



EBA Final Report

29 May 2015

EBA Report

On the monitoring of Additional Tier 1 (AT1) instruments of EU institutions - Update

Reasons for publication

1. Pursuant to Article 80 of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR) on the continuing review of quality of own funds, ‘EBA shall monitor the quality of own funds instruments issued by institutions across the Union’.
2. Furthermore, pursuant to the same Article, ‘competent authorities shall, without delay, upon request by EBA, forward all information that EBA deems relevant concerning new capital instruments issued in order to enable EBA to monitor the quality of own funds 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 of the issuances of Additional Tier 1 (AT1) capital instruments and to present the results of this monitoring.
4. The present report constitutes an update of the first version of the report published in October 2014 and where EBA had indicated that further work was ongoing¹.
5. It may be recalled that, apart from the monitoring of hybrid capital issuances, the EBA has established, published and will maintain a list of Common Equity Tier 1 instruments which was first published on 28 May 2014.

Content

6. The CRR lays down eligibility criteria for AT1 instruments (in particular Articles 51 to 55). Those criteria are supplemented by the Commission Delegated Regulation (EU) No 241/2014 (Regulatory Technical Standards (RTS) on own funds).
7. Several AT1 instruments have now been issued by European institutions in accordance with those criteria.
8. Over the past few years, the EBA has drafted regulatory and implementing technical standards in the area of regulatory capital (around 20 have been delivered). In particular, the EBA has proposed 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 timing surrounding trigger events.
9. Now that this work has been finalised with submission to the European Commission and already adopted as EU delegated Regulation for large parts (Commission Delegated Regulation (EU) No 241/2014), the EBA is putting more emphasis on the review of the implementation of the eligibility criteria applicable to capital instruments on the basis of the CRR and the technical standards.

¹ <https://www.eba.europa.eu/documents/10180/534414/report+AT1.pdf>

10. The EBA has focused its work primarily on the assessment of selected AT1 issuances. The terms and conditions of selected issuances have been assessed against the regulatory provisions in order to identify provisions which the EBA would recommend avoiding.
11. This monitoring is at its preliminary stage. It follows a dynamic approach which will necessitate several iterations. Further experience will need to be gained on the basis of future issuances and the current review has been limited in terms of number of issuances and scope. New issuances and new types of clauses in the future may also have an influence on the conclusions presented in this report. In addition, there is currently no experience available on the effectiveness of the different clauses in practice, in particular in relation to loss absorption mechanisms. Furthermore, it cannot be assumed that provisions/clauses not mentioned in this report can be considered as not raising any concerns.
12. This preliminary review makes no claims to be fully comprehensive but highlights areas where the EBA believes it necessary to revise the wording of some existing clauses for future issuances, or where the EBA would recommend avoiding the use of some clauses currently under consideration in future.
13. The EBA will continue exchanging views with institutions and market participants on the results of its ongoing monitoring.
14. Furthermore, the EBA will develop standardised terms and conditions for AT1 issuances which will cover the prudential parts of the terms and conditions. This is believed to be helpful, in particular, for institutions of a smaller size and, more generally, for supervisors to assess the compliance of the instrument with the regulatory provisions. While these standardised terms and conditions would not be of a compulsory use for institutions, they would help to ensure the compliance of the instrument for an institution which would use these.
15. This report is structured as follows:
- EBA's considerations summarising the main conclusions
 - Detailed analysis with the EBA's views on some of the clauses reviewed
 - Interpretation of some CRR provisions, in particular with the EBA's views on the provisions relating to triggers.

EBA's considerations

16. The EBA has reviewed 15 issuances, issued between August 2013 and November 2014, for a total amount of EUR 21.4 bn. Five issuances were made under a conversion mechanism, and ten under a temporary write-down mechanism.

17. Although they are complex instruments, issuances are in general quite standardised, except for features which are by nature institutions' specific (such as, for example, the level of the triggers; the definition of the triggers at different applicable levels depending on the structure of the groups). This is probably partly due to the existence of quite prescriptive provisions in both the CRR and the RTS.
18. Nevertheless, the monitoring process has shown that a few provisions of existing AT1 instruments or currently under consideration by prospective issuers should be avoided in the future, or revised wordings of those clauses should be used. Some provisions could be worded in a better way because as they stand, 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.
19. This may particularly be the case with some provisions related to regulatory calls, share conversion mechanisms, contingent clauses, and covenants.
20. Furthermore, this document provides EBA guidance in a few areas where there might be different interpretations.
21. 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.
22. The EBA will continue monitoring selected AT1 issuances with the objective to promote/avoid the use of certain wordings in the terms and conditions.
23. The EBA expects that forthcoming issuances will retain some level of standardisation. This appears desirable to mitigate the complexity of hybrid instruments and this report should help to promote further convergence. If the EBA noted a significant deterioration in the quality of the instruments or a significant use of non-standard or complex provisions which might raise doubts on, for example, the effectiveness of loss absorption of the instruments, the EBA would consider taking steps to address this situation.
24. The EBA also expects that issuers will 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.

Detailed analysis

25. The following sections of the report detail some of these provisions as observed in some contracts or under discussion at the EBA for potential forthcoming issuances (thus not observed in current contracts but which should still be avoided in future contracts).

Provisions observed in existing issuances

Calls

26. The EBA has assessed the provisions related to regulatory calls as set out in Article 78 of the CRR.

27. 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 due to a regulatory change.

28. 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 will not be considered as an eligible trigger for a regulatory call.

