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IN-DEPTH ANALYSIS

Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?

External author: Andrea Resti

Provided at the request of the Economic and Monetary Affairs Committee

March 2016
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Provided in advance of the public hearing
of the Chair of the Single Supervisory Mechanism
in ECON
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Abstract

This note provides a primer on subordinated bonds, covering a number of key concepts and definitions. The role of subordinated bonds as a source of bank regulatory capital ("Tier 2 capital") is also discussed. Empirical data are presented, showing that Tier 2 capital accounts for 16.2% of total regulatory capital (or 2.7 percentage points in terms of risk-weighted assets). Based on national statistics and anecdotal evidence, it can be inferred that a significant share of Tier 2 issues is held by retail investors.

We then look at how recent rules on bank bailout and resolution (including the Bank Recovery and Resolution Directive) have changed the risk attached to subordinated bonds and to other bank liabilities that rank senior to them. Key rules on the placement of subordinated bonds to retail clients are also briefly surveyed, highlighting how MiFID II will change the regulatory landscape since 2018, by imposing additional requirements on appropriateness, product governance and conflicts of interest, and by giving supervisors the power to impose extraordinary bans on unsuitable financial products.

In the last part of this note we argue that, rather than prohibiting the sale of subordinated debt to small investors, supervisors should tackle the risk originating from self-placement practices through a thorough and uniform implementation of MiFID (and MiFID II) provisions. Competent authorities may e.g. require banks to: i) set maximum concentration limits in their customers' portfolios; ii) develop adequate pricing procedures; iii) to ensure that remuneration schemes do not lead to improper selling practices.

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LIST OF ABBREVIATIONS

BRRD Bank Recovery and Resolution Directive
CoCos Contingent Convertibles
COREP Common Reporting Framework
CRD4 Directive 2013/36/EU (Capital Requirements Directive #4)
CRR Regulation (EU) No 575/2013 (Capital Requirements Regulation)
EBA European Banking Authority
EIOPA European Insurance and Occupational Pensions Authority
ESMA European Securities and Markets Authority
MiFID II Directive 2014/65/EU
MiFID Directive 2004/39/EC (Markets in Financial Instruments Directive)
MiFIR Regulation (EU) 600/2014
MREL Minimum Requirement of Eligible Liabilities
SREP Supervisory review and evaluation process
TLAC Total Loss Absorbing Capacity

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EXECUTIVE SUMMARY

Subordinated bonds are liabilities that, in case of default, will be repaid only after other debt (senior debt) has been settled in full. Subordination may be statutory (following from the law), contractual or structural (following from the issuer's group structure). Based on the Basel Accord on banking supervision, subordinated bonds (*Tier 2* capital) are eligible to meet a bank's minimum regulatory capital requirements up to 2% of its risk-weighted assets. As of June 2015, Tier 2 capital for the 30 large EU banking groups surveyed by EBA amounts to about €300 billion. On average, Tier 2 capital represents a significant source of regulatory capital (16.2% of the total) and contributes by 2.7 percentage points to total capital ratios. National statistics and anecdotal evidence suggest that retail investors hold a significant share of Tier 2 issues.

While subordinated bonds are riskier than senior ones, they also have advantages for banks and investors. First, they provide investors with an intermediate combination between ordinary shares and plain debt instruments. Symmetrically, they help banks diversify their sources of capital, becoming less dependent on the stock market. Finally, they may provide an incentive for market participants to actively monitor the risks faced by the issuing bank.

In July 2013, the European Commission has requested that subordinated debt be converted into equity or written down before State aid can be granted. The same is required, since 2015, by the Bank Recovery and Resolution Directive ("BRRD"). In addition, the BRRD allows for other forms of bank debt to be written down and/or converted into equity without the need to enter a formal liquidation (as part of the so-called "bail in" requirement). This means that even senior bonds may end up being statutorily subordinated to other liabilities that rank senior to them. While the BRRD did not change the status of subordinated debt (which is part of regulatory capital since 1988 and was always meant to absorb losses in the event of liquidation), it may have increased the risk faced by subordinated bondholders, by making it easier to resolve ailing banks and by constraining governmental support.

The placement of subordinated bonds to retail clients is currently regulated by MiFID, imposing requirements on banks and investment firms in terms of information to clients, suitability, appropriateness, and conflicts of interest. However, as most subordinated bonds are currently classified as non-complex financial instruments, no appropriateness test is required for sales initiated by the customer. In other cases when subordinated bonds are sold "without advice", customers who do not meet appropriateness criteria must be warned by the bank, but may decide to go ahead with their investment.

