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Brussels sprouts a new order: the Banks and Building Societies (Priorities On Insolvency) Order 2018

KEY POINTS

- The Bank Creditor Hierarchy Directive (EU) 2017/2399 came into force on 28 December 2017. In the UK, the Banks and Building Societies (Priorities on Insolvency) Order 2018 implements this Directive and came into force on 19 December 2018.
- In relation to a specified category of financial institutions, the Order alters the ranking of unsecured debt, and creates a new class of secondary non-preferential debt.
- It represents a good – if narrow – example of the EU harmonising local finance and insolvency law across the member states. What remains uncertain is whether any withdrawal agreement approved by Parliament or indeed a hard Brexit would repeal its effect in the UK.

THE EUROPEAN UNION ('EU')

Christmas 2018 may by now seem a long time ago. Readers who enjoyed traditional Christmas dinners may recall opting to leave Brussels (sprouts) out of their Christmas dinner, or for them to remain in, no doubt sharing their festive meals with their 'divided' families of both persuasions and squabbling for at least the third Christmas in a row.

At the time of writing, PM Teresa May has just postponed Parliament's vote on the draft Withdrawal Agreement, and won a confidence vote by her party's MPs. Despite these events unfolding around us, the United Kingdom remains a full member of the EU and, in the absence of either a unilateral withdrawal or agreed extension of Article 50, will remain so until 31 March 2019. In the meantime, all the rights and obligations of EU membership remain in force, and the government continues to negotiate, implement and apply EU legislation. The Banks and Building Societies (Priorities on Insolvency) Order 2018 ('the Order') is a case in point, and is the focus of this short article.

PURPOSE

This Order implements Directive (EU) 2017/2399, the Bank Creditor Hierarchy Directive – ('Directive'), amending The Bank Recovery and Resolution Directive 2014/59/EU ('BRRD'). In a nutshell, for a specified category of financial institutions, the Directive alters the ranking of unsecured debt, and creates a new class of secondary non-preferential debt.

The background is that following the financial crisis in 2008, the European Commission wanted to strengthen the resilience of the EU banking sector. It legislated for the authorities to intervene to manage the insolvency or failure of financial institutions, known as 'resolution.' The BRRD requires the EU National Competent Authorities (including the Bank of England) to set minimal levels of own funds and eligible liabilities ('MREL') which must be held by each financial institution.

If a financial institution were to fail, the resolution authority could use these MREL resources to absorb losses and recapitalise the business going forward. MREL are therefore seen as crucial to an effective resolution strategy. But the Bank of England requires MREL to be subordinated for the biggest financial institutions, to make it less likely that the general body of creditors is worse off in a resolution than in a traditional insolvency.

That subordination requirement can be achieved in three ways. It can be set out in the finance documents (contractual subordination), it can be structural if the debt is issued by the holding company (structural subordination) or statutory where insolvency law prescribes the priority or hierarchy of creditor repayments (statutory subordination).

EU member states have differing regimes for statutory subordination, which has led to concern that creditors are treated differently across EU member states. The European Commission therefore decided to harmonise the EU's approach to statutory debt subordination. This led to the Directive, which amends the BRRD and introduces a new class of secondary non-preferential debt to be issued by financial institutions which in an insolvency would rank behind other senior debt but ahead of contractually subordinated debt. The intention is to create a level playing field for all member states, to assist creditors with exposure in these jurisdictions.

The rationale behind this intervention seems to be that this new debt class will help firms to issue debt instruments which meet the MREL requirements, including the subordination requirement. Some financial institutions are issuing 'Tier 2' debt to meet their MREL, but this type of funding is more expensive than non-preferred senior debt as it ranks behind it and is therefore deemed riskier. The alternative has been to issue debt which is contractually subordinated, or structurally subordinated.

The UK government's Impact Assessment dated 6 November 2018 ('IA') states that the policy objective behind the introduction of this non-preferred senior debt class will give firms an alternative option for issuing debt instruments that are MREL compliant in a way which may reduce the cost of funding for some debt issuers. It should also increase harmonisation of statutory subordination across the EU, and the Directive was fast tracked for that reason. Use of this new debt class is optional, not obligatory, and the existing options of contractual subordination and/or structural subordination will remain available.

