Bail-In Debt Remodels The Risk Profile Of Bank Funding In Europe And North America

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Key Takeaways

- Despite the strengthening of banks in North America and Europe since the Great Recession, the risk profile of their wholesale debt has increased as they skew their term issuance toward bail-in instruments.
- Traditional operating company senior debt is predominantly an asset class that has ratings in the 'A' category for major issuers, but nearly 40% of the outstanding unsecured bank debt in North America and Europe is rated in the 'BBB' category, up from just above 25% four years ago, as loss-absorbing instruments account for a growing share of funding.
- While nonoperating holding company (NOHC) senior debt remains the largest bail-in asset class in aggregate in these two regions, senior subordinated debt (also known as senior nonpreferred and senior resolution notes) is growing fast and now totals nearly $300 billion.
- Looking ahead, we expect bail-in debt issuance in North America and Europe to center on a rolling refinancing of NOHC senior unsecured debt and a further accumulation of senior subordinated debt from European and Canadian issuers.

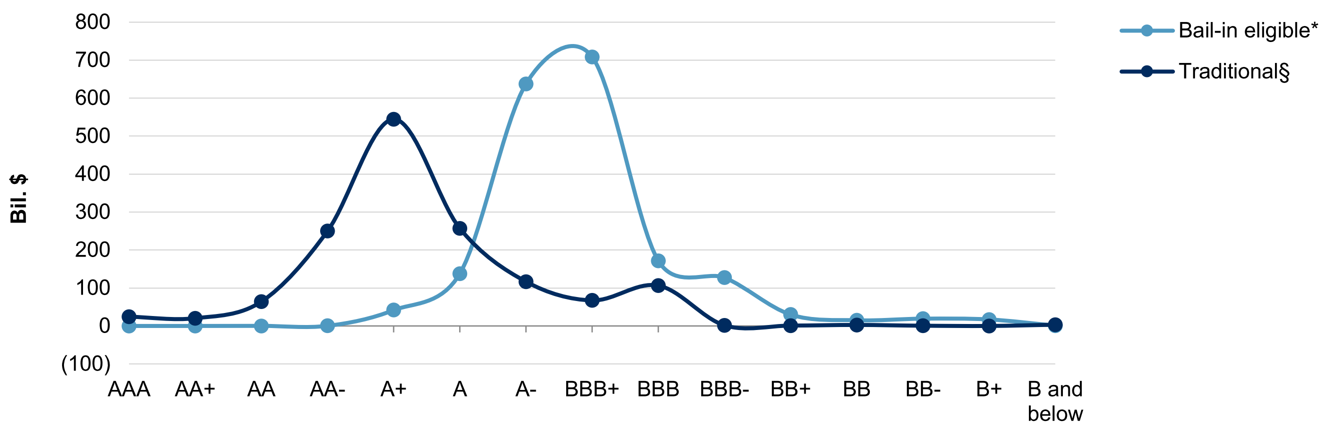
Not All Senior Debt Is Created Equal

Across the Group of 20 and beyond, regulators and policymakers united following the global financial crisis in their desire to address "too big to fail." This led to the publication by the Financial Stability Board of its total loss-absorbing capacity (TLAC) standards in November 2015, and other related national or regional regulations followed. These new rules have underpinned the emergence of senior subordinated instruments in Europe (known as senior nonpreferred) and--more recently--Canada. They have also clarified the loss-absorbing role of some existing instruments such as the nonoperating holding company (NOHC) senior debt of systemic banks in North America and Europe.

Regulations intend these loss-absorbing instruments to reduce the possible need for extraordinary government support if a systemically important bank fails. In such a scenario, the holder of the loss absorbing debt may be bailed-in (that is, their debt or a portion of their debt will be written down or converted to equity to recapitalize the insolvent bank).

Chart 1

Bail-In Debt Is Typically Rated 2 Notches Below Traditional Senior Operating Company Bank Debt



*Non-operating holding company senior unsecured debt and operating company senior subordinated debt.
§Operating company - senior unsecured debt. Data as of July 1, 2019. Source: S&P Global Ratings Research.

S&P Global Ratings has reflected these regulatory developments in our rating approach for these instruments. We typically rate the traditional operating company (opco) senior unsecured debt of banks in the U.S., Canada, and Europe higher than senior NOHC and senior nonpreferred debt. This is due to the explicit loss-absorbing nature of senior NOHC and senior nonpreferred debt in a resolution scenario; indeed, the bail-in of these junior liabilities bolsters the capacity of a bank to pay its senior creditors on time and in full.

