Q&A for the Thoughtful Bank Investor

Non-Preferred Senior Debt Is Not Equidistant from Preferred Senior and Tier 2

The introduction of the new class of MREL/TLAC-eligible senior unsecured debt issued by EU banks has been generating heightened interest from investors, but also triggering questions and uncertainties – for example the positioning of non-preferred senior debt in-between preferred senior and Tier 2. This brief Q&A report tries to address some of these uncertainties.

Q: Against the backdrop of resolution and bail-in, is there a simpler way to look at European banks' senior unsecured debt?

Not too many years ago, in what now looks like a different era, banks' capital structure was fairly simple: senior debt was above subordinated debt, itself above capital. And investors pretty much knew where they were standing in terms of risk taken. Resolution and bail-in, while trying to clarify the end road for large failing banks and making it more remote from a taxpayer bailout, seem to have muddied some waters with respect to what risks investors are incurring. These days, senior unsecured debt is still unsecured, but the seniority is less straightforward. There are now two tiers of seniority – generically called preferred and non-preferred in relation to their bail-in characteristics.

Under the Bank Resolution and Recovery Directive (BRRD), which is now part of the regulatory framework across the EU, in theory all long-term unsecured liabilities of a bank can be eligible for bail-in – implausibly going all the way to include non-covered deposits. However, only a specific class of senior unsecured debt can be eligible to be included in MREL and/or TLAC – which are the first port of bail-in call when a bank is placed into resolution.

This class can take different names: (i) non-preferred senior – as is now the case with French banks; (ii) senior debt with statutory subordination (in insolvency /resolution) – as is the case with German banks; (iii) senior debt with contractual subordination (in insolvency/resolution) – as is the case with banks in other EU jurisdictions in which regulatory and legal clarifications in this area are not yet finalized (e.g. Spain); and finally (iv) senior debt issued at the level of the holding company (HC), in the case of banking groups with a HC structure – UK, some in Benelux, and Switzerland (outside the EU)

It is nonetheless important to remember that, whatever their name or issuance entity (holding company or operating bank), all these categories of MREL/TLAC-eligible senior debt ceteris paribus define the same risk for investors. If and when the European Commission's proposal to amend Article 108 of BRRD will be approved by the European Parliament and EU Council (hopefully sometime this summer), this debt class may be called generically non-preferred senior (replicating the French model). Also, once this regulatory clarification occurs (some call it BRRD II), it will open wide the gate for issuance of NPS debt by many more EU banks which need to build MREL/TLAC cushions in the next few years.

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Q: Given its ranking, is non-preferred senior debt equidistant from preferred senior and from Tier 2?

Not really. One should remember that, as long as the bank is not in resolution, there should be no daylight between preferred and non-preferred senior: both debt classes are senior. The only difference in seniority ranking emerges when the respective bank is placed in resolution. And being placed in resolution is likely to be a highly extreme scenario for a large European bank (*see the next question)*.

On the other hand, Tier 2 securities sit just above Additional Tier 1 (AT1) in terms of seniority ranking, as part of a bank's total capital base. While relatively less risky than AT1 (e.g. coupon payments are more predictable), Tier 2 nevertheless can be converted to equity or written down at the request of bank supervisors before the failing bank is placed in resolution -- for example once it reaches what the supervisors may consider a point of non-viability (PONV).

In other words, there is a plausible scenario of Tier 2 investors being either written off or being forcefully converted into equity investors – at a point in time when the value of the respective bank's equity would be intensely unattractive – while non-preferred senior investors would continue to experience no hick-ups, in sync with the preferred senior investors.

And even in the unlikely scenario of the respective distressed bank being placed in resolution, it is Tier 2 which would be first bailed in (evidently after AT1), assuming a bail-in operation were necessary. It is only if the bail-in of capital securities were to be insufficient to recapitalize the bank in resolution that non-preferred senior debt would be summoned for bail-in.

Consequently, one should conclude that, indeed, non-preferred senior debt is not equidistant from preferred senior and from Tier 2, being closer in risk characteristics to the former and much less so to the latter. The risk pricing for these securities should therefore reflect this reality in our view, taking into account the fundamentals of these bank debt products.

Q: Why is resolution a highly extreme scenario for a large European bank?

As much as the placing in resolution of a large EU bank (thus for which insolvency would not be in the public interest) is fully codified by current regulations (e.g. BRRD), this represents in our view a highly extreme scenario. To date it has not happened, even with banks in material distress. First, the supervisory authorities will plausibly do everything in their powers – which happen to be very substantial – to avoid swinging a distressed bank into resolution. For example, the ECB, as pan-euro area supervisor for the large banks, might be reluctant to 'pass the baton' to the Brussels-based Single Resolution Board, justifiably fearing that politicians and segments of the public opinion could see such a step as proof of its inability to handle a critical situation on its own. To prevent a distressed bank from being placed into resolution, supervisory authorities have at their disposal a panoply of more severe steps under the early intervention mechanism (EIM). At a more extreme end, EIM can result in the forced equity conversion or write-down of capital securities (AT1 and Tier 2). Again, this move could push to the recapitalization of the bank before the resolution scenario is activated.

Second, national politics could also play a role in preventing a large bank going into resolution, especially if the fear existed that depositors (including domestic businesses) could be impacted. The finer details of the bail-in sequence – debt investors are bailed in first, depositors much later, if at all – could well be lost in the political argumentation around such a traumatic development.

Q: How are Scope's bank ratings reflecting the ranking of non-preferred senior?

Our bank rating methodology (last updated this week) has already addressed in a forward-looking manner the adjusted creditor hierarchy. MREL/TLAC-eligible non-preferred senior debt and similar securities (see first question above) are now rated one notch below the bank's Issuer Rating and, when applicable, the ratings of preferred senior debt (e.g. not eligible for MREL/TLAC). At the same time, a bank's Tier 2 securities are rated two notches below the rating of MREL/TLAC-eligible senior debt.

Specific for EU/EEA or Swiss banking groups with a HC structure, senior debt issued by the HC is rated one notch below the senior debt issued by the operating bank not because the HC (and not the operating bank) is the issuer, but because of the former's TLAC/MREL eligibility, vs. the latter's non-eligibility. Indeed, for European banks our rating assessment considers the fundamentals of the entire banking group, rather than solely of the group's operating bank(s) vs. the HC as would be the case for US banking groups.

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