



CREDIT SPECIAL

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Bank bonds in Germany: Imminent launch of new preferred senior bonds

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From 21 July 2018, banks domiciled in Germany will also be able to issue preferred senior bonds. Due to the extensive risk buffer offered by outstanding non-preferred bonds, the spread between preferred senior bonds and covered bonds is likely to be lower in Germany than in other European countries. However, replacement of non-preferred maturities by this new type of bond could weigh on the creditworthiness of both bond categories and tend to widen spreads. Though the extent of this development depends on the funding strategy of the respective bank.

German banks will be able to issue preferred senior bonds from 21 July 2018

Based on current plans, a further change in the insolvency ranking of bank liabilities will take effect on 21 July 2018.¹ In accordance with amendments to section 46f KWG (German Banking Act), banks domiciled in Germany will then be able to issue preferred senior (PS) bonds. In line with the ECB's current guidelines, these will qualify as eligible assets for central bank lending.² After the second and third readings in the Bundestag on 28 June 2018, the legislative procedure for amending section 46f KWG ends with deliberations in the Bundesrat on 6 July 2018.

Bonds issued up to 21 July 2018 remain non-preferred (NPS) under the previous provisions of section 46f KWG.³ Due to their lower liability rank they will lose their eligibility as central bank collateral, however, this will only happen at the end of 2018. Bonds issued since 16 April 2018 would not have been eligible for central bank lending operations on the basis of the ECB guidelines anyway.

As of 21 July 2018, the new provisions of section 46f KWG will apply to senior unsecured bonds issued by German banks:

- (1) The statutory liability rank corresponds to the 'better' preferred rank. It takes effect unless otherwise provided for in the terms and conditions of the bond. Preferred senior bonds (PS bonds) will then be on a par with structured senior bonds and deposits from institutional investors.
- (2) The bond terms and conditions must specify if the lower non-preferred liability rank applies (NPS bonds).

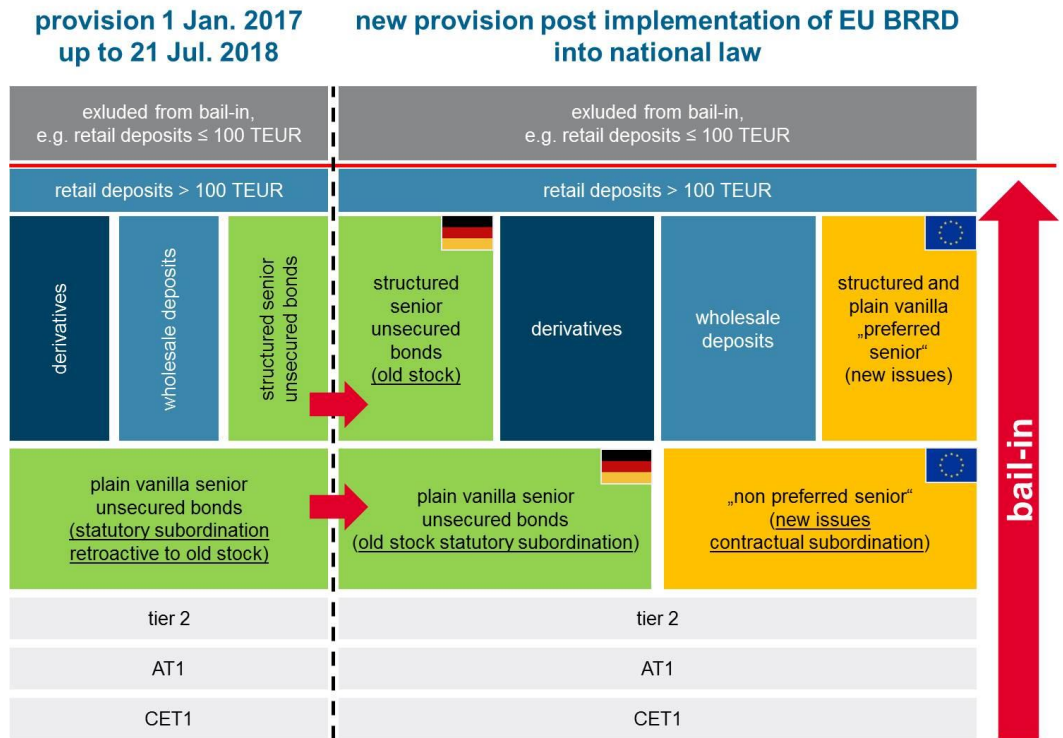
Senior unsecured bonds issued by German banks before the amendment comes into force retain their non-preferred status, even if this is not explicitly stated in the bond terms and conditions. Until their final maturity, they thus remain on a par with non-preferred senior bonds issued in accordance with the new provisions of section 46f KWG that have a contractually defined subordinated liability rank.

