Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on amending Directive 2014/59/EU of the European Parliament and of the Council as regards the ranking of unsecured debt instruments in insolvency hierarchy

(Text with EEA relevance)

{SWD(2016) 377}
{SWD(2016) 378}
EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

• Reasons for and objectives of the proposal

The proposed amendments to Directive 2014/59/EU (the Bank Recovery and Resolution Directive or BRRD) are part of a legislative package that includes also amendments to Regulation (EU) No 575/2013 (the Capital Requirements Regulation or CRR), to Directive 2013/36/EU (the Capital Requirements Directive or CRD) and to Regulation (EU) 806/2014 (the Single Resolution Mechanism Regulation or SRMR).

Over the past years the EU implemented a substantial reform of the financial services regulatory framework to enhance the resilience of financial institutions in the EU, largely based on global standards agreed with the EU’s international partners. In particular, the reform package included Regulation (EU) No 575/2013 (the Capital Requirements Regulation or CRR) and Directive 2013/36/EU (the Capital Requirements Directive or CRD), on prudential requirements for and supervision of institutions, Directive 2014/59/EU (the Bank Recovery and Resolution Directive or BRRD), on recovery and resolution of institutions and Regulation (EU) No 806/2014 on the Single Resolution Mechanism (SRM).

These measures were taken in response to the financial crisis that unfolded in 2007-2008. The absence of adequate crisis management and resolution frameworks forced governments around the world to rescue banks following the financial crisis. The subsequent impact on public finances as well as the undesirable incentive of socialising the costs of bank failure have underscored that a different approach is needed to manage bank crises and protect financial stability.

Within the Union in line with the significant steps that have been taken in international fora, Directive 2014/59/EU (Bank Recovery and Resolution Directive (BRRD))1 and Regulation (EU) No 806/2014 (Single Resolution Mechanism Regulation (SRMR))2 have established a robust bank resolution framework to effectively manage bank crises and reduce their negative impact on financial stability and public finances. A cornerstone tool of a robust resolution framework is the “bail-in” which consists of writing down debt or converting debt claims or other liabilities into equity according to a pre-defined hierarchy. The tool can be used to absorb losses of and internally recapitalise an institution that is failing or likely to fail, so that its viability is restored. Therefore, shareholders and other creditors will have to bear the burden of an institution's failure instead of taxpayers.

One of the key objectives of the BRRD is to facilitate private sector loss absorbency in the event of a bank crisis. To achieve this objective, all banks are required to meet a Minimum Requirement for Own Funds and Eligible Liabilities ('MREL') to ensure that sufficient financial resources are available for write down or conversion into equity. Under the BRRD, MREL does not generally require mandatory subordination of eligible instruments for MREL. This means, in practical terms, that a liability eligible for MREL may rank in insolvency at

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the same level (*pari passu*) with certain other liabilities which are not bail-inable in accordance with the BRRD, such as operational liabilities like short-term inter-bank loans, or certain other liabilities which are bail-inable, but could be excluded from bail-in on a discretionary basis if the resolution authority can justify that they are difficult to bail-in for reasons of operational execution or systemic contagion risk (e.g. derivatives). This could lead to situations where bailed-in bondholders may claim they have been treated worse under resolution than under a hypothetical insolvency. In such case, they would need to be compensated by financial means of the resolution fund. To avoid this risk, resolution authorities may decide that the MREL requirement should be met with instruments that rank in insolvency below other liabilities that are either not bail-inable by law or difficult to bail-in (“subordination requirement”).

At the global level, the Financial Stability Board (FSB) has published on 9 November 2015 the Total Loss-absorbing Capacity (TLAC) Term Sheet ('the TLAC standard') that was adopted a week later at the G20 summit in Turkey\(^3\). The TLAC standard requires global systemically important banks (G-SIBs), referred as global systemically important institutions (G-SIIs) in the Union legislation, to hold a sufficient minimum amount of highly loss absorbing (bail-inable) liabilities ('TLAC minimum requirement') to ensure smooth and fast absorption of losses and recapitalisation in resolution. In its Communication of 24 November 2015\(^4\), the Commission committed to bring forward a legislative proposal by the end of this year so as the TLAC standard can be implemented by the agreed deadline of 2019.

