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Working Paper

Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?

SAFE White Paper, No. 35

Provided in Cooperation with:
Leibniz Institute for Financial Research SAFE

Suggested Citation: Götz, Martin R.; Tröger, Tobias (2016) : Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?, SAFE White Paper, No. 35, Goethe University Frankfurt, SAFE - Sustainable Architecture for Finance in Europe, Frankfurt a. M., https://nbn-resolving.de/urn:nbn:de:hebis:30:3-395948

This Version is available at:
https://hdl.handle.net/10419/129668

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Policy Center

Martin R. Götz, Tobias H. Tröger

Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?

White Paper No. 35

SAFE | Sustainable Architecture for Finance in Europe
A cooperation of the Center for Financial Studies and Goethe University Frankfurt

House of Finance | Goethe University
Theodor-W.-Adorno-Platz 3 | 60323 Frankfurt
Tel. +49 69 798 33684 | Fax +49 69 798 33910
policy_center@safe.uni-frankfurt.de | www.safe-frankfurt.de

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee in advance of the public hearing of the Chair of the Single Supervisory Mechanism in ECON on 22 March 2016.

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IN-DEPTH ANALYSIS

Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?

External authors: Martin R. Götz
Tobias H. Tröger
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EN

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Abstract

An important prerequisite for the efficiency of bail-in as a regulatory tool is that debt holders are able to bear the cost of a bail-in. Examining European banks' subordinated debt we caution that households may be investors in bail-in able bonds. Since households do not fulfil the aforementioned prerequisite, we argue that European bank supervisors need to ensure that banks' bail-in bonds are held by sophisticated investors. Existing EU market regulation insufficiently addresses mis-selling of bail-in instruments.

March 2016
ECON EN

PE 497.723

This paper was requested by the European Parliament's Economic and Monetary Affairs Committee.

AUTHORS

Martin R. Götz, Goethe University Frankfurt and SAFE
Tobias H. Tröger, Goethe University Frankfurt and SAFE

RESPONSIBLE ADMINISTRATOR

Marcel Magnus
Economic Governance Support Unit
Directorate for Economic and Scientific Policies
Directorate-General for the Internal Policies of the Union
European Parliament
B-1047 Brussels

LANGUAGE VERSION

Original: EN

ABOUT THE EDITOR

Economic Governance Support Unit provides in-house and external expertise to support EP committees and other parliamentary bodies in playing an effective role within the European Union framework for coordination and surveillance of economic and fiscal policies.
E-mail: egov@ep.europa.eu

This document is also available on Economic and Monetary Affairs Committee homepage at:
http://www.europarl.europa.eu/committees/en/ECON/home.html

Manuscript completed in February 2016
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CONTENTS

List of abbreviations 5
List of tables 5
List of figures 5
Executive summary 6
1. Introduction 7
2. The Market for Financial Institutions' subordinated Debt in Europe 10
   2.1 European banks' level of outstanding subordinated debt 10
   2.2 European bank's subordinated debt issuances 12
3. Regulatory tools against Mis-selling of Bail-in instruments 14
   3.1 Supervisory interventions under MiFID and MiFIR 14
   3.2 Ex post-liability for damages 15
   3.3 Mis-selling and financial stability objectives of the bail-in tool 15
4. Conclusions 17
References 18
Annex 1 19

LIST OF ABBREVIATIONS

bn	Billion
BRRD	Bank Recovery and Resolution Directive
CET1	Common Equity Tier 1
CRD IV	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
ESMA	European Securities Markets Authority
FSB	Financial Stability Board
G-SII	Global Systemically Important Institution
GDP	Gross Domestic Product
IORP	Institutions for Occupational Retirement Provision
mn	Million
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MREL	Minimum requirement of own funds and eligible liabilities
TLAC	Total Loss-Absorbing Capacity
trn	Trillion
SSM	Single Supervisory Mechanism
SRM	Single Resolution Mechanism

LIST OF TABLES

Table 1: European banks' outstanding subordinated debt (2010 and 2014) 10
Table 2: European banks' debt issuances 12
Table 3: Total European banks' debt issuances by parents and affiliates 13
Table 4: Subordinated debt holdings of European G-SIIs 19

LIST OF FIGURES

Figure 1: European banks' aggregate subordinated debt to GDP across countries 10
Figure 2: Relationship between subordinated bank debt/total liabilities and CET1 11

EXECUTIVE SUMMARY

In response to the financial crisis, policymakers in the European Union have expanded the regulatory toolkit and implemented the BRRD, facilitating the bail-in of bank debt holders in times of banking distress. While the ability of a bail-in of debt holders is considered to improve financial stability and market discipline, it is not clear whether it indeed is able to unfold its powers. Particularly as the efficiency of a bail-in to improve financial stability crucially depends on the characteristics of debt holders and their ability to bear losses. Recent bail-in episodes in Italy and Portugal have highlighted that a bail-in of debt holders is especially problematic if the debt holders are households or other types of retail investors.

In this note, we argue that debt holders of bail-in able debt shall be (a) sophisticated investors, which are (b) active outside the banking sector and are (c) not subject to an asset-liability mismatch due to their investment strategy. We argue that bail-in is most effective when investors of bail-in able debt fulfill these requirements.

