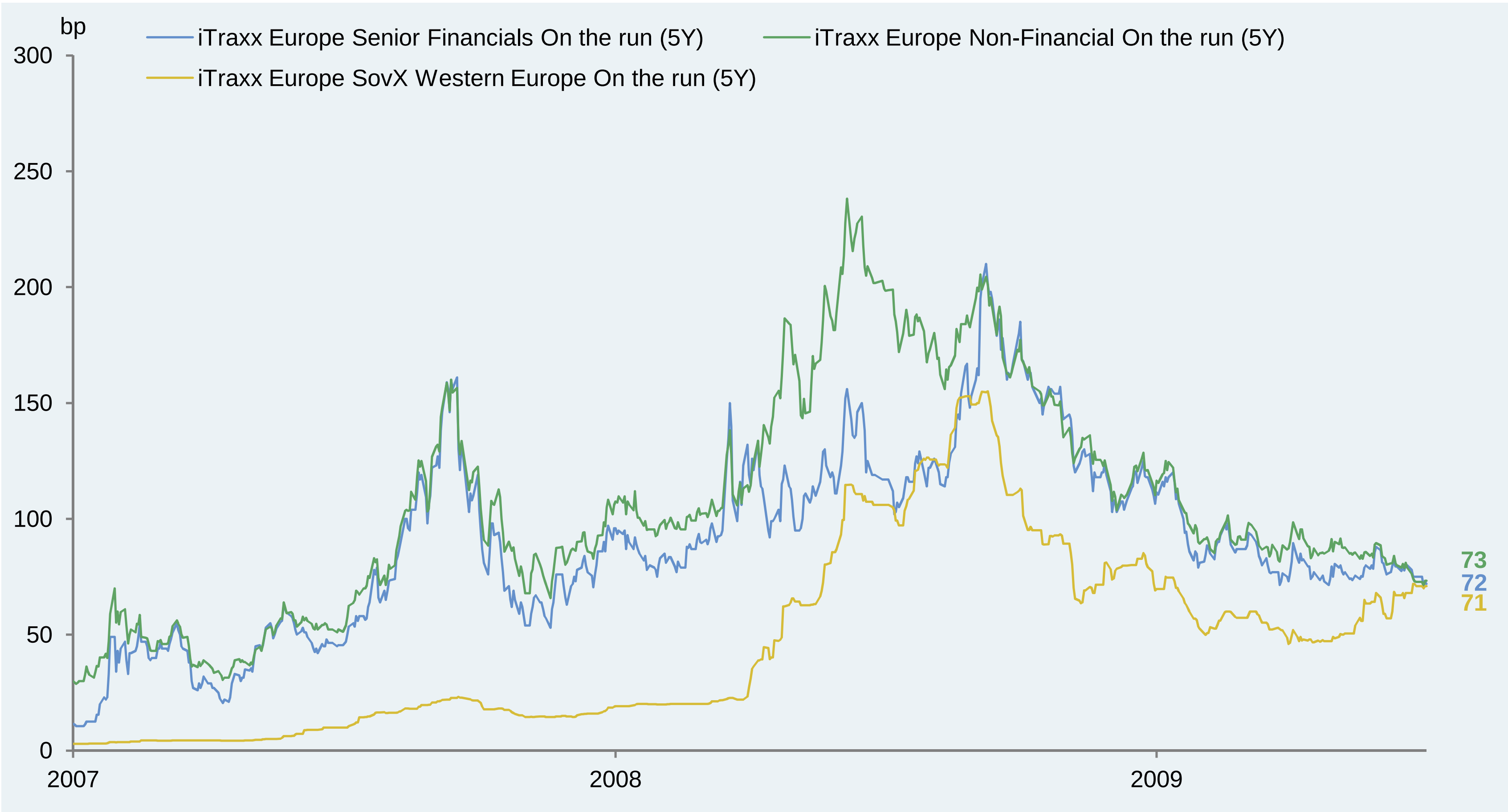
CDS spread evolution, January 2005 – June 2007



