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<tr>
<td>AT1</td>
<td>Additional Tier 1</td>
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<tr>
<td>BRRD</td>
<td>Bank Recovery and Resolution Directive</td>
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<td>CET1</td>
<td>Common Equity Tier 1</td>
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<tr>
<td>CRD</td>
<td>Capital Requirements Directive</td>
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<td>CRR</td>
<td>Capital Requirements Regulation</td>
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<tr>
<td>EBA</td>
<td>European Banking Authority</td>
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<td>EIOPA</td>
<td>European Insurance and Occupational Pensions Authority</td>
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<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<td>ESG</td>
<td>environmental, social and governance</td>
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<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
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<tr>
<td>G-SIB</td>
<td>global systemically important bank</td>
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<tr>
<td>G-SII</td>
<td>global systemically important institution</td>
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<tr>
<td>MTN</td>
<td>medium-term note</td>
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<td>MREL</td>
<td>minimum requirement for own funds and eligible liabilities</td>
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<tr>
<td>Q&amp;A</td>
<td>question and answer</td>
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<tr>
<td>SNP</td>
<td>senior non-preferred</td>
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<tr>
<td>SRMR</td>
<td>Single Resolution Mechanism Regulation</td>
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<tr>
<td>TLAC</td>
<td>total loss-absorbing capacity</td>
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Executive summary

Reasons for publication

1. On 20 May 2019, co-legislators adopted a package of amendments to the banking framework (CRR2, CRD5, BRRD2 and SRMR2). The banking package updates, inter alia, the framework for the minimum requirement for eligible liabilities (MREL) and implements the FSB total loss-absorbing capacity (TLAC) standard in EU legislation. CRR2 also expands the scope of the EBA’s ongoing review of the quality of own funds and the quality of TLAC and MREL eligible liabilities instruments.

2. In addition to its general market monitoring and assessment tasks in the areas of its competence (Article 8(1)(f) in conjunction with Article 32(1) of the EBA Regulation), Article 80(1) of the CRR states that the ‘EBA shall monitor the quality of own funds and eligible liabilities instruments issued by institutions across the Union and shall notify the Commission immediately where there is significant evidence that those instruments do not meet the respective eligibility criteria set out in this Regulation’.

3. Pursuant to the same article, ‘competent authorities shall, without delay and upon request by EBA, forward all information to EBA that 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’.

4. Furthermore, according to Article 25(2) of the EBA Regulation, ‘the Authority [EBA] may identify best practices aimed at facilitating the resolution of failing institutions and, in particular, cross-border groups, in ways which avoid contagion, ensuring that appropriate

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5 Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution - Total Loss-absorbing Capacity (TLAC) Term Sheet.

6 TLAC and MREL instruments’ eligibility criteria are very similar, with a few exceptions, the main one being subordination. As stated in recital (16) of CRR2 and recital (2) of BRRD2, ‘as the TLAC standard and the MREL pursue the same objective of ensuring that institutions have sufficient loss absorption capacity, the two requirements should be complementary elements of a common framework’. Moreover, ‘the provisions introducing the TLAC standard in Regulation (EU) No 575/2013 should be read together with the provisions that are introduced into Directive 2014/59/EU and Regulation (EU) No 806/2014, and with Directive 2013/36/EU’.

7 Article 80 of CRR2.

tools, including sufficient resources, are available and allow the institution or the group to be resolved in an orderly, cost-efficient and timely manner’.

5. More generally, in accordance with Article 32(1) of the EBA Regulation, ‘the Authority [EBA] shall monitor and assess market developments in the area of its competence and, where necessary, inform EIOPA, ESMA, the ESRB, the European Parliament, the Council and the Commission about the relevant micro-prudential trends, potential risks and vulnerabilities’.

6. The EBA is already regularly publishing its observations based on the monitoring of CET1\(^9\) and AT1 issuances\(^10\). The EBA is now extending its work to the monitoring of TLAC- and MREL-eligible\(^11\) liabilities instruments issuances.

7. The purpose of this initial TLAC and MREL report is to inform external stakeholders about the monitoring that the EBA has performed on TLAC- and MREL-eligible liabilities instruments so far and to present its current policy views, as well as areas in which further work is ongoing.

8. To perform its monitoring function, the EBA has focused its work on the assessment of selected TLAC- and MREL-eligible liabilities instruments. The EBA has designed specific assessment templates to drive the analysis of instruments. For this report, the EBA has analysed 27 transactions issued in 14 jurisdictions for a total amount of approximately EUR 22.75 billion, which is composed of EUR 21 billion senior non-preferred (SNP) issuances and EUR 1.75 billion senior holding company issuances. The scope of the monitoring has been limited for now to these two types of issuances.

9. Furthermore, the EBA received input during a roundtable held with different stakeholders in January 2020 regarding the ongoing review of the quality of TLAC- and MREL-eligible liabilities instruments. There was broad support expressed for the preliminary observations presented by the EBA during the roundtable.

10. Although this report provides current policy views, the monitoring of new issuances will continue, with the objective of covering as many jurisdictions as possible and enriching the observations and recommendations going forward.

11. The EBA’s findings contain policy views on existing or new provisions, together with identified best practices. The report also provides an insight into areas for scrutiny/monitoring or potential EBA guidance going forward.

12. Similar to own funds, this monitoring exercise aims to assess the application of the eligibility criteria and provide best practices and recommendations. It is not meant to analyse the final compliance of any given instrument, which will be determined by the relevant resolution authority in consultation with the competent authority. This is particularly because some of the eligibility criteria (such as the absence of excluded liabilities on the balance sheet of a

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\(^9\) EBA Report on the monitoring of CET1 instruments issued by EU institutions.

\(^10\) EBA Report on the monitoring of Additional Tier 1 (AT1) instruments of European Union (EU) institutions.

\(^11\) TLAC/MREL issuances, TLAC issuances and MREL issuances are terms used interchangeably in this report.
holding company in the event of structural subordination) cannot be checked solely on the basis of the contractual documentation.

13. In performing its monitoring function, the EBA ensured consistency with its other connected mandates, such as developing technical standards on direct and indirect funding, incentives to redeem, and the conditions and procedures for authorising institutions to redeem eligible liabilities instruments.\(^\text{12}\)

**Content of the report and main findings**

14. In developing this report, the EBA has leveraged from existing practice in monitoring the quality of own funds. The EBA seeks to ensure consistency, if appropriate, across instruments with similar loss absorbency features, taking into consideration the fact that the aim of TLAC/MREL is not limited to loss absorption, but is mainly recapitalisation or the implementation of other resolution tools.

