EBA REPORT

ON THE MONITORING OF ADDITIONAL TIER 1 (AT1) INSTRUMENTS OF EUROPEAN UNION (EU) INSTITUTIONS – UPDATE

EBA/REP/2021/19
24 June 2021

EUROPEAN BANKING AUTHORITY

Contents

1. Executive summary

1.1 Reasons for publication

1. Pursuant to Article 80 of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)[1] on the continuing review of the quality of own funds and eligible liabilities instruments, the 'EBA shall monitor the quality of own funds and eligible liabilities instruments issued by institutions across the Union.'

2. Furthermore, pursuant to the same article, 'competent authorities shall, without delay and upon request by the EBA, forward all information to EBA that the EBA considers relevant concerning new capital instruments or new types of liabilities issued in order to enable EBA to monitor the quality of own funds and eligible liabilities instruments issued by institutions across the Union.'

3. The purpose of this report is to inform external stakeholders about the continuing work performed by the EBA in terms of monitoring the issuances of Additional Tier 1 ('AT1') capital instruments and to present the results of this monitoring.

4. The present report constitutes the fourth update of the first version of the report published in October 2014[2], the last update having been published in July 2018[3]. Since then, the banking package has updated, *inter alia*, the framework for the minimum requirement for own funds and eligible liabilities (MREL) and implemented the FSB's Total Loss-Absorbing Capacity (TLAC) standard[4] in EU legislation. Therefore, the EBA has extended its work to the monitoring of TLAC- and MREL-eligible liabilities instruments issuances, which has led into the publication of the EBA Report on the monitoring of TLAC-/MREL-eligible liabilities instruments[5] in October 2020. Nevertheless, the EBA continued to monitor AT1 issuances, focusing rather on possible new types of clauses.

5. It may be recalled that, apart from the monitoring of hybrid capital issuances, the EBA publishes and maintains a list of Common Equity Tier 1 (CET1) instruments.[6] The list is accompanied with a CET1 monitoring report.[7]

6. While the initial focus of this report is on AT1 instruments, several findings are relevant for other types of own funds instruments, in particular Tier 2 ones. It is also stressed that this report has been brought in line with findings/recommendations included in the above mentioned

[1] As amended by Regulation (EU) No 2019/876.
[2] EBA AT1 Report first version.
[3] AT1 Report third update.
[4] FSB TLAC Principles and Term Sheet.
[5] EBA TLAC/MREL monitoring report.
[6] EBA updates list of CET1 instruments | European Banking Authority (europa.eu).
[7] EBA CET1 monitoring report.

TLAC/MREL monitoring report where appropriate. It also integrates the latest amendments to the CRR provisions and relevant EBA published Q&As.

7. In October 2020, the EBA published the Opinion on the prudential treatment of legacy instruments.[8] The EBA will ensure transparency on the implementation of its Opinion and corresponding options to address infection risk by competent authorities and institutions. At this stage, the EBA is providing its views on questions received on the use of the options provided in the Opinion.

8. Finally, this report integrates a dedicated part on environmental, social and governance (ESG) capital bonds, as a follow-up of the preliminary observations published in the TLAC/MREL monitoring report. This guidance is valid with no distinction between any type of loss-absorbing regulatory instruments, although it targets more prominently Tier 2 and eligible liabilities instruments which fall more naturally in the ESG sphere.

1.2 Content

9. The CRR lays down the eligibility criteria for AT1 instruments (particularly Articles 51 to 55 CRR). Those criteria are supplemented by Commission Delegated Regulation (EU) No 241/2014 (the regulatory technical standards (RTS) on own funds).[9] Due to the similarities of the eligibility criteria of AT1 and Tier 2 instruments, the observations and recommendations of this report should be considered for Tier 2 instruments as well, to the extent applicable, and should be taken into account when such instruments are issued and when their eligibility is assessed. A few observations included in this report explicitly apply to Tier 2 instruments only.

10. The EBA had drafted the above-mentioned RTS in the area of regulatory capital. With regard to AT1 instruments in particular, these RTS contain a number of provisions in relation to the form and nature of incentives to redeem, the nature of a write-up of an AT1 instrument following a write-down of the principal amount on a temporary basis, and the procedures and timings surrounding trigger events. After the entry into force of the RTS, the EBA's emphasis was placed on the review of the implementation of the eligibility criteria applicable to capital instruments on the basis of the CRR and the technical standards.

11. The EBA has focused its work primarily on the assessment of selected AT1 issuances. The terms and conditions of these selected issuances are assessed against the regulatory provisions in order to identify provisions that the EBA would recommend and, in contrast, recommend avoiding.

12. This monitoring follows a dynamic approach, which has, up to now, resulted in several iterations. It cannot, however, be assumed that provisions/clauses not mentioned in this report can be considered as not raising any concerns.

13. In addition, the best practices mentioned in this report aim to shape market practices and should

[8] EBA Opinion on the prudential treatment of legacy instruments.

[9] Which are currently being updated based on the latest CRR amendments.

therefore pre-empt market practice (unless there is a material impossibility of applying the best practice demonstrated by the institution concerned).

14. This review makes no claims to be fully comprehensive, but highlights areas where the EBA believes it necessary to revise the wording of certain existing clauses for future issuances or where the EBA would recommend avoiding in the future the use of some clauses currently under consideration. The original findings of the first report and subsequent ones have in general been maintained in order to provide a full overview of the investigations led from the beginning of the monitoring, while it is acknowledged that some of the observations made initially have been taken into account by issuers in subsequent issuances and might no longer be found in current issuances. That said, it is deemed important to keep them alive to ensure that they continue to be considered and respected in the issuance of new instruments, and that all findings can be found in a unique consolidated document.

15. The EBA will continue to exchange views with institutions and market participants on the results of its ongoing monitoring and will strive to provide guidance on possible new features it would be made aware of, where necessary separately from this report,[10] in order to provide certainty to issuers sufficiently in advance before the next update of the report.

16. A relatively new market that has been growing fast in recent years is the issuance of ESG bonds. The EBA has developed recommendations and best practices to ensure that the institutions' own funds and eligible liabilities instruments issued with ESG features are compliant with the CRR eligibility criteria and BRRD requirements. The objective of this guidance is not to prevent or promote ESG issuances for capital/loss absorbency purposes, but to clarify the interaction between ESG features and regulatory eligibility criteria.

17. While there might always be a residual reputational risk for the issuer in associating ESG features with loss absorbency ones, the guidance is meant to mitigate possible risks from an issuer perspective. The EBA will continue to monitor ESG issuances for regulatory purposes going forward and will in particular further scrutinise links that could be possibly made between the performance of the underlying assets and the payments on the bonds.

18. Finally, it is to be recalled that the EBA published standardised terms and conditions for AT1 issuances in October 2016 that are meant to cover the prudential aspects of the terms and conditions.[11] The monitoring work performed by the EBA has successfully fed into the development of the standardised templates, which are a useful complement to the regular AT1 monitoring report. While these templates are based on the first version of the CRR and published in 2016, the EBA believes that their main content is still valid. The EBA will reflect on an update of these templates as appropriate.

[10] See in particular the guidance provided on a continuous call option (EBA Q&A_2020_5147).

[11] EBA AT1 standardised templates.

19. This report is structured as follows:

- the EBA's considerations on AT1 monitoring,
- follow-up of the EBA Opinion on legacy instruments,
- the EBA's considerations on own funds or eligible liabilities instruments with ESG features.

2. The EBA's considerations on AT1 monitoring

2.1 Introduction

20. Although they are complex instruments, AT1 issuances are in general quite standardised, except for features that are, by nature, institution specific (such as the level of the triggers and the definition of the triggers at different applicable levels depending on the structure of the groups). This is due to the existence of quite prescriptive provisions in the CRR and RTS.

21. Nevertheless, the monitoring process has shown, especially at its starting point, that a few provisions of existing AT1 instruments, or of those AT1 instruments under consideration by prospective issuers, should be avoided or revised wordings of those clauses should be used. Some provisions could be worded in a better way because, as originally proposed, they may be the cause of uncertainty in relation to regulatory provisions — for instance on the effectiveness/implementation of the loss absorption mechanism — or they may increase the already high complexity of the instruments. This may particularly be the case for some provisions related to regulatory calls, calls linked to specific events (e.g. rating events), share conversion mechanisms, contingent clauses and covenants.

22. Furthermore, this report provides the EBA's guidance in a few areas where there might be different interpretations. This may particularly be the case for some provisions related to triggers for loss absorption, where the appropriate level of application (solo, sub-consolidated or consolidated level) needs to be specified.

23. In the previous versions of the report, the EBA noted that the standardisation of the terms and conditions was still increasing, with some issuers using the provisions proposed in the EBA standardised templates published in October 2016 for some definitions or for some parts, or even to a larger extent. This trend has been continuing during the more recent years and the EBA believes that this increased standardisation is partly due to the guidance regularly published by the EBA (via its AT1 report or via Q&As) and regularly communicated by supervisors.

24. Due to the well-established EBA monitoring work and consideration of this work by issuers, the observations added in this version are less impactful than previous ones in terms of substance. They are rather linked to some updates made necessary, for example, by the changes in the Level 1 text, such as the amended eligibility criteria for AT1 and Tier 2 instruments. Based on a recommendation from the EBA[12], the co-legislators have further acknowledged in the new Article 79a CRR that the substantial features of capital instruments, including separate

[12] See EBA Opinion on CRR review for own funds (LINK), p. 12.

arrangements that are not explicitly set out in the terms and conditions of the instruments themselves, shall be taken into consideration when assessing their compliance with the eligibility criteria.[13]

25. When assessing the eligibility of an instrument, institutions shall further carefully assess the interaction between the different layers of regulatory capital/loss absorbency instruments and other instruments.[14] Having in mind the end of the transitional period for grandfathered pre-CRR own funds instruments at the end of 2021 (which will impact mainly legacy AT1 instruments), combined with the transposition of Article 48(7) of the BRRD[15], the EBA will analyse further, as needed, the potential additional provisions that institutions will introduce in the terms and conditions of issuances with regard to ranking and the potential additional complexity introduced.