PERCEIVED BENEFIT

HM Treasury published a consultation document on 12 September 2018 (Technical Consultation on the draft Banks and Building Societies (Priorities on Insolvency) Order 2018) which ran until 10 October 2018. The Treasury has also consulted with the Bank of England (as the UK's resolution authority) and the Insolvency Service. According to the IA, the costs of the new Order will comprise compliance officers' time at the institutions issuing and buying the debt, plus the cost of enforcement officers at the Insolvency Service! These costs are estimated at £1.27m over a ten-year period, and there is an estimated one-off cost to government of training and the like in the sum of £1.21m in 2018. This is set against an estimated benefit of £106.53m, also over a ten-year period. The underlying assumptions used by the IA include that several of the financial institutions falling within the MERL requirements will have an MREL shortfall and will opt to issue the new non-preferred senior debt rather than Tier 2 debt because it will be cheaper. Financial institutions which are not in a MREL shortfall situation are not expected to issue this new type of debt. It appears the pool of beneficiaries will be a narrow one; the IA observes that the Bank of England has disclosed an MREL requirement for only 16 banks and building societies. The assumption is that non-preferred senior debt would have an expected maturity of seven years. The government found that most investors in this area were international, such that this new debt class would mean a substantial economic benefit to the relevant financial institutions in the UK. Perhaps disappointingly, the IA assumes banks will not be affected as they have the option of issuing senior instruments from their holding company. Such debt would be subordinated structurally, and is cheaper to issue than non-preferred senior debt externally. Building societies do not have that option, but should benefit from lower pricing of secondary non-preferential debt instruments, which are expected to be cheaper than the subordinated debt instruments that building societies are currently permitted to issue.

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SCOPE

The Directive was agreed by the EU Council and European Parliament on 12 December 2017, came into force on 28 December 2017 and must be implemented by member states before 29 December 2018. In the UK, the Order implementing the Directive came into force timeously on 19 December 2018 and its territorial extent is England, Wales, Scotland and Northern Ireland. It does not affect insolvency proceedings commenced before 19 December 2018. The Treasury must review and report on the Order before 18 December 2023 and thereafter every five years or sooner.

ORDER

The Order itself is fairly mechanical. It adds a new s 387A to the Insolvency Act 1986 ('the Act') containing new definitions. 'Relevant financial institution' is defined as any of a credit institution, an investment firm, a financial holding company, a mixed financial holding company, a financial institution which is a subsidiary of the above and covered by the supervision of that entity in accordance with Articles 6 to 17 of Regulation (EU) No 575/2013, or a mixed-activity holding company. These are all defined in Article 4 of that same directive. Self-evidently, it is to such institutions that this Order applies.

The new 'secondary preferential debt' is also defined in this new section (387A):

- 'secondary non-preferential debts' means non-preferential debts issued under an instrument where:
  - the original contractual maturity of the instrument is of at least one year;
  - the instrument is not a derivative and contains no embedded derivative; and
  - the relevant contractual documentation and where applicable the prospectus related to the issue of the debts explain the priority of the debts under this Act...'

There is also a definition of 'tertiary non-preferential debts' as meaning: 'all subordinated debts, including (but not limited to) debts under Common Equity Tier 1 instruments, additional Tier 1 instruments and Tier 2 instruments (all within the meaning of Part 1 of the Banking Act 2009)'.

Thus defined, the new category of secondary preferential debt is then added to the Act in various places. For example, where a relevant financial institution were to propose a company voluntary arrangement, a new paragraph is added to s 4 (Decisions of the company and its creditors) to restrict proposals altering the statutory priority of that class of debt.

The new priority itself is set out in new s 176AZA (Non-preferential debts of financial institutions) which, in summary states that ordinary non-preferential debts shall be paid in priority to secondary non-preferential debts, which in turn shall be paid in priority to tertiary non-preferential debts, but abate in equal proportions if assets are insufficient to meet them.

Similar amendments to the Act are made in relation to the moratorium for small companies in Sch A1, and administrations. Article 15 of the Order amends the Insolvent

Biog box

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Partnerships Order 1994 (although still with a reference to 'company'). Perhaps surprisingly, these amendments are also made in relation to bankruptcy and individual voluntary arrangements: presumably out of an abundance of caution, as it seems unlikely individual debtors could be relevant financial institutions.

Perhaps more likely is that landlords could be relevant financial institutions, and therefore the Housing Act 1996, Housing and Regeneration Act 2008 and Housing (Scotland) Act 2010 are also amended.

Outside the scope of this article are amendments to the Insolvency (Northern Ireland) Order 1989, Insolvent Partnerships Order (Northern Ireland) 1995, and the Bankruptcy (Scotland) Act 2016.

Finally, various tweaks are required to the Investment Bank Special Administration Regulations 2011 and Banking Act 2009.

CONCLUSION

This new Order seems a good – if narrow – example of the EU harmonising local finance and insolvency law across the member states. If neither a withdrawal agreement nor a hard Brexit repeals its effect, we will await the Treasury's first report before 18 December 2023.

In the wider insolvency context, there is perhaps a perception that the EU is marching steadily towards a more unified restructuring playing field. How much of a role will the UK play in that? The Conference of European Restructuring and Insolvency Law published a report on 12 December calling for a bilateral agreement between the UK and the EU, to safeguard post Brexit the mutual recognition rules in the recast European Insolvency Regulation. There is obvious concern at the potential harm to the restructuring sector in event of a hard Brexit.

Christmas dinner, with or without Brussel sprouts, may seem a long time ago, but Brussels and Brexit still loom large in the daily, and legal, news. ■

Further reading

- LexisPSL Restructuring and Insolvency: Overviews: Order of payments – overview
- LexisPSL Restructuring and Insolvency: Practice notes: An insolvency lawyer's guide to the Financial Services Compensation Scheme
- RANDI blog, 19 September 2018: Brexit no deal – impact on insolvency