Moreover, we investigate the extent of European banks' reliance on subordinated debt to understand the market for subordinated debt issued by banks. We find a considerable heterogeneity in European banks' reliance on subordinated debt financing across countries when also considering the size of a bank's home country: while banks headquartered in Greece and Hungary exhibit a smaller degree of subordinated debt financing as a fraction of GDP, banks located in the Netherlands and France rely more (in relation to GDP) on subordinated debt for financing. Moreover, our analysis shows a negative correlation between bank equity and subordinated debt financing, indicating that more fragile banks finance themselves to a larger degree with subordinated debt. Regarding a possible bail-in, this suggests that the subordinated debt of these banks is also more likely to be bailed-in as these banks are themselves riskier. Examining European banks' bond issuances, we find that the average size of such issuances and the average duration of subordinated bonds peaked in 2014. Moreover, the data suggests that banks issue a greater share of their subordinated debt via affiliates. This observation adds a further level of complexity and potential opacity regarding the possibility of a bail-in, which is hard to assess for households and other types of retail investors.

Note that our information comes from banks' balance sheets and bond issuances. Unfortunately, information on the holders of banks' subordinated debt is not reported/publicly available. It is, however, important to identify the holders of European banks' subordinated debt to determine if a possible bail-in of these debt holders is indeed improving financial stability. Aggregate evidence from the ECB's Households and Consumption Survey of 2013 suggests that retail investors may be invested in European banks' subordinated debt: households in countries in which banks are more reliant on subordinated debt financing are also more active in investing in financial markets than in other countries of the Euro Area.

Due to their unique position as regulator and evaluator of European banks, SSM supervisors, as well as SRM resolution authorities, can collect information on the holders of European banks' subordinated debt. Hence, these institutions need to gather information on the owners of banks' bail-in able debt and continuously monitor the ownership structure to assess whether debt holders indeed satisfy the aforementioned three criteria, thereby ensuring that bail-in is a powerful regulatory tool. Existing EU market regulation insufficiently addresses mis-selling of bail-in instruments. Furthermore, ex post-liability, as currently provided by Member States' capital market laws, is conceptually inapt to solve the problem.

1. INTRODUCTION

One key-lesson EU legislators have learned from the financial crisis of 2007/2008 and the ensuing sovereign debt crisis is that prudential regulation has to compel private sector loss-participation when banks fail. Private sector participation would enhance the risk sensitivity of investors if they can no longer rely on government bail-outs that effectively guarantee their claims if an institution should come under financial stress. As a consequence, banks would have to refinance themselves on terms that reflected their specific risk-profile and would no longer benefit from implicit government guarantees, but be exposed to market discipline instead (Zhou et al., 2012). Ultimately, this would dampen banks' appetite for risk in their investment decisions and enhance the financial system's resilience (Tröger, 2015). Moreover, making bank failures an essentially private event would also severe the link between banks and sovereigns and thus put a halt to the mutually re-enforcing downward spiral that can result from bail-outs in the financial sector (Gerlach et al., 2010; Tröger, 2013).

Hence, it was considered to be sound banking policy that the BRRD (arts. 43 et seq.) introduced the bail-in tool as a means to provide fresh capital for banks in times of distress. In case of bank failure, a bail-in of debt holders ensures that debt holders – in addition to bank shareholders – are forced to bear the brunt of the costs of an institution's failure. Several regulatory safeguards were put in place to make sure that at least 8% of the institution's own funds and liabilities are bailed-in prior to tapping any resolution financing arrangement (BRRD, art. 44(5)(a)) or resorting to government funds (BRRD, arts. 37(10), 56(1)). Finally, the supervisory prescriptions of MREL (BRRD, art. 45) – supplemented by the FSB's TLAC standards (FSB 2015) – assure, that EU banks indeed hold sufficient positions on the liability side of their balance sheets which can be subject to bail-in.

Despite these elaborate regulatory precautions, the ability of the bail-in tool to perform as intended may still be inhibited if the demand-side preconditions for its functioning (on these see, for instance, High-Level Expert Group on Reforming the Structure of the EU Banking Sector, 2012; Krahnen and Moretti, 2015; Zhou et al., 2012) are neglected in the legal framework. First, investors in bail-in able instruments need to be able to understand the risk of bail-in, charge adequate risk premiums and thus exert meaningful market discipline on banks. Second, the same investors need to have sufficient loss-bearing capacity to incur a loss when their debt is bailed-in, i.e. written-down or converted into equity. As conversion occurs during periods of distress, new equity holdings will initially be of substantially lower value than the nominal value of prior debt holdings. Third, bail-in shall not propagate risk from one financial institution to another. Particularly, a bail-in of debt holders must not endanger the financial health of other financial institutions as this may trigger a systemic crisis. Taken together, this implies that investors in bail-in able debt are ideally (1) <u>sophisticated</u> investors, (2) <u>outside the banking sector</u> whose (3) assets and liabilities are matched with regards to their maturity, i.e., there is <u>no asset-liability mismatch</u>. For instance, institutional investors such as insurance companies, pension funds or high net-worth individuals represent ideal holders of bail-in able debt[1] as they are able to incur potential short run costs of a bail-in due to their long investment horizon and may have a maturity-matched balance sheet. Should investors fulfil these requirements and consider bail-in able capital as an interesting investment (due to its risk premium), one may conclude that the bail-in tool is indeed a powerful mechanism to regulate banks and can be expected to perform well.