26. The EBA expects that forthcoming issuances will continue to retain a high level of standardisation. This appears desirable to mitigate the complexity of hybrid instruments, and this report should help continuing to promote convergence. If the EBA noted a significant deterioration in the quality of the instruments or a significant use of non-standard or complex provisions that might raise doubts over, for example, the effectiveness of loss absorption of the instruments, the EBA would consider taking steps to address this situation.

27. The EBA also expects that issuers will continue to design issuances so that the terms and conditions are not unduly complex, but as simple and as clear as possible. The EBA views efforts to limit the complexity of AT1 instruments as inherently valuable and takes complexity into account when assessing AT1 instruments.

28. Finally, the EBA has been monitoring AT1 calls and the rationale for calling/not calling instruments going forward. At this stage of its monitoring, the EBA observes that the majority of calls have been exercised at the first call date, while only a few calls have not been exercised based on prudential and/or economic considerations. The EBA also notes that, for institutions in the EEA, the majority of the calls show a yearly frequency.

29. The EBA views favourably the non-automaticity of the exercise of the call at the first opportunity for AT1 instruments in particular, as this goes in the direction of recalling that AT1 instruments are meant to be perpetual. Furthermore, at this stage the EBA does not express a preference for a specific frequency of subsequent call dates, but it will continue to monitor the exercise of calls and a potential link between the frequency of these subsequent call dates and a potentially different pressure to redeem the instrument.

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[13] The EBA has been applying this principle since the beginning of its assessment of own funds instruments (see also paragraph 121of the CET1 Report (Link)).

[14] See EBA Opinion on legacy instruments (Link), in particular paragraphs 14-17.

[15] Article 47(7) BRRD: 'Member States shall ensure that, for entities referred to in points (a) to (d) of the first subparagraph of Article 1(1), all claims resulting from own funds items have, in national laws governing normal insolvency proceedings, a lower priority ranking than any claim that does not result from an own funds item. For the purposes of the first subparagraph, to the extent that an instrument is only partly recognised as an own funds item, the whole instrument shall be treated as a claim resulting from an own funds item and shall rank lower than any claim that does not result from an own funds item.'

2.2 Detailed analysis

30. The following sections of the report detail some of these provisions as observed in some contracts or that the EBA has discussed for potential forthcoming issuances (i.e. those not observed in current contracts that should nonetheless still be avoided in future contracts).

2.2.1 Provisions observed in existing issuances

Status of the notes – absence of guarantees and notion of 'fully paid-up'

31. According to Article 52(1)(e) of the CRR, the instruments are not secured or subject to a guarantee that enhances the seniority of the claims. In this regard, it is welcome to have provisions in the terms and conditions specifying explicitly that no security or guarantee of whatever kind is, or shall at any time be, provided by the issuer or any other person securing rights of the holders.

32. Provisions stating that an institution will have to provide for its guarantee if a subsidiary of the institution substitutes to the institution for all obligations of the institution under the AT1 notes should be carefully assessed. The guarantee could be necessary to cover some restructuring of the issuer, but this can be accepted only if (i) the guarantee is subordinated, (ii) there is no guarantee on the cancelled coupons, so that flexibility of payments is kept at any time, and (iii) the guarantee is specific enough and its scope is restricted to a change affecting the issuer, such as a restructuring or a merger (general guarantees cannot be accepted). In addition, the competent authority should reassess the eligibility of the instrument after restructuring.

33. In those cases in which instruments might cease to be eligible as a result of one of the parties enforcing a contractual option (e.g. an option to substitute the debtor with another entity that is unrelated), the instrument should also contain an explicit reference to the need to obtain the prior permission of the competent authority in accordance with Articles 77 and 78 of the CRR. In particular, if the issuer transfers the instrument from its balance sheet to that of another entity, not only is prior permission required in accordance with Article 52(1)(i) of the CRR in conjunction with Article 77(1) of the CRR, but if the other entity is subject to own funds requirements and wants this instrument to qualify as an own funds instrument, all the criteria for it to qualify as an own funds instrument must also have been met at this point.

34. Similar to CET1 instruments[16], it can be observed that, depending on the statutory or contractual provisions, the status of the instruments as 'not fully paid up' and the requirement to fully pay up may differ. It should be recalled that only the part of capital instruments that is paid up can be counted as AT1 capital for prudential purposes. This is reinforced by the new subparagraph in Article 52(1) of the CRR, which states: 'For the purpose of point (a) of the first subparagraph, only the part of a capital instrument that is fully paid up shall be eligible to qualify as an Additional Tier 1 instrument.'

[16] See paragraphs 38 to 43 of the CET1 Report (second update, published 22 July 2019; LINK).

35. Furthermore, provisions in national legislation or terms and conditions describing the different possibilities under which an instrument can be regarded as being paid up may differ in various jurisdictions. In this respect, an undertaking or commitment to pay cash to the institution on demand or at an identified or identifiable future date cannot be regarded as meeting the requirements for instruments being paid up.

Calls

Regulatory and tax calls

36. The EBA has assessed the provisions related to regulatory calls as set out in Article 78(4)(a) of the CRR.

37. Some issuances include partial regulatory calls, meaning that a portion of the instruments may be called by the institution if the corresponding part of the issuance is no longer recognised in Tier 1 capital because of a regulatory change.

38. Only regulatory calls for the full amount of instruments are acceptable, regardless of whether regulatory changes trigger a full or partial derecognition from AT1 capital. Partial derecognition from AT1 capital owing to write-down or conversion should not be considered an eligible trigger for a regulatory call.

39. For tax calls, Article 78(4)(b) of the CRR indicates that the condition for a tax call to take place is a ‘material effect’ of the change in the tax treatment. Changes in tax treatment will not affect the regulatory treatment but will affect the cost of the issuance. Partial calls could therefore be acceptable if the effect is material.

40. In addition, provisions relating to tax calls should use precise terminology that is in line with the provisions of Article 78 of the CRR. For instance, the terms cannot suggest that a tax event is triggered when ‘there is more than an insubstantial risk’ that additional payments are due on the next payment date. Instead, and in accordance with the CRR, the trigger can only be a material and non-foreseeable change in the applicable tax treatment.

41. Finally, a change in the applicable accounting standards, in particular where this change would not trigger a change in the applicable tax treatment, cannot be considered a valid trigger for a tax call, as this case is not laid down by Article 78(4)(b) of the CRR.

42. Regulatory call provisions should not read as if supervisory approval were a given. Furthermore, the fact that the issuer determines, at its own discretion, that the instruments are subject to ‘any other form of less advantageous treatment’ cannot be a trigger for a regulatory call.

Changes in the assessment of the competent authority regarding tax effects in the event of a write-down

43. An example of change in regulatory assessment would be the following: when applying the answer to [Q&A 2013_29](), the competent authority used to consider that there would not be a tax effect in the event of a write-down, as the institution would probably be facing losses even after taking into account the positive effect of the write-down on retained earnings. Subsequently, based on a specific assessment of the situation of the institution, the competent authority considers that there would be a tax effect and therefore disqualifies part of the instrument.

44. Potential changes in the regulatory assessment cannot be considered valid triggers for regulatory or tax calls.

Calls below par

45. The EBA has also assessed the provisions related to the exercise of calls below par. Some issuances specify that the instrument can be called only at its initial amount (meaning that an instrument that has been written down has to be written up first before being called). The CRR criteria are silent on this issue. From a prudential point of view, requiring the instrument to be fully written up before being called may support the permanence principle and may give comfort to investors that the call will not be exercised. On the other hand, being able to call an instrument that has been written down allows the write-down to be realised and, therefore, it increases CET1. In addition, requiring the instrument to be fully written up may override the tax/regulatory calls and may not allow the institution to call an instrument that is no longer eligible. Overall, it is the EBA's view that there is no specific concern from a purely prudential perspective in allowing calls below and at par, or at par only.

Calls with long notification period

46. Some instruments might provide a call option for the issuer after five years from the date of issuance but with a substantial duration of the notification period (e.g. two years before redemption). It has to be recalled that Article 28(1) of the RTS stipulates that the call shall not be announced prior to receiving the competent authority's approval. In addition, in accordance with Article 28(2) of the RTS[17], the corresponding amount shall be deducted once it is sufficiently certain that the call will be exercised. Therefore, where the terms and conditions of issuances include an extended notification period, the deduction from regulatory capital should be operated within this timeframe. In addition, AT1 instruments cannot be called in their first five years of maturity (Article 52(1)(i) of the CRR) unless the conditions of Article 78(4) of the CRR are met, while Tier 2 instruments shall have a minimum original maturity of five years. As a conclusion, the EBA expresses reluctance on long notification periods that might undermine the permanence of the instruments and do not bring any prudential benefit.

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[17] The EBA is currently working on an updated draft of the RTS in accordance with the extended mandate in Article 78(5) CRR.

Continuous call option

47. The EBA has observed that some issuances contain a continuous call option once the first five years since the issuance have passed.[18] The eligibility criteria of Article 52 of the CRR do not prohibit the inclusion of a continuous call option as long as points (g) to (k) of Article 52(1) of the CRR relating to permanence are met.[19] In accordance with Article 28(1) of the RTS, institutions should not announce the call of the instruments before they obtain prior supervisory approval and it should not be expected that the continuous call option on its own constitutes 'exceptional circumstances' rectifying a shortened application timeframe as specified in Article 31(2) of the RTS.

Redemptions and repurchases

48. The EBA considers that it is appropriate to include in the terms of the instrument a condition stating that the institution should not give a notice of redemption after a trigger event notice has been given. The provisions should also make it clear that, if a trigger event notice is given after a notice of redemption has been given but before the relevant redemption date, this notice of redemption shall automatically be revoked and be null and void and the relevant redemption shall not be made.

