Focus on Bank Risk: In Defence of Senior Unsecured Debt

Later this month the FSB should publish the finalized total loss-absorbing capacity (TLAC) term sheet for global systemically important banks (GSIBs). Later this year or early next year, details of the minimum requirement of own funds and eligible liabilities (MREL) for EU banks should also be made available by the respective resolution authorities. These regulatory wrap-ups are likely to provide more clarity regarding the capital structure of systemically important European banks (EU/EEA and Swiss) in resolution, which currently represents a key consideration for investors in bank debt, notably senior unsecured debt.

We believe that some market views which readily tag bank senior debt as "the new subordinated" are somewhat excessive; this report explains the rationale of our opinion. We see two angles to the TLAC/MREL issue: technical and fundamental. Currently investors seem to be focused primarily on the technical angle (where would TLAC/MREL-eligible senior debt sit in resolution), often overlooking the fundamental angle (what is realistically the likelihood that the bank will be placed in resolution). Our view is that the latter should weigh more in investment decisions regarding banks' senior unsecured debt, although clearly understanding the former is a definite necessity. Said otherwise, a sufficient number of lifeboats on deck will not convince anyone to board a ship of questionable seaworthiness.

Senior unsecured debt in resolution: the technical angle

Capital securities and subordinated debt. Based on regulatory communications so far regarding both TLAC and MREL, market participants expect that in resolution capital securities – additional Tier 1 (AT1) and Tier 2 (T2) – as well as other subordinated debt will come first in the bail-in pecking order (after equity). This would be the case also for banks not subject to resolution, and indeed non-payment of coupons or dividends on hybrid capital/subordinated debt did occur in the past. Even before the resolution regime had been put in place, state-aid rules in the EU (summer 2013) called for non-senior creditors to shoulder the loss burden before any state-aid injections helped the ailing bank. Investors in bank capital securities and subordinated debt should have little doubt that in resolution they would remain in the first echelon for the bail-in, the same way they would be exposed to losses ahead of the other creditors in the event of the bank being placed directly into insolvency proceedings.

Senior unsecured debt. The situation is less clear-cut for senior unsecured debt, which is eligible for both TLAC and MREL. In Europe there are no pre-resolution precedents. The fact that so far there is no single or at least coordinated approach to senior debt bail-in across EU jurisdictions – even in the euro area (EA) – spreads more uncertainty among investors. In general national authorities seem to be aiming at separating senior unsecured debt (which is normally subscribed to by professional institutional investors) from deposits – including non-preferred items (such as corporate deposits). This is because the latter, if converted into equity or written down (via bail-in), could plausibly prevent the bank in resolution from providing critical services (aside from the systemic risk that a likely deposit run would entail). Based on statutory subordination of senior debt, this is the case so far in Germany and probably Italy, and the likelihood is that other EU countries may take a similar route in the near future.

In countries where the large banking groups have a holding company structure – UK, Switzerland and some groups in Benelux countries – TLAC/MREL-eligible senior debt could be subject to what we could call operational subordination, as it is being or will be issued via the holding company rather than via the operating bank(s).

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The situation in France and other EU jurisdictions where banking groups operate without a holding company structure is less clear, which contributes to investor uncertainty. A group like BNP Paribas could of course state that its large amount of senior unsecured debt outstanding is eligible for TLAC/MREL, but this may affect the overall pricing of the entire liability class. We expect and hope for more meaningful clarification on the part of French policymakers in the months ahead with respect to the conditions of senior debt eligibility for bail-in in resolution.

To conclude on the technical angle, we believe that it is these uncertainties facing senior unsecured debt in resolution via bail-in which lead many investors and analysts to consider senior debt as «the new subordinated » and potentially treat it with heightened caution only because of the status in resolution. We question this view by turning now to the fundamental angle of the TLAC/MREL topic.