This proposal is part of the Commission's efforts to implement the TLAC standard in the Union together with a number of other proposals amending the existing Union recovery and resolution framework.

The proposal covers specifically the targeted amendments to the BRRD related to the insolvency ranking of holders of debt instruments issued by Union banks for the purposes of complying with the BRRD and TLAC requirements concerning loss absorption and recapitalisation capacity of banks. In order to enhance the operational execution and robustness of bail-in powers and to avoid legal uncertainty, the TLAC standard requires that liabilities may be eligible for TLAC only if they are subordinated to other liabilities, i.e. if they absorb losses in insolvency or in resolution prior to other “preferred” liabilities that are explicitly excluded from TLAC eligibility, such as derivatives, covered deposits or tax liabilities. The TLAC standard provides, therefore, for a subordination requirement subject to certain exemptions, but it is not prescriptive on the way to achieve it.

The TLAC requirement to hold subordinated instruments combined with the potential discretionary request by Union resolution authorities to meet the MREL also with subordinated instruments have driven some Member States to re-assess their national insolvency ranking. A number of Member States have amended (or are in the process of amending) the insolvency ranking of certain bank creditors under their national insolvency law to operationalise the possible application of the bail-in tool under the BRRD and to ensure that their G-SIIs comply with the “subordination requirement” of the TLAC standard. Under some national approaches, the existing stock of unsecured senior debt have been subordinated with immediate effect to allow banks to comply with any subordination requirement

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\(^{4}\) Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, "Towards the completion of the Banking Union", 24.11.2015, COM(2015) 587 final.
stemming from the BRRD or the TLAC standard. Under other approaches, banks would need to issue new debt, which meets the subordination criterion. As the national rules adopted so far diverge significantly, there is a broad agreement among stakeholders and Member States that having divergent approaches to the statutory insolvency ranking of bank creditors provides uncertainty for issuers and investors alike and makes more difficult the application of the bail-in tool for cross-border institutions. This uncertainty could also result in competitive distortions in the sense that unsecured debt holders could be treated differently in different Member States and the costs to comply with the TLAC and MREL requirements for banks may be different from Member State to Member State. Additionally, the creditors of banks under such divergent national insolvency regimes would be treated very differently when buying debt instruments issued by banks falling under different national creditor hierarchy regimes.

For the above reasons, in its Report on Banking Union\textsuperscript{5}, the European Parliament calls on the Commission to present proposals to further reduce the legal risks of claims under the no-creditor-worse-off principle, and, in its conclusions of 17 June 2016\textsuperscript{6}, the ECOFIN invited the Commission to put forward a proposal on a common approach to the bank creditors' hierarchy.

A specific proposal on bank creditors' hierarchy is justified in view of the distinct nature of the matters concerned and the urgency of harmonised Union rules to prevent any further competitive distortions on the internal market.

1.1. Consistency with existing policy provisions in the policy area

The existing Union bank resolution framework already requires all Union banks to hold a sufficient amount of highly loss absorbing (bail-inable) liabilities that should be bailed-in in bank resolution. By facilitating the execution of the bail-in tool through compliance with the subordination requirement under the BRRD and TLAC standard, the proposal will improve the application of the existing rules and help implementing the TLAC standard in the Union. The proposal is, therefore, consistent with the overall objective of the Union bank resolution framework to reduce taxpayers' support in bank resolution.

