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Security blanket: secured debt gains appeal

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During the financial crisis, certain national authorities imposed losses on holders of senior unsecured debt obligations of financial institutions either in connection with or as a condition to capital injections or other recapitalisation efforts. In the aftermath of the financial crisis, the notion that holders of senior unsecured debt of financial institutions should bear losses prior to any taxpayer funded recapitalisations has gained momentum and this approach is now reflected in various regulatory proposals. It is reflected globally in new legislation and regulatory proposals that banks and other financial institutions be required to issue debt with 'bail-in' features – that is debt subject to write-down or to conversion into equity under certain circumstances. In the EU, a consultation paper setting out the technical details of a proposed framework for bank resolution contemplated the imposition of bail-in features for certain debt. Additional clarity is expected before the end of this year with the publication of a draft EU Directive on Recovery and Resolution Plans. It is anticipated that the approach outlined in the directive might include enhanced powers for regulatory authorities to write off or convert into equity all senior unsecured debt, subject to certain exemptions, and a requirement that banks issue specified amounts of 'bail-in' debt. In the United States, the orderly liquidation authority provisions under the Dodd-Frank Act create a construct for creditor hair cuts in the context of a liquidation.

Of course, market participants have reacted to potential bail-in schemes and have expressed a preference against senior debt of financial institutions. Financial institutions might well contemplate the issuance of debt securities or other instruments that might be excluded from write-down and conversion. These might include short term debt and secured debt, including covered bonds. Covered bonds generally are subject to statutory frameworks that impose requirements related to the eligibility of cover pool assets, which generally include asset quality criteria. Financial institutions, however, may be subject to a cap on their covered bond issuance. Some financial institutions are turning to other forms of secured debt, including 'quasi covered bonds'. These secured debt securities are intended to offer greater flexibility to issuers (as there are no express asset quality requirements) while providing potential investors a security likely to fall within an exemption from bail-in requirements.

A bank also could issue full recourse secured bonds directly to investors. The collateral could comprise residential or commercial mortgages or other assets. To achieve flexibility for the bank and to enable replenishment of the pool enabling longer maturities, the issuer could retain the ability to add additional collateral to the pool as existing collateral amortises or matures subject to meeting specified criteria. Such a structure could also be developed as a continual issuance program with all debt issued under the program sharing in the collateral pool. An alternative would be for the bank to issue full recourse secured bonds directly to investors but with the issuer transferring the collateral to a third party entity (possibly a subsidiary). It may also be possible to structure a financing structure to take advantage of the carve-out from the statutory write-down power in relation to repos. If a bank had securities available to be used for repo transactions, it could enter into repo arrangements with a counterparty. It could also repackage assets of the bank into transferable securities which could be used for repo activities. To obtain funding from a greater range of investors, a bank could enter into a repo facility with a counterparty (which could be a SPV or subsidiary) which could syndicate the repo funding with other investors either directly or through a participation in the repo activities. These are just but a few examples of possible secured financing approaches that may play a more significant role in the funding plans of financial institutions in the coming year as nervous investors seek out additional comfort through security interests and/or exemptions from bail-in type provisions. Given that for many years, financial institutions have largely relied on senior unsecured debt issuances in the public and private markets, there are many new legal and practical questions for issuers and their advisers to consider when contemplating greater protection for creditors. ■

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