49. The possibility of the issuer redeeming or repurchasing the instrument in the context of ordinary, regulatory and tax calls is usually well framed in the terms and conditions, including reference to the necessity of obtaining prior permission from the competent authority as per Articles 77 and 78 of the CRR. However, additional clauses observed in certain issuances go further and protect regulatory own funds even if discretionary repurchases take place without the institution having obtained the prior permission of the competent authority as required. These clauses, which ensure a clawback of every amount that would have been repaid to the investor without the competent authority's permission, create an obligation for the holder to repay or return all amounts received from the issuer, are welcome.

50. Provisions should not include terms that seem to indicate that purchases of the instrument are possible at any time. Under the CRR and the RTS, purchases are not possible at any time (see Articles 77 and 78 of the CRR in particular). Furthermore, they are subject to the limits laid down in Article 78(1) subparagraph 2 of the CRR. Article 78(4)(d) of the CRR also provides an important reference, as it makes clear that exchanges — but not other types of liability management exercises (LMEs) — are possible before five years under exceptional circumstances and under certain conditions.

51. That being said, LMEs should not be referred to or included in the terms and conditions. On the contrary, reference to market making and the exchange with an instrument of same or higher quality is possible, as this comes from Article 78 paragraphs (1) and (4)(d) and (e) of the CRR. The

[18] See EBA Q&A_2020_5147 (LINK).

[19] The same considerations apply to Tier 2 instruments (see points (g) to (k) of Article 63) and TLAC/MREL eligible liabilities (see points (g) to (k) of Article 72c).

drafting of the terms and conditions should mention the prior permission of the competent authority and the limits referred to in the Article 78(1) of the CRR.

52. The EBA has received several Q&As on the notion of 'exceptional circumstances'. The EBA considers that flexibility should be left to the competent authorities to decide on a case-by-case basis whether the criterion of 'exceptional circumstances' is fulfilled, as this is very much a case-by-case assessment. However, the EBA is monitoring the application of Article 78(4)(d) CRR by competent authorities and has observed that the mere improvement of market conditions or reduction in the cost of the issuance is not considered an exceptional circumstance.

53. One issuance presented to the EBA contained a call option which the issuer could exercise in the case of a rating event, subject to the competent authority's permission. The rating event was defined at the issuer's determination, after consulting the credit rating agency, which would notify that the instrument would cease to be included or count in whole or in part towards a specified capital category provided for under its methodology. Such a clause conflicts with the eligibility criteria of Article 63(k) of the CRR, which prohibits any 'indication that the instruments would be called, redeemed, repaid or repurchased early, as applicable, by the institution other than in the case of the insolvency or liquidation of the institution.' Defining the conditions under which a voluntary call can be exercised, such as a call option for a specific case, other than the conditions and circumstances set out in Articles 63, 77 and 78 of the CRR, would further create the holders' expectation that the call will be exercised and would limit the issuer's discretion and flexibility as required by Article 63(i) of the CRR.

54. The EBA has received a Q&A[20] asking if a subsidiary of an institution could purchase AT1 or Tier 2 instruments issued by this institution before five years from the date of issuance of the instrument. As indicated in the answer, one has to recall the eligibility criterion stipulated by Articles 52(1)(b) and 63(b) of the CRR, disqualifying instruments from being eligible as AT1 or Tier 2 in cases where those instruments are purchased by the institution or its subsidiaries, regardless of the nature and situation of the subsidiary. Therefore, the purchase by a subsidiary would qualify as a repurchase and would require prior permission by the competent authority. Within the first five years from the date of issuance, such permission would only be possible under the specific conditions of Article 78(4) of the CRR.

Cancellation of distributions

55. As formulated in the AT1 standardised templates, the EBA considers that it is appropriate to include in the terms of the instrument a mention that, upon the issuer electing to cancel (in whole or in part) any distribution payment of the instrument, any failure to give notice shall not affect the validity of the cancellation and shall not constitute a default for any purpose. On the contrary, the effectiveness of the cancellation shall not be made subject to a notification. In the absence of any notice of cancellation being given, non-payment of the relevant distributions payment on the relevant distributions payment date shall be evidence of the issuer having elected or being

[20] EBA Q&A 2017_3587.

required to cancel such distributions payment.[21]

56. No provision should link a change in payments to contractual, statutory or other obligations, as payments are fully discretionary. Payments should also not be linked to payments on other AT1 instruments.

Event of default

57. Some issuances provide a reference to national bankruptcy acts according to which noteholders may take legal action if the issuer for more than [xx] days has failed to pay any amount that has become due. It is not clear why this condition is needed, while at the same time it is clear from the provisions that interest cancellation and/or conversion does not constitute an event of default. Provisions should not include terms that seem to indicate that the non-payment of any amount due may lead to an event of default. On the contrary, it is best practice for the terms to make it clear that such non-payment is not an event of default.

58. A Tier 2 instrument contained a clause that grants the holders the right to request the acceleration of their claims against the institution in case of insolvency or liquidation. In order to avoid a No Creditor Worse Off (NCWO) issue and to ensure the insolvency hierarchy is not hampered, the acceleration right needs to concern all *pari passu* instruments as well as all instruments ranking senior to them.

Absence of set-off or netting arrangements

59. In accordance with Article 52(1)(r) of the CRR, capital instruments shall qualify as AT1 instruments when they 'are not subject to set-off or netting arrangements that would undermine their capacity to absorb losses.'

60. The EBA has observed that some institutions have grandfathered part of their capital instruments under the reasoning that they do not contain a contractual clause for a waiver of set-off or netting arrangements that would undermine their capacity to absorb losses. As further clarified by EBA Q&A 202_5146, the absence of an explicit waiver clause in the documentation does not by itself lead to the instruments being grandfathered and ultimately disqualified. That said, the instrument concerned would need to be subject to an effective absence of set-off or netting arrangements that would undermine its capacity to absorb losses. In this context, it is observed that some instruments, while containing explicit clauses on the absence of set-off or netting, include a reference to the applicable national law. Such formulations might not be effective in some cases because national law provisions may take precedence over the CRR-compliant contractual provisions and affect their eligibility and effectiveness in the absence of netting. The EBA will further monitor this issue to better understand the interaction between these types of contractual clauses in the terms and conditions of the issuances and the provisions of the relevant national laws.

[21] See also EBA AT1 standardised templates, page 16.

61. Some terms and conditions contain a provision whereby if an amount payable by the issuer in respect of any note to any holder is discharged by set-off or netting, the holder must pay an amount equal to the amount of such discharge to the issuer, and the discharge must be deemed not to have taken place. This is seen as best practice where this is compatible with national law.

Tax gross-up clauses

62. Regarding tax gross-up clauses, the EBA is of the view that:

- It should be clarified that the gross-up clause is activated by a decision of the local tax authority of the issuer, not of the investor.
- Increased payments should be possible only if they do not exceed distributable items.
- Gross-up cases should be allowed only in relation to dividend/coupon withholding tax (gross-up on principal is not allowed).
- Where changes in the withholding tax are triggers for a tax event, the terms should make clear that such an event would be subject to the conditions applicable to the tax calls laid down in Article 78(4)(b) of the CRR. Furthermore, this is subject to the condition that the change in the withholding tax results in an increase in the cost of the issuance for the institution. If that is not the case, the tax change will not be considered to be material. In practice, this means that a withholding tax change without a gross-up on dividends/coupons cannot be considered a trigger for a tax event.

63. In addition, it is to be noted that the EBA received a Q&A asking if gross-up clauses on Tier 2 instruments should be allowed and if so under which conditions. The submitter of the question referred in particular to the content of the AT1 Monitoring Report and asked if such an interpretation would apply in the same manner to Tier 2 instruments.[22]

64. As indicated in its answer to the question (see Q&A 2016_2849), the EBA has provided the view that the same interpretation should be applied to AT1 and Tier 2 instruments, save for the provisions which are not relevant to the latter (e.g. the reference to distributable items). More precisely, Tier 2 gross-up clauses can be considered acceptable if (i) they are activated by a decision of the local tax authority of the issuer and (ii) they relate to dividends and not principal.

Write-down or conversion

65. The EBA assessed the issue of the one-cent floor (for each note) for the write-down of some instruments that have been issued. This type of provision states that the principal amount of the instrument will never be reduced below one cent. It appears that there might be a commercial/civil law issue behind this — namely, that the instrument would legally disappear if written down to zero.

[22] On MREL eligible liabilities see paragraph 15 of the TLAC/MREL monitoring report (Link).

66. However, it might be thought that an instrument with such a feature could not be fully written down and, therefore, the condition laid down in Article 54(4) of the CRR would not be met.

67. The EBA considers that the instrument can still be seen as fully written down on condition that the amount that cannot be written down (i.e. one cent per note) is not included in AT1 capital. Alternatively, it may be possible to use reserves to avoid an explicit floor for the write-down of an instrument. In practice, this means that, if the instruments are written down to zero, one cent per note is taken out of the reserves/retained earnings and assigned to each AT1 note. In this case, the instrument would also be considered fully written down on condition that the amount that cannot be written down (i.e. one cent per note) is not included in the CET1 capital (more specifically, in the reserves/retained earnings).

68. In any case, the maximum floor should be the one required by commercial/civil law (assuming that this would be an insignificantamount).

69. Some provisions specify that there would be a permanent write-down rather than a conversion in the event that an institution was unable to deliver the CET1 instruments into which the instruments would have been converted. This provision could be used, if necessary, to address any concerns about the feasibility of conversion in the longer term, which is prudent, as AT1 instruments are perpetual. This clause merely states that, in the worst-case scenario, there will still be loss absorption in the form of a permanent write-down on condition that this type of clause does not contradict Article 54(6) of the CRR, which requires authorised capital to be, at all times, sufficient to ensure the conversion. In other words, this type of clause is acceptable only if it does not entail relaxing the requirements for the conversion but simply guarantees that loss absorption would happen in different possible situations. Another form of that provision, which is deemed to be equivalent, waives the obligations of the issuer before conversion with respect to the repayment of the principal amount of the AT1 instruments and to the payment of interest or any other amount in respect of those instruments.