As a result, most of North American and European bank NOHC and senior nonpreferred debt is concentrated around the 'A-' and 'BBB+' levels, while most rated traditional senior opco debt is concentrated around the 'A+' rating level (see chart 1), therefore an average gap of two to three-notches.

Regional Preferences For Types Of Loss-Absorbing Instruments Vary Considerably

The new type of senior subordinated resolution instruments that has emerged--also known as senior nonpreferred or senior resolution notes--are mostly found in European and Canadian banks. Conversely, U.S. banks are exclusively meeting resolution requirements with issuance through their NOHCs. In Europe, NOHC structures are less prevalent, apart from countries such as the U.K., Switzerland, Ireland, or, to a lesser extent, the Netherlands.

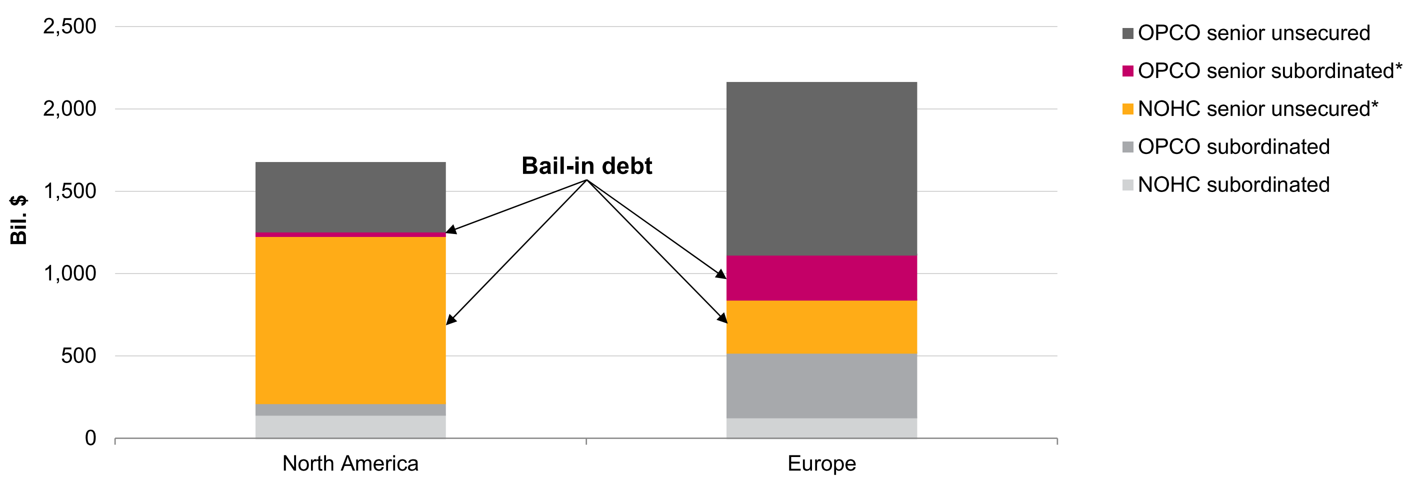
Regulations allowing the issuance of senior subordinated debt have only gradually come into force during the past two years in Europe, and in the past year in Canada. Despite some differences between the respective frameworks, we see European and Canadian senior subordinated and

European and U.S. senior unsecured NOHC debt as having an equivalent risk of default: irrespective of format, our issue ratings are typically one notch below the group stand-alone credit profile (SACP; our view of the risk that the bank becomes nonviable).

As of July 1, 2019, nearly $300 billion of these new senior subordinated debt instruments that we rated were outstanding, up from around $230 billion at the beginning of the year. We expect the amount to continue to increase steadily in the next couple of years. Over the past two years, most European countries have gradually passed the legislation required to create these instruments. In the first half of 2019 alone, the share of traditional opco senior unsecured debt decreased to 48% from 56% of total rated debt outstanding in Europe.

