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Consultation Paper

Draft Guidelines concerning the interrelationship between the BRRD sequence of writedown and conversion and CRR/CRD IV

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1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed / rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 03.01.2015. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Article 48 of Directive 2014/59/EU (BRRD) specifies the sequence in which the power to write down or convert liabilities in resolution should be applied. This sequence provides that capital instruments as defined in Regulation 575/2013/EU (CRR) should bear losses first, before other liabilities. Article 60 of the BRRD makes similar provision about the power to write down or convert capital instruments at the point of non-viability (the PONV conversion power).

To ensure absorption of losses by capital instruments is effective, and that resolution authorities and other stakeholders have a clear understanding of how this sequence should be applied, Article 48(6) of the BRRD mandates the EBA to issue guidelines clarifying the interrelationship between the provisions of the BRRD and the provisions of the CRR and CRD, as far as this affects the writedown sequence.

These draft guidelines provide general guiding rules, based on the resolution principles established by Article 34 of the BRRD, which should be applied in cases where there is potential ambiguity about which category of the writedown sequence a particular instrument belongs to, and discusses their application to particular cases.

The two guiding rules are that:

- when applying the bail in tool or the PONV conversion power, except where exclusions according to Article 38 BRRD are made, the resolution authority should treat capital instruments which rank equally in insolvency equally, whatever their other qualities; and
- the resolution authority should apply the same treatment to instruments which are partially included in the calculation of own funds as to instruments which are fully included.

These are applied to two particular cases where there is potential ambiguity in the interrelationship between the provisions of the BRRD and the CRR/CRD IV:

- Additional Tier 1 instruments grandfathered under Article 52 of the CRR should be treated in the same way as Additional Tier 1 instruments which meet all of the conditions of the CRR
- Tier 2 instruments which are only partially included in the calculation of own funds because they are subject to the amortisation regime of Article 64 of the CRR should be treated in the same way as Tier 2 instruments fully included in the calculation of own funds

3. Background and rationale

Article 48 of the Bank Recovery and Resolution Directive (BRRD) establishes the sequence in which resolution authorities should apply the power to write down or convert obligations (the bail-in power) of an entity under resolution. Obligations should be reduced in the following order:

- a) Common Equity Tier 1
- b) Additional Tier 1 instruments
- c) Tier 2 instruments
- d) Other subordinated debt, in accordance with the normal insolvency hierarchy
- e) Other eligible liabilities, in accordance with the normal insolvency hierarchy

Article 60 of the BRRD similarly provides that, when the power to write down or convert capital instruments at the point of non-viability (the PONV conversion power) is applied, either in conjunction with a resolution tool or independently, Common Equity Tier 1 should be reduced first, then Additional Tier 1 instruments, then Tier 2 instruments.

The CRR and CRD IV allow for some potential ambiguities about the classification of instruments between the categories of the writedown sequence. For example, some instruments are partially excluded from the calculation of own funds. The EBA is mandated under Article 48(6) of the BRRD to issue guidelines clarifying the interrelationship between this writedown sequence and the provisions of the CRR and CRD IV.

The aim of these guidelines is to assist resolution authorities, and other stakeholders such as banks and investors, in determining the appropriate treatment of obligations in cases where there may be ambiguity as to which of categories a) to e) certain instruments belong to when it comes to writedown or conversion action. This must be done in a way which is consistent with the provisions of the CRR and CRD, and the requirements, principles, and objectives of the BRRD. To that end the guidelines identify guiding rules which may be applied in any case, and also discuss their application to a number of particular types of instrument.

The guiding rules identified in these guidelines are based on the resolution principles set out in Article 34 of the BRRD. These require that, in addition to the specific provisions of Article 48 resolution authorities should ensure that shareholders bear first losses, that creditors shall be treated equitably and bear losses in accordance with their order of priority in insolvency (unless otherwise provided in the BRRD), and that no creditor shall incur greater losses than if the institution had entered normal insolvency proceedings.

The first guiding rule is that when applying the bail in tool or the PONV conversion power, except where exclusions according to Article 38 BRRD are made, the resolution authority should treat capital instruments which rank equally in insolvency equally, whatever their other qualities.