Under the MiFID II (2018), appropriateness tests will become compulsory for subordinated bonds. Additionally, banks and investment firms will face stricter "product governance" rules that may prevent self-placed products from reaching unfit retail customers. National authorities and ESMA will also be granted the power to prohibit marketing of a particular instrument if there is a significant investor protection concern that cannot be better addressed by enforcing existing rules. Finally, stronger requirements will be imposed on banks, to identify, prevent and manage conflicts of interest.

This note argues that, rather than prohibiting the sale of subordinated debt to small investors, supervisors should tackle risk originating from self-placement (including mispricing) through a thorough implementation of MiFID and MiFID II rules on conflicts of interest. National authorities may use such rules to require banks: *i)* to set maximum concentration limits in their customers' portfolios; *ii)* to develop adequate pricing procedures; *iii)* to ensure that remuneration schemes do not lead to improper selling practices. When necessary, further legislative provisions may be used to reinforce EBA's and ESMA's mandate to promote stronger supervisory convergence.

Additionally, uncertainties surrounding “bail in risk” should be minimised by providing a consistent implementation of BRRD rules across Europe (e.g. by using Regulatory Technical Standards to promote the use of uniform, transparent and predictable criteria). Finally, ways could be sought of incentivising the investors’ participation in regulated investment vehicles that specialise in bank subordinated and hybrid securities, in a way that provides individuals with the ability to liquidate small investments, achieves adequate diversification across issuers and ensures that trades occur at fair prices. That would increase institutional demand, to the benefit of smaller lenders for which stronger consumer protection practices may prove too complex to implement.

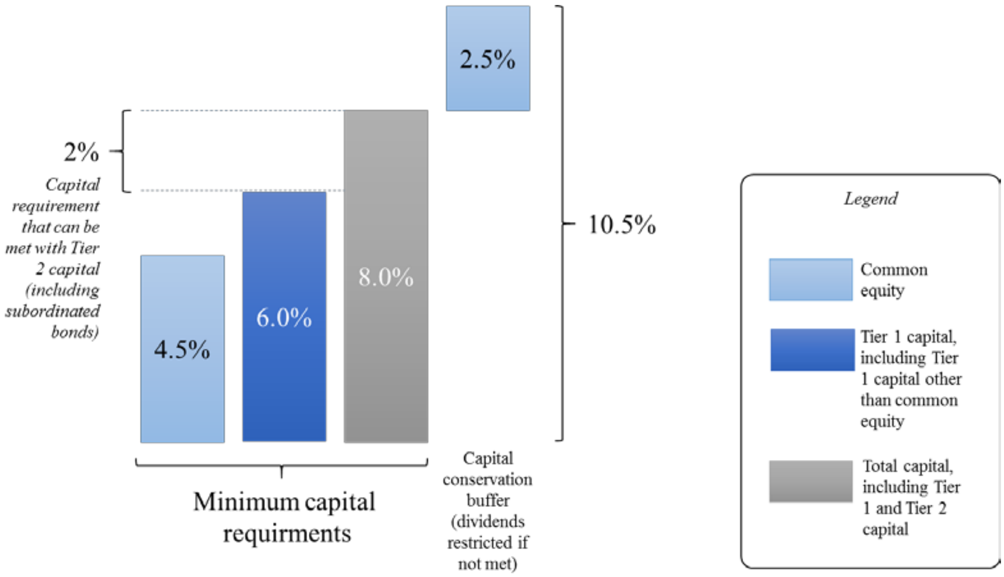
1. BANK SUBORDINATED BONDS: SOME KEY CONCEPTS AND DEFINITIONS[1]

A *subordinated (junior) debt* is a liability that, in case of default, will be repaid only after other debt (called *senior debt*) has been settled in full. In case senior debtholders are not entirely reimbursed, the subordinated claim is null and void.

There can be various degrees of subordination: accordingly, a certain issue, *I2*, may be senior to *I3* and subordinated to *I1*. Common equity can be seen as the most subordinated claim to a company's assets. At the opposite end of the spectrum, one finds *senior secured* exposures (like covered bonds) that get reimbursed first and are given priority over some specific pool of collateral.

Subordinated debt plays a special role in the rules on bank supervisory capital. In fact, since 1988, the so-called Basel Accords[2] allow banks to issue subordinated bonds to achieve their minimum total capital ratios (although most of the regulatory capital has to consist of common equity). Based on current rules, subordinated bonds (*Tier 2* capital) are eligible to meet a bank's minimum regulatory capital requirements up to 2% of its risk-weighted assets. *Tier 1* capital, consisting mostly of common equity, must instead account for at least 8.5% of the risk-weighted assets[3] (6% plus a 2.5% buffer that must be met to avoid constraints on dividend payments - see Figure 1).