Recent bail-in episodes in Italy and Portugal (Reuters, 2015, 2016) show that here investors in bail-in able capital were also private households and bank retail customers. Households, however, are not sophisticated investors, as described above, and, as such, are unlikely to charge an adequate risk premium for bail-in able debt, limiting the market disciplining effect of this regulatory tool.

[1] This statement is independent of indirect investment restrictions that come in the form oft he prudent person principle and regulatory capital requirements for some of these investors e.g. under Solvency II and IORP Directives.

Furthermore, households may invest a large amount of their personal wealth in a bank's bail-in able debt. A bail-in then leads to a substantial loss of their personal wealth with detriments to psychological health and financial difficulties due to an erosion of savings. Politicians may feel compelled to compensate households in case of a loss due to a bail-in. This, in turn, renders the ability of bail-in to help sever the link between banks and sovereigns useless: instead of bailing out banks, governments would bail-out bailed-in retail investors.

Moreover, as explained above, holders of bail-in able debt should also reside outside the banking sector in order to limit the risk of systemic crises in case of bail-in. In case other banks are the major owners of distressed banks' bail-in able debt, a bail-in may cause further stress for the banking sector.[2] As a result, the very purpose of bail-in as a tool to recapitalize struggling banks would be negated.

Information on who holds bail-in able instruments is hence of utmost importance. The sale of bail-in instruments to other banks or to unsophisticated retail investors calls the objective of this regulatory instrument fundamentally into question and the efficiency of the bail-in tool would be compromised in all dimensions. However, meaningful restrictions on the sale of banks' subordinated debt holdings are not established under the current legal framework: neither the BRRD nor any other prudential regulation effectively prevent banks from selling their bail-in able securities to unsophisticated (retail) investors; similarly, banks' holdings of bail-in able instruments can be limited only if they pose a risk for the holding institution's resolvability (BRRD Arts. 44(2) subpara. 5, 17(5)) or violate the large exposure limits under art. 395 CRR[3] which allows only to remedy the most glaring deviations from the social optimum in this regard.

In the following analysis we focus on subordinated debt, as banks' subordinated debt will be the primary target of a bail-in in times of banking distress. Although in principle, the scope of the bail-in tool is much broader[4] we focus on banks' subordinated debt as it will represent the critical balance-sheet position subject to a bail-in, as evidenced by regulatory prescriptions for MREL (BRRD art. 45(4), (13), (14)(b)) and TLAC (FSB, 2015: item 11).

We find that European banks rely to a large extent on subordinated debt financing with substantial heterogeneity among banks in different European countries. Moreover, we find that banks with less equity tend to finance themselves more with subordinated debt. Focusing on banks' bond issuances, we find that banks issue about one third of their subordinated debt via affiliates, adding a further level of complexity, rendering it more difficult for investors to determine the likelihood of a subordinated bond to be bailed-in. Information on the owners of European banks' subordinated debt is not available, but our findings suggest that the market for European banks' subordinated debt is large and increased over the last years. The highlighted changes in the characteristics of subordinated debt can be interpreted to mean that the probability of a bail-in of these bonds is also more likely. SSM supervisors and SRM resolution authorities need to check that banks' subordinated debt is not held by (1) retail investors or (2) other banks. It is highly doubtful that

[2] Generally speaking, banks' investment in other banks' debt should be limited due to possible contagion effects during times of banking distress, as recently illustrated by the case of Düsseldorfer Hypothekenbank (Düsselhyp). Düsselhyp was a large investor in the debt of Austrian bank Hypo Alpe Adria. This debt was transferred to the "bad bank" Heta Asset Resolution AG (Heta) in 2014 and in March 2015 the Austrian regulator imposed a debt moratorium on outstanding debt of Heta. This put pressure on the balance sheet of Düsselhyp and the deposit insurance fund of German private banks decided to bail-out Düsslhyp to avoid further knock-on effects.

[3] The limit applies if an exposure of a bank or banking group exceeds 25% of (consolidated) own funds.

[4] BRRD, art. 44(1) covers essentially the whole liability side of a bank's balance sheet and thus classifies all these positions as bail-in able as a matter of law. Detailed information on this entirety of banks' legally bail-in able debt is not readily available and required deeper investigation. Yet, given the practical limitations on and uncertain consequences of bailing-in many positions (e.g. those arising from derivative contracts) in times of crisis (see e.g. Sommer, 2014), focusing on easy to bail-in subordinated bonds provides information on those liabilities that will be the pivotal financial instruments subject to bail-in in practice.

retail investors are able to charge adequate risk premia. This inhibits the market-disciplining effect of subordinated debt on bank risk. Due to contagion, a bail-in of debt holders may not be feasible if these debt holders are other banks.

We conclude by making the case that existing EU market regulation insufficiently addresses mis-selling of bail-in instruments to retail investors. We also make the point that ex post-liability, as currently provided by Member States' capital market laws, is conceptually inapt to solve the problem.