This rule is applied to the case of grandfathered AT1 instruments which do not meet the conditions for AT1 under the CRR, such as including a contractual write-down or conversion clause. Since they nevertheless qualify as AT1 instruments, they should be treated in the same way as any outstanding fully CRR compliant AT1 instruments which have not yet been written down or converted in accordance with their contractual provisions.

The second guiding rule is that the resolution authority should apply the same treatment to instruments which are partially included in the calculation of own funds as to instruments which are fully included.

This rule is applied to the case of Tier 2 instruments subject to the amortisation regime of the CRR. For Tier 2 instruments with less than five years of residual maturity, the amount which can be included in own funds reduces to zero on a straight-line basis. The guidelines clarify that the amortised amount of such instruments should be treated in the same way as the amount included in own funds. This is necessary to ensure the equitable treatment of creditors in accordance with the insolvency hierarchy.

4. Draft EBA Guidelines concerning clarification of the interrelationship between the provisions laid down in BRRD and CRR/CRD IV

Status of these Guidelines

1. This document contains draft guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC as subsequently amended by Regulation (EU) No 1022/2013 (hereafter referred to as the 'EBA Regulation'). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the guidelines.
2. Guidelines set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. The EBA therefore expects all competent authorities and financial institutions to whom guidelines are addressed to comply with guidelines. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting Requirements

3. According to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by dd.mm.yyyy. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to compliance@eba.europa.eu with the reference 'EBA/GL/2014/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.
4. Notifications will be published on the EBA website, in line with Article 16(3).

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Title I - Subject matter, scope and definitions

1. Subject matter

1. Pursuant to Article 48(6) of the Directive 2014/59/EU, these Guidelines address the interrelationship between Regulation (EU) No 575/2013 and Directive 2013/36/EU with Directive 2014/59/EU for the purposes of the sequence of write down and conversion. The Guidelines clarify this interrelationship for the purposes of Article 48 Directive 2014/59/EU which governs the sequence of write down and conversion when the bail-in tool is applied, and are also relevant to article 60 Directive 2014/59/EU regarding the sequence of write down and conversion of capital instruments at the point of non-viability ('PONV'). 'Capital instruments' for the purpose of these guidelines is taken to mean instruments which qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments for the purposes of Regulation (EU) No 575/2013.
2. Article 48 Directive 2014/59/EU provides that Member States shall ensure that, when applying the bail-in tool, resolution authorities exercise the write down and conversion powers, subject to any exclusions under Article 44(2) and (3) Directive 2014/59/EU, in following order: CET1 items; then AT1 instruments; then T2 instruments; then other subordinated debt that is not AT1 or T2 instruments in accordance with the hierarchy of claims in normal insolvency law; then the rest of eligible liabilities in accordance with the hierarchy of claims in normal insolvency law.
3. Article 48(2) Directive 2014/59/EU states that resolution authorities shall allocate the losses equally between shares or other instruments of ownership and eligible liabilities of the same rank except where discretionary exclusions from bail-in under Article 44(3) Directive 2014/59/EU result in a different allocation of losses amongst liabilities of the same rank. In this case, the level of write down or conversion applied to other eligible liabilities may be increased under Article 44(3), provided that the level of write down and conversion complies with the no creditor worse off safeguard ('NCWO') referred to in Article 34(1), letter (g) of that Directive.
4. According to Article 48(3) Directive 2014/59/EU, before applying the write down or conversion power to other eligible liabilities or liabilities ranking pari passu, resolution authorities shall convert or reduce the principal amount of AT1 and T2 instruments and of other subordinated liabilities when those liabilities have not already been converted and their

terms provide for: (a) the principal amount of the instrument to be reduced on the occurrence of any event that refers to the financial situation, solvency or levels of own funds of the institution; or (b) the conversion of the instruments to shares or other instruments of ownership on the occurrence of any such event.