Figure 1: Minimum capital requirements as a share of risk-weighted assets



[1] Although the views expressed in this report are only mine, I wish to gratefully acknowledge talks and e-mail exchanges with the following people and institutions: Alf Alviniussen, Emilios Avgouleas (Edinburgh Law School), Waleed El Amir (Unicredit), Andrea Enria (EBA), Adam Farkas (EBA), Santiago Fernandez De Lis Alonso (BBVA), Salvatore Gnoni (ESMA), Zdeněk Husták (Masaryk University), Arnold.Kuijpers (Rabobank), Louise Lindgren (Länsförsäkringar), David Llewellyn (Loughborough University), Giovanni Petrella (Catholic University, Milan), Mauro Senati (UBI Banca), Bruna Szegö (Bank of Italy), Diego Valiante (CEPS), Rudi VanderVennet (University of Gent), Guglielmo Zadra (Unicredit).

[2] The Basel Accords are international agreements drafted by the Basel Committee on Banking Supervision, a consultative body including bank supervisors from most advanced countries. Such agreements are subsequently cast into law by national competent authorities (in the EU, this is done through directives and regulations). The most significant Basel Accords are known as Basel I (1988), Basel II (2004) and Basel III (2010, revised in 2011). See (Basel Committee on Banking Supervision 2011; Basel Committee on Banking Supervision 2004; Basel Committee on Banking Supervision 1988). The Basel Accords are currently implemented in the EU through Directive 2013/36/EU (*Capital Requirements Directive n. 4*, or "CRD4") and Regulation (EU) No 575/2013 (*Capital Requirements Regulation*, or "CRR").

[3] Supervisors (including the Single Supervisory Mechanism and national competent authorities for opt-out Member States and less significant institutions) may impose further requirements to account for significant risks that are not comprehensively mapped in the Basel accords. The total capital requirement that follows from such additions is sometimes referred to as a bank's "SREP decision" (where SREP stands for "supervisory review and evaluation process").

Subordination may follow from general legal provisions (*statutory subordination*), from the clauses indicated on a bond's term sheet (*contractual subordination*) or from the legal structure of the issuer (*structural subordination*). Structural subordination refers to bonds issued by a parent company that does not directly hold the group's most valuable assets, but only has a controlling stake in one or more subsidiaries (so that the subsidiary's creditors get paid off first).

The "Banking Communication" issued by the European Commission on 30 July 2013[4] states that subordinated debt must be converted into equity or written down, in principle, before State aid can be granted. The same is required since 2015 by the Bank Recovery and Resolution Directive ("BRRD"), if this is sufficient to keep the bank viable. In addition (since 2015 or 2016, depending on national options), the BRRD allows other forms of bank debt to be written down and/or converted into equity without the need to enter a formal liquidation (as part of the so-called "bail in" requirement). This means that even senior bonds that are not contractually subordinated may end up being statutorily subordinated to other liabilities that rank senior to them (see §4 below).
Subordinated debt is sometimes referred to as *gone-concern capital*, meaning that, in order for it to absorb losses, a bank must enter liquidation or resolution. Common equity and contingent-convertible liabilities ("CoCos", hybrid securities that automatically convert into equity whenever a predefined trigger is met) are instead known as *going-concern capital*, since they can be written down while keeping the bank fully in business.

[4] "Communication from the Commission on the application, from 1 August 2013 , of State aid rules to support measures in favour of banks in the context of the financial crisis", Official Journal of the European Union, C216/1.

2. THE ECONOMIC RATIONALE BEHIND SUBORDINATED BONDS

While subordinated bonds certainly entail more risk than senior ones, they also perform several desirable functions for banks and investors (see Evanoff and Wall 2001 for a full discussion).

First, they provide investors with an intermediate combination (in terms of risk and return) between ordinary shares and plain debt instruments. This makes it possible, for institutional investors that would otherwise be prevented from investing in bank capital, to earn higher coupons than those paid out on senior bonds, while keeping downside risk at reasonable levels. Symmetrically, subordinated bonds help banks diversify their sources of capital, becoming less dependent on the stock market, and enabling them to access a wider audience of potential investors; incidentally, coupons paid on most subordinated bonds are booked by banks as interest payable, originating a tax shield that dividends, in most jurisdictions, do not provide.

Additionally, subordinated bonds may provide an incentive for market participants to actively monitor the risks faced by the issuing bank, as they anticipate a substantial loss rate in the event of a default. In this sense, although empirical tests of such a relationship have provided mixed results[5], most academic studies find that secondary market quotes for subordinated issues convey information about the issuer's default risk, complementing the analyses carried out by supervisors, equity analysts and credit rating agencies[6].

[5] See e.g. (Flannery and Sorescu 1996; Gorton and Santomero 1990; Sironi 2003).
[6] Further discussions of the pros and cons of subordinated debt can be found in (Ashcraft 2008; Blum 2002).

