Finance for Europe

Proposal to amend bank creditor hierarchy

15 March 2017

1 - Overview of Key Messages

1. Importance of an EU bank creditor hierarchy

The EU proposal to harmonise (partially) the creditor hierarchy is vital to enable banks to issue loss-absorbing debt in a timely fashion, which is necessary to support resolution planning and for banks to meet requirements.

Why the bank creditor hierarchy is key for bail-in and the economy

The hierarchy of creditors sets the order in which the liabilities of a bank absorb losses in case of its insolvency or resolution. The European Commission has proposed changes to increase harmonisation of the creditor hierarchy across the EU and introduce a new "non-preferred senior" class of liabilities which sits between capital and other senior debt. Quick agreement on this proposal is vital for several reasons:

- As the ECB has stated in its opinion on the Cmmission proposal: "harmonisation in this area is particularly important to safeguard financial stability as well as to foster effective and efficient resolution action, including the implementation of the bail-in tool … in a cross-border context and to reduce uncertainty for issuers and investors."
- A common approach across the EU is important to support the single market and enhance the development of the market for loss-absorbing instruments (still in its infancy in Europe) and help banks to build up expressly loss-absorbing debt.
- It also enhances legal certainty and workability of the bail-in tool.
- This in turn enhances the credibility of resolution strategies of banks, further minimizing the risk posed by banks' failure to financial stability. At the same time, a clear hierarchy enables banks to plan their funding and loss-absorbing capacity in a timely and cost-effective fashion, levelling the playing field with other jurisdictions and minimizing any potential negative impact on their ability to fund the real economy.

Why it is urgent to agree on the creditor hierarchy proposal

The EU Bank Recovery and Resolution Directive (BRRD) requires banks to meet a Minimum Requirement for Own Funds and Eligible Liabilities (MREL) set by resolution authorities. This requires banks to have sufficient loss absorbing liabilities as a key part of ensuring credible resolution plans without the need for taxpayer bailouts. Some EU Member States have amended national insolvency laws to make changes to the creditor hierarchy which has led to different approaches across the EU. Meanwhile, the Financial Stability Board established requirements for global systemically important banks (GSIBs) to hold a minimum amount of Total Loss Absorbing Capacity (TLAC) by 1 January 2019, to be formed by liabilities which (subject to limited exceptions) are subordinated to liabilities such as deposits and other operational liabilities.

It is now urgent to agree on the EU creditor hierarchy proposal in order to:

- Allow banks to timely plan and issue the proposed new class on senior non-preferred debt, necessary for G-SIB to meet TLAC requirement by 2019, and potentially for non-GSIB where required by Resolution Authorities to meet the MREL requirement.
- Promote clarity for investors, which would otherwise struggle to understand different EU legal systems, and encourage the development of market for loss-absorbing instruments.

2. AFME Recommen-dations

The reasons above show the urgency of putting in place a harmonised EU creditor hierarchy and avoiding any interim uncertainty

Finalise and transpose the EU proposal as soon as possible: For the above reasons, agreement by legislators (and national transposition) on the EU proposal is needed as a matter of urgency. A quick agreement should benefit all and support the important objectives already agreed in the EU (under BRRD) while accomodating existing national approaches.

Avoiding uncertainty of the interim period before the EU proposal applies:
Member States willing to anticipate the transposition of the EU proposal, before its agreement and entry into force, should be able to do so, provided that they commit to adjust their national transposition to the final EU text. This is important to avoid any legal vacuum for banks based in those Member States and establish a level playing field in the EU.

2 – More Detailed background and AFME Comments

BRRD requires banks to build loss-absorbing capacity…

Background to the proposal

The legal framework for the resolution of banks in the EU is based on the principle that shareholders and creditors should bear the burden of a banks' failure as opposed to tax-payers. To support this, the BRRD empowers Resolution Authorities (RAs) to set a Minimum Requirement for Own Funds and Eligible Liabilities (MREL) to be met by each bank in the EU, in order to ensure sufficient resources will be available to absorb losses and recapitalise a bank which is put into resolution (by writing down or converting into equity these liabilities, i.e. bail-in).