5. Article 48(4), Directive 2014/59/EU states that when resolution authorities reduce, but not to zero, the principal amount of an instrument according to paragraph 3 of the same provision, they shall respect the creditor hierarchy and apply the write down and conversion powers to the residual amount of that principal in accordance with the regime of paragraph 1. Furthermore, Article 48(5) states that when deciding on whether liabilities are to be written down or converted into equity, resolution authorities shall not convert one class of liabilities, while a class of liabilities that is subordinated to that class remains substantially unconverted into equity or not written down, unless otherwise permitted under Article 44(2) and (3) Directive 2014/59/EU.
6. The provisions contained in Article 48, in particular the first paragraph thereof, create a number of interrelationships with the regime set forth in Regulation (EU) No 575/2013 and Directive 2014/59/EU that need to be clarified. In particular, this interrelationship concerns the capital instruments (in particular AT1 and T2 classes) for purposes of the sequence of write down and conversion. Indeed, points (69), (73), (74) of Article 2(1) of Directive 2014/59/EU define such instruments as those meeting the conditions laid down, respectively, in Articles 52 and 63 of Regulation (EU) No 575/2013 respectively, without specifying the treatment applicable to instruments of the same class or issuance, but under a different regime for the purposes of calculating the institution's own funds.

2. Scope and level of application

7. These Guidelines are addressed to resolution authorities when they are applying the bail-in tool or the power to write down or convert capital instruments at the point of non-viability to an institution or to an entity referred to in Article 1(1), letters (b),(c), or (d) of Directive 2014/59/EU.

Title II – Guidelines concerning the treatment applicable to instruments provided for in Regulation (EU) No 575/2013 and in Directive 2013/36/EU for the purposes of the sequence of write down and conversion

8. The guidance set out below relates only to the interrelationship between the Regulation (EU) No 575/2013 and Directive 2013/36/EU with Directive 2013/59/EU with regard to the sequence of write down and conversion in case of application of the bail in tool or the PONV conversion power. They do not address any other interrelationship between Directive 2014/59/EU with Regulation (EU) No 575/2013 and Directive 2013/36/EU.
9. They serve to clarify how resolution authorities should take into account the contractual features of instruments which qualify for AT1 or T2 according to the framework laid down in

Regulation (EU) No 575/2013 and Directive 2013/36/EU when determining the order of the write down or conversion. In some cases the latter framework recognises instruments as capital instruments, but due to particular contractual features they are fully or partially excluded from the calculation of “own funds”. In such cases resolution authorities should ensure that the treatment applicable to such instruments in the sequence of write down and conversion is compliant with the creditor hierarchy in normal insolvency proceedings.

10. **Guiding rule 1:** When applying the bail in tool or the write down and conversion power at PONV, except where exclusions according to Article 43 Directive 2014/59/EU are made, the resolution authority should treat capital instruments which rank equally in insolvency equally, whatever their other characteristics. In particular they should be written down to the same extent or subject to the same terms of conversion.
11. **Guiding rule 2:** When determining the order and amount of write down or conversion the resolution authority should apply the same treatment to all instruments eligible as own funds according to Part 2 or Part 10, Title 1, Chapter 2 of Regulation (EU) No 575/2013, independently of whether they are fully or partially excluded from counting towards an institution’s own funds. In particular they should be written down to the same extent or subject to the same terms of conversion.

Question:

Should the Guidelines also provide further clarification on the treatment of instruments which contain different contractual triggers for conversion to shares or other instruments of ownership, or does the BRRD (in particular Article 47 (2)) provide sufficient clarity?

12. Set out below is guidance on how resolution authorities should apply these guiding rules in particular cases.

Applying guiding rule 1: issued AT1 instruments which fully meet the conditions of Article 52 of Regulation (EU) No 575/2013 and instruments grandfathered according to Part 10, Title 1, Chapter 2 of the that Regulation with the same ranking in the creditor hierarchy are subject to the same treatment for the purposes of the sequence of the write down and conversion. In particular they should be written down to the same extent or subject to the same terms of conversion.