3. BANK SUBORDINATED BONDS IN THE EUROPEAN UNION

As shown above in Figure 1, subordinated bonds provide a source of regulatory capital for banks. This means that – if the issuance of such securities were to be limited by further regulatory constraints – banks may suffer from a capital shortage, and would need to turn to more expensive sources of regulatory capital, like ordinary shares[7] or CoCos.

The significance of subordinated bonds for European banks can be assessed – on a sample basis – by looking at the so-called "transparency exercise" data released by the European Banking Authority (EBA). This includes 104 banking groups from 20 Member States, totalling about €30 trillion assets and covering approximately two thirds of the EU banking system.

Although the survey does not include a specific item for subordinated bonds, it shows data for the so-called "Tier 2 capital instruments", consisting mostly of subordinated exposures[8]. The key figures are summarised in Figure 2.

Figure 2: Tier 2 capital instruments at large European banking groups as of 30 June 2015.

	Amount outstanding (€ bn)	*As a share of total regulatory capital*	*As a share of risk-weighted assets*
Austria	10.5	28.4%	4.5%
Belgium	3.7	9.8%	1.8%
Cyprus	0.0	0.3%	0.0%
Denmark	3.9	10.4%	2.0%
Finland	0.7	9.0%	1.8%
France	57.3	15.5%	2.5%
Germany	35.4	14.6%	2.5%
Hungary	0.7	18.5%	3.1%
Ireland	1.9	7.8%	1.5%
Italy	32.0	19.0%	2.8%
Latvia	0.1	39.2%	6.8%
Luxembourg	0.2	3.6%	0.7%
Malta	0.1	17.4%	2.4%
Netherlands	26.2	20.3%	3.9%
Poland	0.6	9.2%	1.3%
Portugal	1.7	10.4%	1.4%
Slovenia	0.0	0.0%	0.0%
Spain	23.5	10.8%	1.5%
Sweden	9.9	13.5%	3.2%
United Kingdom	86.5	20.5%	3.6%
Total	*294.7*	*16.3%*	*2.7%*

Source: European Banking Authority, Transparency Exercise.

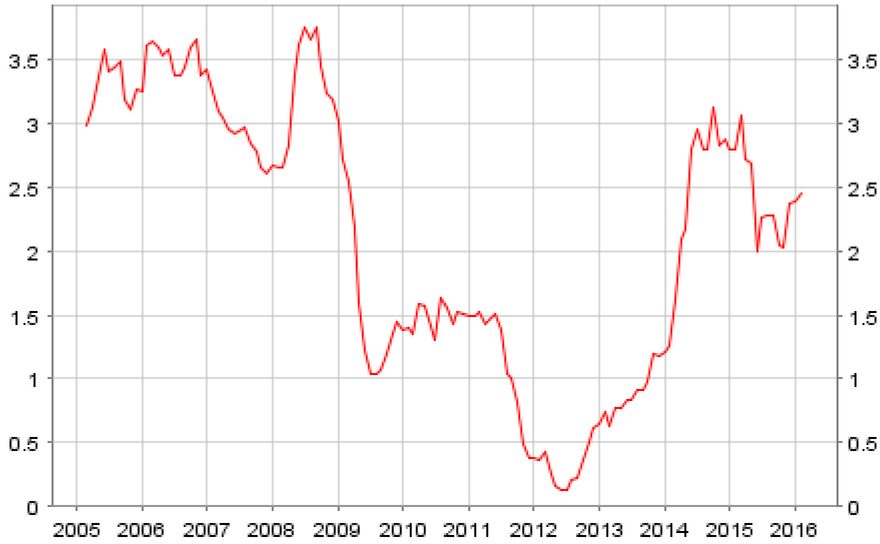
[7] Although ordinary shares do not entail any fixed payment, shareholders expect to earn dividends and capital gains on their investment. This "implicit cost", that banks must cover to prevent a fall in their stock price, is usually higher than the cost of debt, as shareholders face a higher risk than creditors, and is not tax-deductible (which further increases the actual gap with the rates paid on debt).

[8] In the EBA statistics, "Tier 2 Capital instruments (including grandfathered amounts)" includes data from lines 1.2.1 ("Capital instruments and subordinated loans eligible as T2 Capital", as defined in Articles 62 point (a), 63 to 65, 66 point (a), and 67 of the Capital Requirements Regulation), 1.2.2 ("Transitional adjustments due to grandfathered T2 Capital instruments and subordinated loans"), 1.2.3 ("Transitional adjustments due to grandfathered T2 Capital instruments and subordinated loans") and 1.2.4 ("Transitional adjustments due to additional recognition in T2 Capital of instruments issued by subsidiaries") of template CA1 ("Own funds") in the Common Reporting Framework ("COREP"). Accordingly, it includes "grandfathered" subordinated loans that were issued before the Basel III accord entered into force, and will still be accepted as regulatory capital until their expiration date.