Chart 2

Senior NOHC U.S. Bank Debt Remains The Deepest Asset Class (So Far)
Amount of outstanding rated debt instruments from European and North American banks as of July 1, 2019



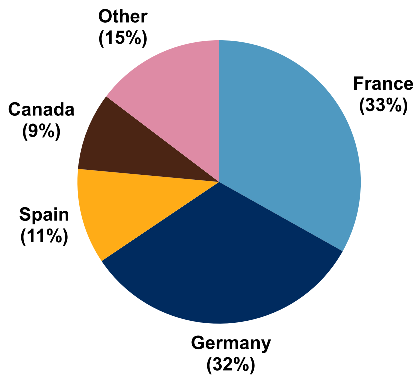
NOHC--Non-operating holding company. OPCO--Operating company.
*Bail-in debt includes non-operating holding company senior unsecured debt and operating company senior subordinated debt. OPCO subordinated includes other types of operating company subordinated debt (e.g. Tier 2) that is not senior subordinated. Source: S&P Global Ratings Research.

The issuance of senior nonpreferred debt is accelerating and spreading across more countries

French banks helped to create the market for senior subordinated debt in 2017, and are the largest issuers, accounting for 33% of the senior subordinated debt we rate, ahead of German banks at 32%. As of mid-2019, Spain accounted for another 11%, followed by Canada with 9%.

Chart 3a

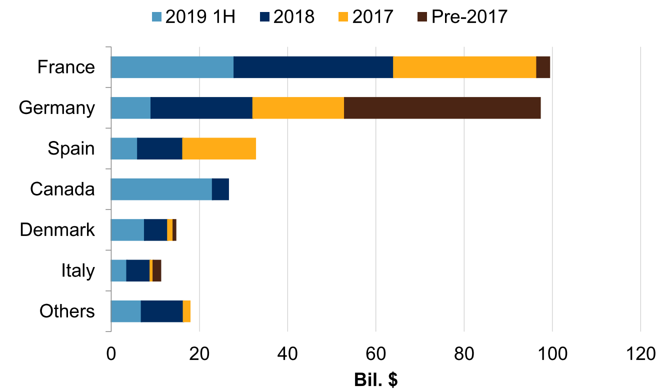
Distribution Of Rated Senior Subordinated Bond Debt By Country



Note: Currently outstanding senior subordinated bonds from North American and European banks. Data as of July 1, 2019. Source: S&P Global Ratings Research.

Chart 3b

Senior Subordinated Debt Issuance Accelerated In 2018 Through 2Q2019



Issue year of currently outstanding senior subordinated bonds, as of July 1, 2019.
Source: S&P Global Ratings Research.

Of the currently outstanding senior subordinated notes, 59% were issued from the beginning of 2018 through June 30, 2019. Through the first half of this year, French and Canadian banks have led new issuance.

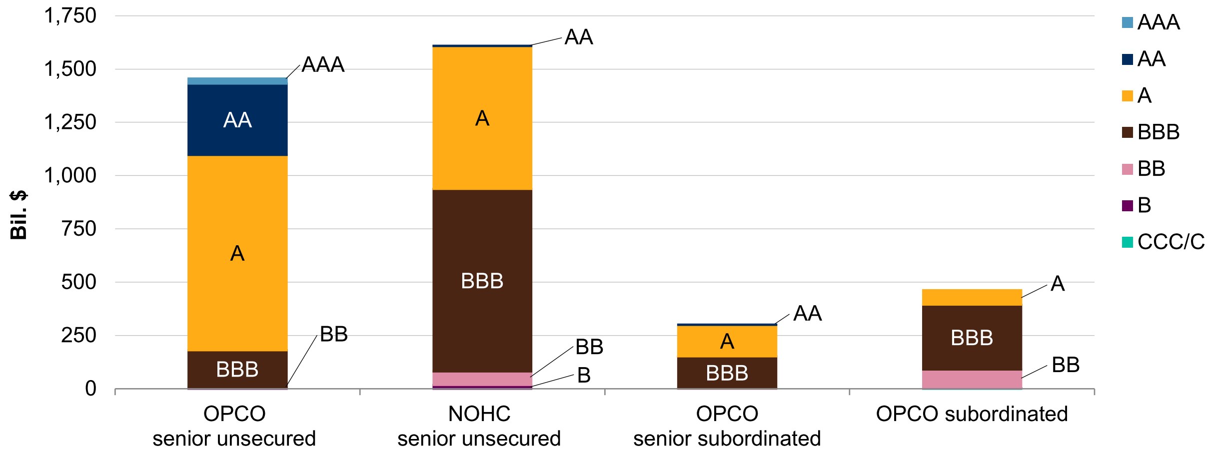
In Germany, more than two-thirds of the currently outstanding senior subordinated bond debt was issued in 2017 and earlier. By contrast, senior subordinated debt tends to be of a more recent vintage in the other countries, with most of it dating from 2018 or 2019.

