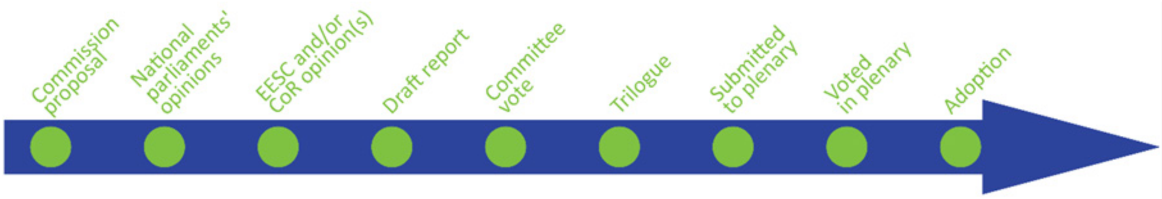
Ranking of unsecured debt instruments in insolvency hierarchy

OVERVIEW

Following the global financial crisis, the European Union extensively reformed its regulatory framework for financial services. With legislation such as the Bank Recovery and Resolution Directive (BRRD), it ensures that, through mechanisms such as 'bail-in', the recovery or restructuring of distressed financial institutions is done without spreading to other institutions, or using taxpayers' money to bail them out. To ensure that sufficient financial resources are available for bail-in, the BRRD requires resolution authorities to set financial institutions a minimum requirement for own funds and eligible liabilities (MREL). In parallel, a similar standard, the total loss-absorbing capacity (TLAC), was adopted internationally for systemically important financial institutions. The discretionary requirements in MREL and the compulsory requirement in TLAC concerning subordination of eligible liabilities have driven some countries to amend the ranking of certain bank creditors. Because national rules adopted so far diverge, unsecured debt holders and other creditors of banks can be treated differently from one Member State to another. The Commission therefore proposed to set harmonised rules. On 30 November and 8 December 2017 respectively, Parliament and Council adopted the text agreed in interinstitutional negotiations. The final act was published in the Official Journal on 27 December 2017.

Proposal for a directive amending Directive 2014/59/EU of the European Parliament and of the Council as regards the ranking of unsecured debt instruments in insolvency hierarchy

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2016) 853 23.11.2016
Rapporteur:	Gunnar Hökmark (EPP, Sweden)	2016/0363(COD)
Shadow rapporteurs:	Pedro Silva Pereira (S&D, Portugal) Syed Kamall (ECR, UK) Thierry Cornillet (ALDE, France) Martin Schirdewan (GUE/NGL, Germany) Ernest Urtasun (Greens/EFA, Spain) Marco Valli (EFDD, Italy) Marco Zanni (ENF, Italy)	Ordinary legislative procedure (COD) (Parliament and Council on equal footing – formerly 'co-decision')
Procedure completed.	Directive (EU) 2017/2399 OJ L 345, 27.12.2017, pp. 96-101	



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Introduction

Following the financial crisis, the European Union (EU) extensively reformed its regulatory framework for financial services, to increase the resilience of its financial institutions. The reform package included, among other pieces of legislation, Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (often referred to as the Bank Recovery and Resolution Directive, BRRD), and Regulation (EU) No 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (SRM/SRF).

While the first two legislative documents focus on a financial institution as a 'going concern', the latter two (the BRRD and the SRM/SRF) have established a framework to effectively manage the phase of recovery and restructuring of distressed financial institutions, to reduce their negative impact on financial stability (contagion) and public finances (taxpayer funded bail-outs).

Existing situation

Limiting the impact of financial institutions in difficulty is achieved through 'bail-in', a mechanism in which either debt is written down or liabilities are converted to equity according to a pre-defined hierarchy.[1] To ensure that sufficient financial resources are available for write-down or conversion into equity, the BRRD (in its Article 45) requires resolution authorities to set financial institutions a **minimum requirement for own funds and eligible liabilities** (MREL) that they have to meet, according to certain criteria.

Under the BRRD, MREL eligible instruments are not mandatorily subordinated in insolvency proceedings.[2] According to the Commission's impact assessment, this implies that 'a liability eligible for MREL may rank in insolvency at the same level… with certain other liabilities which are not bail-inable in accordance with the BRRD…, or certain other liabilities which are bail-inable, but could be excluded from bail-in on a discretionary basis… if the resolution authority can justify that they are difficult to bail-in for reasons of operational execution or systemic contagion risk… This could lead to situations where bailed-in bondholders may claim they have been treated worse under resolution than under a hypothetical insolvency (and therefore demand) to be compensated by financial means of the resolution fund. To avoid this risk, resolution authorities may decide that the MREL requirement should be met with instruments that rank in insolvency or resolution below other liabilities that are either not bail-inable by law or are difficult to bail-in'.