15. Firstly, the EBA observes that European banks have not waited for the adoption of the new banking package to start issuing MREL and TLAC instruments. The FSB TLAC standard addressed to G-SIBs was published in 2015, and in Europe the BRRD introduced, around the same time and for the broader population of banks, an MREL requirement with similar purposes to those of TLAC.

16. All the issuances analysed for the purpose of this report were issued after the publication of the Commission proposals in November 2016. If those notes had been issued before the entry into force of CRR2, it is noticeable that banks had already anticipated the new CRR2/BRRD2 requirements in their documentation (both MTN programmes and specific term sheets), not only the ones immediately applicable (most CRR eligibility criteria) but also some that will be applicable only in the near future.\(^\text{13}\)

17. In general, there has been a noticeable anticipation of regulatory objectives and requirements. According to the EBA quantitative report on MREL,\(^\text{14}\) out of the 222 resolution groups that were considered in the shortfall analysis, 117 show an MREL shortfall,\(^\text{15}\) totalling EUR 178 billion as of December 2018. To mitigate those shortfalls or, if applicable, to reach the MREL targets at the end of the corresponding transition periods, banks issued approximately EUR 117 billion of SNP/senior holding company debt in 2019 according to public data sources.

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\(^\text{13}\) For example, the requirements for write-down and conversion contractual clauses as per Article 72b(2)(n), which is applicable to instruments issued from 2 years after entry into force of CRR2.

\(^\text{14}\) EBA quantitative MREL report.

\(^\text{15}\) MREL shortfall is defined as the difference between the amount of MREL eligible resources as per the relevant resolution authority’s policy as of December 2018 and the end-state requirement, defined as the requirement that banks will be expected to meet at the end of their transition period.
18. For an overview, the following characteristics of the monitored issuances are noteworthy:

- The peculiarity of the TLAC/MREL monitoring work is that most of the necessary information is found in the MTN programmes, whereas the term sheets themselves are very concise. This contrasts with own funds issuances, as their terms and conditions are quite detailed and can be analysed on a stand-alone basis.

- The issuances analysed to date range between EUR 70 million and EUR 2.75 billion. Yields observed ranged from 0.75% annual fixed rate to 5.2%, with one case at a substantially higher level. Most notes are governed by the dual laws of the state of incorporation (for ranking) and either English or New York law.

- Most notes in the sample mature after 5 years, but some range from 3 years to 11 years. In this early phase, only three recent notes contained discretionary issuer calls, all at 1 year before maturity. All notes contained regulatory and tax calls. None of the issuances analysed included discretionary put options.

19. The EBA has focused its analysis on SNP and senior holding company instruments. Two notes analysed were contractually subordinated and predated the introduction of a statutory SNP regime in Directive (EU) 2017/2399 or its transposition into national law. Another one ranked senior at the time of issuance. Two of those notes allowed for their conversion into statutorily subordinated SNP notes upon the entry into force of the SNP regime in the relevant Member States. The EBA’s expectation is that, going forward, as that directive is implemented in all Member States, institutions are unlikely to rely solely on contractual subordination.

20. The EBA observes that, so far, in terms of legal drafting of the notes and programmes, market participants have used quite simple and standardised provisions. This is conducive to legal certainty and reliability at the point of resolution. This convergence and standardisation are probably also due to the experience gained with AT1 instruments’ clauses and EBA past guidance. Issuances typically include provisions that are not per se required by the eligibility criteria but are common in own funds issuances (regulatory and tax calls in particular). Some issuances already refer to possible EBA guidance to come, in addition to future changes in regulations in force, as a rationale for changing/amending some terms and conditions.

21. At this stage, few unusual clauses have been found in the issuances reviewed. Scrutiny will need to be exercised to determine if this still holds now that the uncertainty of the legal requirements has been dissipated with the publication of CRR2/BRRD2.

22. In general, TLAC/MREL issuances are less complex than AT1 bonds. As a result, the EBA’s observations are less numerous than those that it made for the first publication of the AT1 report. The main areas in which the EBA provides observations relate to availability,

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subordination, capacity for loss absorption, maturity and other aspects (for example governing law, and tax and regulatory calls).

Main observations

23. The main observations are as follows:

Availability

24. In most cases, it was observed that the notes had been issued by the resolution entity itself and that the contractual documentation included a reference that the notes had been fully paid up. Nevertheless, availability criteria can generally not be verified solely on the basis of the contract. A complementary analysis may be warranted to establish that the issuing entity is a resolution entity or that the holders are not themselves resolution group entities or funded by the resolution group.

25. No recommendation is included in this section of the report.

Subordination

26. The main areas covered in this section include the types of subordination, namely (i) contractual subordination, (ii) statutory subordination and (iii) structural subordination. The EBA also reviewed the following points: subordination of principal and, partly also of interest, the ranking of SNP notes (as they sit at an intermediary level between common subordinated notes and ordinary unsecured notes), flipper clauses (which, in particular, automatically convert the ranking of the notes to statutory subordination from the entry into force of the national SNP legislation) and the implementation of Directive (EU) 2017/2399 (the Creditor Hierarchy Directive) in the contractual documentation.

The recommendations include the following:

27. Issuers should set out unambiguous terms on the ranking of notes in national insolvency, and in particular there should be no doubt that the notes are subordinated to statutory excluded liabilities. A description of instruments ranking junior and senior to a note under consideration constitutes good practice, particularly if the note is not statutorily subordinated as a result of Article 108 of the BRRD, as amended by the Creditor Hierarchy Directive.

28. Subordination of interest to excluded liabilities is not imposed, as per the CRR, as an eligibility criterion. However, there should always be clarity in the terms and conditions of the bonds of the ranking of interest. In addition, as many transactions already have this subordination of interest in place, it could be seen as best practice when this is compatible with the creditor’s hierarchy according to national insolvency law. The EBA will continue to monitor this aspect.

29. Statutory subordination: in addition to referring to the applicable transposition of the Creditor Hierarchy Directive, a clear description of where the notes sit in the national hierarchy is conducive to additional clarity.
30. If notes are structurally subordinated, good practice consists of clarifying, for investor awareness purposes, the structural subordination mechanism and risks (for example via the risk factors in the contractual documentation).

**Capacity for loss absorption**

31. This section includes an analysis of the clauses on set-off and netting, acceleration of the interest and principal payments of the notes, interest and dividend, write-down and conversion and negative pledges.

The recommendations include the following:

32. Although an explicit waiver of set-off and netting rights is not a legal requirement and the absence of such a clause does not lead the concerned instrument to be grandfathered and ultimately disqualified, such an explicit waiver is conducive to legal certainty, and in the light of market practice is seen as good practice. The EBA will investigate further the interaction between such clauses and relevant national laws to better understand the effectiveness of such a clause in practice.

