Rabobank

# Position Paper: German Legislative Proposal Senior Unsecured Debt

## Introduction

This position paper describes Rabobank's position towards the German legislative proposal ("German Proposal") to subordinate non-operational debt of banks such as senior unsecured bonds, Schuldschein loans and registered bonds ('specific debt instruments') to equally-ranking operational liabilities of such banks such as unsecured deposits and derivatives.[1] Rabobank's position towards the German Proposal is in line with Rabobank's Capital Strategy[2] and the position paper on bail-in written in July 2013.
This paper starts with a summary of the German Proposal followed by Rabobank's position, whereby the impact on availability and pricing of funding and possible rating impact is taken in consideration as well.

## Summary German Proposal

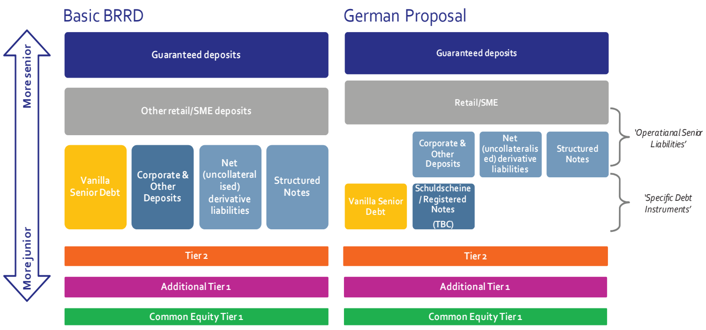
In March 2015, the German Federal Government published a draft law implementing the Single Resolution Mechanism ("SRM") which includes a proposal to change the hierarchy of claims in case of insolvency of German banks by subordinating specific senior debt instruments. This subordination of specific debt instruments is designed to help resolvability and enable the bail-in of senior debt instruments before other, mainly operational senior unsecured liabilities without giving rise to the No Creditor Worse Off ("NCWO") discussion[3]. It also facilitates German banks in meeting the loss absorbency requirements (MREL, TLAC) of new European bank resolution frameworks as these require banks to fill in loss absorbency requirements with either structurally, statutory or contractually subordinated instruments. Senior unsecured liabilities are allowed to fulfill MREL, but only when not hindered in bail-in by the NCWO principle.

With the introduction of the German Proposal, the category of specific debt instruments will effectively rank junior to all other senior operational liabilities and senior to subordinated debt instruments (Additional Tier 1 and Tier 2); i.e. this category of specific debt instruments will be lifted out of the broader senior (operational and non operational) unsecured liabilities category.
The German Proposal addresses the NCWO principle by making a clear separation between specific debt instruments and equal-ranking senior operational liabilities. By separating specific debt instruments from operational liabilities, investors

1) http://www.bundesfinanzministerium.de/Content/DE/Downloads/Gesetze/2015-03-10-bankenabwicklungsrecht-srm.pdf?__blob=publicationFile&v=2
2) See: Rabobank Capital Adequacy and Risk Management report 2014, available at https://www.rabobank.com/nl/images/capital-adequacy-and-risk-management-report-2014.pdf
3) Because bail-in interferes with property rights, the Bank Recovery and Resolution Directive ("BRRD") prescribes that no creditor should be left worse off than it would have been if the bank became insolvent – the so called NCWO principle. Bail-in should also follow the creditor hierarchy – i.e. after equity first subordinated debt and the potentially senior unsecured debt.

in this specific asset class won't be able to use the BRRD's NCWO principle to challenge losses when the bail-in tool is applied.

*Figure 1, BRRD versus German Proposal*




Although there are legal challenges implementing the law and there were technical concerns (retroactive aspect of the German Proposal) raised by the Bundesrat which are still being discussed, we expect that this German Proposal will be approved.

## Position Rabobank

Rabobank does not support the German Proposal to subordinate specific debt instruments. Rabobank is in favour of building up high capital buffers to protect all senior unsecured liabilities. Additionally, Rabobank supports the approach whereby on a statutory basis losses can be spread over as many senior liabilities as possible - the so called comprehensive approach - to reduce the amount of losses on this category. This in contrast to the targeted approach, whereby only designated instruments can be written down. Rabobank thinks that by the German Proposal the price (cost of fund), but more importantly the availability of senior unsecured funding could be at risk as investors can step away from this asset class as risk (and reward) are not the same or could no longer fit the mandate.