1.2. Consistency with other Union policies

The proposal is part of a wider review of the Union financial legislation aiming at reducing risks in the financial sector while promoting sustainable financing of the economic activity. It is fully consistent with the EU’s fundamental goals of promoting financial stability, reducing taxpayers' support in bank resolution as well as contributing to a sustainable financing of the economy.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

2.1. Legal basis

The proposed Directive amends an existing directive, the BRRD. The legal basis for the proposal is the same as the legal basis of the BRRD, which is Article 114 of the TFEU. That provision allows the adoption of measures for the approximation of national provisions which have as their object the establishment and functioning of the internal market.

\textsuperscript{5} Report on Banking Union – Annual Report 2015 (2015/2221(INI)).

The proposal harmonises national laws on recovery and resolution of credit institutions and investment firms, in particular as regards their loss-absorbency and recapitalisation capacity in resolution, to the extent necessary to ensure that Member States and Union banks have the same tools and capacity to address bank failures in line with the agreed international standards (TLAC standard).

By establishing harmonised rules in the internal market on the treatment of certain bank creditors in resolution, the proposal reduces considerably the divergences in the national rules concerning the loss absorbency and recapitalisation capacity of banks, which could distort competition in the internal market. The proposal has, therefore, as its object the establishment and functioning of the internal market.

Article 114 of the TFEU is, therefore, the appropriate legal base.

2.2. Subsidiarity

Under the principle of subsidiarity set out in Article 5.3 of the TEU, in areas which do not fall within its exclusive competence, the Union should act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level.

The Union and its Member States are committed to implement the Union bank recovery and resolution framework in line with the international standards. In the absence of any Union action, Member States would have needed to adopt themselves the rules on the treatment of bank creditors in resolution in order to facilitate the application of the bail-in tool under the BRRD and implement the internationally agreed TLAC standard. As a result of significantly diverging national rules, banks and their creditors (investors) face legal uncertainty, different and potentially higher costs in comparison with what would be the situation should Union action be taken. Union action is, therefore, desirable to facilitate the application of the bail-in tool in a harmonised way in the line with the global TLAC standard so as to alleviate as much as possible the compliance costs of banks and their creditors while ensuring an effective resolution in case of bank failures.

2.3. Proportionality

Under the principle of proportionality, the content and form of Union action should not exceed what is necessary to achieve its objectives, consistent with the overall objectives of the Treaties. The proposal would not materially affect the burden of banks to comply with the existing rules on loss absorbency and recapitalisation capacity and reduce to the minimum their costs to comply with the TLAC standard. In addition, the rights of bank creditors and investors as regards existing stocks of bank debt will not be affected. The provisions of the proposal are, therefore, proportionate to what is necessary to achieve its objectives.

3. RESULTS OF IMPACT ASSESSMENTS

3.1. Impact assessment

Being part of a wider review package of the Union financial legislation aiming at reducing risks in the financial sector, the proposal has been subject to an extensive impact assessment. The draft impact assessment report was submitted on 7 September 2016 to the Commission's
The Board has issued first a negative opinion. After the strengthening the evidenced base of elements of the review package, the Board issued a positive opinion on 27 September 2016.

In line with its "Better Regulation" policy, the Commission conducted an impact assessment of several policy alternatives. Policy options were assessed against the key objectives of enhancing loss absorbency and recapitalisation capacity of banks in resolution and legal certainty and coherence of the resolution framework. The assessment was done by considering the effectiveness of achieving the objectives above and the cost efficiency of implementing different policy options.

The impact assessment dismisses the option of no policy change as regards bank insolvency creditor hierarchy in the Union since this option creates competitive distortions in the internal market for bank senior unsecured debt as a different status of bank debt holders across Member States may impact unevenly the funding costs of banks. In terms of harmonisation, several sub-options have been considered and the impact assessment concludes that the creation of a specific 'unpreferred' senior class for unsecured debt is the most cost effective way to comply with the subordination requirement of the TLAC standard for G-SIIs and with the case-by-case request of resolution authorities to request compliance with the MREL through subordinated debt. Contrary to own funds instruments, such debt instruments could only be bailed-in in bank resolution, after writing down or converting any own funds instruments and before bailing-in other senior liabilities. The main advantage of this option is that banks could continue to issue (less costly) senior debt for funding or operational reasons while the new class of debt could be used mainly for regulatory compliance with the rules on loss absorbency and recapitalisation capacity.