33. A compensatory payment in the terms and conditions of the notes from the holder in case an amount due to the issuer is unduly discharged as a result of netting or set-off can be seen as best practice.

34. It should follow unambiguously from the notes that acceleration can occur only on the ground of insolvency or liquidation, and that, in particular, it cannot occur in resolution (or a moratorium).

35. The AT1 report recommends standard drafting for bail-in clauses under Article 55 of the BRRD. In the medium term, a similar effort could be envisaged in relation to eligible liabilities to ensure compliance with Article 55 of the BRRD as well as Article 72b(2)(n) of the CRR.

36. A clause to the effect that delay or failure by the issuer to notify the noteholders must not affect the validity and enforceability of the bail-in or write-down and conversion powers could be considered best practice.

37. Considering that many notes already exclude negative pledges explicitly, it appears appropriate to recommend such exclusion as best practice.

**Maturity**

38. This section includes an analysis of the clauses on call and put options, incentives to redeem and supervisory approval for early redemption.

The recommendations include the following:

39. The EBA will continue to monitor the wording of options carefully, especially for put options that are not exercised on the initiative of the issuer, to ensure in particular that put options
cannot be exercised at any time, in which case the instrument would not be considered eligible.

40. Guidance (EBA reports and Q&A) to be developed in relation to incentives to redeem in the area of TLAC-/MREL-eligible liabilities should be aligned with the guidance developed for own funds.

41. An explicit reference to prior approval of reductions in eligible liabilities is recommended as for own funds.

Other aspects

42. In this section, the EBA assessed governing law, tax and regulatory calls, and tax gross-up clauses.

   The recommendations include the following:

43. Consistent with the own funds framework, tax gross-up should be accepted only under certain conditions, as applicable to eligible liabilities instruments, i.e. gross-up clauses can be considered acceptable if they are activated by a decision of the local tax authority of the issuer, and if they relate to interest and not to principal.

44. In addition, this report presents, in its final part, areas in which further work is ongoing. This includes work on the general consistency with own funds clauses and existing recommendations from the EBA in this field (including those provided via the AT1 standard templates) if deemed relevant to eligible liabilities instruments. This is, for example, the case for substitution and variation clauses.

45. Moreover, institutions have been issuing ESG 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. The EBA will monitor the ESG TLAC/MREL issuances more closely, in particular with a view to possibly providing further guidance on the interaction between the clauses used for ESG issuances and the eligibility criteria for eligible liabilities instruments.
1. Detailed analysis

46. This part covers the following main areas: availability, subordination, capacity for loss absorption, maturity and other aspects.

1.1 Availability

47. Article 72b(2) of the CRR requires eligible liabilities instruments to be (i) directly issued or raised\(^\text{17}\) and fully paid up, (ii) not owned by an entity in the same resolution group or an undertaking in which the institution has direct or indirect participation, and (iii) not funded directly or indirectly by the resolution entity. Article 72b(2)(e) of the CRR requires that the liabilities are neither secured nor subject to a guarantee or any other arrangement that enhances the seniority of the claim.

48. The availability criteria, also applicable to own funds\(^\text{18}\), aim to provide genuine loss-absorbing capacity to the institution. Inter alia, if the instrument was issued within the resolution group, it would only reallocate losses rather than provide fresh capital at the point of failure.

Comparison of clauses

49. Regarding the direct issuance criterion, a typical drafting is that the notes ‘constitute direct, unconditional and unsecured […] obligations of the issuer’\(^\text{19}\).

50. Eligible liabilities instruments should be issued by the entity that is subject to the requirement, i.e., in the case of (external) TLAC/MREL, a resolution entity. By derogation, liabilities issued by a subsidiary established in the Union that belongs to the same resolution group as the resolution entity must qualify for inclusion in the consolidated eligible liabilities instruments of an institution under the conditions of Article 88a of the CRR (for TLAC) and Article 45b(3) of the BRRD (for MREL). In essence, this concerns liabilities issued to an existing shareholder, the conversion of which would not affect the control of the subsidiary by the resolution entity.

51. Regarding the requirement that notes have to be fully paid, all notes but one explicitly provide that delivery is made ‘against payment’. In addition, one note further specifies that ‘details relating to Partly Paid Notes’ are ‘not applicable’.

\(^{17}\) In limited circumstances, Articles 88a of the CRR and Article 45(b)3 of the BRRD allow liabilities issued by subsidiaries to existing shareholders to count towards the eligible liabilities of the resolution entity under some conditions. In summary, the liabilities must be issued from a subsidiary inside the resolution group to an existing shareholder outside the resolution group; the exercise of write-down or conversion powers must not affect the control of the subsidiary by the resolution entity. These conditions aim to ensure that the presence of externally issued liabilities at the subsidiary level will not affect the direct or indirect control of the resolution entity in the event of write-down and conversion.

\(^{18}\) Note that Articles 52 and 63 have been amended by CRR2 to also require direct issuance in the case of AT1 and Tier 2. The condition was already set out in relation to CET1 in Article 26 of the CRR.

\(^{19}\) The EBA is mandated under Article 72b(7) of the CRR to develop draft regulatory technical standards to specify the applicable forms and nature of indirect funding of eligible liabilities instruments.
Policy observations

52. Some terms provide indications related to availability criteria, such as statements that notes constitute direct obligations of the issuer.

53. Nevertheless, availability criteria can generally not be verified solely on the basis of the contract. For example, a complementary analysis may be warranted to establish that the issuing entity is a resolution entity or that the holders are not themselves resolution group entities.

54. In relation to the requirement for the notes not to be secured by a branch of the institution issuing the liability, the EBA, in Q&A 2016_2966, assessed that debt securities issued under Section 3(a)(2) of the United States Securities Act of 1933 and accordingly guaranteed by a branch of an EU institution should not be considered eligible as MREL from the point of view of that institution. Since the publication of that answer, some stakeholders have conveyed to the EBA the view that such guarantees do not ‘enhance the seniority of the claim’ within the meaning of Article 72b(2)(e) of the CRR whereby investors have contractually waived their right to execute the guarantee. However, it remains that such arrangements set out a complex articulation between strict procedural requirements for the marketing of notes under US law, a restrictive range of exemptions to those requirements under strict conditions, and contractual provisions to rely on the exemption to marketing requirements while bypassing the conditions thereof. In addition, considering the fact that the relevant provisions are governed by third country law, which the EBA is not competent to interpret, the EBA does not see a reason, at this stage, to change the existing position expressed in the Q&A. That said, the EBA will continue to exchange views with stakeholders on this aspect.

