HM Treasury

Draft Banks and Building Societies (Priorities on Insolvency) Order 2018: response to the consultation

November 2018

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Chapter 1
Introduction

1.1 In September 2018, HM Treasury published a consultation document, 'Technical consultation on the draft Banks and Building Societies (Priorities on Insolvency) Order 2018'.

1.2 The consultation document set out the government's proposed approach to implementing the EU Bank Creditor Hierarchy Directive ("the directive") into UK law.

1.3 The consultation ran from 12 September 2018 to 10 October 2018, during which time the government received ten written responses from industry (see Annex A for a list of the respondents). This document briefly outlines the government's approach to implementation of the directive, before summarising the responses received from the consultation and providing an update on the forthcoming legislation.

The EU Bank Creditor Hierarchy Directive

1.4 In November 2016, the European Commission proposed a package of reforms to strengthen the resilience of EU Banks.

1.5 Although this package is still subject to negotiations between the EU Council and the European Parliament, the directive was fast tracked and agreed by the EU Council and European Parliament on 12 December 2017. It came into force on 28 December 2017 and has a transposition deadline for member states of 29 December 2018.

1.6 The directive amends the creditor hierarchy in article 108 of the Bank Recovery and Resolution Directive (BRRD) requiring member states to create a new class of non-preferred senior debt in their creditor hierarchy. The creditor hierarchy dictates the order in which assets are distributed to creditors in case of an insolvency or resolution. Creditors in the new class will only be entitled to receive proceeds from any remaining assets once other creditors with a higher priority have been paid off in full.

1.7 The directive enables financial firms to issue a new class of instrument to meet their minimum requirement for own funds and eligible liabilities (MREL). MREL comprises the firm's regulatory capital and debt instruments that meet certain eligibility criteria, and is the loss absorbing capacity that EU banks are required to hold to bear losses in resolution. The purpose of MREL is to help ensure that if firms fail, the resolution authority can use these financial resources to absorb losses and recapitalise the continuing business. As a result, MREL is a critical element of an effective resolution strategy.

1.8 The primary motivation for fast tracking the directive was to introduce a harmonised approach across the EU to the availability of statutory subordination, which is one of the subordination methods provided for in the Total Loss-Absorbing Capacity (TLAC) standard. Subordination of MREL resources reduces the risk of breaches of the no creditor worse off (NCWO) safeguard in the event of a bail-in. The directive reflects the importance of clarity for creditors of their position in the hierarchy.

General approach to implementing the directive

1.9 The government proposes to make amendments to the 1986 Insolvency Act (alongside other insolvency proceedings, including modifications made by the Banking Act 2009) as was done when the government transposed the original article 108 of the BRRD.

1.10 The government's proposed approach is to create a new section 176AZA (non-preferential debts of financial institutions) in the Insolvency Act 1986. Non-preferential debt was not previously split into classes, so it is proposed that the new section 176AZA creates three new classes. The first is a class of ordinary non-preferential debt which corresponds to the non-preferential debt in the current regime. The second is secondary non-preferential debt, the new class required by the directive, which ranks below ordinary non-preferential debt as required by the updated Article 108(2) in the directive. This proposal ensures that the two new classes are both ranked under preferential debt and that ordinary non-preferential debt is ranked above secondary non-preferential debt. Finally, in accordance with Article 108(3), section 176AZA makes clear that the new class ranks ahead of CET1, additional Tier 1 and Tier 2 instruments and subordinated debt (tertiary non-preferential debt).

1.11 Further details of the government's proposed approach are set out in the consultation document.

1.12 It is intended that the draft regulations will be made under the powers in the European Communities Act 1972.

Chapter 2

Summary of responses

2.1 The government received ten written responses to the consultation. The consultation asked nine questions, the responses to which are summarised below.

Question 1: Do you agree with the general approach outlined above?

2.2 Respondents broadly agreed with the general approach to implementation outlined in section 3.2 of the consultation paper.

2.3 Several building society respondents specifically welcomed the option to issue MREL eligible debt by means of statutory subordination, which they believe will reduce their costs of complying with MREL policy.