In parallel to MREL, which concerns specifically financial institutions in Europe, a similar standard – **total loss-absorbing capacity** (TLAC) – was adopted at global level in 2015, and is expected to be implemented by 2019. This standard focuses on global systemically important banks ('global systemically important institutions', G-SIIs in EU legislation) and requires them to hold a sufficient minimum amount of 'bail-inable' liabilities to ensure smooth and fast absorption of losses and recapitalisation in the resolution phase. It requires that only liabilities subordinated to other liabilities (for instance covered deposits) be eligible for TLAC.

The Commission notes that the discretionary requirement in MREL and the compulsory requirement in TLAC concerning the subordination of debt instruments have driven some Member States to amend the insolvency ranking of certain bank creditors under their national insolvency law. Given that national rules adopted so far diverge,[3] unsecured debt holders and other creditors of banks can be treated differently from one Member State to another. The Commission aims therefore to increase legal certainty and prevent competitive distortions in the internal market, by establishing harmonised rules on the treatment of certain creditors of banks in resolution.

Parliament's starting position

In its 2016 report on banking union, the European Parliament called on the Commission to 'present proposals to further reduce the legal risks of claims under the no-creditor-worse-off principle' (point 56).

Council starting position

In its conclusions of 17 June 2016 on a roadmap to complete the banking union, the Council of the European Union underlined the work being carried out by the Commission in 'put(ting) forward a proposal on a common approach to the bank creditor hierarchy, to enhance legal certainty in case of resolution' (point 7.b).

Preparation of the proposal

In its communication 'Towards the completion of the Banking Union', of 24 November 2015, the European Commission noted that the availability of adequate liabilities that can be bailed-in 'through the proper implementation of the minimum requirement for "own funds" and eligible liabilities (MREL) requirements will be crucial'. In addition, the TLAC requirement has been developed at international level by the Financial Stability Board. The Commission committed to bringing forward a legislative proposal in 2016 (the present proposal) so that TLAC can be implemented by the agreed deadline of 2019.

In the impact assessment accompanying its proposal, the Commission examined two scenarios: the '**no policy change**' scenario – which was abandoned, as it neither has a positive impact on the effectiveness of the bail-in tool, nor does it help banks to meet their TLAC target – and the **partial harmonisation** scenario. This scenario was itself divided into three sub-categories, i.e. the 'statutory subordination of all unsecured debt and retroactive application', the 'statutory preferred status for all deposits vis-à-vis senior debt' and, finally, the creation of a **non-preferred senior debt category** – which would provide sufficient flexibility to take account of different bank business models across the EU, and reduce over time the impact on bank funding costs. The latter was selected as the way forward.

The changes the proposal would bring

The proposal amends Article 108 of the BRRD, by partially harmonising the creditor hierarchy in case of bank insolvency, as regards the priority ranking of holders of bank senior unsecured debt eligible to meet the BRRD rules, and the TLAC standard on loss absorbency and recapitalisation capacity for banks, in particular the 'subordination' requirement. To reduce to a minimum credit institutions and investment firms' costs of compliance with the subordination requirement, as well as any negative impact on their funding costs, the new provision keeps the existing class of senior debt (which has the highest insolvency ranking among debt instruments and is less costly for credit institutions and investment firms to issue than any other subordinated liabilities). It creates a new asset class of 'non-preferred' senior debt that, by virtue of contractual terms, should only be bailed in in resolution after other capital instruments, but before other senior liabilities. Institutions remain free to issue debt in both classes. Only the 'non-preferred' senior class is eligible for the minimum TLAC requirement or any subordination requirement that could be imposed by resolution authorities on a case-by-case basis.

A paragraph would be added to the article, providing that Member States must ensure that, for all entities within the scope of the BRRD – apart from branches of institutions established outside the EU – unsecured claims from a new class of non-preferred senior debt instruments[4] come *after* unsecured claims resulting from debt instruments with the highest priority ranking in national insolvency law. In addition, Member States must ensure that unsecured claims from this new class come – in national insolvency proceedings – *before* claims resulting from Common Equity Tier 1 items, Additional Tier 1 instruments, Tier 2 instruments, or subordinated debt that is not AT1 or Tier2. Finally, the amendment provides that, those Member States which had adopted insolvency laws before end-2016, must ensure that those national laws apply for ordinary unsecured claims resulting from debt instruments issued by the aforementioned financial entities, prior to the date of application of the directive.

Advisory committees

At its 523rd plenary session, held on 22 and 23 February 2017, the EESC adopted an opinion on 'Banking reform – Creditor hierarchy in insolvency'. The EESC welcomes the fact that the proposal contributes to the robustness of the banking resolution mechanism and, at the same time, improves and may speed up its operational applicability. The EESC furthermore deems a harmonised approach for the ranking of unsecured debt instruments in insolvency proceedings important, in order to create a more level playing field between institutions and Member States, and to reduce risks in the financial sector.

National parliaments

The deadline for the submission of reasoned opinions on the grounds of subsidiarity passed on 8 March 2017. No reasoned opinion was adopted prior to that date.

