Spanish Law Aspects of Senior Non-Preferred Notes

Ferran Foix Miralles
Senior Associate, Banking, Capital Markets and Insurance Practice Area, Gómez-Acebo & Pombo

The financial crisis has brought significant regulatory changes for credit institutions, many of them aimed at strengthening their capital requirements and creating safety buffers to absorb losses and recapitalise unsound and failing institutions.

The latest is an instrument known as senior non-preferred debt, which is midway between senior debt and subordinated/Tier 2 debt. This instrument will not qualify as Tier 1 or Tier 2 capital, but will be eligible to compute for purposes of TLAC/MREL requirements and will be cheaper for banks than pure subordinated debt.

Member states will have to introduce changes in their local laws relating to bank resolution and insolvency proceedings in order to allow credit institutions to issue senior non/preferred debt. France has already done so, and French banks such as Societe Generale and Credit Agricole have been the first in continental Europe to tap the market with such instruments.

Spain has not yet regulated senior non-preferred instruments, but will have to do so by June 2017. In anticipation of such regulation, earlier this year Banco Santander already issued €1.5 billion of Second Ranking Senior Notes that contractually build in the features of senior non-preferred debt. It is expected that all Spanish credit institutions will issue similar instruments in the coming months.

The purpose of this note is to provide the regulatory context in which this new asset class is created, describe the main features of these instruments and point out certain considerations from the perspective of Spanish law.

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Regulatory background

Bail-In Tool

Directive 2014/59/EU[1] (the **BRRD**) established an EU framework for the recovery and resolution of credit institutions and investment firms, providing national resolution authorities with certain tools and powers to intervene pre-emptively where institutions are in situations of stress of this type. The BRRD has been partially implemented in Spain through Act 11/2015 of 18 June on the Recovery and Resolution of Credit Institutions and Investment Firms (**Act 11/2015**) and Royal Decree 1012/2015 of 6 November, implementing Act 11/2015 (**Royal Decree 1012/2015**).

These rules establish a specific administrative resolution proceeding only available with respect to credit institutions and investments firms (different from the judicial insolvency proceeding applicable to all entities) to intervene in failing or non-viable institutions when the public interest and financial stability are at stake. As part of such proceeding, resolution authorities are granted a bail-in power to write-down or convert into equity certain claims of unsecured creditors as well as the equity of failing institutions (**Bail-In Tool**).

MREL and TLAC

The BRRD also sets forth a minimum requirement for own funds and eligible liabilities (**MREL**) that credit institutions and investment firms must satisfy in order to ensure that sufficient financial resources are available for write down or conversion into equity when using the Bail In Tool in a resolution scenario.

On 9 November 2015, the Financial Stability Board (**FSB**) published its final principles and a term sheet setting out international (i.e. EU and beyond) standards for global systemically important institutions (**G-SII**s) to enhance the total loss absorbing and recapitalization capacity (**TLAC**) of these institutions[2]. The FSB term sheet includes a requirement for G-SIIs to hold a sufficient amount of highly loss absorbing (bail-inable) liabilities to ensure smooth and fast absorption of losses and recapitalisation in resolution.

Both the MREL and TLAC requirements seek to ensure that losses will be absorbed by shareholders and certain subordinated or non-preferred creditors rather than being borne by depositors or taxpayers. Implementation of the TLAC/MREL requirements is expected to be phased in for EU credit institutions from 2019 to 2022.

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance. http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN

2 http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf

Despite pursuing the same regulatory objective, there are some differences between TLAC and MREL. TLAC requirements only apply to G-SIIs, while MREL requirements apply to the entire banking industry. Also, TLAC rules require a harmonised minimum level of loss absorbing capacity for all G-SIIs, while MREL is an institution-specific requirement based on case-by-case assessments.

Proposed amendments

On 23 November 2016, the European Commission published various proposals for directives to amend and supplement certain EU rules, including the BRRD, in order to implement the TLAC standard and integrate it into the general MREL rules (the **Amendments**).

The Amendments create a new asset class known as non-preferred senior debt, which will be eligible to count as TLAC and MREL and should only be bailed in after Tier 1 and Tier 2 capital instruments but before other senior liabilities[3]. This new asset class partially harmonises bank insolvency creditor hierarchy as regards the priority ranking of holders of bank senior unsecured debt in order to satisfy the subordination requirements and the no-creditor-worse-off principle imposed by TLAC and the MREL rules.

The Amendments require Member States to incorporate this new asset class of senior non-preferred debt into their national laws by [June 2017] so that it is available for institutions by [July 2017].

Feature of the new Senior Non-Preferred Debt

Ranking in insolvency and other basic features

The Amendments require Member States to introduce into the insolvency hierarchy for credit institutions and investments firms a new class of senior unsecured debt (the senior non-preferred debt), which in normal insolvency proceedings will rank (i) junior to other senior unsecured claims, and (ii) senior to subordinated liabilities qualifying as Tier 1 or Tier 2.

In order to enjoy this "intermediate" ranking between ordinary senior unsecured claims and subordinated claims, senior non-preferred debt must satisfy the following requirements:

(i) an initial maturity of at least one year;

(ii) it must have no derivative features; and

(iii) the contractual documentation must explicitly refer to the ranking set forth above.