2.4 In response to the government's request for views on the decision to use the terms "secondary non-preferential debt" and "ordinary non-preferential debt" within the Order, several respondents explicitly stated that they were content with this approach. One respondent raised concerns that the use of this terminology could cause confusion given that a market standard has already developed around the terms "senior preferred" and "senior non-preferred" debt, and suggested that the government provides further clarification.

2.5 The purpose of using this terminology is to maintain consistency with the 1986 Insolvency Act (which does not use the concepts of "senior" and "junior" debt) as well as with the text of the directive. As both "senior non-preferred" and "secondary non-preferential" both abbreviate to SNP, the government does not think that the continued use of both terms to refer to the new class of debt should pose a problem.

2.6 The government is pleased with the broadly positive response from industry on the general approach that is being taken to implement this directive.

2.7 Some respondents made technical comments on the draft Order that was published alongside the consultation. This included a suggestion that the status of dividends that are declared but unpaid within the creditor hierarchy was ambiguous and could result in legal challenges and delays in liquidation. The respondent noted that the reference to "debts under Common Equity Tier 1 instruments" as a class of tertiary non-preferential debts (proposed by article 11 of the Order), might capture unpaid dividends. The respondent suggested that these should be treated as ordinary non-preferential debts, and proposed a revision to Section 387A(3)(c)(i) of the Insolvency Act 1986 to explicitly exclude unpaid dividends from "debts under Common Equity Tier 1 instruments".

2.8 This proposal has not been incorporated, as the government views that Section 74 of the Insolvency Act 1986 already clearly outlines the status of unpaid dividends.

2.9 As unpaid dividends rank below the company's obligations to general creditors, the government does not view their status within the creditor hierarchy as ambiguous and it is therefore acceptable for unpaid dividends to be captured under tertiary non-preferential debts.

2.10 A further technical comment raised concerns about the use of the words "any prospectus" in Article 387A(3)(b)(iii) of the Insolvency Act 1986. The respondent suggested that as different debt securities, some of which may be subordinated and others unsubordinated, are often issued within the same issuance programme and prospectus, references to subordination in a prospectus may not always be relevant to all issuances in the programme and prospectus. In addition, the broad use of "prospectus" could be understood to include other marketing materials, term sheets and listing particulars. The respondent suggested that such ambiguity might lead to delays and unnecessary litigation and proposed an amendment which reduced the scope of the term prospectus.

2.11 This suggested amendment has not been incorporated as the government does not believe that it was the intention of the EU directive to refer only to prospectuses as defined by the 2003 EU Prospectus Directive. To the extent that there is any ambiguity, the government is taking the opportunity to more closely follow the wording of the original directive text, with "<u>any prospectus</u> related to the issue" amended to "<u>where applicable the</u> prospectus related to the issue".

Question 2: Do you agree with the placement in the creditor hierarchy of this class of "secondary non-preferential debt" in accordance with section 176AZA of the Insolvency Act 1986 (as mirrored elsewhere in the regulations?)

2.12 Most respondents who answered this question directly were content with the placement in the creditor hierarchy of the new class of secondary non-preferential debt.

2.13 Several respondents specifically welcomed the proposal to ensure that secondary non-preferential debt is distinct from, and senior to, subordinated debts. Respondents were pleased that this approach should circumvent 'blocker language' incorporated into some legacy Tier 2 issuances, which prohibits the issuance of subordinated debt instruments between Tier 2 and ordinary unsecured debt. By ensuring that SNP is non-preferential debt rather than subordinated debt, firms should be able to issue SNP to meet their MREL requirements without amending the 'blocker language' in the language of existing notes.

2.14 However, three respondents requested greater clarity in the definition given for "tertiary non-preferential debts" as the use of the term "other subordinated debt" in section 837A(3)(c) of the Order could be construed to refer to debt in the secondary non-preferential debt category, which should not be subordinated.