70. A reference to prior loss-absorbing instruments where the conversion or write-down of the AT1 instrument is linked to the prior activation of a similar mechanism for other instruments, including senior instruments, can be problematic. The EBA considers that there should be an additional provision in the contract specifying that, if there is any issue with the senior instruments and they are not converted or written down for any reason, this should not prevent the AT1 instrument itself from being converted or written down. More generally, a conversion or write-down of the instrument should depend only on a breach of the trigger and should not be prevented by any other event.

71. Provisions should not include curing a trigger event in two stages, where the first stage is the cancellation of coupons. In this case, the first remedy to the breach is the cancellation of coupons, and the write-down (or conversion) happens only if the cancellation of coupons is not sufficient to cure the trigger event. This provision should be avoided, as there should be an automatic write-down (or conversion) as soon as the trigger is breached. Nothing should prevent the loss absorption mechanism from taking place and it should not be conditional. It should

happen even if the cancellation of coupons is enough to cure the trigger event (i.e. the cancellation of coupons should happen in addition to the curing of the trigger event).

72. The terms and conditions of the instrument shall use the calculation for the write-up as provided in the RTS and not a different one (i.e. the correct formula and the correct definition of 'profits').

73. Provisions should not give the impression that a write-down (or conversion) notice has to be given to investors before the institution can write-down (or convert) the instrument (pre-condition). Failure to provide a notice shall not prevent the exercise of the loss absorption mechanism, and the mention of notices should not show any order (e.g. the notice first and then the write-down or conversion). Article 54(5) of the CRR does not list the different steps as cascading events.

74. In cases where the conversion is not made in shares of the issuing entity but is made in shares of the holding company, it is prudent for convertible instruments to have an emergency permanent write-down provision available in case the conversion cannot take place as intended. Generally, any provision complicating the conversion makes the inclusion of the emergency permanent write-down more pressing. Therefore, for instruments with a specific type of conversion where the first step is conversion into shares of another entity of the group, this entity then subscribing to the shares of the issuer shall include an emergency permanent write-down in case the conversion fails. This is all the more necessary because the CRR does not provide for the direct conversion into shares of an entity other than the issuing entity.

75. No provision should link the write-up of the instrument to contractual, statutory or other obligations, as write-ups are fully discretionary.

76. It would be appropriate to specify the interaction between the loss absorption of AT1 and Tier 2 instruments in the terms in order to provide clarity to holders. In the same vein, it would be appropriate to insert sequencing on loss absorption between full or partial write-downs or conversions of different categories of instruments.

77. The EBA also considered issuances where the issuer included a provision whereby the trigger level of the AT1 instrument could be increased by the issuer at any time. The EBA considers that a change in the trigger level might be viewed as a new issuance. In addition, and as indicated earlier, features that unduly increase the complexity of an instrument should be discouraged, and a provision such as this would fall into that category.

Other issues

78. The inclusion of provisions that would allow AT1 holders to propose changes to the terms and conditions of an instrument could be acceptable from an own funds perspective only where the issuer has the right to refuse the changes and the competent authority has the possibility to object where necessary, as long as the changes may affect the prudential aspects. It should be recalled that Q&A 2013_16 introduces the general principle that a material change in the terms and conditions of a pre-existing instrument shall be considered in the same way as the issuance

of a new instrument. More generally, it is recommended that any changes foreseen in the terms and conditions of an issuance are notified in advance to the competent authority, as such changes may affect the eligibility criteria for classification as regulatory own funds instruments, so that the competent authority has the opportunity to express a view on these changes, in particular with regard to their materiality.

Pre-emption right for shareholders

79. Some issuances include share conversion clauses that give shareholders the chance to buy the shares from the conversion (i.e. pre-emption right to shareholders) and give cash to AT1 holders as compensation.

80. The EBA initially expressed some reservations about this type of clause, raising questions about its necessity for an institution listed on a stock exchange where shares can be bought on the market, and particularly underlining that clauses mitigating the risk of dilution should not be encouraged.

81. On the other hand, the EBA also considered that writing down instruments does not result in a dilution of the shares. Furthermore, giving current shareholders the possibility of buying the shares resulting from the conversion could simplify the process regarding the application of 'fit and proper' rules for qualifying holdings after the conversion and guarantee some stability in the shareholders' structure. Finally, the fact that shareholders may buy the shares does not jeopardise the loss absorption, as the conversion will increase CET1 regardless of the identity of the investor paying for the shares.

82. In the end, despite initial reservations, the EBA agrees that this feature is acceptable.

Contingent clauses

83. The EBA also assessed the potential use of contingent clauses, which might include language that would, for example, make interest payments mandatory in the event that the AT1 status was lost (contingent settlement mechanisms). It is to be noted that current AT1 issuances without this clause are generally classified as equity under IFRS standards by European institutions.

84. The EBA is aware of the potential benefits of such clauses, as argued by market participants. In particular, this is believed to be the only practicable way to ensure that an AT1 instrument is treated as debt under IFRS. This, in turn, ensures the possibility of using hedge accounting.

85. In particular, using contingent clauses would allow (via debt accounting) cover against volatility in own funds due to foreign exchange risk or interest rate risk. In addition, in some jurisdictions, an issuer's ability to deduct interest payments for tax purposes may be undermined if the AT1 is classified as equity instead of debt. Finally, not allowing contingent clauses may render issuances more difficult and expensive for some non-Eurozone institutions in particular.

86. On the other hand, there are drawbacks to allowing the use of contingent clauses by EU

institutions. These are of a different nature.

87. Contingent clauses introduce complexity and there may be unintended consequences from the existence of such provisions. They might, for example, constrain regulatory changes — as those would lead to disqualification and the activation of the clause — making a whole array of instruments 'must pay'.

88. While the CRR does not require equity classification for AT1 instruments, the accounting treatment should be derived from genuine reasons. In addition, if the accounting rules change, the contingent clause may become useless and issuers may need a new type of provision to ensure a debt treatment. In addition, it is expected that issuers will be inclined to use an additional specific clause in order to trigger a debt classification for pre-existing issuances currently classified as equity.

89. It would need to be demonstrated that AT1 instruments with temporary write-down features accounted as debt under IFRS would create CET1 for the full amount of the instrument when written down with regard to the CRR provisions, which require that write-down or conversion of an AT1 instrument shall, under the applicable accounting framework, generate items that qualify as CET1 items. With this in mind, a haircut for the inclusion of the instruments in own funds could be introduced in order to take this possibility into account.

90. After having considered all the benefits and drawbacks of such clauses, it is the EBA's view that, while presenting some benefits (particularly in terms of hedge accounting), contingent clauses present the prudential concerns as expressed above and these are deemed to outweigh the potential benefits.

91. In addition, the EBA is of the view that opening the door to this type of clause will lead to the acceptance of other types of clauses and will undermine the EBA's expectation expressed in the report that terms and conditions should be kept simple. This will probably lead to a new round of financial innovation around AT1 instruments.

92. The EBA thus recommends disallowing the use of contingent clauses in the terms and conditions of EU issuances.

93. Finally, alternatives to the contingent clause in which the concept of coupon payment is shifted to a concept of principal payment (i.e. where the institution would be obliged to redeem the principal amount of the instrument following a full loss of AT1 regulatory capital treatment) are also not acceptable, as this would make the redemption of the instrument mandatory.

Contingent conversion convertibles

94. Simply described, the rationale for contingent conversion convertibles is to structure an AT1 instrument with a loss absorption feature through conversion and to add a conversion option for the holder if the share price of the institution is above a certain price (upside conversion). The presence of the option for the holder would potentially help in reaching a new type of investor

and would reduce coupons.

95. There has been at least one issuance of this type in the EU, but it has to be recalled that the issuance was made before the entry into force of the CRR and the related RTS.

96. One of the forms of incentives to redeem as identified in Article 20(2) of Commission Delegated Regulation (EU) No 241/2014 (the RTS on own funds Parts 1 and 2) is 'a call option combined with a requirement or an investor option to convert the instrument into a CET1 instrument where the call is not exercised'.

97. In order to comply with the provisions of the RTS, some proposals could feature an upside conversion up to the first call date in order to avoid the possibility of a conversion following a call date. Giving the conversion option to investors results in a subsidy of the coupon and reduces the instrument's cost for the period from the issue date to the first call date. The initial credit spread or margin will result from the comparison with the non-subsidised coupon level agreed between investors and the issuer. In that case, the 'coupon subsidy' would disappear at the first reset date, which would have a material effect on the coupon.

98. It has to be noted that, in this type of structure, the reset at the first call date would probably always be an increase in the coupon, whereas a normal reset could also drive the coupon down. A conversion option itself before 5 years is not a problem, but should not be featured with the sole objective of reducing the cost of issuance (as this would be seen as an incentive to redeem at the first call date).

99. Conditions that could be considered for accepting this type of instrument should refer to cases where the subscriber is an existing shareholder or cases where the conversion option is to be exercised as a result of change in the ownership of the institution. Even in these cases, the terms of the conversion option should be carefully assessed and, as stated previously, there should not be a direct link with a reduction of the coupon.

100. In theory, a conversion option in an issuance with no call date could be acceptable, although it is likely that the interest in such structures would be low, as there would be no subsidy of the coupon in this case (the cost of the issuance at inception would be higher).

Anti-circumvention principle

101. In previous versions of this report, the EBA communicated that terms should refer to associated arrangements (such as covenants) only when they make clear what those arrangements are, either by a description of the terms of the arrangement that affect the terms of the instrument or by using a hyperlink to the text of the arrangement, or simply by attaching the terms of the arrangement. In any case, it is desirable to exclude any reference to associated arrangements that affect the prudential terms of the instruments. In this regard, it is now stressed in addition that the new Article 79a of the CRR explicitly stipulates that 'the assessment of the substantial features of an instrument shall take into account all arrangements related to the instruments, even where those are not explicitly set out in the terms and conditions of the instruments

themselves, for the purpose of determining that the combined economic effects of such arrangements are compliant with the objective of the relevant provisions.'