2. THE MARKET FOR FINANCIAL INSTITUTIONS' SUBORDINATED DEBT IN EUROPE

2.1 European banks' level of outstanding subordinated debt

We focus on banks licensed in the countries that participate in the Banking Union[5] and use information from banks' balance sheets at the end of 2010 and 2014, obtained from SNL Financial. Information on the holders of banks' subordinated debt is not available and hence we focus on describing and analysing the amount of total outstanding bank debt to draw inferences on the potential for undesirable holdings of bail-in bonds. Table 1 shows aggregate data for the years 2010 and 2014. As reflected in Table 1, European banks' total amount of subordinated debt has decreased over the last years. However, at the end of 2014, European banks' total subordinated debt in our sample amounts to 471.5 bn EUR. This is about the size of the Belgian GDP in 2014. Compared to the GDP of the considered countries, the level of banks' aggregate subordinated debt is equivalent to 4.62% of total GDP.

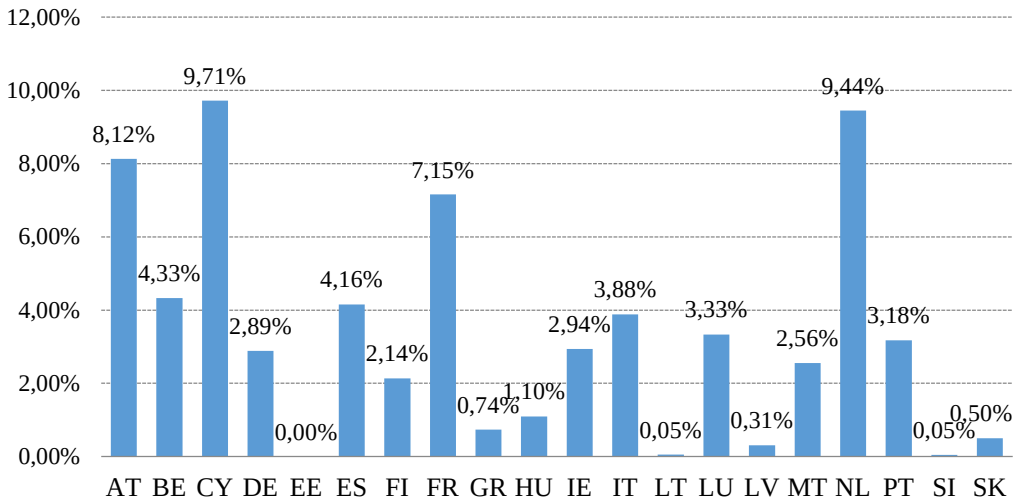
Table 1: European banks' outstanding subordinated debt (2010 and 2014)

	Total (EUR)	As share of GDP
2010	697.6 bn	7.23%
2014	471.5 bn	4.62%

Source: SNL Finance. Eurostat. Time Period: 2010; 2014.

There is considerable heterogeneity among European countries. Figure 1 displays the the share of the domestic banks' subordinated debt as a fraction of that country's GDP.

Figure 1: European banks' aggregate subordinated debt to GDP across countries



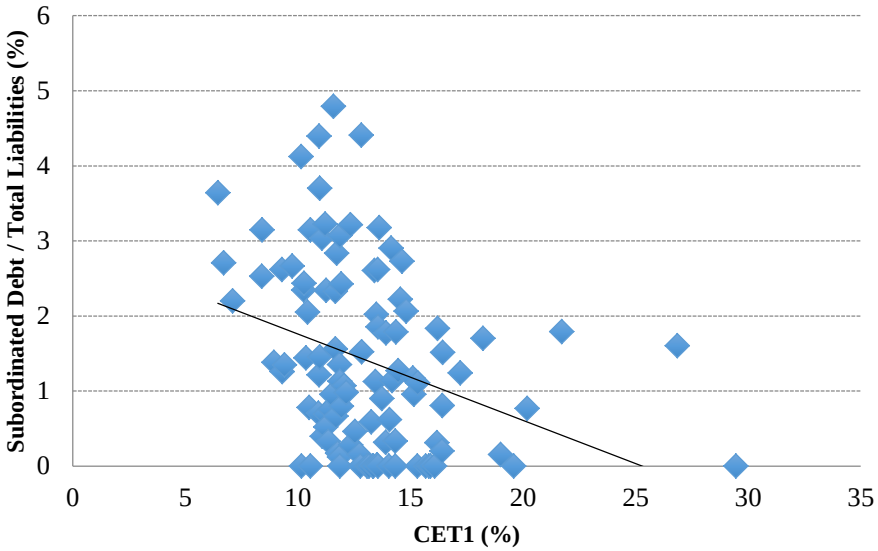
Source: SNL Financial, Eurostat, Time Period: 2014.

Figure 1 shows that some domestically chartered banks' subordinated debt as a share of GDP is rather low for some smaller countries (e.g. Estonia, Greece, Hungary, Lithuania, Latvia, Slovenia and Slovakia). The amount of banks' subordinated debt in proportion to a country's GDP for the Netherlands, Cyprus, and France, on the other hand, is above the European average. Hence, compared to those countries' economic performance, the level of oustanding subordinated debt of their banking sector is fairly high.