13. In order to be included as own funds AT1 instruments should meet the conditions of Article 52 Regulation (EU) No 575/2013, which provides that AT1 instruments should contain contractual provisions according to which, upon the occurrence of a trigger event, the principal amount of the instruments be written down on a permanent or temporary basis or the instruments be converted to CET1. For the purposes of this provision, article 54(1), letter (a) of Regulation (EU) No 575/2013 further requires that AT1 instruments are converted when the CET1 ratio hits 5.125%, or higher if specified in the provisions governing the instrument. The provisions of the instrument may include more than one trigger, must specify either the rate of conversion and limit on permitted amount of conversion, or a range within which the

- instruments will convert to CET1 (Article 54(1), letter (b) and (c) of Regulation (EU) No 575/2013).
14. Directive 2006/48/EC did not provide for the same condition for the purposes of the eligibility of instruments as own funds.
 15. According to the provisions of Part Ten, Title 1, Chapter 2, of Regulation (EU) No 575/2013 (grandfathering of capital instruments), items eligible as own funds under national transposition measures for Directive 2006/48/EC are eligible to be calculated in the own funds for the purposes of Regulation (EU) No 575/2013 even though they do not meet all the conditions provided for in Articles 52 and following of Regulation (EU) No 575/2013. Thus, grandfathered instruments which do not provide for the contractual trigger of Article 54 of Regulation (EU) No 575/2013 are included in the own funds in accordance to the limits laid down in the latter Regulation.
 16. According to the Guiding Rule 1 and in order to ensure respect for the creditor hierarchy, the resolution authority should treat all AT1 instruments which rank equally in insolvency in the same way for the purposes of write down and conversion (unless otherwise specified in Directive 2014/59/EU) without considering other differences between the loss absorbing capacity of these AT1 instruments resulting from their contractual clauses. Therefore, in case of application of the bail-in tool or the write down or conversion power at PONV, the resolution authority should treat equally AT1 instruments issued according to Regulation (EU) No 575/2013 and grandfathered AT1 instruments.
 17. Grandfathered instruments according to Regulation (EU) No 575/2013 are included in own funds according to the limits of Regulation (EU) No 575/2013 (Part Ten, Chapter 2), according to which these items are progressively excluded from own funds ⁽¹⁾. In the sequence of the write down and conversion, AT1 items compliant with the rules of Regulation (EU) No 575/2013 and grandfathered instruments including any amount that is progressively excluded from the own funds because of the limits set out in Part Ten, Chapter 2 of Regulation (EU) No 575/2013 (in particular Article 486) should be subject to the same treatment.

Applying Guiding rule 2: Tier 2 instruments under the amortisation regime should be subject to the same treatment as Tier 2 instruments fully included in own funds.

18. According to the amortization regime laid down in article 64 Regulation (EU) No 575/2013, the value of a Tier 2 instrument that can be included in own funds is its nominal value amortised on a straight line basis in the final five years before maturity. The amount subject to amortisation is not included in own funds, even if the Tier 2 instrument is eligible according to Article 63 of Regulation (EU) No 575/2013. When determining the order and amount of write down or conversion the resolution authority should treat equally Tier 2 instruments included in the same class and should not apply a discriminatory treatment to issuance of the same T2 instruments.

¹ For the purposes of these Guidelines, all the amount of items calculated as own funds according to the limits provided for in part ten, chapter 2 CRR are subject to the same treatment.

19. The amortised amount of the Tier 2 instruments should also be subject to the same treatment as the amount of the T2 instruments included in own funds when the amortisation regime is applied to a grandfathered instrument. In this case, applying the guiding rules 1 and 2 and in line with the creditor hierarchy, the full nominal amount of a grandfathered Tier 2 instrument subject to the amortization regime should be subject to the same treatment as equally ranking Tier 2 instruments in order to determine the sequence and amount of write down and conversion.

5. Accompanying documents

5.1 Draft Cost- Benefit Analysis / Impact Assessment

Introduction

The EBA is mandated under Article 48(6) of the BRRD to issue guidelines on clarifying the interrelationship between the writedown sequence specified in Article 48 and the provisions of the CRR and CRD IV.