Formal issues

102. Prudential provisions or clauses of importance from a prudential point of view should not be worded in a way that makes it unclear whether or not they do actually apply (e.g. 'it is expected that', 'if required by the regulation', etc.). Provisions should be worded clearly.

103. The wording used should be in accordance with that in the CRR; for instance, 'non-objection' cannot be used as a substitute for the CRR wording of '(supervisory) permission'. Likewise, the terms of the issuance should not include provisions that may create confusion with the Level 1 provisions (the CRR) or the RTS. For example, the terms should not indicate that the relevant regulator may have agreed with the relevant issuer to reduce the principal amount of the note after a longer period than the one laid down in the CRR (1 month).

104. The terms should make clear that the trigger event may be calculated at any time. Therefore, the definition of the CET1 ratio should not refer to the last quarterly financial date or any extraordinary calculation date. The EBA noted a need for further guidance in that respect, as exemplified by recent issuances, for which the wording used was not always satisfactory. The definition of the trigger event should be clear and simple. In particular, the definition should explicitly refer to the possibility of calculating 'at any time'. In addition, it should avoid making references to 'as determined by the bank' or to regulatory reporting dates.

105. An adequate formulation for the trigger event is the following: 'capital adequacy trigger means, at any time, that the CET1 capital ratio of the Issuer is below [xx%]; whether the capital adequacy trigger has occurred at any time shall be determined by the Issuer, the Competent Authority [or any agent appointed for such purpose by the Competent Authority]'. This wording is used accordingly in the proposed standard AT1 templates. It should be noted that having a reference to the competent authority is seen as prudent, as the competent authority could also determine that a trigger event has occurred.

106. It is not desirable to specify that provisions apply 'under applicable law' or 'if required by the applicable banking rules' when it is clear that legal requirements come directly from the CRR or the RTS. The reference to 'applicable law' might cause uncertainty regarding the application of the CRR and could be understood as questioning its applicability.

107. It is preferable not to have detailed lists of situations where the institution will not make distributions, as it creates the impression that the list covers all eventualities when this may not be the case.

2.2.2 Interpretation of some CRR provisions

108. Although some differences observed in the issuances are justified, the EBA's monitoring has also shown that there are differences in the interpretation of some provisions of the CRR relating to AT1 instruments. This is notably the case for the triggers for loss absorption. These issues need to be tackled to promote a common interpretation of the CRR.

Calculation of the amount available for the write-up when the instrument features a double trigger

109. The existence of different triggers raises the question on the calculation of the amount available for the write-up (and thus the length of the write-up period) when there are different net incomes calculated on a (sub-)consolidated or a solo basis (sometimes called the 'maximum write-up amount') and when the triggers on the solo and the (sub-)consolidated levels are hit at the same time. The available amount can be calculated on the basis of the solo or (sub-)consolidated net income, which is then multiplied by the aggregate original amount of AT1 capital divided by the total Tier 1 capital.

110. The EBA considers that, when there are triggers on the basis of more than one level of solvency, the relevant available amount for the write-up should be the lower amount of the profits (or net income) arising from the different levels. For instance, assuming that the profit calculated on a solo basis is lower than the profit calculated on a consolidated basis, the relevant amount for the purposes of the write-up should be capped at the level of the profit calculated on a solo basis.

111. While the maximum amount to be used for the write-up based on the use of the 'lower of the profits' is usually before the application of the write-up formula, the EBA would not prevent using the 'lower of the write-up amount' obtained after the application of the write-up formula. This is particularly relevant in cases where comparing the results of the formula using, on the one hand, the profits on a solo basis and, on the other hand, the profits on a consolidated basis would lead to more conservative results.

Triggers for instruments issued within a banking group

112. Under the CRR provisions, triggers for the loss absorption of AT1 instruments shall be based on the CET1 of the institution, at a level of 5.125% or more. However, it is unclear whether these triggers should be based on the institution's solo CET1 or on the institution's (sub-)consolidated CET1. An additional question is whether the trigger should be based not only on the CET1 of the issuer but also on the CET1 of the group, particularly when the issuer is not the head of the group.

113. Different situations may arise: banking groups with a parent institution; banking groups with a parent holding company; and mutual groups with a central body.

114. The EBA considers that there should be a trigger on the basis of all levels of solvency applicable to the institution (or the banking group). This means that there should be a trigger on the basis of consolidated CET1 when the entity is supervised on a consolidated basis, based on sub-

consolidated figures when the entity is supervised on a sub-consolidated basis, and based on solo figures when the entity is supervised on a solo basis, as well as any applicable combination of any of the cases mentioned above. The inclusion of triggers referring to the application scope of supplementary supervision pursuant to the Financial Conglomerates Directive (FICOD) is possible but not mandatory.

115. Where an institution is subject to Article 11(2) of Regulation (EU) No 575/2013 — i.e. in cases where an institution is controlled by a holding company — in order for AT1 instruments to be included as qualifying Tier 1 instruments in the consolidated Tier 1 capital of the holding company within the limits laid down in Article 85 of the CRR, the terms and conditions of the instruments issued by that institution should include a trigger event on the basis of the consolidated CET1 of the parent financial holding company or parent mixed financial holding company. The absence of this trigger would make the issuance ineligible for the purpose of the computation of the consolidated Tier 1 of the holding company. However, the issuance would still be eligible at the sub-consolidated and solo levels if it included triggers at these levels.

116. It is worth specifying that it would not be possible for an AT1 instrument issued by a subsidiary to have only a trigger based on the consolidated solvency of the parent holding company: the trigger at the level of the issuing entity is mandatory, except in cases where Article 7 of Regulation (EU) No 575/2013 is applied. Without that trigger, the instrument would be disqualified at all levels, based both on a reading of Article 54 of the CRR and on concerns that the absence of this trigger would not be prudentially sound.

Group/solo triggers for the eligibility criteria for instruments issued by subsidiaries in third countries (calculation of third-country CET1)

117. In addition to the issue of triggers — which is relevant for both EU and non-EU issuances — there are specific issues relating to the issuance of AT1 instruments in third countries, notably because the CRR is more stringent or more specific than the Basel III framework with regard to some eligibility criteria. In particular, the CRR rules prohibit dividend stoppers for AT1 instruments and require 5.125% triggers for all AT1 instruments regardless of their accounting treatment. In third countries, the mechanism of write-down/write-up may also differ from that prescribed by the RTS. Those rules do not necessarily exist in third countries even if the AT1 instruments issued by institutions in those third countries are Basel III compliant.

118. An instrument issued in a third country with, for instance, a dividend stopper could be eligible as AT1 in the third country but would not be recognised as AT1 for the purposes of the consolidated solvency position of an EU banking group.

119. More generally, and as mentioned in Q&A 2013_385 , instruments issued by subsidiaries in third countries shall comply with all requirements that are specified under the CRR and associated implementing regulations in order to be eligible at the level of the group.

120. For the purposes of the definition of the trigger event, the CET1 capital shall be calculated in accordance with the provisions of the national law or contractual provisions governing the

instrument in accordance with Article 54(1)(e) of the CRR, provided that the competent authority, after consulting the EBA, is satisfied that those provisions are at least equivalent to the requirements set out in Article 54 of the CRR.

121. In addition, it has to be recalled that the amendments to the CRR introduced additional criteria for the issuance of AT1 instruments[23] where the issuer is established in a third country and has been designated as part of a resolution group, the resolution entity of which is established in the Union or where the issuer is established in a Member State. For those issuances, point (p) of Article 52(1) of the CRR requires the law or contractual provisions governing them to recognise the decision of the resolution authority to exercise the write-down or conversion powers in accordance with Article 59 of the BRRD. Further, point (q) of Article 52(1) of the CRR limits the choice of law under which the instruments are issued to these jurisdictions which recognise the write-down and conversion powers referred to in Article 59 of the BRRD and ensure their enforceability and effectiveness.

122. Institutions shall consider the additional complexity when issuing AT1 instruments under a third country law or when planning to include the issuance of a third country subsidiary in their own funds on a consolidated level. In particular, institutions which are planning to issue such instruments should carefully assess the effectiveness and enforceability of the resolution authority's write-down and conversion powers referred to in Article 59 of the BRRD under the applicable contract and law. The EBA has observed that some competent authorities regard all AT1 issuances subject to third country law as complex and require assurance of compliance with the criteria, such as a legal opinion confirming the effectiveness and enforceability of the write-down and conversion powers of the resolution authority referred to in Article 59 of the BRRD.

123. In the context of the new criteria, and in particular concerning issuances under English law[24], the EBA was asked whether the introduction of the contractual recognition of the write-down and conversion powers in AT1 instruments issued prior to 27 June 2019, in order to avoid grandfathering in accordance with Article 494b CRR, would be considered a 'material change' within the meaning of EBA Q&A 2013_16 and therefore as new issuance. The EBA confirms that any change in the terms & conditions of an already issued instrument, which might have an impact on the eligibility criteria, should be considered a 'material change' and that any change made should aim at full eligibility of the instrument under the CRR applicable provisions. That said, under the exceptional circumstances of the UK's departure from the EU, the residual time to maturity/first call date would not be affected and the original date of issuance would remain unaltered.

[23] Article 52(1)(p) also covers issuances of AT1 instruments where the issuer is established in a third country and has not been designated as part of a resolution group, the resolution entity of which is established in the Union. For those issuances, the Level 1 text requires the law or contractual provisions governing the instruments to recognise the decision by the relevant third-country authority to write down the instruments on a permanent basis or to have them converted into CET1.

[24] Since 01.01.2021, the UK has to be considered a third country and therefore own funds instruments issued under English law have to be considered third country issuances, resulting in the application of points (p) and (q) of Article 52(1) CRR and Article 494b(1) CRR.

Loss absorption in institutions that issued instruments with different triggers (e.g. 5.125% and 7%)

124. When an institution issued instruments with different triggers (e.g. 5.125% CET1 or 'low' trigger and 7% CET1 or 'high' trigger), it is possible for all the triggers to be hit simultaneously (e.g. the CET1 of the institution is reduced to 4.5% from over 7%).