Source: DataQuery, 2 May 2012. CDS mid-level

Onset of the financial crisis

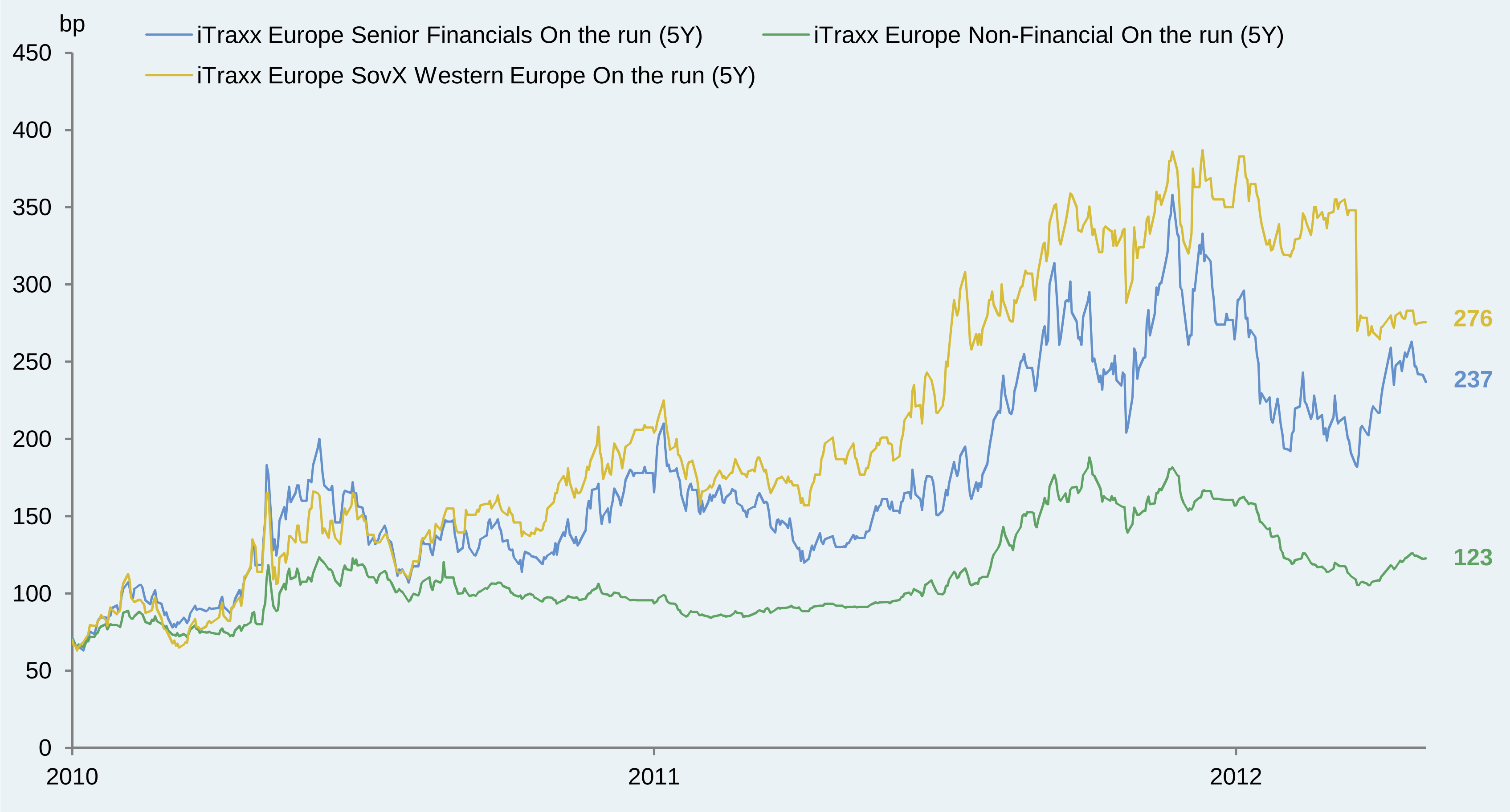
CDS spread evolution, July 2007 – December 2009



Source: DataQuery, 2 May 2012. CDS mid-level

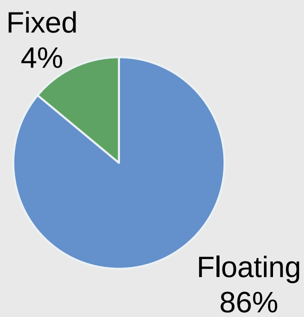
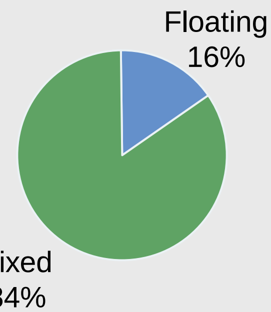
The world turned upside down