2.15 Additionally, one respondent also suggested that the use of the catch-all term "other subordinated debt" within the definition of "tertiary non-preferential debts" could exclude the ability for issuers to use a combination of statutory and contractual ranking methods to achieve subordination on a *pari passu* basis at the secondary non-preferential layer. One respondent also expressed concern that the use of the catch all term "other subordinated debt" within the definition of "tertiary non-preferential debts" might restrict an issuer from ever issuing a liability that ranks senior to secondary non-preferential debt but junior to the ordinary non-preferential layer.

2.16 The government has accepted the proposed amendment to the definition of "tertiary non-preferential debts" provided by one respondent to ensure that only debts falling into the tertiary class are understood to be subordinated while the ordinary and secondary buckets are clearly unsubordinated. The definition of tertiary non-preferential debts has therefore been reworked slightly in the Order to read "all subordinated debts, including (but not limited to) debts under Common Equity Tier 1 instruments, Additional Tier 1 instruments and Tier 2 instruments…". This drafting amendment should resolve the concerns raised above.

2.17 A further comment raised concerns with the definition of "secondary non-preferential debts" within section 387A(3)(b) of the Order. They noted that paragraphs (i) and (ii) of this definition address characteristics of SNP instruments that are required to qualify as MREL. They suggested that it should not be necessary to link the insolvency ranking of the instrument together with other conditions of MREL qualification, as this could lead to unnecessary complication in the assessment of instruments by issuers. Instead, the respondent suggested that only limb (iii) of the current definition be included, so that the Insolvency Act ranking simply deals with the hierarchy of claims and not MREL eligibility criteria.

2.18 This suggested amendment has not been incorporated, as it deviates significantly from the directive text. The policy intent behind the creation of a new class of senior non-preferential debt within the creditor hierarchy was to aid the fulfillment of firms' MREL requirements. As such, it seems appropriate that the Order requires instruments to meet certain MREL eligibility criteria in order to be eligible as secondary non-preferential debts.

Question 3: Do you expect the approach taken to affect any existing debt instruments? Please provide details.

2.19 Most respondents did not consider that the approach taken would have any significant or concerning impact upon existing debt instruments.

2.20 Many of these respondents made the point that the implementation of a new class of secondary non-preferential debt would have a positive impact on existing ordinary non-preferential debt. The new layer of secondary non-preferential debt should provide increased protection for the existing ordinary non-preferential debt, potentially improving credit quality and slightly reducing yield. On the other hand yields could be pushed up as issuance shifts towards secondary non-preferential instruments and ordinary non-preferred debt becomes relatively scarcer.

2.21 One respondent expressed concern that some senior noteholders may assume that they rank in line with deposits for building societies. This will not be the case, and depositors will continue to rank above senior noteholders within the creditor hierarchy.

Question 4: What are your views on the protections given to creditors of this class of "secondary non-preferential debt"?

2.22 All respondents who chose to directly answer this question stated that the protections given to creditors in this class of debt are appropriate.

Question 5: What is your assessment of the impact of these changes on the cost of funding? Please provide details on:

- **the spread difference between Tier 2 issued debt and secondary non-preferential debt**
- **the expected issuance of secondary non-preferential debt, the expected maturity profile of the debt, and any other impacts**
- **the spread difference between Tier 2 issued debt, and other contractually subordinated debt instruments**

2.23 The government has used the responses to these questions to inform the Impact Assessment produced for the implementation of this directive. An Impact Assessment has been published alongside the statutory instrument text and Explanatory Memorandum on legislation.gov.uk.

Question 6: HM Treasury assumes that other bondholders in the capital structure will not be affected by the introduction of secondary non-preferential debt (regardless of whether other bondholders are higher or lower in the hierarchy compared to secondary non-preferential debt holders). Please explain whether you agree and why.

2.24 Respondents agreed that other bondholders in the capital structure should not be materially or adversely affected by the creation of a new class of secondary non-preferential debt. However, a number of respondents acknowledged that some second-order effects may arise. These effects are outlined above under Question 3.

Question 7: HM Treasury assumes that debt holders higher up and lower down the debt hierarchy compared to secondary non-preferential debt holders will not have their cost of funding affected. Please explain whether you agree and why.