125. In that specific case, losses corresponding to the amount required to go back to 5.125% should be absorbed by both the low-trigger and high-trigger instruments on a pro rata basis. Losses above 5.125% will be supported by only the high-trigger instrument.

Loss absorption in cases where the definition of loss-absorbing instruments is extended beyond AT1 instruments

126. It was observed in some issuances that the definition of (Other) Loss-Absorbing Instruments contains other obligations or capital instruments (apart from the AT1 instruments that are subject to the issuance or other AT1 instruments) which are intended to absorb losses on a pro rata basis and which contain a loss absorption mechanism activated by an event equivalent to the trigger event for the AT1 instruments subject to the issuance and with a threshold for such activation which may be identical to, higher than or lower than the trigger event threshold as defined for the AT1 instruments subject to the issuance.

127. In cases where the definition of (Other) Loss-Absorbing Instruments includes non-AT1 instruments (for example Tier 2 instruments) and where trigger levels can vary rather than being identical, the principle of the pro rata basis laid down in the RTS on own funds (Article 21(1) of the RTS on own funds Part 1) for operating the write-down of several instruments among all holders of AT1 instruments that include a similar write-down mechanism and an identical trigger level could not be implemented. Hence, this type of extensive definition should be avoided.

128. In case of the existence of other similar loss-absorbing instruments, a clause clarifying the following is considered as a best practice: that these instruments, that may be written down or converted into equity in full but not in part only, shall be treated for the purposes only of determining the relevant pro rata amounts as if their terms permitted partial write-down or conversion into equity.

Tap issuances

129. The question is whether or not tap issuances — meaning subsequent issuances made fully fungible with the original issuance (same coupon, same frequency of payments, ISIN etc.) — with the same reset mechanism applied to the tap leading to a different result from that for the original issuance may be considered as creating incentives to redeem.

130. More precisely, where a tap of an instrument is priced at a lower credit spread than the initial spread of the original issue, this raises the question of whether or not the reset of the margin for both the tap and the original issuance at the identical first call date to the initial spread of the

original issue should be considered an incentive to redeem.

131. In its analysis of the specific situation of tap issuances, the EBA had regard to Article 20(2)(c) of the RTS on own funds Parts 1 and 2. This provision clearly states that 'a call option combined with a change in reference rate where the credit spread over the second reference rate is greater than the initial payment rate minus the swap rate' constitutes an incentive to redeem. From this it follows that, if the reset mechanism of the original bonds is set to apply more than five years after the tap issuance and also applies to the latter, there is an incentive to redeem if the credit spread for the tapped amount increased because it was lower than the credit spread of the original bond.

132. The EBA Banking Stakeholder Group (BSG) has also been consulted on this issue, in particular with a view to assess in more detail current market practices and issuances and any potential impact of disallowing tap issuances.

133. BSG representatives argued that the position taken by the EBA in the previous point could disincentivise institutions from making tap issuances, whereas tap issuances limit the costs of making a completely new issuance and allow the institution to take the chance of benefiting from certain market opportunities that may arise shortly after the original issuance was placed. Obviously, this is on the assumption that the tap issuance would present exactly the same terms and conditions as the original issuance, would be fully fungible and would have a call date a minimum of five years after the date of the tap issuance.

134. Furthermore, tap issuances in the future may concern not only own funds instruments but also issuances of eligible liabilities. It is also to be noted that tap issuances for AT1 instruments are not a common practice at the moment (unlike tap issuances for senior bonds).

135. As indicated in the answer to Q&A 2016_2848, a tap of an instrument (being an AT1 or T2 instrument) shall be considered as a new issuance (see Q&A 2013_238). If the reset mechanism of the original bonds is set more than five years after the tap issuance and the mechanism also applies to it, there is an incentive to redeem in the sense of Article 20(2)(c) of Commission Delegated Regulation (EU) No 241/2014 if the credit spread for the tapped amount increased because it was lower than the credit spread of the original bonds.

136. In providing this answer, the EBA took the view that the current texts of the CRR and corresponding technical standards on own funds do not leave much room for manoeuvre. In addition, the EBA was concerned about introducing increased complexity to the own funds framework by setting possible criteria for allowing tap issuances (e.g. a given timeframe for the tap to take place or amount constraints in terms of complementary amount to the original issuance) whereas it seems, based on the outstanding issuances, that the impact of not allowing them would be limited.

3. Follow-up of the EBA Opinion on legacy instruments

137. In October 2020, the EBA published its Opinion on the prudential treatment of legacy instruments.[25] When reviewing EU institutions' legacy instruments and examining the clauses that led to their grandfathering, the EBA identified two main issues which could create so-called infection risk, i.e. the risk of other layers of own funds or eligible liabilities instruments being disqualified.

138. Since the publication of its Opinion, the EBA has started monitoring the situation of the legacy instruments, placing particular focus on the use of the proposed options across jurisdictions with a view to ensuring consistent application. In addition, the EBA is considering the transposition of specific provisions of Directive 2014/59/EU (BRRD, in particular Article 48(7)) into national legislation and looking at how this might alleviate concerns about the existence of infection risk linked to subordination aspects.

139. Transparency on the implementation of the options envisaged in the Opinion by institutions and competent authorities will be ensured in due time by the EBA. At the time of the publication of this report, 19 EU competent authorities reported that, for institutions under their direct supervision, there are no outstanding legacy instruments or outstanding legacy instruments posing infection risk and, as such, these are assessed as outside the scope of the EBA Opinion.

140. The EBA has received questions on different aspects of the proposed options aimed at addressing the infection risk. Some institutions intend to cascade down grandfathered AT1 instruments as fully eligible Tier 2 instruments under the rationale that their terms and conditions satisfy the ranking rules of Article 63(d) CRR, i.e. rank below eligible liabilities instruments. In addition and in order to ensure that the ranking rules between different tiers of own funds are respected, some institutions suggested amending the ranking of current and future AT1 instruments issued so they are always subordinated in liquidation to the legacy AT1 intended to be treated as fully eligible Tier 2. While this approach might mitigate the infection risk in the higher tiers of own funds, i.e. CET1 and AT1, it raises concerns on the eligibility of already issued Tier 2 instruments. As the EBA has underlined in its Opinion, the subordination provisions covering the instruments should be assessed not only against the ranking rules across the tiers of own funds and eligible liabilities, but also within the specific tier of own funds in which the instruments are placed.

141. While the eligibility criteria of the CRR do not explicitly prohibit Tier 2 instruments not ranking *pari passu*, the EBA emphasises that it does not consider it appropriate for institutions to implement a multiple-layered structure for Tier 2 instruments. Such an approach would add

[25] EBA-Op-2020-17 Opinion on legacy instruments.pdf (europa.eu).

complexity in the own funds structure and would give rise to legal risk in the case of a bail-in due to the NCWO principle, in particular taking into account that the sequence established in Articles 48(1) and 60(1) BRRD refers to CET1 followed by AT1 and Tier 2, which implies a *pari passu* principle of loss absorption between instruments pertaining to the same category. In addition, it is recalled that any instrument that would be reclassified in the Tier 2 category would need to meet not only all relevant provisions of the CRR and the RTS, but also all the related guidance on the consistent and effective application of the regulatory framework provided via EBA Q&As and reports, including this AT1 monitoring report.[26]

142. Other institutions were concerned whether a change in the terms and conditions in order to mitigate the infection risk would be considered a material change within the meaning of EBA Q&A 2013_16 and would lead to the instrument being treated as a new issuance, therefore, affecting its maturity. As already pointed out in EBA Q&A 2017_3299, changes made to pre-CRR instruments shall aim at ensuring full eligibility under the applicable provisions. EBA Q&A 2018_4417 further clarifies that the *'terms and conditions need to be assessed against the rules which are applicable at the moment of the reclassification of the instrument. These rules encompass the relevant regulatory provisions stemming from Part Two (Own funds) and Part Ten, Title I (Transitional Provisions) of the CRR (legislative act) and Regulatory and Implementing Technical Standards (delegated and implementing acts), as supplemented by related guidance for the consistent and effective application of the regulatory framework provided via EBA Q&As or reports available at the time of reclassification.'* That being said, given that one of the options envisaged in its Opinion for addressing infection risk is the amendment of the terms and conditions of legacy instruments, then to promote legacy AT1 instruments ranking, *pari passu* with Tier 2 instruments, for example, the EBA clarifies that such amendments will not be seen as affecting the residual maturity of the instrument or its original date of issuance. This is under the condition that, except for the maturity aspect, any change made should aim for full eligibility of the instrument under the provisions applicable to the own funds or eligible liabilities layer where the instrument is to be placed and where the changes are made in order to continue classifying the instrument as own funds or as eligible liabilities.

[26] See paragraph 17 of the Opinion.

4. EBA's considerations on own funds and eligible liabilities instruments with ESG features

4.1 Introduction

143. Banks have started issuing Environmental, Social, Governance ('ESG')[27] bonds for MREL purposes since 2018, and an increasing number of issuers are looking at green capital as an opportunity to both finance and capitalise their green portfolios. More recently, the ESG trend has crossed to other capital products (own funds) with a first-ever Tier 2 issuance and AT1 issuance, both issued in July 2020.

144. This relatively new market segment has been growing and developing fast in recent years and months. ESG bonds are issued by entities that seek to have positive environmental, social and governance characteristics, the proceeds of which are meant to be invested in ESG assets. These bonds are usually marketed as green bonds or social bonds, commonly follow green[28] or social impact standards[29], and are certified by an independent verifier following the climate bond standard and certification scheme.[30]

145. As highlighted in the EBA's TLAC-MREL monitoring report[31], the EBA only conducted preliminary work on ESG bonds for TLAC-MREL purposes at the time of its publication and identified this area for future work and recommendations.