This stark contrast reflects the German government's decision to enact a statutory subordination of most outstanding senior unsecured bank debt in insolvency and resolution. Germany has so far been the only country to opt for a legislation with retroactive effect (see "Credit FAQ: Rating Implications For German Banks Due To Evolving Bank Resolution Regulations," published Dec. 15, 2016). By contrast, other European policymakers have been content for banks to very gradually ramp-up their issuance of loss-absorbing capacity; this was enabled by changes to European insolvency laws through 2016-2018 to give a statutory basis for the senior nonpreferred debt class.

New issuers come to market every month but the inescapable fact remains that the market has seen very little issuance of speculative-grade senior subordinated debt. Furthermore, there has been limited issuance to date in central and southeastern Europe, and questions remain about the breadth of the potential investor base.

Chart 4

Growth In Bail-In Instruments Reduces The Share Of 'A' Category Bank Debt
Amount of outstanding rated debt instruments from European and North American banks as of July 1, 2019



OPCO--Operating company. NOHC--Non-operating holding company. Note: Bail-in debt includes non-operating holding company senior unsecured debt and operating company senior subordinated debt. OPCO subordinated includes other types of operating company subordinated debt (e.g. Tier 2) that is not 'senior subordinated'.

Source: S&P Global Ratings Research.

Outside Europe, Canada is the only country with legislation and regulations supporting the issuance of bail-in senior notes. This is a recent development, as the applicable regulations have only come into effect in the past 12 months (see "Review Of Canadian Bank Resolution Regime Completed; Ratings And Outlooks On Systemically Important Banks Unchanged," Aug. 16, 2018). Issuance has picked up rapidly in the few months since then, with $23 billion of rated senior subordinated debt issued through the first half of 2019.

Excluding Traditional (Preferred) Senior Opco Debt, Most Bank Debt In These Regions Is Rated 'BBB' Or Lower

As of July 1, 2019, 53% of rated NOHC and senior subordinated debt was in the 'BBB' category, while the majority (63%) of "traditional" opco senior unsecured (preferred) debt was rated in the 'A' category.

This split has contributed to a growing proportion of bank debt rated in the 'BBB' category, which has risen to 39% of outstanding unsecured rated bank debt as of mid-2019, up from 26% in mid-2015. In part, the rise of senior subordinated debt has added to this growth, as slightly over 50% of the debt that is rated is in the 'BBB' category. Nearly half of the 'BBB' category senior subordinated debt is rated 'BBB-', and much of this is debt from Deutsche Bank AG.

Another key factor in the rise of 'BBB' category unsecured bank debt is the growth of NOHC senior unsecured debt. Here, 53% is rated in the 'BBB' category. We lowered the issuer credit ratings (ICRs) of the NOHCs of several of the largest systemically important financial institutions in the

U.S., U.K., and Switzerland into the 'BBB' category during 2015. For the U.S. banks alone, these downgrades affected more than $700 billion in associated debt. These banks were downgraded based on the removal of uplift for the likelihood of extraordinary government support from our ratings, reflecting the progress regulators and the system had made in putting in place a viable U.S. resolution plan for systemically important banks.

In the U.S., Canada, and Europe, overall 'BBB' bank debt issuance has continued to grow over the past 10 years to represent between 33% and 40% of total rated issuance from end-2015 to mid-2019, compared with less than 20% in 2010-2015.

By rating category, senior unsecured bond debt from opcos accounts for the majority of 'A' category bond debt of banks, and the senior unsecured opco debt accounts for nearly all of unsecured bank debt in the 'AAA' and 'AA' categories. Notably, in this study, we've excluded senior secured debt, such as covered bonds, the vast majority of which are rated in these higher categories.

'A' rated debt has continued to dominate opco senior unsecured debt in these regions--despite some erosion since the great financial crisis and the eurozone sovereign crisis in 2011-2012. Overall ratings since 2015 have not only benefited from the economic recovery and improvements in bank capitalization, but also the issuance of loss-absorbing instruments by systemic banks. Ratings uplift related to the buffer afforded by the latter has offset the removal of the uplift for the likelihood of extraordinary government support from the opco ICRs and senior unsecured debt ratings for most European banks. This reflects our view that these subordinated buffers--which can be used to recapitalize the banks in a resolution scenario--can reduce the default risk for traditional senior unsecured debtholders.