Rabobank is targeting high capital ratios to protect senior unsecured liabilities against bail-in, i.e. ensuring a low probability of default ("PD"). Senior unsecured liabilities cannot be excluded from insolvency or bail-in, but a large buffer can offer protection to senior unsecured liabilities. Rabobank formulated its capital strategy in 2012 whereby the initial Total Capital target was a minimum Total Capital of 20% of Risk Weighted Assets. On the back of the Total Loss Absorbency Capital ("TLAC") proposals Rabobank has increased this target to 25%.

Secondly, Rabobank supports the so called comprehensive approach whereby in case of an unlikely event of bail-in of senior unsecured liabilities, on a statutory basis, losses should be spread over as many senior balance sheet items as possible (resulting in low loss given default ("LGD")). Therefore, targeting only selective instruments for bail-in but also asset encumbrance should be as limited as possible. The combination of high buffers and comprehensive approach results in a low expected loss ("EL") for Rabobank senior unsecured liabilities and thereby as low as possible funding costs.

Clearly, the German Proposal is not in line with Rabobank's view: Rabobank focuses on high capital ratios and a layer of bail-inable liabilities as broad as possible instead of lifting out a specific asset class to comply with new regulations. Introducing the German Proposal could also give rise to moral hazard. Banks who have not been actively raising capital are 'being rewarded' with including senior unsecured. Moreover, it discourages efforts to build up capital buffers, as MREL and TLAC buffers could be filled with non capital instruments, i.e. senior unsecured debt instruments. This German Proposal also goes against the Basel 3 reforms to increase quality and quantity of buffers and endangers the price and availability of senior unsecured funding as investors can step away from investing in this asset class.

## European developments – a level playing field?

In the Netherlands, we understand that the DNB/ECB, Dutch National Resolution Authority ("NRA") and the Dutch Ministry of Finance are analysing this German Proposal.
In a broader European context, a few alternative approaches for dealing with the NCWO principle have been suggested or discussed. The Italian Treasury may propose a new rule to ensure deposit preference over senior unsecured debt. This approach might be different but has the same objective as the German Proposal. Furthermore, Spain has taken an approach that does not follow the German approach but

they have provided for a statutory approach to allow for an additional layer ("Tier 3") in the capital structure of banks. In contrary to the German and Italian proposals, the Spanish proposal has no direct impact on existing bondholders hierarchy.

On the 2nd of September, the ECB has published an opinion on the topic stating that it sees the German Proposal as good alternative to Holdco senior as changing the statutory creditor-hierarchy in the bank insolvency proceedings is expected to enhance the implementation of the bail-in tool in resolution. In addition they see that the statutory subordination may facilitate the implementation of the forthcoming TLAC proposals as the instruments to fulfil these requirements need to be contractually, statutorily or structurally subordinated to operating liabilities. They seem to have a preference for a common framework at Union level to avoid fragmentation of the market within the Union market for these instruments.

As a consequence of the subordination, the ECB confirmed in its opinion that bank debt instruments subject to a statutory subordination of the kind proposed would no longer be eligible as collateral for Eurosystem credit operations. The ECB also notes that the introduction of such statutory subordination will not be without any impact on in particular pricing and capital requirements for holding senior unsecured, investment mandates and ratings and therefore refinancing costs.

### Market Impact

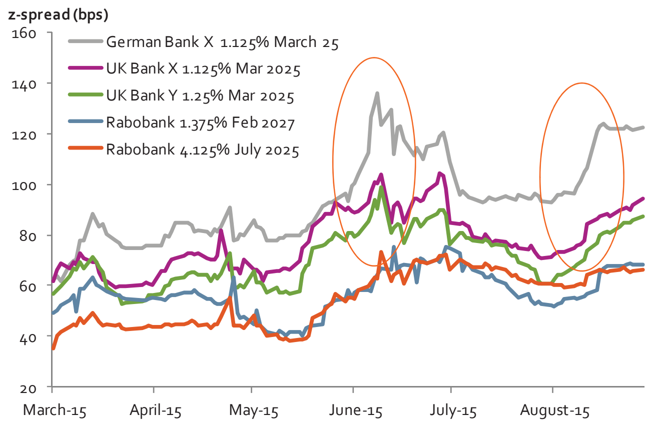
We expect that the German Proposal will, in the short and medium term and possibly in the long term, increase funding costs of banks, assuming all other things to remain equal. Especially in times of market volatility this could become a visible as investors could demand higher risk premia, they could shift their funds elsewhere, try to unwind positions and/ or make a flight into quality/ low risk investments. Moreover, there is a risk that investor mandates do no longer allow to invest in this type of senior debt, as mandates do not allow for subordinated investments.