[5] These countries are: Austria, Belgium, Cyprus, Germany, Estonia, Spain, Finland, France, Greece, Hungary, Ireland, Italy, Lithuania, Luxembourg, Latvia, Malta, Netherlands, Portugal, Slovenia, Slovakia.

In Figure 2, we explore the quality of European banks' subordinated debt and examine the relationship between the share of subordinated debt to total debt outstanding to the Tier 1 common equity (CET1). As higher equity implies that banks are more likely to withstand times of financial distress, we consider CET1 to reflect a bank's financial soundness.

Figure 2: Relationship between subordinated bank debt/total liabilities and CET1



Source: SNL Financial, Time Period: 2014.

Figure 2 shows a negative relationship between equity and subordinated debt financing.[6] Hence, banks with less equity tend to finance themselves more with subordinated debt than banks with more equity. This negative correlation gives rise to possible concerns as lower CET1 implies less buffers to absorb losses and hence indicates a greater probability of bail-in. Whether investors are aware of this negative relationship and hence charge an appropriate risk premium is not clear. Aside from our analysis, however, we were not able to find evidence, suggesting that the relationship we find is widespread (market) knowledge. Hence, it can be assumed that at least retail investors are not aware of this correlation, most likely holding a more optimistic view of the risk of banks' subordinated debt.

Information on the holders of banks' subordinated debt is not available and hence we cannot assess to what extent other banks are holders of these bonds or how high the share of retail investors is. A big portion of European banks' outstanding debt is probably held by institutional investors, satisfying our aforementioned requirement[7] regarding the sophistication of investors in bail-in able debt. Whether these sophisiticated investors reside indeed outside the banking sector cannot be assessed due to a lack of detailed data. However, it is reasonable to assume that at least a fraction of the sizeable amount of subordinated debt is also held by other banks in their banking book, which is also the presumption in EU legislation which explicitly puts – very wide – limits on such holdings (cf. BRRD arts. 44(2) subpara. 5, 17(5) ; CRR art. 395). Data from the EBA (EBA (2014) indeed indicate that European banks are interlinked via their holdings of debt. Focusing on the holding of subordinated debt, issued by other financial institutions, we find that large European banks in 2014 held a total amount of almost 13 bn EUR (cf. Table 3 – Annex). Furthermore, we find that some banks, headquartered in France and Italy, exhibit relatively large holdings of other financial institutions' subordinated debt. This is worrisome if these holdings are, for instance, concentrated in a few institutions and maybe subject to a high risk of bail-in.

[6] The correlation between CET1 and the share of subordinated debt financing is -0.39.
[7] Investors of bail-in able debt should be (1) sophisticated investors, (2) outside the banking sector and do (3) not have an asset-liability mismatch.

Regarding retail investors, evidence from the ECB's Household Finance and Consumption Survey suggests that households may be important holders of banks' subordinated debt as well. For instance, the financial market participation rate of households is above European average in Germany, France, and the Netherlands (Table C1 - ECB, 2013). Similarly, one out of seven Italian households tends to own bonds, indicating that Italian households are important investors in the bond market (Table C1 - ECB, 2013). Hence, in addition to institutional investors, households may also play an important role in the market for banks' subordinated debt, questioning the power of a possible bail-in due to the aforementioned concerns.

2.2 European bank's subordinated debt issuances

We now examine banks' bond issuances in greater depth to analyse patterns in bond issuances over time as well as differences in the characteristics of these bond issuances. Therefore, we use information from SDC Thomson Reuters and focus on the issuances of Euro-denominated subordinated debt by financial institutions. As already shown above, the majority of outstanding bank subordinated debt is concentrated in a few countries and hence we focus on debt issuances in the ten countries with the highest activity.[8]

Table 2: European banks' debt issuances

	Subordinated debt issuances		Senior debt issuances	
Year	Fixed duration (mn EUR)	Perpetual (mn EUR)	Fixed duration (mn EUR)	Perpetual (mn EUR)
2010	19,477	3,335	591,655	-
2011	17,350	-	582,511	-
2012	15,026	1,947	482,747	-
2013	22,516	4,497	358,038	69
2014	28,345	27,609	404,747	-
2015	24,020	9,669	302,096	846

Source: SDC Thomson Reuters, Time Period: 2010-2015.

Table 2 reports the total principal amount of subordinated and senior bond issuances by European banks, differentiated whether the bond has a fixed maturity date ('fixed duration') or is a perpetual bond ('Perpetual'). Table 2 shows interesting patterns regarding the characteristics of issued subordianted bonds. Regarding total subordinated bond issuances, we find that the total principal amount of subordinated bonds peaked in 2014, reaching more than 55 bn Euro. Interestingly, this peak is due to a huge increase in the offering of perpetual subordinated debt in 2014. During that year, the level of bank's subordiated perpetual bond offerings jumped to almost the same size as the offerings of fixed duration debt instruments. These patterns are in stark contrast to characteristics of banks' senior debt issuances.