Structural Versus Statutory Subordination In Bank Issuance

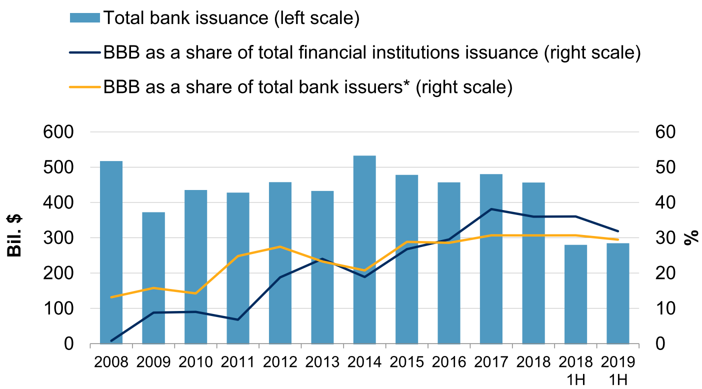
With European banks increasingly issuing new instruments such as senior subordinated debt to meet resolution requirements, a growing share of bond issuance from European banks is rated in the 'BBB' category. While 31% of European bank ICRs are in the 'BBB' category, 36% of European bank issuance was rated in that category in 2018.

In contrast, U.S. banks are using structurally subordinated NOHC debt to meet TLAC requirements. On the back of regulatory changes, we removed government support uplift from our ratings on the NOHC of systemic U.S. banks in late 2015. NOHC are the entities that U.S. banking groups use to meet most of their funding needs.

As a result, after the NOHC ratings of several systemically important financial institutions (and therefore large issuers) were lowered to the 'BBB' category in late 2015, the 'BBB' share of North American bank issuance more than doubled to 44% in 2016. Since then, the 'BBB' share of new issuance fell back to 32% in 2018 following the upgrade of Bank of America's holdco ICR to 'A-' in November 2017.

Chart 5a

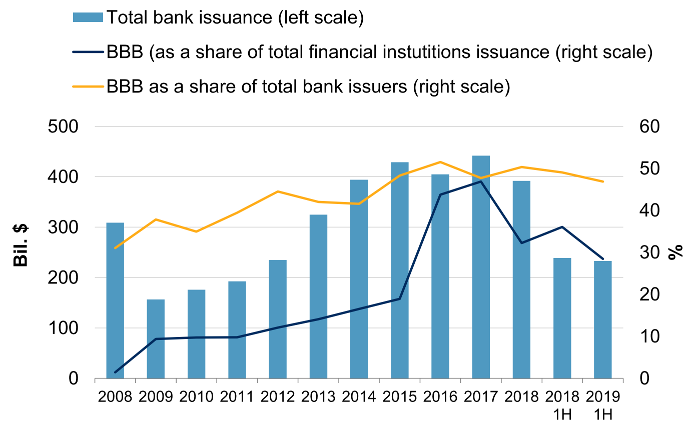
European Banks--'BBB' Category Issuers And Issuance



*Based on the number of bank issuer credit ratings. Issuance shows secured, unsecured, and subordinated bond issuance from European banks. Sources: S&P Global Ratings Research, Thomson.

Chart 5b

North American Banks--'BBB' Category Issuers And Issuance



Includes secured, unsecured, and subordinated bond issuance from North American banks. Sources: S&P Global Ratings Research, Thomson.

Bail-In Senior Debt Is Now Firmly Established As A New Debt Type

While new U.S. bail-in debt issuance (out of NOHCs) will likely mostly focus on refinancing, we expect further growth in the issuance of bail-in debt in Europe and Canada, whether senior NOHC debt or opco senior subordinated. In Europe, the pace of growth may be restrained by relatively prolonged implementation horizons for resolution regulations (such as those on minimum requirements for own funds and eligible liabilities or MREL) and the fact that some banks with small extra requirements are likely to simply top–up existing buffers of Tier 2 capital, among other factors.

In other parts of the world, we may also at some point see the emergence of new bail-in instruments, such as senior nonpreferred instruments, although the timing and extent of such a development remains uncertain.

Related Research

Resolution Regimes And Financial Institutions: Research By S&P Global Ratings, Sept. 26, 2019

This report does not constitute a rating action.