3.2. Fundamental rights
This proposal complies with the fundamental rights and observes the principles recognised in particular by the Charter of Fundamental Rights of the European Union, notably the rights to property and the freedom to conduct a business, and has to be applied in accordance with those rights and principles. In particular, this Directive ensures that interference with property rights of bank creditors is not disproportionate. It will ensure that affected creditors do not incur greater losses than those which they would have incurred if the institution had been wound up under normal insolvency proceedings at the time that the resolution decision is taken.

4. BUDGETARY IMPLICATIONS
The proposal does not have implications for the Union budget.

5. OTHER ELEMENTS
5.1. Implementation plans and monitoring, evaluation and reporting arrangements
The proposal requires Member States to transpose the amendments to the BRRD in their national laws by [June 2017] and requires banks to comply with the amended rules by [July 2017].

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7 Link to Impact Assessment and to its summary.
8 The three sub-options are: (i) statutory subordination of all unsecured debt with a retroactive effect; (ii) creation of a non-preferred senior debt category; (iii) statutory preference for all deposits vis-à-vis senior debt.
5.2. Detailed explanation of the specific provisions of the proposal

The proposal amends Article 108 of the BRRD by partially harmonising bank insolvency creditor hierarchy as regards the priority ranking of holders of bank senior unsecured debt eligible to meet the BRRD rules and the TLAC standard on loss absorbency and recapitalisation capacity for banks, in particular the 'subordination' requirement.

The new provision keeps the existing class of senior debt while it creates a new asset class of 'non-preferred' senior debt that should only be bailed-in in resolution after other capital instruments, but before other senior liabilities. Institutions remain free to issue debt in both classes while only the 'non-preferred' senior class is eligible for the minimum TLAC requirement or any subordination requirement that could be imposed by resolution authorities on a case-by-case basis.

The proposed Directive should not affect the existing stocks of bank debt and their statutory ranking in insolvency and will be applied to any issuance of bank debt following its date of application. As regards debt instruments issued before the date of application of this Directive referred to in Article 2(1) [July 2017], their insolvency ranking should be governed by the national laws of Member States as they were adopted on [31 December 2016].

The proposed Directive requires Member State to transpose it by [June 2017] and its date of application is fixed for [July 2017].
Proposal for a

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on amending Directive 2014/59/EU of the European Parliament and of the Council as regards the ranking of unsecured debt instruments in insolvency hierarchy

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 114 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Central Bank

Having regard to the opinion of the European Economic and Social Committee,

Acting in accordance with the ordinary legislative procedure,

Whereas:

(1) The Financial Stability Board (FSB) published the Total Loss-Absorbing Capacity (TLAC) Term Sheet (‘the TLAC standard’) on 9 November 2015 which was endorsed by the G-20 in November 2015. The TLAC standard requires global systemically important banks (G-SIBs), referred to as global systemically important institutions (G-SIIs) in the Union framework, to hold a sufficient minimum amount of highly loss absorbing (bail-in-able) liabilities to ensure smooth and fast absorption of losses and recapitalisation in resolution. In its Communication of 24 November 2015, the Commission committed to bring forward a legislative proposal by the end of 2016 that would enable the TLAC standard to be implemented by the internationally agreed deadline of 2019.

