TRENDING TOPIC

#4 — JUN. 19

BANK RESOLUTION

BRRD amendments: Senior Creditors Worse Off

The amendments to the Portuguese Banking Law, which extend the depositor preference to all deposits, will mean that in the event of a bank insolvency common creditors will likely see their recovery expectations greatly reduced in comparison with the previous regime. As a consequence, in the event of a bank resolution, the value of the claims and of any “no creditor worse off” compensation granted to investors holding senior debt issued by Portuguese banks could be significantly lower.

With the stroke of a pen, Portuguese lawmakers have made unsecured bonds issued by Portuguese banks riskier in the event of a bank resolution, following the entry into force of **Law no. 23/2019** of 13 March ("Law no. 23/2019"), that implemented Directive (EU) 2017/2399[1] in respect of the ranking of unsecured debt instruments in hierarchy of credit institutions' insolvency proceedings, which amends Directive 2014/59/EU (Bank Recovery and Resolution Directive, "**BRRD**").

This is the result of the Portuguese law going beyond what was required by Directive (UE) 2017/2399 and providing a general preference for all types of deposits (including those of large corporates), which means that bondholders and other common creditors could potentially see the value of their claims greatly reduced in event of bank resolution.

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Directive (EU) 2017/2399. A further step on the harmonisation of bank insolvency ranking.

Directive (EU) 2017/2399 is a step towards a more consistent implementation of the BRRD in order to reduce legal risk arising from the application of the no creditor worse off principle[2] and in particular the bail-in tool, by:

i) Introducing a minimum level of harmonization of the insolvency ranking for eligible deposits, ensuring a higher priority ranking of eligible deposits and deposits guaranteed by the deposit guarantee scheme (i.e., deposits from natural persons and micro, small and medium-sized enterprises ("**SMEs**")), in the amounts exceeding the EUR 100,000 coverage level; and

ii) Creating the so-called *"non-preferred senior debt"* category in the context of bank resolution in the EU, which is ranked in insolvency above own funds instruments and subordinated liabilities that do not qualify as own funds instruments, but below other senior liabilities, and is intended to ensure compliance with the TLAC subordination requirements set out in CRD IV (credit institutions remain free to issue debt in both the senior and the non-preferred senior classes).

However, the Portuguese legislator has gone significantly beyond what was required by Directive (EU) 2017/2399 and, by granting a general preference to all bank deposits, has indirectly placed debt instruments issued by Portuguese banks in the form of bonds and other unsecured claims in a potential much worse position in the event of a bank resolution than under the previous regime.

Portuguese law (again) goes much further than the Directive

In relation to the priority ranking of the part of eligible deposits that exceeds the coverage level (provided for under Article 6 of the BRRD), Portuguese law has implemented a considerably

1 Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy.
2 http://www.europarl.europa.eu/doceo/document/TA-8-2017-0041_EN.html?redirect

different approach than that provided under the BRRD[3]. Whilst Member States must ensure that claims arising from the uncovered portion of eligible deposits rank senior to ordinary unsecured claims, Portuguese law has established that claims in respect of all deposits shall benefit from a general credit privilege *(privilégio creditório geral)* over the moveable assets of the insolvent entity and a specific credit privilege *(privilégio especial)* over its immoveable assets[4].

This could be seen as resulting in the creation under Portuguese law of secured claims in insolvency proceedings of banks (the highest insolvency ranking under Portuguese law), ranking junior only to claims secured by mortgages over the insolvent's immoveable assets. Qualifying such deposit claims as secured claims seems inconsistent with the BRRD, as it would mean that such deposit claims are excluded from bail-in due to the *in rem* nature of this privilege[5].

"In relation to the priority ranking of the part of eligible deposits that exceeds the coverage level (provided for under Article 6 of the BRRD), Portuguese law has implemented a considerably different approach than that provided under the BRRD."

Moreover, with Law no. 23/2019 the Portuguese Parliament has extended the general depositor preference in the insolvency of banks to *all* bank deposits, including those held by corporates and regardless of coverage by the deposit guarantee scheme.

The cumulative effect of such deposit preferences is that it could drastically reduce the pool of liabilities eligible for bail-in in the context of a resolution, hence increasing the risk of bail-in of banks' remaining eligible liabilities, notably holders of banks' debt instruments.

