Banks and Building Societies (Priorities on Insolvency) Order

BSA response to HM Treasury's consultation on Creditor Hierarchy Directive implementation

October 2018

Building Societies Association

Introduction

The BSA is pleased to respond to the Treasury's consultation on the draft Statutory Instrument (SI) that will implement the EU's Creditor Hierarchy Directive (CHD) in the UK. The BSA has strongly advocated the CHD and its fast-tracking, given its importance for larger building societies in meeting their MREL obligations at a more reasonable cost. We appreciate the Treasury's support in the European Council for fast-tracking CHD and (in response to **Q1**) we support the Treasury's general approach to implementation in the draft SI. Our detailed responses to the other consultation questions follow. We are grateful for rapid input both from our larger members contemplating MREL instrument issuance, and from leading market practitioners.

Policy detail

We agree with the general policy outline and proposals which are thoroughly explained in the technical consultation (TC) paper. The Box 1 diagram is helpful. In particular, we agree with the proposed placement and terminology (**Q2**) : the term "senior non-preferred" is established shorthand within the markets, but as the TC says, the concepts of "senior" and "junior" are not used in the Insolvency Act, so that term risks misleading by suggesting these debts are higher ranking than CHD intends. We are content with the terminology of "secondary non-preferential debt" (SNP), alongside "ordinary non-preferential debt" (ONP).

Outside the purely legislative or legal context, we expect the term "senior non-preferred" will continue to be used in parallel, but as both further abbreviate to SNP, this need not pose any problem. Some care will also be needed to avoid confusion when describing instruments across the whole creditor hierarchy – capital instruments are already ranked in the opposite direction as Tiers 1,2 and 3 while the SI introduces (necessarily) the distinction between ordinary, secondary and tertiary non-preferential debts. But with good sense, no real problems need arise.

In response to **Q3**, we do not think that this approach will significantly affect any existing debt instrument classes but some second –order effects are probably inevitable :

- At least temporarily, while large societies are meeting MREL requirements in full, new issuance will shift towards SNP rather than Tier 2 or ONP.

- The risk profile of ONP should improve where supported by a new layer of SNP: this improves credit quality but – logically- could slightly reduce yield. On the other hand, relative scarcity of both ONP and Tier 2 could edge yields upwards.

The protections given to the new class look appropriate (**Q4**), within the bounds of what is necessary for MREL – as these securities have to be effective in loss- absorbing.

The drafting of the SI also needs to clarify as far as possible that the issuance of this entirely new category of debt will not be prevented or obstructed by contractual language in, for instance, existing Tier 2 instruments that aim to block subsequent non-pari passu issuance of other subordinated debt.

Finally, we think some clarification may also be needed as to the scope of “embedded derivative” in Article 11. It is common for these types of instrument also to contain an early optional repayment date, or call option. While we don’t think that would necessarily prevent an instrument meeting the criteria, and that certainly isn’t intended, we think it would make sense to explicitly carve out early call optionality to avoid any risk that feature could be construed as an embedded derivative which would impact eligibility.

A suggestion to cover off this point would be to include an additional sub-paragraph (c) within the new section 387A(5) (which is at the bottom page 4 of the draft SI , introduced by Article 11) as follows:

“, or (c) it contains an optional early repayment date.”

Impact

The TC rightly identifies the particular benefit to (large) building societies, as they cannot use the structural subordination route available to big banks, and the benefit of the new debt class is that it is expected to carry a lower funding cost than the main alternative MREL ingredient which is some variant of Tier 2 subordinated debt. So the SI will save those large building societies that will require some level of issuance of MREL instruments an appreciable amount of money.

Turning to **Q5** -our original estimates, earlier in 2018, were that secondary non-preferential debt would carry a spread (e.g. over LIBOR or other benchmark) that is 50 bp, or ½% p.a., lower than a corresponding issue of Tier 2. Some latest indications from the market suggest, however, that this spread differential may have widened substantially as there has recently been some decompression of spreads for different levels of the creditor hierarchy.

The exact level of secondary non-preferential issuance depends on how much MREL issuance large building societies need, on top of their existing capital, and whether any banks opt to issue in this form either externally, or for internal MREL using structural subordination. But we reckon total issuance by large building societies (including any instruments that may have been issued on the basis of CHD text but in anticipation of this SI) is likely to be between £ 3 billion and £ 5 billion over the first five years. (This therefore suggests a cost saving possibly as high as between £ 30 million and £ 50 million per annum.) We have invited those members to provide their own estimates directly in response to the TC.

We are not aware of a sufficient market in other contractually subordinated but non-Tier 2 instruments issued by building societies to be able to estimate a spread difference. But we estimate that the spread difference between secondary and ordinary non-preferential debt was (earlier in the year) a further 50 bp – that is, the new class broadly halved the 1% differential between existing “senior” and Tier 2. The recent decompression mentioned above will however have altered this picture.

We have not identified any reason or circumstance (**Q6**) why other bondholders in a building society capital structure should be materially and adversely affected by the new class, though as mentioned above, some second-order effects may arise. Taking as counter-factual the issuance of the same amount of more expensive Tier 2 to satisfy MREL, then to the extent that secondary non-preferential instruments enable a society to satisfy MREL at much lower cost, the society’s financial soundness is enhanced, to the benefit of all existing creditors. More senior creditors will be protected either way by a further layer of junior debt. There is perhaps a marginal effect on existing Tier 2 holders, where any exist, who would probably rank pari passu with further Tier 2 issues but will rank behind the new instruments. But we doubt this is material.

If the volume of new issuance by the largest societies temporarily shifts towards SNP, the trading liquidity of e.g ONP might reduce slightly if the total stock begins to shrink. The secondary market might also price in the possibility of liability management exercises to rationalise and improve the efficiency of the existing instrument stack.

Again, we see no other reason why (**Q7**) the cost of (or rather the return on) funding provided by existing debt holders elsewhere in the creditor hierarchy should be adversely affected, if we take the above counterfactual. Existing ONP instruments would see their credit quality enhanced – as explained above- as a result of a new layer of MREL debt below them, and therefore, logically, their yield might fall – ceteris paribus, regardless of whether the MREL is Tier 2 or SNP. So this should not be attributed to SNP in isolation.The very slight difference as regards any existing Tier 2 holders is probably not material enough to affect the yield of that class.

The legal and compliance burden (**Q8**) should be very modest. The majority of societies will not be affected as they are not required to hold MREL in excess of their Pillar 1 plus Pillar 2A capital. For those large societies that need to issue MREL, we expect the incremental burden of assimilating the provisions of this SI that implement the CHD (which they have already been anticipating) will be negligible, certainly in comparison with other costs of MREL issuance, and with the benefits of cheaper issuance.

We agree that building societies are likely to be significant users of this new instrument class (**Q9**). As an example, our largest member, Nationwide BS, explaining its MREL plans in a public document[1] earlier in 2018, stated that it would meet its requirements predominantly through further issuance in this category. The BSA therefore supports the approach embodied in the draft SI and looks forward to full implementation of the CHD.

[1] https://www.nationwide.co.uk/-/media/MainSite/documents/about/investor-relations/NBS-Factsheet-FY-17-18.pdf

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Our members have total assets of over £387 billion, and account for 22% of the UK mortgage market and 18% of the UK savings market.