(2) The implementation of the TLAC standard in the Union needs to take account for the existing institution-specific minimum requirement for own funds and eligible liabilities (‘MREL’) applicable to all Union credit institutions and investment firms as laid down in Directive 2014/59/EU of the European Parliament and of the Council.
As TLAC and MREL pursue the same objective of ensuring that Union credit institutions and investment firms have sufficient loss absorbing capacity, the two requirements should be complementary elements of a common framework. Operationally, the harmonised minimum level of the TLAC standard for G-SIIs (‘the TLAC minimum requirement’) should be introduced in Union legislation through amendments to Regulation (EU) No 575/2013 of the European Parliament and of the Council 13, while the institution-specific add-on for G-SIIs and the institution-specific requirement for non-G-SIIs should be addressed through targeted amendments to Directive 2014/59/EU and Regulation (EU) No 806/2014 of the European Parliament and of the Council14. The relevant provisions of this Directive as regards the ranking of unsecured debt instruments in insolvency hierarchy are complementary with those in the aforementioned pieces of legislation and in Directive 2013/36/EU15.

(3) Member States should ensure that credit institutions and investment firms should have sufficient loss-absorbing and recapitalisation capacity to ensure smooth and fast absorption of losses and recapitalisation in resolution with a minimum impact on financial stability and taxpayers. This should be achieved through constant compliance by credit institutions and investment firms with a TLAC minimum requirement as provided in Regulation (EU) No 575/2013 and a requirement for own funds and permissible liabilities as provided in Directive 2014/59/EU.

(4) The TLAC standard, as implemented in Union law by Regulation (EU) No 575/2013, requires G-SIIs to meet the minimum TLAC requirement, with certain exceptions, with subordinated liabilities resulting from debt instruments that rank in insolvency below other senior liabilities (‘subordination requirement’). Directive 2014/59/EU allows resolution authorities to request, on a case-by-case basis, that G-SIIs and other institutions meet their firm-specific requirement with subordinated liabilities so as to alleviate the risk of legal challenge by creditors on the basis that their losses in resolution are higher than the losses that they would incur under normal insolvency proceedings.

(5) A number of Member States have amended or are in the process of amending the insolvency ranking of unsecured senior debt under their national insolvency law to allow their credit institutions and investment firms to comply with the subordination requirement as provided in Regulation (EU) No 575/2013 and Directive 2014/59/EU.

(6) The national rules adopted so far diverge significantly. The absence of harmonised Union rules creates uncertainty for issuing credit institutions, investment firms and investors alike and makes the application of the bail-in tool for cross-border institutions more difficult. This also results in competitive distortions on the internal market given that the costs for credit institutions and investment firms to comply with

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the subordination requirement established in Regulation (EU) No 575/2013 and Directive 2014/59/EU and the costs borne by investors when buying debt instruments issued by credit institutions and investment firms may differ considerably across the Union.

(7) In its Report on Banking Union, the European Parliament called on the Commission to present proposals to further reduce the legal risks of claims under the no-creditor-worse-off principle, and, in its conclusions of 17 June 2016\(^\text{16}\), the Council invited the Commission to put forward a proposal on a common approach to the bank creditors' hierarchy to enhance legal certainty in case of resolution.

(8) It is, therefore, necessary to remove the significant obstacles in the functioning of the internal market and avoid distortions of competition resulting from the absence of harmonised Union rules on bank creditors’ hierarchy and to prevent such obstacles and distortions from arising in the future. Consequently, the appropriate legal basis for this Directive should be Article 114 of the Treaty on the Functioning of the European Union (TFEU), as interpreted in accordance with the case law of the Court of Justice of the European Union.

(9) In order to reduce to a minimum credit institutions and investment firms' costs of compliance with the subordination requirement and any negative impact on their funding costs, this Directive should allow Member States to keep the existing class of unsecured senior debt, which has the highest insolvency ranking among debt instruments and is less costly for credit institutions and investment firms to issue than any other subordinated liabilities. It should, nevertheless, require Member States to create a new asset class of 'non-preferred' senior debt that should only be bailed-in during resolution after other capital instruments, but before other senior liabilities. Credit institutions and investment firms should remain free to issue debt in both classes while only the 'non-preferred' senior class should be eligible to meet the subordination requirement of Regulation (EU) No 575/2013 and of Directive 2014/59/EU. This should allow credit institutions and investment firms to use for their funding or any other operational reasons the less costly senior debt while issuing the new 'non-preferred' senior class for compliance with the subordination requirement.