55. The assessment above is without prejudice to notes that are issued under US law but under different grounds, such as ‘Rule 114A’ concerning notes distributed to qualified institutional buyers to the extent that they are not guaranteed.

1.2 Subordination

56. Pursuant to Article 72b(2)(d) of the CRR, instruments may only be eligible provided that the claim on the principal amount is ‘wholly subordinated to claims arising from the excluded liabilities’ referred to in Article 72a(2) of the CRR. Three types of subordination are admitted in points (i) to (iii):

(i) Contractual subordination: this refers to notes subordinated to claims arising from any of the excluded liabilities referred to in Article 72a(2) of the CRR as a result of the contract.

(ii) Statutory subordination: this refers to notes subordinated to claims arising from any of the excluded liabilities referred to in Article 72a(2) of the CRR as a result of applicable law.
For example, Article 108 of the BRRD, as amended by the Creditor Hierarchy Directive, introduces a harmonised level of statutory subordination in all Member States by providing for an intermediary ranking between subordinated claims and ordinary unsecured claims, and therefore meeting, depending on the national insolvency applicable regime, in principle the subordination criteria of Article 72b(2)(d)(ii) of the CRR. Senior non-preferred claims must refer to the intermediary ranking under the new provision.

By convention, the EBA designates as ‘statutorily subordinated’ instruments, the ranking of which in the event of normal insolvency proceedings is mandatorily governed by legislation, even if the decision to elicit that insolvency ranking is provided for in the contract. As the Creditor Hierarchy Directive was only adopted in December 2017 and was due for transposition by the end of 2018, most of the senior non-preferred instruments issued before the entry into force of the national measures implementing the directive were either subordinated purely as a result of contractual provisions (contractual subordination) that gave them that ranking, or by cross-reference to early national legislation (statutory subordination) that anticipated the directive.

(iii) Structural subordination: this refers to notes issued from a resolution entity that does not have on its balance sheet any excluded liabilities referred to in Article 72a(2) of the CRR that rank pari passu with or junior to eligible liabilities instruments.

Figure 1.: Simplified stack - statutory subordination for the purpose of MREL

57. As an exception to the principle of subordination, Articles 72b(3) to (5) of the CRR permit senior liabilities to qualify as eligible liabilities instruments, up to a certain ceiling. In addition, Article 45b of the BRRD also allows senior liabilities to count towards the MREL requirement in principle, with some provisions for minimum subordination requirements. At this stage, the EBA is focusing its effort on senior non-preferred and senior instruments that are structurally subordinated. This approach ensures that instruments that have been issued mainly with a view to meeting eligible liabilities instruments’ requirements are prioritised.
1.2.1 Contractual subordination

Comparison of clauses

58. Only two issuances of contractually subordinated (in this case SNP) notes have been analysed so far. Those notes have been issued before the enactment of senior non-preferred legislation at national level. In one issuance, the notes set out a contractual subordination regime combined with a flipper provision to convert to statutory SNP once the legislation enters into force.

Policy observations

59. When it comes to contractual subordination other than that by reference to an SNP legislation, the question of how subordination should be defined arises. Indeed, notes classically define subordination by reference to a higher class, such as ‘senior notes’. However, the notion of subordination for the purpose of the CRR is not defined in terms of commonly defined class but in terms of subordination to ‘claims arising from … excluded liabilities’ (Article 72b(2)(d) of the CRR). In this regard, when faced with a note that specifies that it is subordinated to senior claims or ranks pari passu with senior non-preferred claims, one could wonder if it is without any doubt subordinated to excluded liabilities. As a conclusion, explicit language mentioning subordination ‘to excluded liabilities’ within the meaning of the CRR could achieve legal certainty if banks rely purely on contractual subordination.

1.2.2 Statutory subordination

60. Most subordinated notes are subordinated under statutory terms: they mention a national law transposing the Creditor Hierarchy Directive or cross-refer to early national legislation that anticipated the directive.

Comparison of clauses

61. Interestingly, statutorily subordinated notes do not only cross-refer to the SNP legislation but also proceed to describe the senior non-preferred ranking in the hierarchy of claims.

62. As SNP notes sit at an intermediate level between common subordinated notes and ordinary unsecured notes, practice varies as to whether or not SNP notes are presented as a specific subcategory of notes with senior status (this is the case for most base prospectuses, or as a stand-alone category between senior and subordinated). Some prospectuses present the notes as being ‘unsubordinated’ – which is counterintuitive, as SNP is meant to ensure a form of resolution-driven subordination – but they explain that SNP notes are in fact senior to classic forms of subordinated debt. This is confirmed by other notes that describe themselves as being senior to ‘ordinarily subordinated’.

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20 Excluded liabilities are listed in Article 72a(2) of the CRR and essentially cover non-bail-inable liabilities, which may in certain cases also be exempt from losses in liquidation, for example covered deposits and secured liabilities.
63. In general, notes extend the subordination status to both principal and interest (‘(if applicable) the relative Coupons’; ‘any related receipts’, ‘and the coupons’) and therefore go beyond Article 72b(2)(d) of the CRR, which refers only to the principal. By contrast, in rare cases the provisions used might give the impression that interest claims are more subordinated than principal claims.

Policy observations

64. In principle, unless otherwise specified under national insolvency frameworks, reference to SNP legislation should not raise any doubt that those liabilities are genuinely subordinated to ‘excluded liabilities’ within the meaning of Article 72a(2) of the CRR. This is because Article 108 of the BRRD has been especially amended by the Creditor Hierarchy Directive, with a view to meeting subordination criteria for eligible liabilities instruments. Nonetheless, from the moment that notes do attempt to describe the ranking of SNP notes, they would ideally also make clear that the notes are ‘wholly subordinated to claims arising from the excluded liabilities within the meaning of Article 72a(2) of the CRR’, as seen in some contractual documentation. It could also be clearer to investors if SNP were presented as a stand-alone category, rather than as a subcategory of senior notes.

65. Having interest subordinated to excluded liabilities is not a CRR eligibility criterion. However, the ranking of interest is an important issue, as interest can only be counted towards the TLAC/MREL capacity of the bank if it is subordinated and, as per Article 72c(1) of the CRR, has a residual maturity of at least 1 year. In addition, as per Article 108 of the BRRD (as amended by the Creditor Hierarchy Directive), debt instruments with variable interest derived from a broadly used reference rate and debt instruments not denominated in the domestic currency of the issuer, provided that principal, repayment and interest are denominated in the same currency, must not be considered to be debt instruments containing embedded derivatives solely because of those features. Given this, there should always be clarity in the terms and conditions of the bonds of the ranking of interest in the insolvency hierarchy. Furthermore, interest subordination can be seen as best practice when this is compatible with the creditor’s hierarchy according to national insolvency law.