2.25 Respondents who chose to directly answer this question agreed that the pricing of debts higher up and lower down the hierarchy, compared to secondary non-preferential debt, should not be materially affected.

Question 8: How many hours would firms' compliance officers expect to spend understanding the change in legislation and disseminating

information? Please include details on the number of compliance officers and other staff involved in this process.

2.26 All respondents who specifically answered this question stated that compliance officers would not need to spend significant time understanding the changes in legislation.

Question 9: HM Treasury assumes that building societies that issue MREL above their capital requirements will take advantage of this legislation but that banks are unlikely to, as banks can already issue MREL-eligible debt through structural subordination. Please explain whether you agree and why.

2.27 Most respondents agreed that building societies are likely to be the most significant users of this new instrument and will issue MREL eligible debt using statutory subordination. Several building societies specifically expressed their intent to issue MREL in this category, and welcomed the potential for issuing MREL at the best possible rate for their members.

2.28 Many respondents saw limited incentive for banks to take advantage of this legislation given their ability to issue MREL-eligible debt through structural subordination. However, some respondents noted that banks would be interested in issuing internal MREL resources in the form of secondary non-preferential debt. The Statement of Policy on the Bank of England's approach to setting MREL (2018) (hereafter referred to as MREL SoP) allows this:

> "(8.3) As in the case of eligibility for external MREL liabilities, internal MREL resources must be subordinated to the operating liabilities of the group entities issuing them…Internal MREL eligible liabilities will need to be contractually or statutorily subordinated."

Further responses

2.29 A few respondents had comments on the drafting of the Order which did not directly correspond to any of the stated questions.

2.30 Some respondents suggested that the definition of an embedded derivative should be further clarified within the Order, given that one of the criteria for the new category of secondary non-preferential debts is that such instruments must not be a derivative or contain an embedded derivative. The respondent noted that it is common for such instruments to contain an option for the issuer to redeem the instrument before the contractual maturity date (early call optionality). They suggested that there remains ambiguity as to whether early call optionality would be considered an embedded derivative and therefore ineligible for issuance as SNP. The respondents suggested an amendment to the text to explicitly carve out early call optionality to ensure eligibility and increase clarity.

2.31 This proposal has not been incorporated into the Order as such a 'carve out' of early call optionality would go beyond the original text of the directive. However, the government notes that the Bank of England's MREL SoP provides guidance on the status of call options for the purpose of MREL issuance:

"**(5.6)** The Bank does not consider liabilities, the value of which is dependent on derivatives, to be appropriate to qualify as MREL eligible liabilities. The Bank does not consider liabilities which only include put or call options to be dependent on derivatives for this purpose."

2.32 Another respondent expressed concern that the treatment of statutory interest is not adequately addressed in the Order. They suggested that greater clarity should be given as to whether statutory interest should be paid in full on the ordinary unsecured creditors prior to any repayment of the new class of secondary non-preferential creditors' principle debt.

2.33 The treatment of statutory interest is covered by s189 of the Insolvency Act 1986 and Article 160 of the Insolvency (Northern Ireland) Order 1989.

2.34 A further respondent raised the concern that the voting rights of the new class of creditors in an insolvency, or their rights to representation on any creditors' committee are not clear within the Order.

2.35 The Order makes no provision in respect of voting, so the existing rules will apply as before (for example the Insolvency Rules 2016) and no restriction has been made in respect of the classes described by the Order.

Chapter 3
Next steps

3.1 The government has consulted with the Bank of England and the Insolvency Service throughout the drafting of this Order.

3.2 The negative statutory instrument for the Banks and Building Societies (Priorities on Insolvency) Order will shortly be laid in parliament to meet the EU's deadline for transposition of 29 December 2018. The Order will come into force 21 days after laying.

Annex A
List of respondents

A.1 The government would like to thank the following respondents for their comments:

- Allen & Overy LLP
- Barclays plc
- Building Societies Association
- Clifford Chance LLP
- Coventry Building Society
- KPMG
- Leeds Building Society
- Metro Bank PLC
- Nationwide Building Society
- Royal Bank of Scotland

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