Tier 2 capital for the surveyed banks amounts to about €300 billion; as the EBA data only cover large banking groups, the total amount for European Union lenders can be reasonably set at half a trillion euros[9]. On average, Tier 2 capital represents a significant source of regulatory capital (16.2%) and contributes by 2.7 points to total capital ratios.

After experiencing a severe drop following the 2007-2009 financial crisis and the widening of the Eurozone sovereign crisis in 2011, issuances of subordinated bonds have significantly increased since 2014 (see Figure 3), due to favourable market conditions and to the need to replace old subordinated issues that would no more qualify as Tier 2 under the Basel III Accord.

Figure 3: Banks' long term debt securities issuance (subordinated, unsecured).



Source: ESRB Risk Dashboard, ECB Statistical Data Warehouse, € billion.

Although no official data are publicly available[10], on a EU-wide basis, concerning holders of subordinated bonds, national statistics and anecdotal evidence suggest that retail investors play an important role in the market. This includes the following:

- as of October 2015, the Bank of Italy estimates that 46% of the total subordinated securities (€67.2 billion) issued by Italian banks is held by individuals and families;
- data released by CNMV (the Spanish financial markets' watchdog) indicate that €22.5 billion of preferred shares (hybrid securities that rank junior to subordinated bonds) had been sold by banks to retail investors, as of May 2011;
- according to Fitchratings[11], a credit rating agency, Portuguese retail investors had bought bonds for around €6 billion through Banco de Espirito Santo's (BES) branches; the bonds

[9] Tier 2 capital also includes minor items that are not linked to subordinated debt (e.g., loan-loss reserves held against future, unidentified losses). On the other hand, some subordinated bonds are not eligible (or are only partially eligible) as Tier 2 capital, such as bonds with a time to maturity of less than 5 years, or bonds temporarily repurchased by the issuer.

[10] Since 2012, he ECB has a legal mandate to collect information on securities holdings in the Eurozone. The project (called "Securities Holdings Statistics") includes data on individual securities held by each sector in each country (e.g., households in Germany). Based on data reported by (Amann et al. 2015), as of September 2014 Eurozone households and no-profit institutions held €526 billion in long-term bonds (both senior and subordinated) issued by deposit taking corporations (including banks) and money-market funds. To the best of our knowledge, no detailed data on subordinated bank bonds is currently disclosed. See (Rousová and Caloca 2015) for further details.

[11] (Fitchratings 2015).

were issued by other companies in the BES group, and therefore were structurally subordinated to the bank's senior debtholders;

- French banks have also been active in distributing subordinated bonds to retail customers. There is evidence of Crédit Agricole (CA) issuing about €3 billion and Groupe BPCE (Banques Populaires et Caisses d'Épargne) issuing €611 million in the course of 2015; another €600 million was sold by CA in the early months of 2016[12].

It should be emphasised that the sale of subordinated bonds through retail networks is common practice also at mid- and small-sized institutions, given their limited ability to tap the institutional market and to issue hybrid securities like CoCos.

The three ESAs (ESMA, EBA and EIOPA[13]) have issued a joint document in 2014 concerning self-placement practices and the related risks for retail investors[14], to remind industry participants of their legal obligations (see §5 below) and the potential issues involved. The document acknowledges that regulatory changes (including an increased emphasis on higher capital ratios following CRD4, Solvency 2 and various supervisory reviews, as well as new risks for senior unsecured bonds following from BRRD and TLAC[15]) may have put pressure onto financial institutions to sell hybrid, subordinated and other bail-inable securities to uniformed customers. This has led to breaches of existing regulatory obligations on conflict of interest, remuneration, information to clients, suitability and appropriateness[16].

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[12] Source: http://www.credit-agricole.com/en/Investor-and-shareholder/Debt/Issues-in-retail-networks2/Issues-Credit-Agricole-S.A; http://www.groupebpce.fr/en/Investors/Funding/Retail-bond-issues.

[13] European Insurance and Occupational Pensions Authority.

[14] (Joint Committee of European Supervisory Authorities 2014)

[15] See §4 below.

[16] A survey conducted by the ESAs through the national authorities of Member States has highlighted situations where retail investors: have received no, insufficient or misleading information about the issuing bank and/or the financial products; have been approached through aggressive selling techniques (e.g., giving the impression that a recommended product is as safe as a deposit, while it was not protected by a deposit guarantee scheme); have received unsuitable advice; have been sold inappropriate products during non-advised sales.