CDS spread evolution, January 2010 – present



Source: DataQuery, 2 May 2012. CDS mid-level

Transformation of the investor base for European banks

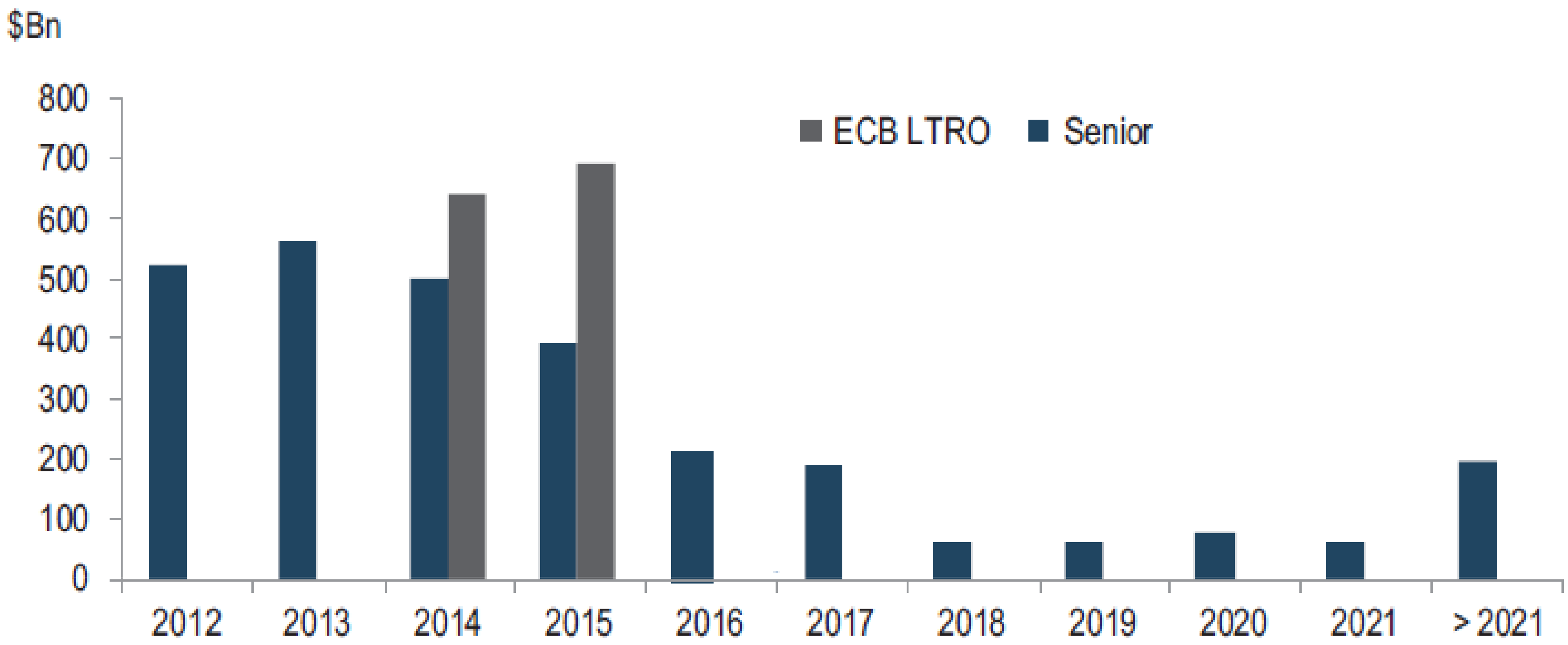
	Pre-Crisis	Today
CP	Money market funds (2a7)	Money market funds (2a7)
Term Senior	Bank liquidity / treasury portfolios / limited real money participation	Real money accounts / limited bank participation
ABS	SIVs and bank treasuries / ABCP conduits / money market funds	Real money (US) / US bank portfolios
Covered	Real money accounts / rates accounts	Real money accounts / rates accounts / bank treasury / central bank participation
Lower Tier 2	SIVs / bank prop desks	Real money accounts
Tier 1	Real money accounts / hedge funds bank prop desk / retail (private banks) / depositors	Private banks / hedge funds / real money accounts
Equity	Real money accounts / hedge funds / strategics (levered)	Real money accounts strategics (un-levered)
Fixed vs. Floating (real money vs. funded investors)	**2006** 	**2011** 
Tenor	**2006** 5–10yrs: 15% 10yrs+: 8%	**2011** 5–10yrs: 50% 10yrs+: 16%

J.P.Morgan

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 <u>need</u> 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