With potential negative consequences for holders of bank debt

General depositor preference rules have been established in certain EU Member States and have been previously supported by the European Central Bank ("**ECB**") in the 2017 opinion on the draft Directive (EU) 2017/2399[6]. And the argument can be made that Member States remain free to establish a general depositor preference in national law.

However, it is noteworthy that in spite of the ECB's opinion, neither the European Commission nor the European legislators followed through on the ECB opinion and Recital (16) of Directive (EU) 2017/2399 clearly states that it *"does not cover the insolvency ranking of deposits beyond the existing applicable provisions of"* the BRRD and defers a review of the depositor preference framework (and assessment of the need thereof) to a later time, until 29 December 2020.

3 Article 166-A(4) and (5) of the Banking Law (Regime Geral das Instituições de Crédito e Sociedades Financeiras). Article 166-A(4), which grants privileged status to eligible deposits of natural persons and SMEs that exceed the covered amount (only subordinated to the privileges attached to covered deposits), was first provided with the full transposition of the BRRD by Law no. 23-A/2015 of 26 March, while Article 166-A(5) and (6) has been introduced by Law no. 23/2019, providing privileged status to all other deposits (subordinated to the privileges of naturals persons and SME deposits and of the Resolution Fund or the Deposit Guarantee Scheme).

4 Article 166-A(4) and (5) of the Banking Law.

5 As per Article 44(2)(b) of the BRRD, while according to paragraph (a) only covered deposits are excluded from bail-in (covered deposits are the part of eligible deposits that does not exceed the coverage level laid down in Article 6 of the CRD IV (i.e., EUR 100,00), as per point (5) of Article 2(1) of the CRD IV). Article 145-U(6)(a) of the Banking Law has explicitly excluded from bail-in bank deposits guaranteed by the Deposit Guarantee Scheme up to EUR 100,000; however, Article 145-U(6)(b) excludes from bail-in credits that benefit from an in rem guarantee, thus making unclear if bank deposits by virtue benefiting from privileged status (which under insolvency law are considered as a guarantee) are excluded from bail-in under paragraph (b).

6 https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2017_6_with_twd.pdf

As the current BRRD framework stands, restricting the scope of this privilege to priority ranking for the deposits of natural persons and SMEs implies the acceptance by EU lawmakers of a greater degree of risk associated with deposits not held by natural persons and SMEs, so as to ensure consistency across the EU of the bail-in risk associated with banks' general liabilities.

It is also questionable whether providing a preference to all types of bank deposits (including from large corporates) will avoid bank runs or lead to greater financial stability and there seems to exist limited rationale to treat differently deposits by large corporates from other types of banks senior claims, including senior bondholders.

Depositors that suspect that a bank is at risk of a resolution (especially large and professional investors) will most probably try to recover their deposits as early as possible in spite of any preferential treatment in insolvency. On the other hand, the general preference granted to bank deposits could lead to regulatory arbitrage, whereby certain large depositors may choose to lend to a bank through deposits that can subsequently be securitised, increasing transaction costs and generating inefficiencies.

In fact, it could be argued that a worse insolvency treatment of bank bondholders vis-à-vis large corporates deposits can lead to greater financial instability in times of market stress.

Investors may for now disregard this increased risk of bank bonds in the event of insolvency at time when Portuguese banks' balance sheets are improving and the level of NPLs is reducing (even though at least one Portuguese credit institution saw the credit rating of its senior bonds lowered in anticipation of the approval of Law 23/2019). But in the event of a downturn or of market stress, the perceived higher risk of a bank's bonds as a result of its lower ranking vis-à-vis large deposits could exacerbate volatility of bond prices and create a negative feedback loop for the institution.

Finally, by creating a preference status for deposits and maintaining *pari passu* treatment of senior bonds along with other common creditors, one may say that the litigation risk associated with treating bondholders differently from other common creditors has increased and the exercise of the bail-in tool is not necessarily improved. ■

Conclusion

Until a greater level harmonization is introduced at the European level, investors in bank debt should be attentive to the particularities of the legal regime of each Member State, as these might have significant influence on the risk level in case of a bank's resolution or insolvency.

In spite of the current market conditions, the past years have shown that market perceptions can move quickly and, when they change, it may be difficult and burdensome to win back investors trust.