The increase in issuing perpetual subordinated bonds strongly suggests that banks may have responded to changes in regulation. The BRRD was adopted on May 14, 2014 and had to be implemented by December 31 of that year, with most of the harmonized provisions applying from January 1, 2015 onwards, with the notable exception of the bail-in tool and its MREL-prescriptions that had to become applicable law by January 1, 2016 (BRRD, art. 130(1)). In reaction to these visibly tightened requirements to constantly hold specific levels of bail-in able instruments, banks may have issued longer term subordinated debt to limit the extent of rollover risk when issuing debt of shorter duration. The aforementined pattern (Table 2) suggests that banks preemtively issued

[8] These countries are Austria, Belgium, Germany, Greece, Spain, France, Italy, Portugal, the Netherlands and Ireland.

more subordinated debt in order to prepare for the emerging BRRD requirements and capitalizing on favorable market conditions (generally low interest rates).

The increase in perpetual subordinated bond issuances in 2014 could also reflect greater demand for perpetual bank bonds. This, however, seems unlikely given that the amount of banks' perpetual senior bonds did not peak in 2014. Given the relatively low interest rates and investors' search for yield, one could assume that also retail investors – not properly informed about the inherent risk of bail-in bonds – were inclined to invest as well.

A lack of data does not allow a closer examination, though. In case retail investors are more invested in European banks' subordinated debt issuances, however, the identified changes in European banks' subordinated debt issuances may raise concerns. First, the increase in principal amounts over the last years suggests that either a larger share of retail investors is now exposed to possible bank bail-ins or that a constant number of such investors has greater sums at stake than before. Second, the low trading volume of bank (subordinated) debt in secondary markets and the long duration of banks' subordinated debt further inhibits the possibilities of households to divest their holdings of long-term subordinated debt, and hence exposes households to the risk of bail-in for a longer period. Moreover, these features (very long duration, illiquid secondary markets) seem hard to square with an average retail investor's needs. The observation corroborates the concern that if these bonds ended up in retail investors' portfolios, some misinformation, deception etc. may have occured.

European banks often have a complex organizational structure with several affiliates. We find that banks make use of this and not only issue subordinated bonds at the parent level, but also issue a significant amount of subordinated debt at the level of affiliates. Focusing on the same sample of banks as before, Table 3 reports aggregate volumes of senior debt issuances and subordinated debt issuances, depending on whether that bond was issued by the parent or an affiliate.

Table 3: Total European banks' debt issuances by parents and affiliates

	Subordinated debt issuances (mn EUR)		Senior debt issuances (mn EUR)	
Year	Parent	Affiliate(s)	Parent	Affiliate(s)
2010	19,269	3,542	290,205	301,450
2011	13,072	4,278	320,262	262,249
2012	15,537	1,435	238,353	244,394
2013	22,444	4,568	145,907	212,200
2014	32,477	23,478	195,675	209,073
2015	26,190	7,499	112,967	189,976

Source: SDC Thomson Reuters, Time Period: 2010-2015.

Table 3 shows that the on average about 26% (52%) of European banks' subordinated (senior) debt was not issued by the parent, but by affiliates. Similar to before, 2014 seems to present a break and European banks issued relatively more subordinated bonds via affiliates than at the parent company level.

Issuing bonds via affiliates adds another layer of opacity regarding the risk of bail-in of a certain bond. Hence, retail investors may not be aware of the organizational structure and hence disregard or misjudge the possibility of a bail-in. Although the FSB's TLAC standards forsee that from January 1, 2022 subordinated bonds for a resolution entitiy (banking group) need to be issued at the parent level (FSB, 2015: item 8 lit. c)), the status quo presents a suboptimal situation as especially retail investors may have difficulties evaluating the risk of bail-in if the bond is issued by an affiliate.

3. REGULATORY TOOLS AGAINST MIS-SELLING OF BAIL-IN INSTRUMENTS

In this chapter, we address the legal rules that potentially work against mis-selling of bail-in bonds. We first address supervisory powers to intervene in cases in which financial instruments subject to bail-in are systematically sold to unsophisticated retail investors. These powers are vested exclusively with capital market supervisors (national competent authorities and ESMA), whereas banking supervisors and resolution authorities currently have no power to interfere with sale practices that contravene the essential demand-side preconditions for the proper functioning of the bail-in instrument as outlined in the introduction. This fragmentation of competences inhibits tackling the problem adequately. Second, we find that liability for damages, as currently provided for by Member States' private laws, is conceptually insufficient to reduce these practices effectively.

3.1 Supervisory interventions under MiFID and MiFIR

Bail-in instruments that are sold to retail investors are typically marketed by investment firms that fall within the scope of MiFID and MiFIR.[9] MiFID (arts. 24, 25) compels Member States to impose detailed obligations on investment firms to act honestly, fairly and professionally in accordance with the best interest of their clients. In particular, investment firms have to ensure that the financial instruments they offer or recommend are compatible with the needs of the clients to whom they provide investment services and ensure that financial instruments are offered or recommended only when this is in the interest of the client (MiFID, art. 24(2) subpara 2). In light of the aforesaid (supra chapter 1), we believe, that these general duties of investment firms already prohibit most marketing practices that broadly target unsophisticated investors as buyers of banks' bail-in instruments.