Senior unsecured debt in resolution: the fundamental angle

It is the overall fundamentals of a bank which should be the paramount criterion for investors in its senior debt

In our view it is the overall fundamentals of a bank which should be the paramount criterion for investors in its senior debt. Often, in the heated market debate and assumptions about where senior unsecured debt sits in resolution, the degree of comfort with a particular bank's credit fundamentals seems to be falling by the wayside. But at the end of the day if being placed in resolution remains a very remote probability for a bank with good fundamentals, exactly how senior debt were treated in that unlikely scenario, while definitely worth knowing, should in our opinion be only a secondary concern.

Regarding the 25 large European banks publicly rated by Scope (*please see rating table at the end*), we would see no bank for which resolution is more than a very remote scenario, even at the lower end of the rating range (A-/BBB+). There are of course in Europe numerous banks with weaker fundamentals than the ones we rate, but again in each case we believe that the «assess your bank» principle should apply. If investors are rightly concerned about a weakened bank's senior unsecured debt potentially being bailed in (as the market is currently assessing this likelihood for Greek banks), the same concern should not taint the investment view for a bank in decent-to-good credit shape -- as all institutions on our bank rating list are.

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A belief often connected with the new resolution regime is that before the crisis investors in large banks' paper were reassured by the « too big to fail » (TBTF) status. The reality, for those with pre-2007 memories, is that TBTF was an expression almost never utilized by policymakers or bank supervisors in developed markets (a US congressman used it more than 30 years ago in reference to Continental Illinois' rescue by the FDIC, and analysts and investors embraced it afterwards). Governments were of course forced in the past to support failing large banks in their countries to safeguard financial and economic stability, which in Europe happened on a relatively large scale during the major banking crisis of the late 1980s-early 1990s. But before the recent crisis no official we know of would have passed the message to investors that a large bank's financial deterioration would be offset by its TBTF status.

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In this context, the «assess your bank» principle should have applied before the crisis as much as it should apply now. To the same extent that the TBTF exit door should not have been an excuse for pre-2007 investors to ignore a large bank's financial health, the treatment of TLAC/MREL-eligible senior unsecured debt in resolution should not be a barrier for post-crisis investors to consider it safe as long as they are comfortable with the bank's fundamentals.

The proactive role of bank supervisors. Resolution is a very remote scenario for those banks in decent financial shape also because of the several layers of preventing it which are now embedded in the supervisory work. We should remember that the new regulatory

landscape for European banks consists not only of stronger prudential rules (on capital, leverage, liquidity and funding) and of the new resolution and recovery framework, but also, importantly, of a much-enhanced supervision process which is both more proactive and more risk-based when compared to the pre-crisis years. In passing, we note that stronger supervision is not always accepted by analysts and investors as a clear positive factor for banks' financial health.

We have to assume that any modern-day bank supervisory body will do its utmost to prevent a bank from sliding into a weakness situation which could lead to resolution

We have to assume that a modern-day bank supervisory body anywhere in Europe will do its utmost to prevent a bank from sliding into a situation of structural weakness which could lead to placing it in resolution. After all, a large bank in resolution would be a excessively costly and painful outcome for the financial stability of a country. Even if taxpayers will no longer be called to recapitalize the bank, a ripple effect on market sentiment and a likely wider panic affecting other banks can be envisioned.

Supervision process all through resolution

A. Normal supervision (competent authorities)

- **SREP** **Score:1-4; F**
  - Business model /strategy
  - Governance/controls
  - Capital (ICAAP)
  - Liquidity (ILAAP)
- **Stress Test**
- **Supervisory outcome (including Pillar 2 decision) through:**
  - Ad-hoc supervisory judgment
  - Supervisory colleges
  - Crisis management groups

B. Early intervention (competent authorities)

- **Based on:**
  - Low SREP score (3-4)
  - Material anomalies
  - Significant Events
- **Can represent PONV**

C. Resolution (resolution authorities and competent authorities)

- **Based on:**
  - Institutions failing or about to fail
  - No alternative (private sector or further supervisory action)
  - Public interest