4. SUBORDINATED BONDS AND BAIL IN

Since 2015, most bank liabilities in Europe are subject to the risk of being "bailed in" (that is, converted into common equity and/or written off) in case the issuer undergoes resolution. The bail in of at least 8% of the bank's liability (including capital) is a prerequisite for tapping public support. For this reason, all banks which may be subjected to resolution have to comply with a "minimum requirement of eligible liabilities" (MREL), and must prove to their competent supervisor that they have enough bail-inable instruments in place at all times.

Similar to European bail-in rules, the Basel Committee on Banking Supervision has agreed that global systemically-important banks (approximately 30 institutions worldwide) must have a "total loss absorbing capacity", or TLAC (equity and other instruments that can be written off or converted into equity in the event of a resolution), of at least 16% of their risk-weighted assets.

Bail-inable bonds are not "earmarked" through *ad hoc* contractual arrangements; this means that even plain vanilla debt – including senior bonds sold to retail customers and large deposits not covered by guarantee schemes – may be subjected to a write-down ("statutory bail-in") if resolution kicks in. Such a scenario would entail heavy reputational damage for banks, and might jeopardise their ability to tap the market for retail funding at reasonable costs.

To avert such an outcome, many banks are currently considering to issue larger amounts of subordinated bonds (including so-called "Tier 3" bonds that are not eligible as regulatory capital), to serve as a "shock absorber" ("bail-in buffer") in the event of a resolution[17]. In fact, by ensuring that the MREL is adequately met at all times by equity capital and subordinated debt (and CoCos, when available), lenders may succeed to reassure investors who wish to buy bonds without facing the impending threat of a bail in. Such a stronger separation between instruments that are likely to be bailed in and relatively safer senior bonds would also be welcomed by rating agencies, as it would lead to "more clarity about capitalization and a more stable and efficient funding market" (Standard & Poor's 2012). To achieve this, it is important that the market for subordinated bonds continues to operate orderly, and is not disrupted by supervisory mishaps and/or by overly conservative customer protection rules.

It is worth noting that the entry into force of the BRRD did not change the status of subordinated debt. In fact, subordinated debt is part of regulatory capital since the Basel I Accord (1988) and was always meant to absorb losses in the event of a bank being liquidated. However, by making it easier to resolve ailing banks while keeping their core operations in business and minimising public support, the BRRD may have increased the actual risk faced by subordinated bondholders.

[17] See (Thomson 2015; Bowman 2016; Skeet 2015).

5. RELEVANT RULES ON INVESTOR PROTECTION AND MIS-SELLING

Rules on investor protection for subordinated bonds are going to be tightened under the new MiFID II/MiFIR framework, which is expected to enter into force by January 2018[18]. The remainder of this paragraph provides some insights on current rules and foreseeable changes (see Figure 4).

Figure 4: Investor protection rules on subordinated bonds under MiFID and MiFID II/MiFIR

<table>
<tr><th></th><th>MiFID</th><th>MiFID II / MiFIR</th></tr>
<tr><td rowspan="3">Conduct of business</td><td>No appropriateness test required when sold without advice at the customer's initiative.</td><td>Appropriateness test always required when sold without advice.</td></tr>
<tr><td colspan="2">Suitability test required when sold with investment advice or under discretionary management</td></tr>
<tr><td></td><td>Product governance rules to prevent marketing of self-manufactured instruments to unfit customers</td></tr>
<tr><td>Product bans</td><td>Limited powers granted to ESMA under exceptional circumstances when financial stability is at risk</td><td>Powers assigned to national competent authorities (and ESMA) when significant investor protection concerns cannot be addressed by existing regulation</td></tr>
<tr><td>Conflicts of interest</td><td>General duty to have in place arrangements that prevent conflicts. If these are not enough, then the conflicts must be disclosed to customers</td><td>Stronger emphasis on the prevention of conflicts, inclusing those arising from remuneration schemes. Disclosure as a «measure of last resort»</td></tr>
</table>

5.1. Key regulations already in force

The sale of financial instruments to retail clients is currently regulated by MiFID (Directive 2004/39/EC). Under MiFID, banks and investment firms must comply with conduct of business requirements when selling or advising on financial instruments (including those issued by themselves), e.g. requirements on information to clients, suitability, appropriateness, conflicts of interest.