…but does not clarify the creditor hierarchy

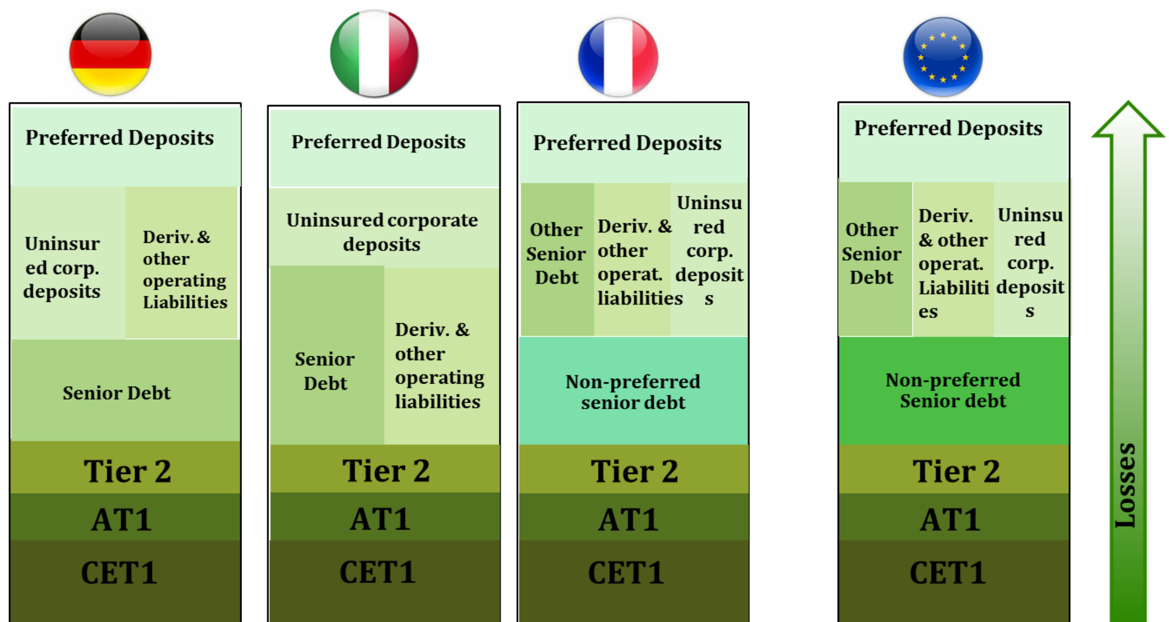
While the BRRD established a common priority ranking of certain insured and eligible deposits above other liabilities, the BRRD does not otherwise make changes to the existing creditor hierarchy, leaving this to national insolvency law.

Whereas the FSB require GSIBs to issue subordinated liabilities (TLAC)…

At global level, the Financial Stability Board (FSB) agreed on a minimum amount of Total Loss Absorbing Capacity (TLAC) to be held by global systemically important banks (GSIBs) by January 2019. The FSB prescribed that, to be eligible for TLAC, liabilities should, subject to limited exceptions, be subordinated to certain excluded liabilities e.g. deposits and other operational liabilities. The proposed amendments to the CRR implement TLAC in the EU.

With a view to clarify the ranking of liabilities eligible for MREL, meet the TLAC requirement and provide clarity for banks' issuances of loss absorbing capacity, some Member States in the EU have amended the creditor hierarchy for banks under national insolvency laws. This has led to a fragmented situation in the EU as shown below.

…and some EU MS put in place different creditors' hierarchies..



…Leading to a fragmented internal market for loss-absorbing debt

Having different legal regimes in different Member States is likely to hinder the development of a single market for loss-absorbing instruments which is unhelpful for the banks issuing these instruments as well as the potential investors in these instruments. This may also constitute a barrier to the development of a deep and liquid market in instruments which would meet MREL-TLAC, which is a market still underdeveloped in most Member States, as evidenced by the EBA[1]. Moreover, not all Member States have changed the ranking of loss-absorbing capacity in national insolvency legislation, with

[1] The EBA confirmed that "besides a few established capital markets, most domestic markets for MREL instruments are relatively small" (EBA Final Report on MREL, 14 December 2016, at p.27.