However, we harbour doubts with regard to an effective enforcement of these obligations by capital market supervisors. To be sure, MiFID arts. 69, 70, oblige Member States to give national competent authorities all relevant supervisory and administrative sanctioning powers to effectively enforce the substantive duties established in the transposition of MiFID or by MiFIR.[10] Hence, these supervisors certainly possess the powers to prevent mis-selling of bail-in instruments. Despite these legal powers, concerns remain as to whether these supervisors can indeed prevent mis-selling of bail-in bonds. Specifically, as their primary mandate (investor protection,[11] market integrity) is different from that of banking supervisors and resolution authorities, they do not systematically collect and thus largely lack the necessary information on the specific function of subordinated debt in individual banks. Because they are neither involved in resolution planning (BRRD, arts. 10 et seq.) nor in the determination of MREL (BRRD, arts. 10(7)(p), 45) and the pertinent deadlines, the effective use of their powers regarding individual bail-in instruments is clearly restricted. Given the institution-specific features of any resolution, bank-level knowledge seems of essential importance to understand already at the stage of marketing of subordinated bonds whether they will become critical in a specific bank's failure and are thus extraordinarily sensitive to mis-selling. Hence,

[9] According to the definition in MiFID, art. 4(1)(1) an investment firm is any legal person that regularly provides investment services (MiFID, art. 4(1)(2)), i.e. *inter alia* provides investment advice (Annex I Section A para 5) pertaining to transferable securities (Annex I Section C para 1), where investment advice means "the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm" (MiFID, art. 4(1)(4). In particular, where banks sell bail-in instruments (subordinated bonds) through their retail network, they fall within the scope of application of MiFID and MiFIR.

[10] In particular, MiFID, art. 69(2)(k), compels Member States to vest their supervisory authorities with the power to require the temporary or permanent cessation of any practice or conduct that the competent authority considers to be contrary to the provisions of MiFIR and the provisions adopted in the implementation of MiFID.

[11] The relevant section of MiFID comes under the title of "Provisions to ensure investor protection".

resolution authorities' intimate knowledge of these facts gives them a far better position to intervene in problematic cases.[12]

The structural problems rooted in capital market supervisors' primary mandate also apply to ESMA's potential role because this European authority also primarily serves the identified objectives of its national counterparts. Moreover, its temporary intervention powers (in particular, MiFIR art. 40(1)(a)) are only available if national authorities refuse to act (MiFIR, art. 40(2)(c)). ESMA's power thus hinges on a very cumbersome procedure. In addition, the staggered competence also requires that not only national supervisors but also ESMA dispose of a sufficient information basis, which again is doubtful with regard to pivotal bank-level data.

3.2 Ex post-liability for damages

Furthermore, we do not believe that liability for damages, as currently provided for by Member States' private contract or tort law, constitutes a sufficient remedy, regardless of how momentously supranational law shapes the pertinent national rules (cf. Busch, 2012). Ex post-liability is structurally inadequate when banks mis-sell their bail-in instruments because accountability will typically occur during the crises or immediately after the institution's stabilization and will thus precipitate undesirable additional or new financial stress. Moreover, we believe that private enforcement in the absence of U.S.-style class actions, which are unavailable for securities litigation in most Member States, can only provide a suboptimal deterrent: particularly small retail investors will rationally opt not to sue if the expected value of the damage award won only with some probability does not compensate for the costs they will incur in litigation (Spier, 2007).[13] As a result, the threat of severe under-enforcement looms large which is particularly detrimental given the financial stability objective of the bail-in tool.

3.3 Mis-selling and financial stability objectives of the bail-in tool

Finally, we believe that the focus on mis-selling is too narrow in light of the preconditions for the proper functioning of the bail-in instrument we sketched above. Even if households and other types of retail-investors receive adequate information on the specific risk of a bail-in instrument, they may still lack the necessary loss-bearing capacity and thus suffer unsustainable losses in a bank's failure that potentially induce undesired government intervention. As a consequence, even where no mis-selling occurs, policy makers may wish to give authorities the power to impose and enforce investment restrictions with regard to bail-in bonds.[14] Such a mandate clearly deviates from the tasks given to capital market supervisors, and is inextricably linked to those of the resolution authorities.

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[12] An alternative is to ensure that resolution authorities share the relevant information with capital market supervisors. We believe, however, that such a solution is substandard. Understanding and evaluating a bail-in instrument's function in a bank's failure requires first-hand knowledge of the bank and its resolution planning, which lies with the resolution authority. This knowledge is typically not transferable and hence, even sharing the data will alone would not allow an ex ante assessment of mis-selling if the capital market supervisors were not ready to fully retrace the resolution authorities' determinations.

[13] This general problem of an underenforcement of small claims is attenuated where small retail investors have access to cost-saving alternative dispute resolution procedures, for instance ombudsmen hearings. Yet, even if these procedures were universally embraced by claimants, they only shift the margin of enforcement activity but still don't bring its level to the social optimum.