1.2.3 Structural subordination

66. In the event of structural subordination, subordination does not stem from contractual or legal provisions that would govern the respective ranking of investors in the entity. Instead, in this configuration, excluded liabilities are essentially located at a lower level in the group in a separate entity. In the event of bail-in at the level of the parent issuer (identified as resolution entity), creditors of the issuer will absorb losses first. The notes issued by the parent issuer are thus labelled ‘senior’ but are in effect structurally subordinated to all (excluded and other) liabilities of subsidiaries. This is provided if there are effectively no excluded liabilities ranking junior to or pari passu with MREL-eligible liabilities instruments on the balance sheet of the parent issuer, or it might also be the case for non-significant amounts of such liabilities ranking
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pari passu or junior (less than 5% of the amount of the own funds and eligible liabilities of the institution) if the conditions under Article 72(b)(4) of the CRR are fulfilled.

Comparison of clauses

67. In some notes analysed that are structurally subordinated, the risk factors in the issuance programme explicitly explain the status of the issuer as a holding company and the fact that the noteholders will be structurally subordinated to other creditors who hold debt instruments at the level of one or more of the operating subsidiaries of the issuer.

Policy observations

68. For this type of subordination, the analysis of eligibility depends not on the formal insolvency ranking set out in the note but on the actual liability structure of the entity and the issuance of subordinated internal MREL at the level of operating subsidiaries. This means that, purely on the basis of the notes, it might be difficult to conclude that the issuing entity is ‘clean’ from excluded liabilities and that the liabilities are structurally subordinated to the operating liabilities of the subsidiaries. As in the example, the contractual documentation might explicitly state that the notes are structurally subordinated to the operating liabilities of the subsidiaries.

69. Such a statement acknowledging the structural subordination to creditors in subsidiaries appears to be good practice, as it clarifies the intended status of the note vis-à-vis investors and authorities and provides high-level information on the liability structure.

70. Nevertheless, this kind of statement does not in itself solve the question of whether or not the notes meet the CRR subordination criteria, because it does not guarantee that, within the balance sheet of the holding company, no excluded liabilities rank or will rank junior to or pari passu with the issued note. Therefore, reaching a conclusion on eligibility necessitates precise information on the presence of excluded liabilities on the balance sheet and on their relative ranking vis-à-vis eligible liabilities. The assessment is also time dependent, as the liability structure of the entity may also evolve after the issuance. In practice, it is the responsibility of institutions to ensure compliance at all times, under the surveillance of resolution authorities in cooperation with competent authorities, facilitated by granular reporting of liability structures21.

1.2.4 ‘Flipper’ bonds

Comparison of clauses

71. The EBA had a look at two issuances issued before the enactment of a statutory SNP regime in the relevant jurisdiction. They both contained flipper clauses that were meant to automatically convert the ranking of the notes to statutory subordination from the entry into force of the

21 The EBA is currently developing a reporting framework for TLAC and MREL, as mandated in Article 430a of the CRR (for TLAC) and Article 45i of the BRRD (for MREL).
national SNP legislation. One converted from contractual subordination to statutory subordination, whereas the other converted from a senior ranking to statutory subordination.

72. It is noted more generally that some MTN programmes also provide a mechanism for notes to convert from ‘senior preferred’ to ‘senior non-preferred notes’, even though that mechanism is not applicable to the notes analysed so far. Two different possibilities are provided: either an optional conversion triggered by a notice given by the issuer or an ‘automatic conversion’ triggered by the occurrence of an ‘automatic conversion date’ to be set out in the applicable supplement. In both cases (automatic and optional conversion), the MTN specifies that a conversion does not constitute an event of default.

Policy observations

73. Preliminarily, flipper clauses were conducive to the quality of eligible liabilities instruments, since they increase the level of subordination or elicit a statutory regime that has been designed on purpose to meet TLAC/MREL subordination. Until the moment that the notes are converted, they should be analysed under their current regime, for example a senior ranking or contractual subordination. From the point of conversion, considering the fact that investors were informed and agreed to be bound by the conversion ex ante, such conversion should not in principle be considered prejudicial to the interests of the noteholders, even though the conversion might downgrade the claim in the insolvency hierarchy of claims.

74. In the case of optional or automatic conversion, the EBA assessed that, in principle, this should not be problematic, as long as all eligibility criteria are or continue to be met at the point of conversion. However, there must be no ambiguity about the fact that, if it is not guaranteed that the eligibility criteria are or continue to be met at the point of conversion, the instruments should not be qualified or should be disqualified as TLAC-/MREL-eligible instruments. Furthermore, in one case the national law implementing the SNP directive explicitly provided for the recognition of flipper clauses, which should be seen as an additional element of certainty.

Recommendations

(1) Issuers should set out unambiguous terms on the ranking of notes in national insolvency, and in particular there should be no doubt that the notes are subordinated to excluded liabilities within the meaning of Article 72a(2) of the CRR. A description of instruments ranking junior and senior to a note under consideration constitutes good practice, particularly if the note is not statutorily subordinated as a result of the application of the national measures implementing Article 108 of the BRRD, as amended by the Creditor Hierarchy Directive.

(2) Having interest subordinated to excluded liabilities is not a CRR eligibility criterion. However, there should always be clarity in the terms and conditions of the bonds of the ranking of interest in the insolvency hierarchy. Furthermore, interest subordination can be seen as a best practice when this is compatible with the creditor’s hierarchy according to national insolvency law. The EBA will continue to monitor this aspect.
1.3 Capacity for loss absorption

1.3.1 Absence of set-off or netting arrangements

75. In accordance with Article 72b(2)(f) of the CRR, ‘liabilities shall not be subject to set-off or netting arrangements that would undermine their capacity to absorb losses in resolution’.

Comparison of clauses

76. The issuances reviewed so far all contain a clause to such effect. Their wording differs slightly, but in all cases it is to the effect that said rights are waived.

77. In some cases, the MTNs also 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 any 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.

Policy observations

78. In general, the language found in the contractual terms of the issuances reviewed to date is clear and precise on the waiving of set-off or netting rights by the holder, and in some cases it goes beyond precluding set-off and netting as required in the CRR and provides for a backstop in case an amount is discharged through netting or set-off in spite of the waiver.