146. The purpose of this guidance is to i) give an overview on the identified risks, ii) comment on identified differences of clauses based on a larger set of regulatory ESG transactions in comparison to the TLAC-MREL monitoring report and iii) discuss policy observations on how the clauses used for ESG issuances and the eligibility criteria for own funds and eligible liabilities instruments interact, with the ultimate aim of identifying best practices or practices/clauses that should be avoided. Therefore, the analysis is not meant to address potential compliance issues of ESG bonds with ESG requirements themselves, but it is aimed at clarifying the extent to which some provisions included in ESG bonds may raise regulatory concerns in the context of the eligibility criteria for own funds and liabilities instruments.[32]

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[27] For the purpose of this report 'ESG' bonds means any type of own funds or eligible liabilities instrument that has been classified or labelled as 'Green', 'Social', 'ESG', etc. by the issuer. For the avoidance of doubt, to date there is no 'ESG' regulatory bond standard or label.

[28] https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp .

[29] https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/ .

[30] https://www.climatebonds.net/certification .

[31] EBA Report on the monitoring of TLAC-MREL eligible liabilities instruments of EU institutions.

[32] In this regard it should be noted that the Commission is working on a legislative proposal on Green Bond Standards (following the recommendations of the Technical Expert Group on Sustainable Finance), which should include an EU

147. To perform its monitoring function, the EBA has focused its work on the assessment of selected ESG own funds and TLAC- and MREL-eligible liabilities instruments.

148. Furthermore, the EBA received input during a roundtable held with different stakeholders in April 2021 regarding findings and possible best practices on ESG bonds for own funds and eligible liabilities. Overall, stakeholders welcomed the EBA providing clarity on the compatibility between ESG features and regulatory eligibility criteria and shared the analysis presented on the identified risks and possible mitigants. The recommendations were well understood and shared. Participants urged the EBA to continue working on the aspects relating to the use of ESG performance targets (Key Performance Indicators - KPI) for bond remuneration in a context where Sustainability Linked Bonds are expected to grow in the next few years.

149. Although this guidance provides current policy views, the monitoring of new ESG bond issuances will continue to enrich the observations and recommendations going forward as far as needed. The EBA will continue to monitor the developments of Sustainability Link Bonds and possible related KPI if issued for regulatory purposes.

150. In performing its monitoring function, the EBA ensured consistency with its other connected mandates and current developments in the broader developments at EU level of ESG standards from Green and Social bonds.

4.2 Main observations

151. The EBA has observed that there are some divergences in the documentation (EMTN programmes) of issuers. While some documentation remains quite general, stating on the one side the ESG requirements and on the other side the requirements for own funds and eligible liabilities instruments, being silent on possible interactions between the two, others include, more or less extensively, specific provisions on these interactions. Recent issuances have proven to be more explicit in this regard.

152. Overall, explicit provisions in the documentation on these interactions with regard to several aspects such as loss absorbency, status of the notes/subordination, event of default, early redemption or acceleration rights are welcomed by the EBA. They are deemed to reinforce certainty on the nature of the bonds from a regulatory perspective and to mark more clearly the difference with other types of more common bonds such as senior debt or covered bonds that could be used for ESG financing purposes.

153. An area where caution is warranted is the link between the performance of the ESG capital bonds and the performance of the underlying ESG assets. At this stage of its monitoring, it is the EBA's view that step-up and/or fees based on missing certain ESG targets or other performance

definition of green bonds and specify the requirements that these instruments should have in order to comply with the EU Standards. Since this proposal is not yet known, the present guidance does not prejudge on the compliance of the regulatory ESG transactions with the forthcoming Green Bond Standards. The EBA will continue to monitor the interaction between these forthcoming Standards and the regulatory eligibility criteria.

indicators should not be allowed or encouraged, as they could be regarded as incentives to redeem, hence contradicting the eligibility criteria for own funds and eligible liabilities. That said, the EBA will continue to monitor and assess these features going forward.

4.3 Detailed analysis

154. The following sections provide an analysis of the possible risks of these ESG bonds from an own funds and eligible liabilities perspective, followed by a section with provisions observed in existing ESG bonds issuances, how they match the CRR eligibility criteria and BRRD requirements as well as policy recommendations and best practices.

Overview of identified risks

155. ESG bonds have been marketed, sold and labelled as 'green/social' bonds and give investors certain expectations on the conduct of the issuer and performance of the bonds. ESG bonds in general increase the reputational risk for the issuer compared to normal bonds, particularly in cases where something unexpected happens. Identified risks include:

From an issuer perspective:

- risk of earmarking the proceeds for ESG projects or activity with impediments to use the proceeds to cover losses from other assets/all parts of the business of the bank;
- risk that a change in the allocation of proceeds/a potential disqualification of the original assets as green assets might be perceived by investors as an obligation for the issuer to redeem the instrument;
- risk of having the maturity of green assets not matching the minimum duration of the instrument (in particular for perpetual ones/subsequent lack of new green assets and related perception by investors as an obligation for the issuer to redeem the instrument at the maturity of the assets;
- more generally, risk of having features of predefined sustainability or ESG objectives directly impacting the eligibility criteria of the instrument, in particular with regard to:
    - permanence (early redemption or other incentive to redeem like step-up or fee linked to specific ESG targets),
    - loss absorption (write-down or conversion, acceleration rights, possibility of bail-in etc.),
    - flexibility of payments.

From an investor perspective:

- risk that investors do not realise that the instruments absorb losses from all activities of the bank or that coupons might be skipped in AT1 instruments due to losses/issues not related to green assets, even if the ESG targets are reached.

156. Overall, the above-mentioned risks can be grouped into four distinct areas, namely:

I. fungibility of the use and management of proceeds (i.e. no segregation of assets and liabilities);

II. clear description of the status of the notes (i.e. hierarchy, subordinated nature, no impediment for resolution, etc.);

III. absence of link between performance or use of assets and notes (i.e. no acceleration, no event of default, lack of assets not being an incentive to redeem, no performance fees or ESG targets linked to the premiums);

IV. reputational risk for the issuer (i.e. in addition to previous risks, legal definition of ESG, loss of green bonds label, loss of third-party verification, etc.).

157. The purpose of this guidance is to cover areas I to III. It is focused only on ESG capital bonds (bonds issued for own funds or eligible liabilities purposes).

Observations and provisions observed in existing issuances

Fungibility of the use and management of proceeds

158. There are many articles in the CRR (including Article 52(1)(o), Article 52(1)(f), Article 63(f), Article 72b(2)(e) Article 51(1)(r), Article 63(p) and Article 72b(2)(f)), the ultimate aim of which is to ensure that own funds and eligible liabilities instruments cover all losses in the balance sheet of an institution, regardless of whether the bonds are labelled 'Green' or 'ESG' and regardless of whether the losses stem from Green or ESG assets or other assets including non-eligible assets (as further explained below).

159. Furthermore, Articles 45 and 45c of the BRRD provide the minimum requirements for own funds and eligible liabilities (MREL) and the criteria to set the MREL based on the total risk exposure amount of the institutions.

160. Bearing this in mind, most EMTN programmes highlight that 'an amount equivalent or equal to the net proceeds from the issue of any tranche of notes will be applied by the Issuer for the general funding purposes of the Issuer' or have similar language in the documentation regardless of whether the notes are ESG or not. However, in some of the ESG bonds, the final terms include drafting whereby the issuer commits to allocate an amount equal to the net proceeds primarily towards the financing or refinancing of eligible Green or Social loans or projects ('eligible assets').

In rare cases, EMTN programmes explicitly exclude the proceeds from being used as finance, such as for nuclear power generation, large scale dams, defence, mining, carbon related or oil and gas activities.

161. The level of commitment by the issuers varies across EMTN programmes. Some issuers commit to a full allocation or a certain percentage of the use of proceeds to the eligible assets and include language such as 'the (a percentage of the) net proceeds of the green bonds issued under this framework will be allocated to Eligible Assets' or similar wording. However, other EMTN programmes use softer language such as 'It is the Issuer's intention to apply an amount equivalent to the net proceeds of the issue to finance or refinance (via direct expenditures, via direct investments or via loans), in part or in full, on eligible activities' or 'While it is the intention of the Issuer to apply the net proceeds of any Green Notes, as described in use of proceeds section, there can be no assurance that the Issuer will be able to do this.'

162. Furthermore, most EMTN programmes clarify that in some/limited instances, the issuer could temporarily hold the balance of net proceeds not yet allocated to eligible assets in its treasury portfolio, in cash or other short term and liquid instruments at its own discretion and in accordance with the institution's liquid portfolio investment policy, while some restrict the investments for the treasury portfolio to bonds with a sustainable character (such as green and social bonds).

163. All in all, some issuances seem more precautionary than others. Where EMTN programmes mention that the proceeds might not be used for financing certain assets identified as harmful for the environment, it would need to be clear to the investor that losses on these assets shall also be absorbed by these funds as far as necessary. In addition, some issuances seem less committed than others when mentioning that 'an amount equal to the net proceeds' would be used to finance ESG assets while others would 'exclusively' dedicate the net proceeds to finance ESG assets. Finally, the risk around a possible reallocation of the proceeds in a treasury portfolio or liquidity portfolio, with an additional obligation in some cases to be in cash/instruments with a sustainable character, potentially creating substantial maturity mismatches between green assets and bonds, might not always be well covered in the documentation.

164. From a regulatory perspective, it is key to guarantee that there is no direct link between the ESG assets and the notes. An appropriate clarification in the documentation is needed to ensure that the issued capital is available to absorb losses incurred not only on ESG assets but also on all types of assets in the balance sheet of the institution, if needed.

165. In this regard, explicit provisions in the documentation stating that proceeds from own funds and eligible liabilities issuances should cover all losses in the balance sheet regardless of whether the bonds are labelled Green or ESG and regardless of whether the losses stem from Green/ESG assets or other assets, should be seen as best practice. In the same manner, a clear statement/provision that transactions with an ESG or Green label are fully subject to the application of the CRR eligibility criteria and BRRD requirements for own funds and eligible liabilities instruments and related risks as loss-absorbing instruments should be seen as best

practice. The investor should be made well aware that there is no arrangement in place that enhances the performance of the notes. The EBA will continue to monitor and assess ESG-labelled capital bonds with the CRR eligibility criteria and BRRD requirements going forward.