[14] Technically, these restrictions could also be enforced through ex post interventions of the competent authority. If, for instance, applicable regulations would exclude bail-in bonds held by retail investors in the calculation of MREL, a sale of such bonds to retail investors would be unattractive for banks ex ante as resolution authorities would require additional issuances of bail-in capital. Similarly, if competent authorities could initiate a liability management exercise at the issuing price immediately after bail-in bonds have been placed with retail investors, incentives to conduct such a placement in the first place would be erased. Yet, the key aspect remains: the intervention has to occur in close vicinity of the issuance of bail-in bond, i.e. at their placement in the primary market.

Furthermore, banks' investments in bail-in instruments of other financial institutions are equally unwanted. Given the expertise of the buyer, however, this will typically not occur in mis-selling scenarios. Yet, the possibility that a bail-in of other financial institutions leads to contagion and triggers a systemic crisis exists and authorities need to prevent this scenario ex ante. Hence, they should still be able to interfere at a very early stage if bail-in able instruments are absorbed by the banking sector. Once again, such a mandate would be entirely new for capital market supervisors. Moreover, it can only be administered effectively if the competent authorities understand the role of the instrument in the case of the issuing bank's failure correctly. Hence, resolution authorities seem to be in the best position to assume this competence.

4. CONCLUSIONS

The power of bail-in to serve as a regulatory tool to recapitalize banks during times of distress depends crucially on the characteristics of debt holders. We argue that debt holders of bail-in able debt should be sophisticated investors outside the banking industry with no asset-liability mismatch. The level of European banks' subordinated debt is large and recent developments in subordinated debt issuances highlight a greater exposure of debt holders to a bail-in. Detailed information on the owners of subordinated, and hence bail-in able, debt is not available, casting doubts on the ability of bail-in to serve as a powerful tool to improve financial stability.

Supervisors with a mandate to provide a safe and sound banking system should therefore, at the very minimum, collect information on the marketing of subordinated debt and gather an understanding of banks' subordinated debt holders. This is particularly important since, as we argued before, debt holders of bail-in able debt need to be investors outside the banking sector to avoid the threat of a systemic crisis as a result of knock-on effects in a bail-in. The purpose of the bail-in tool is to (1) provide a means for bank recapitalization during times of distress and (2) improve market discipline ex ante by limiting the risk-taking of banks. The possibility of the bail-in tool to perform these two functions properly is hence interweaved with the structure of bail-in able debt holders. Regarding the first point, resolution authorities need to ascertain that the holders of banks' bail-in able debt are indeed able to bear the costs of a bail-in. This implies that these investors reside outside the banking sector to avoid contagion within the banking sector. Regarding the second point, investors of banks' bail-in able bonds need to be sophisticated investors that are able to charge an adequate risk premium. Although the issue of mis-selling is important, we believe, that additional scrutiny by resolution authorities regarding the marketing of subordinated debt is important to ensure that the bail-in tool is also operable in practice. Collecting more information would further enable resolution authorities to evaluate better whether a bail-in of debt holders will be feasible and hence assess the efficiency of the bail-in tool. Depending on the structure of bank bondholders, further restrictions on the sale of these bonds can be considered to ensure that a bail-in of these debt holders will indeed contribute to financial stability and not increase problems.

Regarding mis-selling, our observations translate into a key policy recommendation: private enforcement is generally inapt to effectively prevent mis-selling, which constitutes a major impediment to an effective functioning of the bail-in instrument. Public enforcement thus provides the superior option. Yet, the relevant competences should lie with those authorities that administer the bail in-tool in all other dimensions and thus dispose of all relevant bank-level information needed to identify mis-selling early. Hence, intervention powers should be given to resolution authorities. This is all the more true, as these powers should not be limited to mis-selling cases in the classical sense but also encompass scenarios where no mis-information, deception etc. is present, yet the allocation of bail-in risk is still undesirable.

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ANNEX 1

Table 4: Subordinated debt holdings of European G-SIIs

Bank name	Subordinated debt securities issued by other financial institutions (mn EUR)
KBC	255
Intesa	0
MonteDeiPaschi	550
Unicredit	2,728
BayernLB	20
Commerzbank	158
Deutsche Bank	17
DzBank	805
Helaba	0
LBBW	167
NordLB	68
BPCE	929
CreditMutuel	56
Postale	195
ABN AMRO	0
ING	35
Rabobank	90
Erste Group Bank AG	434
SocieteGenerale	0
BnpParibas	2,183
CreditAgricole	3,799
Santander	126
BBVA	164
BFA	3
Caixa	32
Total	12,816

Source: EBA, 2014.

Европейски парламент Parlamento Europeo Evropský parlament Europa-Parlamentet Europäisches Parlament
Euroopa Parlament Ευρωπαϊκό Κοινοβούλιο European Parliament Parlement européen Parlaimint na hEorpa
Europski parlament Parlamento europeo Eiropas Parlaments Europos Parlamentas Európai Parlament
Parlament Ewropew Europees Parlement Parlament Europejski Parlamento Europeu Parlamentul European
Európsky parlament Evropski parlament Euroopan parlamentti Europaparlamentet

QA-02-16-239-EN-C (paper)
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PE 497.723

ISBN 978-92-823-8902-7 (paper)
ISBN 978-92-823-8886-0 (pdf)

doi:10.2861/732126 (paper)
doi:10.2861/879240 (pdf)