Q&A for the Thoughtful Bank Investor

The ECB Recommends General Depositor Protection Across the EU: A Valuable Proposition

Last week the ECB made public its opinion on the European Commission's (EC) November 2016 proposal to amend the Bank Resolution and Recovery Directive (BRRD) regarding the ranking of unsecured debt instruments in insolvency and resolution hierarchy. This opinion has been provided at the request of the EU Council and the European Parliament.

In the opinion document, the ECB welcomes the EC's proposed amendments to BRRD and makes some additional recommendations aiming for more clarity and consistency. We view positively the ECB's recommendations, the most notable of which is the introduction of a general depositor preference across the EU – which we believe would give more credibility and predictability to the bail-in of senior unsecured debt in resolution. Another aspect worth highlighting is the ECB's attempt to promote more consistency across banks' entire capital structure, thus aiming to complement the harmonisation goals of the EC-proposed amendment to BRRD.

This brief Q&A report summarises and comments on the recommendations advanced by the ECB.

Q: What is the background behind the ECB's 8 March 2017 opinion?

On 23 November 2016, the EC published a proposal to amend Article 108 of the BRRD with respect to the ranking of EU banks' unsecured debt in insolvency or resolution. Specifically, the proposal states that it "keeps the existing class of senior unsecured debt while it creates a new asset class of 'non-preferred' senior debt that should be bailed-in in resolution after other capital instruments, but before other senior liabilities".

We expect this proposal to be adopted this year by the European Parliament and the EU Council, and subsequently to be integrated in EU/EEA member states' BRRD regulations.

Q: What are the ECB's recommended amendments to the EC proposal?

In brief, they are: (i) the possibility of bailing in 'non-preferred' senior debt (NPS) with maturities of less than one year; (ii) a clarification that NPS ranks *pari passu* with senior unsecured debt already subject to statutory subordination in insolvency/resolution; (iii) an introduction of a general depositor preference based on a tiered approach across the EU; and (iv) the requirement that, across all EU jurisdictions, national insolvency regimes be aligned in such a way that Tier 2 instruments rank below other subordinated liabilities.

Q: Why is the bail-in of short-term NPS of importance?

According to BRRD, it is only unsecured liabilities with a maturity of over one year that are eligible for bail-in in resolution. The ECB proposes that EU banks be allowed to issue NPS with initial maturities of less than one year. Such instruments, as well as long-term NPS with residual maturities of less than one year, be bail-in-able in resolution even though they would not be eligible for MREL/TLAC. The purpose of this proposal is to increase the institution's loss-absorbing capacity.

We also view this proposal positively as it enables banks to potentially fine-tune funding and provides ALM flexibility, especially in a scenario of upward-sloping yield curves. Said otherwise, increased financial flexibility (e.g., with respect to maturities) does not have to occur at the expense of increased loss-absorption capacity.

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Q: What is the significance of NPS ranking *pari passu* with senior unsecured debt already subject to statutory subordination (in insolvency or resolution)?

The EC proposal to amend Article 108 of BRRD with respect to the ranking of senior unsecured debt in insolvency or resolution was published last November with the aim of harmonising the approach to MREL/TLAC eligibility of senior debt across the EU. However, before that, a few EU countries had already initiated their own steps in this respect. For example, Germany adopted the general subordination law for bank senior unsecured debt in insolvency (and by implication in resolution) – effective as of the beginning of this year. For such a situation, the ECB's opinion is that future NPS should not undergo further (lower) differentiation in the hierarchy of creditor claims in relation to senior unsecured debt already subject to statutory subordination.

We view positively this recommended amendment. If adopted, it should remove a cloud of uncertainty with respect to the relative risk (and its impact on pricing) attached to the creditor hierarchy in resolution which may now exist for some investors.

Q: Why is a general depositor preference significant for the credibility and predictability of bail-in in resolution?

A general depositor preference means that all depositors of a bank have a higher priority among unsecured claims in the bank's insolvency. They include corporate deposits, thus not only covered depositors (balances up to EUR 100,000, covered by a Deposit Guarantee Scheme) and 'preferred' depositors (balances higher than EUR 100,000 of individuals and small- and medium-sized enterprises). A general depositor preference does not exist in the current version of BRRD, nor is it part of the EC amendment proposal. The ECB rightly points out that a general depositor preference, embedded in EU member states' national legislations, would strengthen the credibility and predictability of bail-in in resolution. Indeed, resolution authorities would be able to bail in a bank's senior unsecured debt – even that which is not part of MREL and/or TLAC – before touching any deposit category – again, including 'non-preferred' deposits. This would minimise the risk of compensation claims under the 'no creditor worse off' principle, and in general is likely to carry a lower contagion risk than deposits would.