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¹ See Credit Special: "[Ungedekte Bankanleihen in Deutschland: BMF-Referentenentwurf zur Insolvenzrangfolge](#)" of 14 February 2018

² See Credit Special: "[Europäische Bankanleihen: EZB regelt Notenbankfähigkeit neu](#)" of 21 December 2017

³ The statutory liability rank in Germany was changed to non-preferred status on 1 January 2017, see: "[Deutschlands neue Insolvenzrangfolge bei Banken: Weitere Anpassungen absehbar](#)" of 3 January 2017



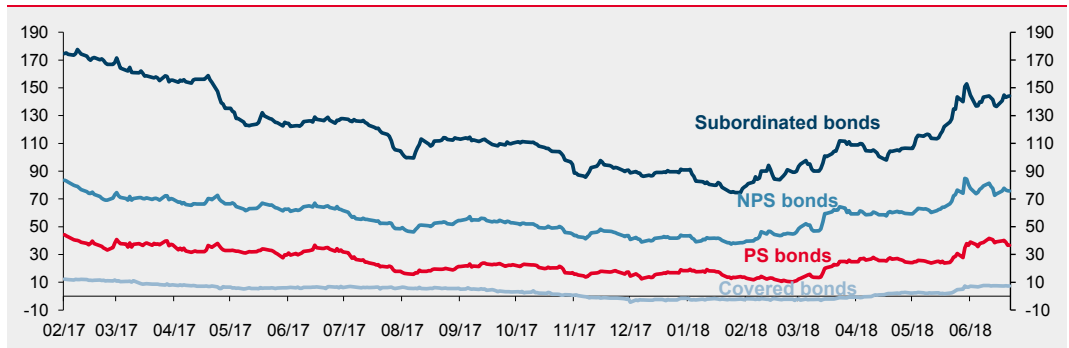
Sources: VÖB, Helaba Research

Preferred senior spreads between Non-preferred and covered bonds

The iBoxx EUR Banks Senior Preferred Index representing the PS bonds of European competitors trades between the indices for covered bonds and for NPS bonds, thus in accordance with the creditor hierarchy. In countries such as France, Spain and Italy, legislators have not changed the legal liability rank for bonds; instead, NPS bonds have been created as a new category in these countries. Their subordinated liability rank had to be contractually defined in the bond terms and conditions from the outset. In particular, the market for NPS bonds of French banks is already relatively liquid: globally systemically important banks from France who mainly fund themselves on the capital markets were forced to start issuing at an early stage in order to meet the minimum requirements for own funds and eligible liabilities that will apply from 2019.⁴ The current NPS issues reduce the possible default rates and thus support the creditworthiness of the banks' outstanding bonds in these countries.⁵

Spreads reflect bail-in hierarchy

iBoxx EUR Banks Indices, ASW in bps



Sources: Datastream, Helaba Research

⁴ See also: "TLAC für global systemrelevante Banken" of 25 November 2015

⁵ See in detail, inter alia, Credit Focus (1) "Société Générale: Geglückte Premiere mit NPS-Anleihe à la Française" of 12 January 2017, (2) "BNP Paribas: Emissionsplan gestützt auf NPS-Anleihen" of 9 February 2017, (3) "BBVA: Bonitätstrend stützt anstehende NPS-Emissionen" of 28 July 2017

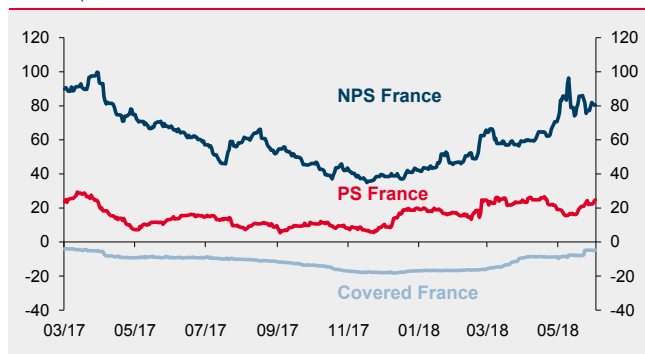
Spreads of German preferred senior bonds expected to be comparatively low

We expect the spreads of the new PS bonds of German banks to be at a level that will also lie between the spreads of covered bonds and NPS bonds according to the creditor hierarchy. At the same time, the difference to covered bonds is likely to be smaller than for European competitors: while the latter are only establishing non-preferred buffers that rank junior to preferred bonds in the bail-in hierarchy, German banks already have ample non-preferred eligible liabilities with their outstanding bonds. These NPS bonds of German banks also count towards the institutions' total eligible liabilities (MREL).⁶ This means that the new preferred bonds already have an extensive buffer against the risk of loss.