As concerns the sale of financial products (when no investment advice is provided), MiFID envisages two different regimes, known as *appropriateness test* and *execution only*. Under the former, the bank or investment firm must ascertain that the customer's investment knowledge and experience is adequate to understand the risks involved; if this is not the case, a warning must be issued, but the customer may choose to go ahead with the investment. No appropriateness test is required instead under the "execution only" regime, when a customer independently initiates a transaction in *non-complex financial instruments*; according to Article 19.6 of MiFID, the latter comprise all bonds with no derivative components, including many subordinated bonds[19]. When

[18] On February 10 the European Commission has proposed that MiFID II/MiFIR be delayed by one year, from January 2017 to January 2018. Such a move, supported by ESMA and motivated by the complex technical arrangements that investment firms must put in place to allow for full implementation of the new rules, has still to be approved by the European Council and Parliament.
[19] In its Opinion 2014/146, the European Securities and Markets Authority (ESMA) has stated that subordinated bonds and other products where "capital protection may be withdrawn on the occurrence of certain events" should be

instead a customer receives investment advice or discretionary asset management services, MiFID requires a *suitability test*, where the bank or investment firm must collect information in order to reach an understanding of the investments that fit the customer's profile.

MiFID also requires that banks and investment firms have in place organizational arrangements to prevent conflicts of interests; when such arrangements are not enough, then the conflict of interest should be clearly disclosed to customers before a transaction takes place.

Subordinated bonds that are offered to the public or admitted to trading on a regulated market in a Member State are also subject to the Prospectus Directive[20], which requires the issuer to provide clear and comprehensive information on the characteristics and risks of the securities. ESMA has recently clarified[21] that prospectuses concerning bail-inable securities (including subordinated bonds) should mention the risk of conversion/write down in the "risk factors" section, whenever such risk is considered material.

5.2. Changes expected under MiFID II

Under the MiFID II/MiFIR[22] framework, the ESMA will be able to classify bail-inable securities as *complex financial instruments*[23], meaning that banks and investment firms shall carry out the appropriateness test before such bonds can be sold (without advice) to unsophisticated investors[24]. This will include subordinated bonds: in fact, ESMA has clarified that subordination constitutes an autonomous element of complexity[25]. Similar to MiIFD, however, customers may choose to go ahead with a transaction after being warned that it is not appropriate. However, under Article 24.2 of MiFID II, banks and investment firms that manufacture financial instruments for sale to clients will have to ensure that those securities meet the needs of their target market and are distributed accordingly; such "product governance" rules may help prevent self-placed products from reaching unfit retail customers.

Furthermore, under MiFIR, national authorities will be granted the power, subject to proportionality, to prohibit or restrict marketing of a particular instrument if there is a significant investor protection concern that cannot be better addressed by enforcing existing regulatory requirements. Similar powers will be assigned to ESMA[26] whenever national authorities fail to act; these product bans (either on a EU-wide basis or targeted at individual Member States) will expire after three months, unless explicitly renewed[27].

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considered as complex *products* and carefully monitored by national competent authorities, even though they do not qualify as complex *financial instruments* under MiFID.

[20] Directive 2003/71/EC and subsequent amendments.

[21] See ESMA/2015/1874, item 96.

[22] Directive 2014/65/EU; Regulation (EU) 600/2014.

[23] Like MIFID, MiFID II requires investment firms to request clients' knowledge and experience information in order to be able to assess their ability to understand "complex" financial products (Article 25.3). However, bonds are not always classified as non-complex products that may be sold under the "execution-only" regime (Article 25.4). Instead, Article 25.10 requires ESMA to develop guidelines for the assessment of products incorporating a structure that makes it difficult for the client to understand the risk involved. Such guidelines (ESMA/2015/1783) were released on November 26, 2015. As all guidelines issued by European Supervisory Authorities, they are aimed at competent authorities based on a "comply or explain" principle.

[24] See Guidelines on complex debt instruments and structured deposits - ESMA/2015/1783, Annex V, §13g and §16,; Annex IV, §73.

[25] See Guidelines on complex debt instruments and structured deposits - ESMA/2015/1783, Annex V, §13b; Annex IV, §78.

[26] EBA, in the case of structured bank deposits.

[27] The regulation estabilishing ESMA already provides for the power to ban or restrict products in limited cases when they threaten the functioning and integrity of the financial system.

As concerns conflicts of interest, Article 21 of MiFID II will request that such conflicts are not only identified, but also prevented and managed. Consistent with that provision, ESMA[28] has argued that the disclosure of conflicts to clients should be regarded as a solution of last resort, as banks and investment firms should instead focus on improving the effective management and avoidance of conflicts.

[28] See ESMA's technical advice to the European Commission on the delegated acts to be issued by the latter under MiFID II and MiFIR, issued on 19 December 2014 following a formal request from the Commission on 23 April (ESMA/2014/1569). The ESMA advice also includes some more tailored requirements in the context of placing of own instruments or instruments issued by other entities of the same group (self-placement).