Specifically, the ECB is recommending a general depositor preference based on a tiered approach, via the introduction of a third priority ranking in Article 108 of BRRD for other deposits, such as large corporate deposits, deposits by credit institutions, funds, etc. This category would rank below the higher priority ranking for covered and 'preferred' deposits, but ahead of other senior liabilities – notably senior unsecured debt (not eligible for MREL/TLAC).

If implemented as recommended by the ECB, a general depositor preference in a revised BRRD would create a level playing field across the EU, similar with depositor-protection legislation already existing in euro area jurisdictions (Italy, Greece, Slovenia), as well as other countries beyond Europe, such as Australia, Canada and the US.

The importance of the ECB's recommendation for a general depositor preference cannot be overemphasised, in our view. As noted it adds clarity and predictability to the bail-in process in resolution. We note that many institutional investors and other market participants have expressed a dose of scepticism with respect to the proper functioning of the bail-in mechanism in resolution (several rating agencies continue to notch up bank ratings on account of expected state bailouts), among other things because of the doubt that depositors would actually be bailed in. Separating senior unsecured debt (a non-risk-free asset class sought by professional institutional investors) from deposits – including 'non-preferred' deposits (operational liabilities enabling corporate and institutional clients of the bank to carry out their activities) – inherently provides more credibility to the bail-in process, if needed beyond MREL/TLAC. Any political pressure to avoid the bail-in of depositors would not exist, or at least would exist to a much lesser degree, if only institutional investors in the bank's senior debt were affected, on the premise that these investors are professionals paid to take credit risk rather than being bank clients.

Q: Treating Tier 2 instruments differently from non-Tier 2 subordinated debt in insolvency/resolution: is it that relevant?

The ECB notes that, while some national insolvency regimes rightly differentiate between Tier 2 instruments and other subordinated liabilities, others do not. Its recommendation is to align insolvency regimes across EU jurisdictions with respect to these securities. The opinion rightly points out that Additional Tier 1 and Tier 2 securities are to be bailed in prior to non-Tier 2 subordinated debt.

Again, we believe that more clarity with respect to this differentiation would be positive. More transparency for investors in such instruments is always welcome, and in fact it could spur market interest for the issuance by banks of subordinated debt outside the Tier 2 bucket – once that bucket had been filled. Such debt would rank junior to NPS in insolvency/resolution – being positioned in-between NPS and Tier 2 – and as such, if more material in outstanding volume, it could represent a safety cushion protecting all senior unsecured creditors, including NPS investors.

Q: What are the consequences of the EC proposal and the ECB opinion for Scope's EU bank ratings?

Scope's bank rating methodology – last updated in May 2016 – has already addressed in a forward-looking manner the forthcoming creditor hierarchy adjustments being developed by regulators. Our methodology calls for NPS and similar securities – such as senior unsecured debt with statutory subordination (in Germany) – to be rated one notch below the bank's Issuer Credit-Strength Rating (ICSR) and, if applicable, the ratings of senior debt not eligible for MREL/TLAC. At the same time, a bank's non-Tier 2 subordinated debt would be rated one notch below the rating of MREL/TLAC-eligible senior unsecured debt.

In 2016, after the publication of our methodology update, we proceeded to upgrade by one notch the ICSRs of banks in the United Kingdom and Belgium (and, outside of the EU/EEA, in Switzerland), to address the MREL and/or TLAC eligibility vs non-eligibility of senior debt. We also upgraded the ICSRs of rated German banks by one notch above the ratings of their senior debt which from early 2017 are subject to statutory subordination in insolvency/resolution. In December 2016, we also initiated ratings on the newly issued NPS of some French banks, while upgrading by one notch the ICSRs and the non-MREL/TLAC-eligible senior debt ratings of all French banks rated by Scope.

In early 2017, we continued the process by upgrading by one notch the ICSRs of the remaining EU/EEA rated banks (in Denmark, Italy, Netherlands, Norway, Spain, and Sweden).

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