79. It is striking that all notes reviewed so far contain an explicit waiver of set-off rights, considering the fact that the legislature has explicitly sought to clarify in recital (26) of CRR2 that the prohibition of set-off and netting rights ‘should not mean that the contractual provisions governing the liabilities should contain a clause explicitly stating that the instrument is not subject to set-off or netting rights’. Nonetheless, an explicit waiver seems to be conducive to legal certainty, and, in the light of market practice, a recommendation to include such a waiver could be envisaged and would reportedly meet market expectation.

80. However, the absence of a clause to this end does not — by itself — lead to the instruments being grandfathered and ultimately disqualified as eligible liabilities, as explained in Q&A 2020_5146. The instrument concerned remains eligible, provided that it meets all eligibility criteria set out in Article 72b of the CRR, including the effective absence of set-off or netting
arrangements that would undermine its capacity to absorb losses in resolution. In general, set-off is not permitted in an insolvency proceeding, unless certain requirements for set-off have been met prior to the insolvency declaration and comply with specific national insolvency legislation.

81. An additional element worth noting is that it seems that some instruments, while containing explicit clauses on the absence of set-off as previously mentioned, sometimes include a reference to the applicable national law. For example, the clause might mention that all set-off rights are waived, ‘to the fullest extent permitted by applicable law in relation to all such actual and potential rights, claims and liabilities’ or ‘to the extent permitted under applicable law’ or equivalent formulations.

82. 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.

**Recommendations**

(5) Although this is not a legal requirement and the absence of such a clause does not mean that the instrument concerned needs to be grandfathered and ultimately disqualified, an explicit waiver of set-off and netting rights is conducive to legal certainty, and, in the light of market practice, is seen as good practice. The EBA will investigate further the interaction between such clauses and relevant national laws to better understand the effectiveness of such a clause in practice.

(6) Some issuances not only explicitly preclude set-off and netting but also provide for a compensatory payment from the holder in case an amount due to the issuer is nevertheless unduly discharged as a result of netting or set-off. This is seen as best practice, where this is compatible with national law. The EBA will continue to monitor such mechanisms regarding their application and effectiveness.

1.3.2 No right for holder to accelerate the payment of interest or principal

83. Article 72b(2)(l) of the CRR requires that ‘the provisions governing the liabilities do not give the holder the right to accelerate the future scheduled payment of interest or principal, other than in case of the insolvency or liquidation of the resolution entity’.

84. In spite of the broadness of the term ‘insolvency or liquidation’, which can receive different definitions under national law, this requirement should be understood as precluding acceleration in any circumstances other than an insolvency proceeding, including insolvency liquidation but excluding resolution proceedings.
85. Indeed, the purpose of this prohibition seems to be to make sure that instruments can play their role in resolution, i.e. to absorb losses of an institution that is failing or likely to fail so that resolution authorities can maintain, inter alia, critical functions. This purpose would be defeated if counterparties could claim an anticipated payment on the ground that the institution is undergoing resolution or is subject to a moratorium. The situation is different when a bank is put under ‘normal insolvency proceedings’ \(^{22}\) (also known as liquidation) leading to the discontinuation of the activities of the institutions. In normal insolvency, acceleration is not problematic, because it does not cause the bank to pay any amount to the counterparty but renders the liability due and enables the counterparty to file its claim with the insolvency estate.

86. In the same vein, Directive 2001/24/EC\(^{23}\) on the reorganisation and winding up of credit institutions, which sets out intra-EU cross border recognition of insolvency proceedings of credit institutions, distinguishes between ‘reorganisation measures’, which are ‘intended to preserve or restore the financial situation of a credit institution’ and ‘winding up measures’, which means the ‘realisation of assets of an institution’. When the BRRD was adopted in 2014, Directive 2001/24/EC was explicitly amended to specify that reorganisation measures ‘include the application of the resolution tools and the exercise of resolution powers’.

**Comparison of clauses**

87. In general, MTN programmes include provisions if acceleration rights are granted to the noteholders only in the event of liquidation/winding up of the issuer, but not if a resolution action is to be instituted, observing the criterion of Article 72b(2)(l) of the CRR.

88. MTNs usually clarify that noteholders may not be able to exercise their rights in an event of default or that events of default do not apply to senior non-preferred noteholders other than in the case of dissolution, liquidation, winding up or bankruptcy of the issuer. In those cases, noteholders may give notice to the issuer, and the notes become due and payable. No other remedy against the issuer should be available to the holder.

89. Some MTNs specifically state that noteholders may not be able to exercise their rights in an event of default in case of the adoption of any early intervention or resolution measures under national transposition of the BRRD and the SRMR.

90. In the case of liquidation/winding up of the issuer, both the principal amount and the accrued and unpaid interest on the notes are included in the claim. However, in some MTNs, noteholders can also claim payment of other amounts payable, e.g. damages.

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\(^{22}\) See Article 2(1)(47) of the BRRD: the term ‘normal insolvency proceedings’ means collective insolvency proceedings that entail the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person.

Policy observations

91. All issuances analysed contain clauses according to which acceleration rights are granted to the noteholders in the case of ‘liquidation’, ‘winding-up’ or ‘bankrupt[cy]’ of the issuer. The terms vary, as insolvency terminology is different from one Member State to another and considering the fact that, as recital (45) of the BRRD recalls, ‘a failing institution should in principle be liquidated under national insolvency proceedings’. Resolution is not explicitly excluded from the grounds for acceleration in the documentation, and therefore the eligibility assessment of those clauses is dependent on the assumption that the procedures described above cannot be understood as comprising resolution. A possible best practice could be to explicitly exclude any acceleration on the ground of the institution being placed in resolution under the BRRD/SRMR.

Recommendations

(7) It should be clear from the notes that acceleration can occur only on the ground of insolvency or liquidation, and that, in particular, it cannot occur in resolution or a moratorium under the BRRD.

(8) Whether, as best practice, ‘resolution’ and ‘moratorium’ should be mentioned explicitly by the notes as not giving rise to acceleration is subject to further reflection.

1.3.3 Level of interest or dividend not amended based on credit standing

92. Article 72b(2)(m) of CRR2 requires that ‘the level of interest or dividend payments, as applicable, due on the liabilities is not amended on the basis of the credit standing of the resolution entity or its parent undertaking’.

Comparison of clauses

93. None of the issuances reviewed provide for an amendment of the level of interest or dividend payment on the basis of the credit standing of the resolution entity or its parent undertaking. The MTNs or final terms foresee a fixed coupon, a floating rate or a combination thereof, with an automatic conversion from fixed interest to a floating rate at a given date.