3 https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-853-F1-EN-MAIN.PDF

Spanish law considerations on insolvency

Under Spanish insolvency laws, claims against an insolvent debtor are generally classified within the insolvency proceedings as: (i) specially privileged (mainly secured debt), (ii) generally privileged (e.g. salaries, tax claims, certain deposits), (iii) ordinary claims (non-subordinated unsecured claims, such as senior unsecured debt) and (iv) subordinated claims.

Any liability that is contractually subordinated to all other non-subordinated liabilities would be included in the last category of "subordinated claims" in insolvency proceedings and, as such, would not be entitled to vote in any proposed composition with creditors.

In fact, following a similar contractual approach as the Amendments, Act 11/2015 introduced a new category of Tier 3 debt (sometimes called subordinated senior debt), which consists of contractually subordinated debt that does not qualify as additional Tier 1 or Tier 2 capital. In an insolvency, such Tier 3 debt would be considered "subordinated claims" but, within that category, would rank senior to Tier 1 or Tier 2 subordinated debt.

It does not seem, however, that the new class of senior non-preferred liabilities required by the Amendments will be considered to be adequately addressed by such Tier 3 already existing in the Spanish legal system. The Amendments seem more inclined towards treating the senior non-preferred debt as senior debt that should not have the consideration of subordinated claims in insolvency proceedings. How this will be implemented in Spain is still unclear, but an option would be to create a ranking within the category of ordinary claims (higher ranking and lower ranking ordinary claims) or a new sub-class of ordinary claims that is junior to the other ordinary claims.

One aspect that remains to be seen is whether these new lower-ranking or sub-class ordinary claims will have the same voting rights as the higher ranking ordinary claims in the approval of a composition with creditors. Only ordinary claims, which now all share a single ranking within insolvency proceedings, are entitled to vote on compositions with creditors. However, once the new class of senior non-preferred comes into effect, ordinary claims may no longer be treated *pari passu* within the insolvency and, therefore, their interests may be misaligned when considering a specific composition with creditors. For such reason, we cannot completely rule out that certain provisions regarding voting rights may also be introduced.

Subordination requirement and no-creditor-worse-off principle

The reason for altering the claim hierarchy in insolvency is mainly to allow this type of instrument to satisfy the subordination requirement and no-creditor-worse-off principle imposed by TLAC and MREL rules.

In order to be TLAC eligible, liabilities must be subordinated in insolvency, either by contract or by law, to non-TLAC eligible liabilities[4]. In practice, this means that in order to qualify for TLAC, a liability would have to be recognized a certain degree of subordination in insolvency with respect to other senior liabilities.

MREL rules do not generally require mandatory subordination of eligible instruments for MREL. However, resolution authorities may decide on a case-by-case basis that the MREL requirements should be met with instruments that rank in insolvency below other liabilities that are either non bail-inable by law or difficult to bail-in in line with the no-creditor-worse-off principle. This principle provides that no creditor shall incur greater losses than it would have incurred if the institution had been wound-up under normal insolvency proceedings[5]. Among other things, this means that, unless otherwise permitted in the BRRD, resolution authorities shall apply the Bail-In Tool in a way that respects the *pari passu* treatment of creditors and the statutory ranking of claims under applicable insolvency law.

In other words, the creation of a new class of claims in the insolvency hierarchy is required in order for the new senior non-preferred debt to satisfy the subordination requirement and the no-creditor-worse-off principle for purposes of TLAC and MREL.

Other TLAC and MREL eligibility requirements

But in order for senior non-preferred debt instruments to be TLAC and MREL eligible, they must satisfy other requirements in addition to the basic features mentioned above, including:

(i) the debt instrument shall be directly issued or raised by an institution, fully paid up, not purchased by an entity of the same group or related and not funded directly or indirectly by the institution;

(ii) the debt instrument shall not be secured, guaranteed or subject to an arrangement that enhances its seniority in certain specified manners;

(iii) the debt instrument shall not be subject to any set-off arrangements or netting rights that would undermine its capacity to absorb losses in resolution;

(iv) its terms and conditions shall not include incentives for the principal amount to be called, redeemed, repurchased or repaid prior to the stated maturity, nor a redemption feature by holders, and any call or early repayment option may only be exercised at the sole discretion of the issuer and subject to supervisory approval;

(v) no events of default shall give the holder the right to accelerate, other than in the case of insolvency or liquidation of the issuer;

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[4] Art. 72.b.(d) of Regulation (Eu) No 575/2013 of The European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the "**Capital Requirement Regulation**). http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&from=EN

[5] Art. 43 of the BRDD.

(vi) no changes in interest on the basis of the credit standing of the issuer; and

(vii) its contractual provisions require conversion or write down when the Bail-In Tool is exercised by the resolution authorities.

We should point out that the fact that senior non-preferred debt instruments may be eligible for purposes of TLAC and MREL does not make them eligible to compute as Tier 1 or Tier 2 regulatory capital as they are not subordinated liabilities.

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