6. MAIN WEAKNESSES AND POSSIBILE SOLUTIONS

As discussed above, banks wishing to sell subordinated bonds to retail customers may do so under MiFID without carrying out any appropriateness test; MiFID II will close that loophole, by clarifying that subordinated debt (and other bail-inable exposures) must be treated as complex financial instruments. Even so, there is a risk that increased information requirements may just translate into an additional box-ticking exercise (where customers receive information that they cannot fully digest and understand) and does not lead to higher risk awareness for retail investors.
To increase investor protection and prevent reputational damages for banks (which would ultimately translate into higher funding costs), it has been suggested[29] that the sale of subordinated bonds to small savers be outright banned, restricting those instruments to professional customers (e.g. high net worth individuals) and institutional investors.

While a legislative ban on subordinated debt may be unnecessary under the MiFID II/MiFIR regime (where national authorities will be empowered to issue *ad hoc* restrictions when required), it may even prove paradoxical, given that riskier securities, such as listed shares, would continue to be sold on an "execution only" basis[30].

By comparing subordinated bonds to listed shares, one sees that what may make the former unfit for retail customers is not their risk profile, but rather the fact that, unlike the latter:

1. they are customarily sold to retail customers by bank branches belonging to the same group of the issuer (*self-placed*); this may lead, *inter alia*, to customers investing a disproportionately high share of their portfolio into a small set of securities (leading to excessive concentration risk);
2. they may not be priced fairly when issued on the primary market (*mis-pricing*);
3. they may not be listed on a regulated market or multilateral trading facility; in case they are, the trading venue may provide limited liquidity, giving rise to the risk of wide, unexpected price swings (*illiquidity risk*);
4. unlike ordinary shares, where the future value of the investment only depends on the underlying business, subordinated bonds may be affected by supervisory decisions, concerning the way a bank will eventually be liquidated or resolved; this compounds business risk with an additional layer of *legal risk*.

Regulators and supervisors may want to look at ways to address these issues (ideally across all types of securities, including e.g. corporate bonds), rather than just prohibiting the sale of subordinated debt to small savers.

Risks originating from self-placement (including mispricing) could possibly be tackled through a thorough implementation of MiFID and MiFID II rules on conflicts of interest. The duty to have in place adequate processes to identify, prevent and manage conflicts (Article 23.1 of MiFID II) could e.g. be used by national authorities to require banks: *i)* to set maximum concentration limits in their customers' portfolios, and *ii)* to develop adequate pricing procedures (based on the credit spreads paid on the institutional market by the bank itself or by a peer group of comparable institutions, and including a premium for secondary market illiquidity); iii) to effectively ensure that remuneration schemes do not lead to improper selling practices. When necessary, such a process may benefit

[29] On 11 December 2015, the Bank of Italy's Senior Deputy Governor, Salvatore Rossi, said the central bank had called for a ban on the sale of subordinate bonds to private individuals (ANSA 2015). Since October 2014 the UK Financial Conduct Authority restricted banks and investment firms from distributing CoCos to retail investors, although this does not apply to Tier 2 subordinated bonds (Financial Conduct Authority 2014).

[30] Additionally one may argue that, even in a world where subordinated loans may not be sold to retail investors, the latter would still be exposed to a risk of statutory subordination on senior bonds (via MREL and bail in, see §4 above), if banks were to operate without an adequate cushion of equity and junior bonds.

from further legislative provisions aimed at reinforcing EBA's and ESMA's mandate to promote stronger supervisory convergence.

As concerns secondary market prices and liquidity, one could explore ways of requesting that subordinated bonds aimed at retail customers are exchanged on a trading venue, with market making obligations aimed at keeping bid/ask spreads at reasonable levels. Such quoting requirements, however, may involve significant costs, which could make subordinated loans unattractive for banks and/or investors.

Additionally, legal risk should be minimised by providing a consistent implementation of BRRD and TLAC rules across Europe. As concerns the former, level 2 texts (including Regulatory Technical Standards on the methodology used by resolution authorities to set MRELs for individual institutions) should be used to promote uniform, transparent and predictable criteria.

Finally, ways could be sought of incentivising the investors' participation in regulated investment vehicles that specialise in bank subordinated and hybrid securities, in a way that provides individuals with the ability to liquidate small investments, achieves adequate diversification across issuers and ensures that trades occur at fair prices. That would increase institutional demand, to the benefit of smaller lenders for which stronger consumer protection practices may prove too complex to implement.

At a minimum, sound information flows on subordinated bonds (and other bail-inable securities) should be provided to ESAs on a regular, pan-European basis, in order to improve transparency and facilitate supervisory reaction to market developments on the basis of sound empirical evidence[31].

[31] As part of such an effort, the participation of non-Eurozone countries to the SHS database mentioned in Footnote 10 should be encouraged, as well as its accessibility to supervisors, regulators and scholars.

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