The EC proposal addresses all these challenges…

some Member States reportedly awaiting a possible harmonised European approach to adjust the national insolvency law accordingly.

…and accommodates existing national approaches

To tackle all the mentioned challenges (fragmentation of internal market, TLAC 2019 deadline for G-SIBs, need for clarity for banks and investors etc.), the Commission proposed in November 2016 to amend BRRD to establish a new class of "non-preferred" senior debt which should absorb losses in resolution after capital instruments but before senior liabilities (as in the chart above).

The Commission proposal also provides that outstanding liabilities should continue to be governed by national laws adopted by 31 December 2016 to accommodate existing national approaches.

AFME recommendations

AFME, and its pan-European membership of GSIBs as well as non-GSIBs, recommends:

I. **Reaching agreement on (and transposing) the EU proposal as soon as possible;**

II. **Avoiding uncertainty of the interim period before the EU proposal applies;**

A fast agreement should be reached on the proposal, to allow banks to issue the new loss-absorbing debt in a timely fashion…

I. Reaching agreement on (and transposing) the EU proposal as soon as possible;

A quick agreement on the Commission proposal is essential to enable banks to continue to increase their loss absorbing resources, improve their resolvability, ultimately enhancing the credibility and feasibility of their resolution plans and the protection against taxpayer bail-outs. These are key objectives agreed under BRRD, and supported by AFME, and the Commission proposal is an important step to achieve these objectives.

Quick agreement and transposition is essential to enable banks to issue the new class of debt. For GSIIs, this is essential to achieve their TLAC requirements by 1 January 2019. The introduction of the new senior non-preferred class could also be important for other banks where required to achieve their MREL. Any delay may impact banks' ability to meet these requirements in a timely and cost-effective manner.

… and to promote the formation of a much needed European market for loss-absorbing instruments

This proposal helps to ensure clarity and harmonisation across the single market: its swift entry into force and transposition are key to support the development of an effective market throughout the EU for explicitly loss-absorbing bank debt. It is important to note that there is not yet a well-developed market in Europe for this instruments [see footnote 1] and a significant volume of issuances of loss-absorbency instruments is expected: the EBA for instance estimated the need of an increase of 11% of the issuances of subordinated liabilities, to obtain around € 100 bn, and this is for by GSIBs only.

Agreement on a common creditor hierarchy as soon as possible is therefore required to facilitate this and to ensure that existing markets are not disrupted. A delay and lack of clarity for banks and investors could create significant market capacity concerns due to significant issuance in a compressed period of time.

II. Avoiding uncertainty of the interim period before the EU proposal applies;

MS willing to anticipate transposition of the EU proposal should be able to do so without creating a legal vacuum

The proposed cut-off date of 31 December 2016 is understood by AFME as a measure designed to accommodate existing national approaches, avoid any retroactive impact of the proposed partial harmonisation of the creditors hierarchy and to encourage rapid agreement of the new directive.

As mentioned, some Member States reportedly have been waiting for an proposal at European level before changing the national insolvency law, so to adjust the national approach accordingly. Therefore, the proposed directive should allow Member States wishing to do so to proceed with an 'anticipated transposition' of the EU proposal to allow banks based in those Member States to begin issuing liabilities in the new class of debt as soon as possible. To avoid any deviation, this early transposition for Member States should be allowed with the commitment of making any necessary adjustments once the final EU text is approved. This will ensure a level playing field across the EU, and not "keep on hold" Member States eager to clarify the creditors hierarchy (for all the reasons mentioned above). Otherwise, many banks will find themselves in a position of 'legal vacuum' between 31 December 2016 and the date of transposition of the directive, during which either issuance may be legally impossible, or will require complex legal 'work-arounds'.

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