



LEGAL SUBORDINATION OF SENIOR UNSECURED LIABILITIES COMMENTS OF THE EUROPEAN SYSTEMIC RISK BOARD (ESRB)

1. The European Systemic Risk Board (ESRB) would like to thank the Financial Committee of the German Parliament for the invitation to attend a hearing on the draft resolution legislation (*Abwicklungsmechanismusgesetz*) currently under discussion. The invitation reached the ESRB only a few days ago and therefore points 3 to 6 of the comments below represent only a very preliminary staff-level reaction.
2. The ESRB included in its Recommendation on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1) a recommendation which encourages Member States to ensure that their macro-prudential authorities are involved in the design and contribute to the national implementation of recovery and resolution regimes for banking and nonbanking financial institutions. This Recommendation, published in the Official Journal of the European Union (2013/C 170/01), is justified by the potentially systemic relevance of the design of resolution and recovery mechanisms. In fact, in the motivation to the Recommendation, the ESRB wrote:

“Regulatory authorities need tools to prevent financial crises and mitigate their effects if they nevertheless arise. Prevention and mitigation require recovery plans (drawn up by banks) and resolution plans (drawn up by the authorities). Early intervention powers for authorities allow them to act to seek to prevent the failure of a bank should recovery actions taken by the latter prove insufficient. Resolution powers enable them to assume control of a failing bank if preventive measures taken by the bank or the authorities have failed. This regime, as proposed in the Bank Recovery and Resolution Directive (BRRD), aims to minimise the systemic impact of bank distress and failure by ensuring the continuity of banks’ functions, containing the impact of failures and minimising losses to taxpayers by allocating them to stakeholders (e.g. through bail-in or leaving them behind in an administration procedure whilst critical functions are transferred to a bridge bank or third-party purchaser). From a macro-prudential perspective, the BRRD helps minimise the systemic implications of exposure concentrations, improve understanding of connectedness and mitigate the impact of crisis externalities.

The transmission works through two main channels. First, it limits moral hazard in systemically important banks and the implicit subsidy they may enjoy by helping to ensure that creditors, rather than third parties such as national governments, bear losses in the event of a bank’s failure. Second, effective resolution mitigates the impact of direct or indirect spillovers from an individual bank’s failure (contagion). It can also bolster public confidence in financial institutions. The removal of implicit state guarantees could be expected to cause bank funding costs to rise and sovereign funding costs to fall, by roughly equal amounts. However, bank funding costs would be much more elevated if the only alternative to a government bailout were a disorderly and potentially prolonged and costly bankruptcy process. So, overall effective resolution regimes should help to improve access to credit by the real economy in the medium to long term.

Effectively dealing with banks that fail could be undermined by a lack of resolution powers and tools, insufficient credibility in applying them and too little temporary funding to provide the necessary liquidity to support resolution measures. These deficiencies should be taken into consideration and avoided in setting up resolution regimes.”

3. The documentation received from the German Parliament has been the subject of staff-level discussions in one precise respect: Article 2, paragraph 23, introducing in article 46f of the German Banking Law (*Kreditwesengesetz, KWG*) the new sub-paragraphs (5) to (8) (at page



20 of the document marked 18/5009). Pages 81 and 82 of the accompanying explanatory note have also been considered. No other section of the document has been the subject of discussions, which have only taken place between staff of the institutions which are part of the ESRB's Steering Committee.

4. The ESRB would like first of all to emphasise the preliminary nature of its assessment, which derives from very initial discussions without the possibility to consider the actual situation of the banking sector in Germany, including on the basis of statistical information.
5. A few staff members representing the institutions belonging to the ESRB's Steering Committee considered statutory subordination of senior debt as an interesting technical avenue to achieve subordination, which they assess would have possible merits – at least in principle – in their own countries. They noted that the “Total Loss Absorbing Capacity” (TLAC) proposals of the Financial Stability Board (FSB) - which, if adopted, would apply to globally systemically important banks (G-SIBs) - would require the subordination by some means of loss absorbing capacity to operating liabilities. They noted that the draft legislation, in the specific area considered, would indeed enhance legal certainty and transparency regarding the order in which creditors may expect to be exposed to loss in resolution, and help to provide resolution authorities with a sufficiently broad set of liabilities that can credibly and feasibly be exposed to loss in resolution without giving rise to valid creditor compensation claims. Some of them, however, noted that – although this solution would present advantages, at least for large systemic banks – they would prefer other forms of subordination of loss absorbing liabilities, such as structural or contractual subordination. In their view, these different methods would allocate uncertainty and losses to a more designated group of investors, thereby reducing the financial stability risk of exposing a very heterogeneous group of senior bond holders to losses (including other banks and retail investors). They felt that, since the BRRD gives resolution authorities the discretionary power to require the issuance of such instruments, the contractual solution would be at the disposal of German authorities. Others would not see at present a need to introduce statutory subordination due to the relatively straightforward liability structure of their banks. Finally, some members were of the view that legal subordination of all unsecured senior debt may also not be the most appropriate solution for all firms in their jurisdictions, and that specific provisions might be designed for the smallest financial institutions.
6. While recognising that subordination of loss absorbing capacity of some kind is generally desirable, at least for systemically important firms, a few other members raised some questions about the draft German proposals:
 - a. What would be the impact of the entry into force of such a provision on the credit ratings of German credit institutions?
 - b. Would this provision have immediate implications for the cost of funding of the institutions involved?
 - c. Is there any risk of substitution of senior unsecured bonds with less stable forms of funding (interbank deposits, money market instruments, corporate deposits, etc.)?



- d. Would the statutory subordination of securities held by other banks be a potential vehicle for direct contractual contagion? Should cross holdings of debt securities issued by banks be either prohibited or be subject to specific supervisory surveillance?
 - e. Would the statutory subordination of bonds which do not have any ex ante explicit bail-in clause or structure increase the risk of indirect contagion?
 - f. Would this provision have cross-border effects on holdings of the relevant securities across the single market?
 - g. Would the subordination by law have implications on the eligibility of the securities issued by German banks as collateral in operations with the Eurosystem?
 - h. Would this provision possibly give rise to any inconsistency among Member States?
 - i. Is there any merit in seeking possible EU-wide common solutions within the single market?
 - j. What would be the effect of a blanket statutory subordination on smaller firms, for which loss absorbing capacity in excess of capital resources would not be required and which, if they were to fail, would like to enter an insolvency process rather than the resolution regime?
 - k. How does the proposed retroactive statutory amendment to the terms of already issued bonds tie in with constitutional law limits?
 - l. Was there any assessment of the effects related to the retroactive features of the amendments being introduced?
 - m. What is the market share of the unsecured debt securities that would be transformed into subordinated claims, which is held by retail counterparties?
 - n. Would there be an investor base for these bonds, as currently the mandates of investors such as pension funds and insurers prevent them from investing in subordinated bonds?
 - o. Why have other forms of subordination (i.e. contractual and structural) been deemed as not being appropriate or sufficient?
7. The ESRB would like to informally provide this feedback to the Financial Committee of the German Parliament, in order to offer a description of different issues from a macro-prudential perspective, to be taken into account when deliberating on the draft legislation.

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