Furthermore, the fact that the new bond category will remain eligible as ECB collateral beyond December 2018 should generate additional demand for the preferred issues.

France has comparatively high number of NPS bonds

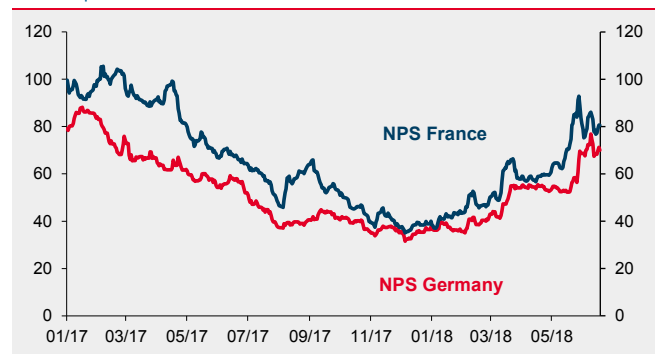
ASW in bps



Sources: Bloomberg, markit, Helaba Research

Spreads in Germany at a low starting level

ASW in bps



Sources: Bloomberg, markit, Helaba Research

Credit outlook depends on development of non-preferred senior volume

Meanwhile, with their outstanding non-preferred bonds, German issuers already meet their capital requirements in full and are therefore not compelled to issue further non-preferred bonds with comparatively high spreads. In our view, replacing NPS maturities with preferred issues to cover financing needs would appear to be a lucrative option. This could result in a trend towards smaller NPS buffers going forward.

In our opinion, the creditworthiness outlook for existing NPS bonds, whose spreads are relatively low by international standards, is therefore rather negative. We understand that Moody's supports this view. The agency had already made it clear in November 2017 that the issue of preferred senior bonds would have a negative impact on the creditworthiness of outstanding non-preferred bonds in Germany: replacing them with preferred bonds at maturity would reduce their liable capital, so that default rates would rise in the case of creditors' participation in losses.⁷

Overall, we assume that both investors and issuers will make active use of the expansion in the range of bonds, as in other countries. Ultimately, the issuance schedule and, by extension, the credit quality outlook will depend, in particular, on the funding strategy of the individual banks. In our view, it is desirable for issuers to create a high degree of transparency in this respect.

⁶ Because, as described above, they are protected by grandfathering rules, i.e. they retain their subordinated liability status until their maturity.

⁷ See Credit Special: "[Europäische Banken: Bewegung bei Harmonisierung von NPS-Anleihen](#)" of 28 November 2017

Background - Amendments to the EU Bank Recovery and Resolution Directive

The original version of the 2014 European Bank Recovery and Resolution Directive (BRRD), which regulates the minimum requirements for own funds and eligible liabilities (MREL), did not contain a clear bail-in hierarchy for bank liabilities in the event of a crisis. This led to uncertainties for creditors in terms of their participation in losses in a crisis and for the issuing banks with respect to the eligibility of issues for MREL. National legislators in Europe therefore created inconsistent regulations in the respective countries to clarify the creditor hierarchy at banks. Investors, issuers and the ECB then called for a uniform, Europe-wide framework. In December 2017, EU institutions agreed on a uniform supranational regulation of the bail-in hierarchy and made appropriate improvements to BRRD. Accordingly, in future the preferred rank will correspond to the statutory liability rank, while a non-preferred rank must be specified in the bond terms and conditions. EU countries must now implement this at national level by 28 December 2018 at the latest. While some countries, e.g. France, Italy and Spain, had already implemented corresponding legislative amendments in 2017, Germany still had to follow suit.⁸

⁸ See Credit Special: (1) "[Europäische Banken: Bewegung bei Harmonisierung von NPS-Anleihen](#)" of 28 November 2017 as well as (2) "[Ungedekte Bankanleihen in Deutschland: BMF-Referentenentwurf zur Insolvenz-rangfolge](#)" of 14 February 2018

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