29. The EBA has also assessed the provisions related to the exercise of calls below par. Some issuances specify that the instrument can only be called 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 which 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.

30. For tax calls, 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.

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

31. An example of change in regulatory assessment would be the following: in application of the answer to Q&A 2013/29, the competent authority used to consider that there would

not be a tax effect in case 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 the 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.

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

Redemptions

33. 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, such notice of redemption shall automatically be revoked and be null and void and the relevant redemption shall not be made.

Tax gross up clauses

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

- it should be clarified that the gross up clause gets activated by a decision of the local tax authority of the issuer, not of the investor.
- increased payments should only be possible if they do not exceed distributable items.
- gross up cases should be allowed only in relation to dividend/coupon withholding tax.

Write-down or conversion

35. 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.

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

37. The EBA considers that the instrument can still be seen as being able to be fully written down, under the condition that the amount that cannot be written down (e.g. one cent per note) is not included in AT1 capital. Alternatively, it may be possible to use reserves to avoid an explicit floor to 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 reserves/retained earnings and assigned to each AT1 note. In this case, the instrument would also be

considered as being able to be fully written down, on condition that the amount that cannot be written down (e.g. one cent per note) is not included in CET1 capital (more specifically in the reserves/retained earnings).

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

39. Some provisions specify that there would be a permanent write-down rather than a conversion in the event that an institution is unable to deliver the CET1 instruments that the instruments would have been converted into. 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 that 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 repayment of the principal amount of the AT1 instruments and to payment of interest or any other amount in respect of those instruments.

40. 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 that they are not converted or written down for any reason, this should not prevent the AT1 instrument itself being converted or written down. More generally, a conversion or write-down of the instrument should only depend on a breach of the trigger and should not be prevented by any other event.

Other issues

41. Regulatory call provisions should not read as if supervisory approval was 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.

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

43. In the same vein, no provision should link the write up of the instrument to contractual, statutory or other obligations, as write ups are fully discretionary.

44. It would be appropriate to specify the interaction between the loss absorption of AT1 and Tier 2 instruments in the terms in one way or another in order to provide clarity to holders.

Pre-emption right for shareholders

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

46. The EBA initially expressed some reserves on this type of clauses, raising questions about the need of this type of clause for an institution listed on a stock exchange where shares can be bought on the market, and underlining in particular that clauses mitigating the risk of dilution should not be encouraged.

47. On the other hand, EBA also considered that writing down instruments does not result in a dilution of the shareholders. Furthermore, giving current shareholders a possibility to buy 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.

48. In the end, despite initial reservations, EBA agreed that this feature is acceptable.

Formal issues

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

50. 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 which may create confusion with the Level 1 provisions (CRR or 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 foreseen in the CRR (one month).

51. 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.

52. 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 cast uncertainty on the application of CRR and could be understood as questioning its applicability.

53. Terms should only refer to associated arrangements (such as covenants, for instance) 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 instrument.
54. It is preferable not to have detailed lists of situations where the institution will not make distributions because it creates the impression that the list covers all eventualities whereas this may not be the case.

Contingent clauses

55. 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 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.
56. The EBA is aware of the potential benefits of such clauses as argued by market participants. In particular, it 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 to use hedge accounting.
57. Using contingent clauses would allow in particular, via the debt accounting, to 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.
58. On the contrary, there are drawbacks in allowing the use of contingent clauses by EU institutions. These are of different nature.
59. Contingent clauses introduce complexity and there might be unintended consequences from the existence of such provisions. It might, for example, constrain regulatory changes, as those would lead to disqualification and activation of the clause, making a whole array of instruments 'must pay'.
60. While the CRR does not require equity classification for AT1 instruments, the accounting treatment should be deriving from genuine reasons. In addition, if the accounting rule changes, 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.

61. 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 requiring that write down or conversion of an AT1 instrument shall, under the applicable accounting framework, generate items that qualify as Common Equity Tier 1 items. With this in mind, it could be envisaged to introduce a haircut for the inclusion of the instrument in own funds in order to take this possibility into account.

62. After having considered all the benefits and drawbacks of such clauses, it is EBA's view that while presenting some benefits, in particular in terms of hedge accounting, contingent clauses present at the same time some prudential concerns as exposed above and which are deemed to outweigh the potential benefits.

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

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

Provisions for potential forthcoming issuances

65. 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.

66. 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 that a provision such as this would fall into that category.

Interpretation of some CRR provisions

67. 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 regarding 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

68. The existence of different triggers raises the question about 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 (sub)consolidated or solo basis (sometimes called 'maximum write-up amount') and when the triggers on solo and (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 total Tier 1 capital.

69. 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 of the profit (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.

Triggers for instruments issued within a banking group

70. Under 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 consolidated (or 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, in particular when the issuer is not the head of the group.

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

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

73. 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 sub-consolidated and solo levels if it includes triggers at these levels.

74. It is worth specifying that it would not be possible for an AT1 instrument issued by a subsidiary to only have a trigger based on the consolidated solvency of the parent holding company: the trigger at the level of the issuing entity is mandatory, unless 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 the 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 eligibility criteria for instruments issued by subsidiaries in third countries (calculation of third country CET1)

75. In addition to the issue of triggers – which is present both for 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 a 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.

76. 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.

77. More generally, and as mentioned in QA 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. In particular, for the purposes of the definition of the trigger event, the CET1 capital shall be calculated in accordance with the provisions of the CRR.

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

78. 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%).

79. 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 the high trigger instruments on a pro rata basis. Losses above 5.125% will only be supported by the high trigger instrument.