As German banks have a relatively limited amount of senior unsecured debt outstanding, the effect on pricing and availability of funding could be more remote than in other countries like the Netherlands where banks are more dependent on (senior unsecured) wholesale funding. Keeping in mind that European banks in general have billions of unsecured debt on their balance sheets, every basis percentage point increase in funding cost is substantial. Rabobank has approximately EUR 150 billion of senior unsecured debt outstanding and a 50bps increase in spread could result in an increase in funding cost of about EUR 750 million per annum. Clearly, the rationale behind the German initiative is to make bail-in of a certain asset class more efficient. However, Rabobank argues it is better to take all senior unsecured liabilities for that matter. As the cost of bail-in is then spread more evenly, i.e. the LGD will be lower, similar is to the current bankruptcy laws without effecting these laws.

Market data (see graph below) show an impact of the German Proposal on the witnessed spread levels of senior unsecured of a German bank. The spreads of the German bank widened significantly more during volatile market conditions and recovered less strong afterwards as investors differentiate between senior unsecured banking debt of banks and countries. Also on the day the ECB released its opinion supporting the German Proposal, German bank spread widening has been witnessed.

Access to funding through the cycle, so also in volatile market conditions, is of high importance to Rabobank and banks in general and could be impacted by subordinating a specific category of senior unsecured debt. In the Rabobank model access to funding should be assured by reducing the PD by operating with high buffers to protect these kind of liabilities.

*Figure 2, Spread development European Senior Unsecured*



## Views from the Rating Agencies

Fitch initially expected that the German Proposal would have no immediate implication for German bank senior unsecured debt ratings, but stated that the legislation could raise funding costs or even reduce market access for banks dependent on senior debt issuance, which could be negative for ratings. Following these statements, Fitch followed up in June with a report on the impact for bank counterparties of evolving resolution frameworks. They believe that in light of recent developments different types of senior creditors could be treated differently, which could lead to either rating adjustment for the specific category of senior debt (negatively) or other operational liabilities (positively). Fitch announced that it will publish a document on this later this year. More generally, Fitch rewards high capital buffers for those banks who can recapitalise by means of their capital buffers. Rabobank is one of the banks of which Fitch continues to support the one notch uplift of the Long Term IDR and senior debt above the Viability Rating. This uplift reflects the substantial protection offered to senior creditors by Rabobank's qualifying junior debt.

Moody's views the German Proposal as being credit negative for the subordinated senior unsecured instruments while being credit positive for the other senior unsecured liabilities. Moody's Loss Given Failure (LGF) framework clearly considers the thickness and the layering of subordination. From a practical point of view, the impact of this legislation on a bank's senior rating will depend on how significant the new subordination is. Moody's rewarded Rabobank by the application of the advanced LGF analysis with a 2 notch uplift from its Baseline Credit Assessment.

S&P did not make a public statement on the German Proposal yet, but the ALAC methodology rewards high capital buffers protecting senior unsecured.

In sum, as the German Proposal is still in concept and subject for change, rating agencies are cautious to give a strong verdict at this stage. Also investors do not seem to be sure yet either. The German Proposal could be seen as a tailor made proposal for German banks and their funding models. Other countries should base their decision on the funding model used for the banks active in these countries, whereby a harmonised view in Europe is beneficial for all countries.

## Conclusion

The consequences of the German proposed legislation could be substantial and should be thought through well as could potentially influence price and availability of funding. Rabobank does not support the idea to take the German Proposal to subordinate specific senior unsecured debt instruments. Rabobank builds up high capital buffers to protect senior unsecured liabilities and additionally, Rabobank supports the comprehensive approach whereby losses can be spread over as many senior balance sheet liabilities as possible. By this strategy, Rabobank aims to ensure access to funding through the cycle, also in volatile market conditions which is of high importance to Rabobank and banks in general.

The German context is different to the other European countries, given for example the amount of retail deposits and market structure. There is no one size fits all solution. Rabobank argues for a comprehensive and inclusive approach by legislators and supervisors and leaving responsibility to the banks to formulate their capital and funding strategy to meet these targets without changing the hierarchy of claims of limiting asset classes.

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