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Non-preferred senior debt in Spain

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On 23 June 2017, Spain introduced a new debt asset class, known as "non-preferred senior" debt, available only to credit institutions and investment firms. In the event of insolvency of any such entities, non-preferred senior claims rank ahead subordinated claims, but behind other ordinary senior claims and privileged claims. This new asset class meets the subordination requirement and the no creditor worse off principle and is therefore eligible to compute for purposes of loss absorbing standards and rules applicable to financial institutions (TLAC and MREL).

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

[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

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tools and powers to intervene pre-emptively in situations of stress of this type of institutions. The BRRD has been partially implemented in Spain through Law 11/2015 of 18 June on the Recovery and Resolution of Credit Institutions and Investment Firms (**Law 11/2015**) and Royal Decree 1012/2015 of 6 November, implementing Law 11/2015 (**Royal Decree 1012/2015**).

These rules establish specific administrative resolution proceedings only available with respect to credit institutions and investments firms (different from insolvency court proceedings applicable to all entities) to intervene in failing or non-viable institutions when the public interest and financial stability is at stake. As part of such proceedings, resolution authorities are granted a bail-in power to write down or convert into equity certain claims of unsecured creditors (**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 shall satisfy in order to ensure that sufficient financial resources are available for write-down or conversion into equity in the use of 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 (susceptible to bail-in) liabilities to ensure smooth and fast absorption of losses and recapitalisation in resolution.

Both the MREL and TLAC requirements intend 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.

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

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

Proposed amendments

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

The Amendments envisage, among other things, the creation of a new asset class known as non-preferred senior debt that 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].

The Amendments require Member States to incorporate this new asset class of non-preferred senior debt into their national laws by introducing in the insolvency hierarchy for credit institutions and investments firms a new class of senior unsecured debt (the non-preferred senior debt) that shall rank in normal insolvency proceedings (i) junior to other senior unsecured claims, and (ii) senior to subordinated liabilities qualifying as Tier 1 or Tier 2.

Subordination requirement and no creditor worse off principle

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

In order to be TLAC eligible, liabilities shall be subordinated in insolvency, either by contract or by law, to TLAC non-eligible liabilities[4]. This in practice 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 not susceptible to bail-in 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 that 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

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

[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.

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

The new Non-Preferred Senior Debt introduced by RDL 11/2017

Spain has introduced this new asset class through Royal Decree-law 11/2017, of 23 June, on urgent measures on financial matters (**RDL 11/2017**), by amending Additional Provision 14 of Law 11/2015 that establishes the insolvency creditor hierarchy for credit institutions and investment firms.

General claim classification in insolvency

Under general 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 (unsubordinated unsecured claims, such as senior unsecured debt) and (iv) subordinated claims.

Any liability that is contractually subordinated to all other unsubordinated 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.

The new sub-category introduced by RDL 11/2017

What RDL 11/2017 does is create, for credit institutions and investment firms only, a new sub-category of "ordinary claims" referred to as "ordinary non-preferred claims", which will rank within the insolvency behind the "rest of ordinary claims" but ahead of the subordinated claims.

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

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

(ii) have no derivative features; and

(iii) the contractual documentation (and, if applicable, the prospectus) explicitly refers to the ranking set forth above.

Following a similar contractual approach as RDL 11/2017, Law 11/2015 introduced a new category of Tier 3 debt (sometimes called subordinated senior debt), which consisted on contractually subordinated debt that does not qualify as additional Tier 1 or Tier 2 capital. Such Tier 3 debt in insolvency would be considered "subordinated claims" but, within that category, ranking senior to Tier 1 or Tier 2 subordinated debt.

RDL 11/2017 also amends the Spanish Securities Market Law in order to provide that any instruments or securities eligible for the Bail-In Tool shall be treated as "complex instruments" for purposes of rules of conduct in relation to investment services.

Urgency of this amendment

The introduction of this new asset class for banks and investment firms was done through a royal decree-law initially passed by the Spanish government without Parliament approval for reasons of urgency (subsequently ratified by the Spanish Parliament on 11 July 2017).

The motivations for doing so, according to the introduction of the RDL 11/2017, included the following observation which helps put into a market context the relevance of this new asset class:

"[Financial] institutions will have to satisfy, in the following months, important requirements on loss-absorption eligible liabilities that will have to be placed in the markets. The market for non-preferred senior debt has, as any market does, a limited capacity to absorb transactions. Moreover, the pricing of these issuances vary, in particular for a newly created asset class. For such reason, the institutions shall stagger their issues in a manner that the market can absorb."

Other TLAC and MREL eligibility requirements

It is worth noting that, in order for non-preferred senior debt instruments to be TLAC and MREL eligible, they shall satisfy other requirements in addition to the three 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, nor 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;

(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.

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