As per Article 16(2) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any Guidelines developed by the EBA shall be accompanied by an Impact Assessment (IA) annex which analyses 'the potential related costs and benefits'. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

This annex presents the impact assessment with cost-benefit analysis of the provisions included in the Guidelines described in this Consultation Paper. Given the nature of the Guidelines, the impact assessment is high-level and qualitative in nature.

Problem definition

The mandate of Article 48(6) requires the EBA to issue guidelines clarifying the interrelationship between the provisions of Article 48, which govern the sequence of writedown or conversion in bail-in, and the provisions of the CRR and CRD IV. The sequence provided for in Article 48 distinguishes between the treatment of Common Equity Tier 1, Additional Tier 1, Tier 2, other subordinated liabilities, and other eligible liabilities. Since the first three of these categories are defined by reference to the CRR, the main interrelationship which needs to be addressed is to ensure that all obligations of the institution or entity under resolution which may be subject to write-down or conversion can be clearly assigned to one, and only one, of these categories. Similar considerations apply to the sequence provided in Article 60 BRRD for the PONV writedown

or conversion power, which may be applied either in conjunction with a resolution power or independently.

Regulatory and specific objectives

The specification of the treatment of capital instruments in the writedown sequence in the BRRD serves two main regulatory objectives:

- a) First, to ensure that capital instruments are able to meet their primary purpose of absorbing losses in the sequence envisaged in the CRR/CRD when a resolution power, or the PONV writedown and conversion power, is applied.
- b) Second, to allow institutions and investors to form clear expectations about the treatment of capital instruments in resolution, enabling efficient pricing and market discipline. These objectives must be met while ensuring appropriate protection for the property rights of shareholders and creditors of the institutions, as provided for in the resolution principles and safeguards of the BRRD.

The specific objective of these guidelines is to enable resolution authorities, and other stakeholders, to resolve any potential ambiguities arising from the interrelationship between the provisions of the BRRD and the CRR/CRD as to which category of the writedown sequence applies in any given case. They do not aim to address other relationships between the BRRD and the CRR/CRD IV, which do not affect the sequence of application of bail-in. And they do not aim to address ambiguities in the write-down sequence which do not arise from the CRR/CRD IV, arising for instance from the interpretation of contractual language.

Options considered

Three options for the general approach to developing these guidelines were considered.

Option 1: Provide only general criteria and guiding rules

Option 2: Provide only clarification on specifically identified issues

Option 3: Provide both

The EBA has considered whether it would be more appropriate to provide general criteria for resolution authorities to apply in the circumstances of individual resolution cases, or to provide a more specific discussion of how particular types of instrument would be affected by the writedown sequence.

Option 1 could be expected to deliver objective b) less well, giving only a relatively small benefit to investors and institutions, as the additional clarity would be limited. Investors may need considerable understanding of the resolution framework in order to understand clearly how these criteria would be applied. This may result in a higher risk premium being applied to institutions'

funding costs than if investors had full information, and/or to unexpected adjustments in risk premia if resolution actions were unexpected.

Option 2 could be expected to deliver objective a) less well. Limiting the scope of the guidelines to particular types of instruments could increase the likelihood that resolution authorities encounter types of instruments not covered by the guidelines whose position in the writedown sequence is to some extent ambiguous. They may then be more cautious about exercising their powers to writedown or convert those instruments. This risk could be mitigated by including a more comprehensive categorisation of instruments in the guidelines, at the cost of increasing the complexity of the guidelines, and failing to be future-proof.

The EBA's view is that the best way of balancing these concerns is to combine the two approaches, providing general criteria which resolution authorities may apply in any circumstances, and specific discussion of how these criteria apply to the most common specific issues. Resolution authorities are also expected to benefit from symmetric information, and more effective and efficient cooperation across jurisdictions. Option 3 is therefore selected as the preferred option.

5.2 Overview of questions for Consultation

Q1: Should the Guidelines also provide further clarification on the treatment of instruments which contain different contractual triggers for conversion to shares or other instruments of ownership, or does the BRRD (in particular Article 47 (2)) provide sufficient clarity?