(10) To ensure that the new 'non-preferred' senior class of debt instruments meet the eligibility criteria of Regulation (EU) No 575/2013 and of Directive 2014/59/EU, Member States should ensure that their initial contractual maturity spans one year, that they have no derivative features, and that the relevant contractual documentation related to their issuance explicitly refers to their ranking under normal insolvency proceedings.

(11) To enhance legal certainty for investors, Member States should ensure that standard senior debt instruments have a higher priority ranking in their national insolvency laws than the new 'non-preferred' senior class of debt instruments under normal insolvency proceedings. Member States should also ensure that the new 'non-preferred' senior class of debt instruments have a higher priority ranking than the priority ranking of own funds instruments or any other subordinated liabilities and that, contrary to such instruments or liabilities, the 'non-preferred' senior class of debt instruments could only be bailed-in when the issuing institution is placed under resolution.

(12) Since the objectives of this Directive, namely to lay down uniform rules for bank creditor hierarchy for the purposes of the Union recovery and resolution framework, cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale of the action, be better achieved at Union level, the Union may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty on European Union. In accordance with the principle of proportionality, as set out in that Article, this Regulation does not go beyond what is necessary in order to achieve those objectives.

(13) It is appropriate for the amendments to Directive 2014/59/EU provided for in this Directive to apply to liabilities issued on or after the date of application of this Directive and to liabilities still outstanding as of that date. However, for legal certainty purposes and to mitigate transitional costs in as much as possible, Member State should ensure that the treatment of all outstanding liabilities that credit institutions and investment firms have issued before that date is governed by the laws of the Member States as they were adopted on [31 December 2016]. Outstanding liabilities should thus continue to be subject to the regulatory requirements set out in Directive 2014/59/EU and the relevant national law in the version that was adopted on [31 December 2016].

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Amendments to Directive 2014/59/EU

1. The words "of deposits" are deleted from the title of Article 108 and the word "non-preferred" is deleted from point (a) of the first subparagraph of Article 108.

2. The following paragraphs are added after the end of Article 108:

"2. Member States shall ensure that, for entities referred to in points (a), (b), (c) and (d) of Article 1(1), ordinary unsecured claims resulting from debt instruments with the highest priority ranking among debt instruments in national law governing normal insolvency proceedings have a higher priority ranking than that of unsecured claims resulting from debt instruments which meet the following conditions:

(a) the initial contractual maturity of debt instruments spans one year;
(b) they have no derivative features;
(c) the relevant contractual documentation related to the issuance explicitly refers to the ranking under this subparagraph.

3. Member States shall ensure that ordinary unsecured claims resulting from debt instruments referred to in paragraph 2 shall have a higher priority ranking in national law governing normal insolvency proceedings than the priority ranking of claims resulting from instruments referred to in points (a) to (d) of Article 48(1).

4. Member States shall ensure that their national laws governing normal insolvency proceedings as they were adopted at [31 December 2016] apply to ordinary unsecured claims resulting from debt instruments issued by entities referred to in points (a), (b), (c) and (d) of Article 1(1) prior to [date of application of this Directive – July 2017]."
Article 2
Transposition

1. Member States shall adopt and publish by [June 2017] the laws, regulations and administrative provisions necessary to comply with this Directive. They shall communicate the text of those measures to the Commission forthwith.

Member States shall apply those measures from [July 2017].

2. When Member States adopt the measures referred to in paragraph 1, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such a reference is to be made.

3. Member States shall communicate the text of the main provisions of national law which they adopt in the field covered by this Directive to the Commission and to European Banking Authority.

Article 3
Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the Official Journal of the European Union.

Article 4
Addressees

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament
The President

For the Council
The President