Legislative process

On 12 October 2017, the **Parliament's** Committee on Economic and Monetary Affairs (ECON) adopted its report. It proposed to amend, among other things, the following points:

In Article 2(1), point (48), the definition of debt instruments would widen to encompass, in the case of the ranking of deposits in insolvency hierarchy (Article 108), 'bonds and other forms of transferrable debt and instruments creating or acknowledging a debt'.

In the main article amended (Article 108), Parliament would specify that covered deposits and deposit guarantee schemes would have the same priority ranking, which would be higher than the ranking provided for the claims of ordinary unsecured creditors, as well as the ranking of all other ordinary unsecured liabilities.

Still in Article 108, Parliament would amend paragraph 2, to specify that the debt instruments' original contractual maturity should be at least one year; that those debt instruments should neither be nor contain (embedded) derivatives; and that the relevant contractual documentation related to their issuance (and, where applicable, the prospectus), should explicitly refer to their lower ranking under normal insolvency proceedings.

Under paragraphs 4a-4c of the same article, the EBA would have to develop draft RTS to specify what constitutes embedded derivatives (4a). Then, two exceptions would be introduced to the Commission's 'grandfathering regime' (according to which, claims resulting from debt instruments issued prior to the entry into force of the directive are governed by national laws adopted up to 31 December 2016). The first exception would concern the case where a Member State had adopted national laws that already address the objectives of the directive.[5] The second would concern those having adopted, before this date, laws under which either those claims are split into two or more different priority rankings, or the priority ranking of those claims is changed in relation to all other claims of the same ranking.[6]

Lastly, new article 2a (Review) would oblige the Commission to review the application of Article 108(1) – in particular the need for any further amendments with regard to the ranking of deposits in insolvency – three years after the date of entry into force of the directive.

On 16 June 2017, the **Council** agreed its stance on the proposal. The Parliament and Council's positions largely converged.

Nonetheless, while Council also proposed that covered deposits and deposit guarantee schemes should have the same priority ranking, which is higher than the ranking provided for the claims of ordinary unsecured creditors, it did not go as far as Parliament, giving them also higher ranking than all other ordinary unsecured liabilities. Neither did it propose an amendment empowering the EBA to develop draft RTS. Lastly, the date of transposition was longer for the Council (12 months from the date of entry into force of the directive for the Parliament, 18 months for the Council).

Following trilogue negotiations, the two institutions reached a provisional agreement on 25 October 2017. The main amendments introduced to the proposal increase the original contractual maturity of the debt instruments to at least one year. They added the prospectus to the list of contractual documents that must explicitly refer to the lower ranking. To provide further legal certainty, they amended the Commission's 'grandfathering regime', keeping the two main exemptions to the Commission's regime as reflected above.

Finally, Article 2 (transposition) brings forward to 29 December 2018 the obligation of Member States to bring into force the laws necessary to comply with the directive, aligning it with the entry into force of the TLAC standard.

On 30 November 2017, Parliament adopted the text agreed in interinstitutional negotiations. On 8 December, Council adopted the act. The final act was published in the Official Journal of the European Union on 27 December 2017. Member States have to transpose its provisions into national law by 29 December 2018.

OTHER SOURCES

Link to Oeil to access all procedural documents:

Bank recovery and resolution: ranking of unsecured debt instruments in insolvency hierarchy, European Parliament, Legislative Observatory (OEIL).

ENDNOTES

1 Shareholders are the first in line to cover restructuring costs; then creditors contribute, with those with non-guaranteed deposits (i.e. over €100 000) stepping in last, so as to cover losses up to at least 8 % of the total liabilities including capital (or alternatively 20 % of risk weighted assets in specific situations) of the financial institution undergoing restructuring. Above this level, resolution funds can assume 5 % of the losses. Therefore, public funds would normally only be used after these losses are imposed.

2 Subordinated debt can be defined as 'a loan or security that ranks below other loans and securities with regard to claims on a company's assets or earnings'. In the case of loss absorption, they are written down before other liabilities.

3 For instance, in some Member States, entire categories of unsecured senior debt are considered subordinated to other senior liabilities whereas, in others, this consideration only applies to newly issued debt meeting specific criteria.

4 Instruments with initial contractual maturity of one year, with no derivative features and whose relevant contractual documentation related to the issuance explicitly refers to the ranking under normal insolvency proceedings.

5 If – between 31 December 2016 and the entry into force of the directive – a Member State had adopted national legislation governing the ranking in normal insolvency proceedings of unsecured claims resulting from debt instruments issued after the date of application of such national law, paragraph 4 would not apply to claims resulting from such debt instruments, under specific conditions (4b).

6 Those Member States which, prior to 31 December 2016, had adopted national legislation governing normal insolvency proceedings whereby unsecured claims resulting from debt instruments issued by entities were split into two or more different priority rankings, could provide that debt instruments with the lowest priority ranking among those ordinary unsecured claims have the same ranking as that of claims that meet the conditions of paragraphs 2 and 3 (4c).

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