166. While different types of wording with regard to the commitment to invest in ESG assets have been observed, it is essential that short-term ESG projects or the lack of ESG assets have no consequence on the instruments' permanence and loss absorbency and that this is made clear to investors. Stronger commitments to fund eligible assets might be seen as contradicting the necessary fungibility of proceeds.

Clear description of the status of the notes

167. Several articles in the CRR (in particular Article 52(1)(d), Article 52(1)(n), Article 51(1)(l)(iii), Article 63(k), Article 72b(2)(d), Article 72b(2)(k), Article 52(1)(r), Article 63(p), Article 72b2(f)) govern the ranking, loss absorption, permanence and flexibility of payments, aiming to ensure that own funds and eligible liabilities instruments provide genuine loss-absorbing capacity to the institution and preserve the necessary amount of capital at all times (i.e. going concern and in resolution or a moratorium under the BRRD). Furthermore, these provisions ensure that in an event of bail-in, the own funds and eligible liabilities instruments function following the creditor's hierarchy according to national insolvency law. This principle should always be upheld regardless of whether the bonds are labelled Green or ESG or not.

168. In light of this, the EBA observes that only a minority of EMTN programmes (in particular recent ones) clarify that failure by the issuer with regards to the use of proceeds or the expected performance of the eligible assets will not jeopardise the qualification of the notes as AT1 or Tier 2 capital or eligible liabilities instruments of the institution and/or the group.

169. In the same context, a minority of EMTN programmes also clarify that the risk of subordinated notes becoming subject to a write-down when the issuer is failing or likely to fail or the issuer becomes insolvent or subject to resolution applies equally to subordinated notes which are issued as ESG bonds.

170. All in all, the majority of the issuances do not recall the risks associated with the regulatory nature of the instruments, although more recent issuances/documentation are starting to incorporate this risk in the wording.

171. It is essential for the documentation of the issuances to provide full clarity on the status of the notes in terms of hierarchy/subordination, risks associated with bail-in and resolution, as well as risks associated with coupon payments for the more subordinated instruments.

172. In particular, it should be seen as best practice to clearly state in the documentation that the ESG, Green or Social classification does not affect the status of the notes in terms of subordination, loss absorbency features and regulatory classification as own funds or eligible liabilities instruments. Reference to the subordinated nature and ranking of the instruments compared to more senior claims is also recommended.

173. For investor awareness purposes, it should be highlighted in the documentation that the resolution tools, write-down mechanisms and bail-in powers apply equally to all notes, including those that are issued as ESG bonds (i.e. no impediment to resolution).

174. For the avoidance of doubt, for AT1 instruments, the documentation should explicitly specify that the features of the coupons that may be cancelled at any time up to the institution's discretional decision and other circumstances (i.e. MDA rules) apply equally to notes that are issued as ESG bonds and that this does not constitute an event of default.

No link between performance of assets and notes

175. Several articles in the CRR (including Article 52(1)(g), Article 52(1)(j), Article 63(h), Article 63(j), Article 63(l), Article 72b(2)(g), Article 72b(2)(j) and Article 72b(2)(h)) aim to ensure that own funds and eligible liabilities instruments do not include any incentive to redeem the bonds or give rights to the note holders to accelerate future payments, in the case of AT1 on a perpetual basis and in the case of Tier 2 and eligible liabilities prior to the stated maturity subject to certain specific conditions. Furthermore, in order to preserve capacity for loss absorption, Article 52(1)(l)(ii), Article 63(m) and Article 72b(2)(m) of the CRR ensure that the level of interest or dividends payments, as applicable, due on the instruments does not change due to the creditworthiness of the issuer at any time. This principle should always be upheld regardless of whether the bonds are labelled Green or ESG or not.

Event of default

176. Most EMTN programmes clarify that no event of default shall occur in cases where the net proceeds of the notes are not used as set out and described in the use of proceeds section of the documentation, and they specify that there can be no assurance that the ESG projects financed or the use of the proceeds related to the eligible assets will i) be capable of being implemented in the manner as described in the prospectus, ii) be implemented within any timing schedule, or iii) result or lead to an outcome (whether or not related to the environment) as originally expected or anticipated by the issuer. Any such event or failure by the issuer will not constitute an event of default.

177. In addition, many EMTN programmes clarify that failure by the issuer to provide or publish any reporting, any (impact) assessment or to obtain any (third) opinion or certification will not constitute an event of default under the notes or give rise to any obligation or liability of the issuer or other claim of noteholders against the issuer.

178. Rarely, it is specified that the remedies available to holders of subordinated notes or of senior notes with restricted events of default apply equally to ESG bonds and the enforcement rights of holders in respect of these notes are extremely limited.

179. All in all, not all issuances mention the failure to apply the proceeds to ESG assets or to publish related certifications as not being an event of default. It should be clear to the investor that the performance of the eligible assets cannot be linked to the performance of the notes and that

failure to comply with general ESG targets set at company (issuer) level cannot be linked to the performance of the notes or lead to an event of default.

180. Explicit provisions in the documentation clarifying that not meeting any ESG target or objective does not constitute an event of default are welcome. Furthermore, a reference is recommended whereby an event of default is not triggered if the amount equivalent to the proceeds is not used for funding eligible assets or if the performance of those eligible assets is not as expected.

181. In addition, stating in the documentation that failure by the issuer to provide or publish any reporting, any (impact) assessment or to obtain any (third) opinion, certification or label should not constitute an event of default is best practice.

Acceleration and (early) redemption

182. A minority of EMTN programmes clarify that failure by the issuer with regards to the use of proceeds or with the expected performance of the eligible assets will not i) lead to an obligation of the issuer to redeem the notes, ii) be a relevant factor for the issuer in determining whether or not to exercise any optional redemption rights in respect of any notes and/or iii) give a right to the holders to request the early redemption or acceleration of the notes. Among these programmes, some refer only to early redemption, some to redemption in general, rare ones refer to both. In addition, there is no full clarity on whether the trigger related to the use of proceeds is related to, inter alia, the initial allocation of the funds, the reallocation and the loss of the ESG feature of the original project.

183. One recent issuance clearly states that failure by the issuer will not give a right to the holders to request acceleration on the notes. In general, it seems that the more recent issuances have included more explicit wording on the absence of obligations to (early) redeem or accelerate.

184. It should be clear to investors that failure to invest in eligible assets does not lead to the ESG bonds being redeemed or repaid under any circumstances. In the same vein, it should be clear that the notes will not accelerate due to the ESG nature of the notes in any circumstance and that the holders cannot exercise any rights due to failure by the issuer to comply with any ESG target.

185. In addition, the risk of having the maturity of ESG assets not matching the minimum duration of the instrument should be highlighted to investors, stressing that this mismatch shall not lead to an incentive/obligation to redeem the instrument.

186. In this regard, it is preferable to insert explicit provisions in the documentation that failure by the issuer with regards to the use of proceeds at whatever point in time (i.e. being initial allocation of the funds, subsequent reallocation) or with regard to the expected performance of the eligible assets (including the loss of the green/ESG feature of the original project, for example), as well as the existence of a potential mismatch between the duration of the eligible assets/projects and the duration of the instrument will not lead to an obligation for the issuer to redeem the notes, be a factor in determining whether or not to exercise any optional redemption

rights, and/or give a right to the noteholders to request the early redemption or acceleration of the notes or give rise to any claim against the issuer.

Step-up or fee linked to specific ESG targets

187. Most of the EMTN programmes do not mention anything relating to the step-up premiums or discounts in cases where specific ESG targets have been missed (which is positive in the sense that *a priori* such step-ups could not occur). That said, one recent EMTN programme states that for the avoidance of doubt, 'it is specified that payments of principal and interest (as the case may be) on the notes shall not depend on the performance of the relevant eligible assets', which is a welcomed clarification.

188. Many stakeholders are seeking clarification from the EBA on this feature, as for ESG bonds in the corporate sector, it is quite common to have ESG bond coupons linked to performance targets of the eligible assets or general (ESG) targets of the issuer (sustainability linked bonds).

189. In general terms, the EBA does not see favourably a link being established between payments on a regulatory instrument and any performance of assets/fulfilment of specific targets (that could be of a varied nature, including outside the ESG world).

190. The existence of a call, associated with a step-up or a fee triggered by a specific target being missed, will be assessed as contradicting the regulatory eligibility criteria as well as the provisions on incentives to redeem contained in the technical standards on own funds. This is even more true for AT1 instruments which are perpetual instruments. Even in the absence of a call, some of these features could still be assessed as incentives to redeem, since they could lead to repurchases or buybacks. A weak performance of the ESG bond may, in the long run, produce similar effects as a step-up clause. This element may be particularly dangerous, as the existence of incentives to redeem is normally assessed at the moment of the issuance.

191. Furthermore, due to the incorporation of ESG factors into the issuers' ratings by credit rating agencies, missing ESG targets might reduce the credit standing of the issuer, potentially creating a link between the interest on the bond in cases of step-up/fees and the issuer's own credit standing, which could also lead to non-compliance with the CRR requirements.

192. As a result, in order to ensure that there is no incentive to redeem, it is the EBA's view that step-up and/or fees based on missing certain ESG targets or other performance indicators should not be allowed or encouraged. While these indicators would understandably need to be defined at the level of the company (issuer), the EBA would need to understand better why they could not be operationalised in a different manner than using regulatory capital and eligible liabilities instruments.

193. That said, these aspects will be kept for further investigation depending on the precise features/structures that might appear in the future in particular in relation to eligible liabilities. The EBA will continue to monitor developments in this area and will stand ready to provide further guidance where and when needed.

194. In terms of documentation, specifying explicitly that payments of principal and interest on the notes shall not depend on the performance of the relevant eligible assets or ESG targets of the issuer is best practice.

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