94. The EBA will further monitor this aspect going forward.

1.3.4 Write-down and conversion clauses (bail-in clauses)

95. Article 72b(2)(n) of the CRR requires the relevant contractual documentation and, if applicable, the prospectus to explicitly refer to the possible exercise of the write-down and conversion powers in accordance with Article 48 of the BRRD. Such write-down and conversion, triggered upon intervention of the resolution authority in the context of the bail-

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24 See Article 33a of the BRRD.
in tool, must not be confused with automatic (i.e. without authorities’ intervention) write-down and conversion at the ‘trigger event’ within the meaning of Article 54 of the CRR.

96. In all issuances analysed so far, and although the requirement in Article 72b(2)(n) of the CRR only applies to instruments issued after 28 June 2021, a reference to the exercise of write-down and conversion powers by the relevant resolution authority is already included in the MTNs of issuances assessed.

97. In addition, Article 55 of the BRRD requires instruments governed by third country law to include a contractual term by which the creditor or party recognises that the liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction in the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority. The requirement may be subject to exemption or may not be applicable if either (i) the effectiveness of the bail-in is achievable through the law of third countries or an international treaty concluded with the third country, or (ii) the resolution authority agrees that the inclusion of the contractual recognition meets the conditions of impracticability or is illegal, as notified by the institution. However, in the latter case the instrument cannot count towards MREL, in accordance with the last subparagraph of Article 55(2) of the BRRD.

98. In relation to Article 55 of the BRRD (in its versions prior to its amendment by BRRD2), the EBA has provided guidance in the past and has also suggested model recognition clauses (AT1 report, paragraphs 45-54, AT1 template October 2016). For example, the EBA highlighted that contractual terms 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 (precondition)’.

99. Against this background, terms on write-down and conversion will be closely monitored by the EBA, keeping in mind similarities with own funds-related aspects.

Comparison of clauses

100. All issuances analysed contain at least an acknowledgement that the notes may be bailed-in. In all cases but one, the MTNs provide contractual language whereby noteholders acknowledge, accept, consent to and agree to be bound by bail-in.

101. Interestingly, the EBA observed in one case a provision stating that, upon the exercise of any bail-in or loss absorption power by the relevant resolution authority, the issuer will provide a written notice to the noteholders regarding such exercise and that any delay or failure to give notice will not affect the validity and enforceability of the bail-in or write-down and conversion powers.
Policy observations

102. A possible open question is the extent to which clauses under Article 72b(2)(n) of the CRR could be approached in a similar way to clauses under Article 55 of the BRRD. The drafting of Article 55 of the BRRD is, prima facie, more constraining than Article 72b(2)(n) of the CRR, because it requires an ‘explicit recognition’ and that the creditor or party to the agreement or instrument ‘agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation’, whereas the latter provides for an ‘explicit reference’ to the possible exercise of the write-down and conversion powers.

103. Nevertheless, from a practical point of view, it might be more efficient, in the interests of institutions and authorities, to recommend drafting that would meet the purpose of both provisions.

104. However, it will be necessary to reflect further on whether including a clause to the effect that delay or failure by the issuer to notify in advance the noteholders of the write-down or conversion action must not affect the validity and enforceability of the bail-in or write-down and conversion powers could be considered good practice. In this regard, such best practice has been included in the AT1 report.

Recommendations

(9) The AT1 report recommends standard drafting for bail-in clauses under Article 55 of the BRRD. In the medium term, a similar effort could be envisaged in relation to eligible liabilities, to ensure compliance with Article 55 of the BRRD as well as Article 72b(2)(n) of the CRR, taking into account their specificities.

(10) A clause to the effect that delay or failure by the issuer to notify in advance the noteholders of the write-down or conversion action shall not affect the validity and enforceability of the bail-in or write-down and conversion powers could be considered good practice.

1.3.5 Negative pledges

105. A negative pledge can be defined as ‘a covenant by the issuer in the terms and conditions of the issue which restricts the freedom of the issuer (and possibly other entities related to the issuer) to grant security for other debts without granting equal security for the debt in question’. The most common practice in international bond issues is that the negative pledge prohibits granting security for only other listed bonds. Such an issuer is then not able to issue secured listed bonds without granting equal security for the existing bonds but could secure different kinds of its debt, for example by taking out secured bank loans. Nevertheless, the scope of the negative pledge may vary substantially from issue to issue. The existence of a negative pledge, therefore, only means that the freedom of the issuer to grant security for its other debts is limited rather than unlimited.
Comparison of clauses

106. Some SNP transactions allow for a negative pledge to apply to senior preferred notes, whereas senior non-preferred notes do not have the benefit of the negative pledge covenant. That such a clause is not applicable to senior non-preferred issuances seems reasonable, as it disturbs the allocation of losses and possibly impedes resolvability, which contradicts the objective of MREL. That said, some MTN programmes go further and exclude very explicitly any negative pledge, regardless of the type and ranking of the notes (i.e. for both senior preferred and senior non-preferred notes).

Policy observations

107. Although the CRR does not require an explicit clause to include a no negative pledge provision, given that a fair number of issuances do provide for such explicit exclusion, the EBA views this provision as good practice. In addition, this is deemed not to go against market practices or expectations.

Recommendations

1. Considering the fact that many notes already explicitly exclude negative pledges, it appears appropriate to recommend such exclusion as best practice.

1.4 Maturity

1.4.1 Call and put options

108. This section deals solely with discretionary options to redeem, at the exclusion of options on regulatory or tax grounds, which are dealt with later in this report.

109. The admissibility of call and put options for TLAC/MREL is different from that of own funds. This is linked to the fact that TLAC/MREL permanence is mainly based on residual maturity, whereas own funds must be either perpetual or compliant with minimum original maturity requirements.

110. The BRRD was silent on the admissibility of issuer calls and whether or not it results in shortening the residual maturity for the purpose of TLAC/MREL eligibility. It only specified the rules applicable to holder put options, providing that ‘where a liability confers upon its owner a right to early reimbursement, the maturity of that liability shall be the first date where such a right arises’.

111. Article 72c(2) of the CRR confirms the treatment of holder put options set out by BRRD1, and Article 72c(4) of the CRR clarifies that issuer call options have no effect on the calculation of

25 Article 45(4) of BRRD, last subparagraph.
the residual maturity, provided the instrument does not contain an incentive to redeem\(^{26}\). If, on the contrary, the notes contain an incentive to redeem, the residual maturity is defined as the first date at which the option can be exercised\(^{27}\).