Source: Scope Ratings

The table above illustrates our understanding of the several layers of supervisory prevention of a resolution scenario for a bank. First, we expect supervisors to gauge a worsening situation in a bank via the Supervisory Review and Evaluation Process (SREP). A deteriorating SREP score should undoubtedly lead to more vigorous supervisory action to try to revert the situation. In a more extreme case, if this action ends up being fruitless and the bank's condition continues to slide, early intervention by the competent authorities (supervisors) is likely, entailing forced management changes, closing risky business activities, preventing the bank from paying dividends, and other

steps. These could also include the non-payment of coupon on AT1 securities, or more extremely the conversion to equity or the writedown of capital securities (AT1 and T2) if the supervisors decide that the bank has reached its point of non-viability (PONV).

Placing a bank in resolution would probably be a far messier and painful process than elegantly passing the baton from competent to resolution authorities

In the unlikely case that all supervisory action and early intervention do not prevent the bank from reaching a « failing or about to fail » state, placing it in resolution, as we mentioned above, would probably be a far messier and difficult process than elegantly passing the baton from competent to resolution authorities (in the EA, from the ECB in Frankfurt to the Single Resolution Board in Brussels). A bail-in scenario is then likely, in which we expect all liabilities junior to senior unsecured debt to be converted first. Only if this additional step were still not enough would TLAC/MREL-eligible senior unsecured debt be bailed in.

To conclude, the outcome of a large bank in decent-to-strong financial shape having its senior unsecured debt bailed in is extremely improbable, which should give material reassurance to investors looking at this debt class.

Bank Ratings as of 4 November 2015						
Bank	**ICSR**	**Outlook**	**Short-term Rating**	**Short-term Rating Outlook**	**AT1**	**T2**
Banco Santander SA	A+	Stable	S-1	Stable	BBB-	
Barclays Bank PLC	A	Stable	S-1	Stable	BB *(Barclays Plc)*	BBB+
BBVA SA	A	Stable	S-1	Stable	BB+	
BNP Paribas SA	A+	Stable	S-1	Stable	BBB	
BPCE SA	A+	Stable	S-1	Stable		
Commerzbank AG	A-	Stable	S-1	Stable		
Credit Agricole Group	A	Positive	S-1	Stable	BB+ *(CASA)*	BBB+ *(CASA)*
Credit Mutuel SA	A	Stable	S-1	Stable		
Credit Suisse AG	A	Stable	S-1	Stable	BBB-, BB+ *(CS Group)*	A-, BBB *(CS Group)*
Danske Bank A/S	A-	Positive	S-1	Stable	BB	
Deutsche Bank AG	A-	Stable	S-1	Stable	BB	
DNB Bank ASA	A+	Stable	S-1	Stable	BBB-	
HSBC Holdings PLC	AA-	Stable	S-1+	Stable	BBB	
ING Bank NV	A	Positive	S-1	Stable		
Intesa Sanpaolo SPA	A-	Stable	S-2	Stable		
KBC Group NV	A-[1]	--	S-1	Stable	BB+	BBB *(KBC Bank NV)*
Lloyds Bank PLC	A	Stable	S-1	Stable	BB+ *(Lloyds Banking Group Plc)*	
Nordea Bank AB	A+	Stable	S-1	Stable	BBB-	
Rabobank Group	A+	Stable	S-1	Stable		
Royal Bank of Scotland PLC[2]	BBB+	Stable	S-2	Stable		
Societe Generale SA	A	Stable	S-1	Stable	BBB-	
Svenska Handelsbanken AB	A	Stable	S-1	Stable		
Swedbank AB	A-	Stable	S-1	Stable	BB	
UBS AG	A	Stable	S-1	Stable	BBB- *(UBS Group)*	A-
Unicredit SPA	BBB+	Stable	S-2	Stable		

[1] Under review for possible upgrade

[2] Ratings benefit from a one-notch rating uplift due to the UK government's majority ownership

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