**Comparison of clauses**

112. A limited number of issuances reviewed contain issuer call options. In those cases, the option is available from 1 year before maturity, and there is no subsequent call. This was obviously designed to enable a rollover, once the instrument comes below the minimum 1-year maturity required for TLAC/MREL. In terms of the extent of the possible redemption, MTNs allow redeeming ‘all or some only’ of the notes or, as the terminology varies, redemption ‘in whole or in part’.

113. No put option is applicable to any of the final terms reviewed so far. Although some base prospectuses do not have any provisions on noteholder put options as a general rule, other MTN programmes do contain such provisions but put options are not applicable, as per the final terms. Among those MTN programmes that contain provisions on put options, some MTNs exclude put options for ‘unsubordinated notes’, whereas others restrict it to preferred senior notes; therefore, put options would never be applicable to subordinated and senior non-preferred TLAC-/MREL-eligible liabilities under those MTNs.

114. As per the relevant MTN programmes, put options would be exercisable only on an optional redemption date that would be defined in the final terms. The EBA will monitor this aspect over time to ensure that put options could not be exercised at any time, which would de facto render the concerned instruments ineligible since the maturity eligibility criteria would not be met any more.

**Policy observations**

115. As the CRR offers more explicit reassurance on the admissibility of issuer call options, and although some MTNs have now paved the way for TLAC/MREL to be callable, the EBA expects to see more call options in forthcoming issuances, in particular with a view to replacing TLAC-/MREL-eligible liabilities when they come below the 1-year residual maturity requirement.

116. Based on Article 78a of the CRR, which limits the capacity of institutions to redeem eligible liabilities instruments and requires the resolution authority’s permission, the EBA will continue to monitor the wording of options carefully, as redemptions have the potential to hinder loss-absorbing capacity. The same is even more relevant for holder put options, as per Article 72c(2) of the CRR, in particular to ensure that the timing of the exercise of the put

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\(^{26}\) As per Article 72b(7)(b) of the CRR, the EBA is mandated to develop regulatory technical standards to specify the form and nature of incentives to redeem in the context of eligible liabilities instruments, which must be fully aligned with the technical standards on own funds.

\(^{27}\) Article 72c(3) of the CRR.
The option by the holders does not lead to an infringement of the minimum maturity requirement and thus the eligibility of the instrument.

117. The above is without prejudice to non-discretionary options, which are dealt with later in this report.

### Recommendations

(12) The EBA will continue to monitor the wording of options carefully, especially for put options that are not exercised on the initiative of the issuer, to ensure in particular that put options cannot be exercised at any time.

#### 1.4.2 Incentives to redeem

**Comparison of clauses**

118. The EBA analysed some of the features that are critical from the point of view of incentives to redeem, such as interest and gross-up. Regarding gross-up, potential concerns are explored later in this report.

**Policy observations**

119. In principle, incentives to redeem must be defined consistently across own funds and eligible liabilities, despite triggering different consequences. Both own funds and eligible liabilities are underpinned by an objective of permanence: they should offer stable funding, as otherwise loss absorption capacity would tend to disappear ahead of financial distress. This is why incentives to redeem receive a restrictive regime across both categories. It is true that, although in the case of own funds incentives to redeem are subject to a strict prohibition and trigger ineligibility, in the case of eligible liabilities they instead cause a shortening of the maturity if combined with a call option. However, this is not linked to a different concept of incentives to redeem but is because maturity conditions are more stringent for own funds, which are meant to be of a higher loss absorption quality (and thus must be perpetual or meet a longer original maturity requirement). This explains why, in mandating the EBA to develop regulatory technical standards on incentives to redeem, Article 72b(7), second subparagraph, of the CRR requires such standards to be ‘fully aligned’ with the own funds regulatory technical standards.

#### 1.4.3 Supervisory approval for early redemption

120. CRR2 has expanded the supervisory permission regime in Article 77 of the CRR, previously only applicable to own funds, to cover eligible liabilities instruments as well. Article 77(2) of the CRR now requires an institution to obtain the prior permission of the resolution authority to effect the call, redemption, repayment or repurchase of eligible liabilities instruments as applicable, prior to the date of their contractual maturity. Article 78a of the CRR lays down the conditions under which the resolution authority must grant its permission. The EBA is mandated to
develop draft regulatory technical standards\textsuperscript{28} to further specify the procedure for this permission regime.

Comparison of clauses

121. The MTNs of all issuances examined referred to prior permission as a condition to redemption. The contractual language used is variable and in some cases rather broad, which reflects the fact that, at the moment of issuance, no prior permission regime was in force for TLAC/MREL and the ongoing legislative discussion was only in an early phase. Thus, the corresponding provisions refer to obtaining prior consent ‘of the regulator if required pursuant to such regulations’, ‘from the relevant supervisory consent’ or ‘prior written approval of the relevant regulator to the extent required at such date’. One issuance contains a broad requirement that redemption or repurchase is ‘subject to compliance by the issuer with any conditions to such redemption or repurchase prescribed by the MREL or TLAC Requirements at the relevant time’.

122. Furthermore, some MTNs provided for the possibility of substituting the debtor, with the consent of the noteholders or with a guarantee of the original issuer, by transferring the instrument to another entity (related or not related). Some MTNs require an approval from the relevant authority.

Policy observations

123. In the area of own funds, the EBA has held the view that instruments should contain an explicit reference to regulatory conditions linked to prior permission. The EBA’s Q&A (\textit{QA 2013_544}) states that ‘any call options, redemptions or repurchase transactions related to Tier 2 instruments must meet the requirements of Article 63(i), (j) and (k) of the CRR. For Tier 2 instruments, Article 63(j), in conjunction with Article 77 of the CRR, stipulates that the institution must not effect the call, redemption, repayment or repurchase prior to the date of an instrument’s contractual maturity without the prior permission of the competent authority. Such instruments should therefore contain an explicit reference to these regulatory conditions in their terms’.

124. Indeed, in the absence of contractual provisions acknowledging prior permission regimes, an institution might be seen as contractually allowed to redeem an instrument and yet not allowed to do so as per the CRR, which could lead to difficult litigation and costly damages. For example, if an institution redeems a note whose terms and conditions do not include a clause requiring the resolution authority’s permission, there could be disputes: the holder could seek to obtain an annulment; in the event of an annulment, the holder could engage the contractual liability of the issuer; and other investors could also seek annulments or personal liabilities of bank managers.

125. For the same reasons, the EBA also recommends that TLAC/MREL notes should contain an explicit acknowledgement of the requirement to obtain prior permission for any call, redemption, repayment or repurchase. This is a good practice that reinforces legal certainty and investor awareness of the relevant framework. However, this kind of provision only fully achieves its purpose if it is precisely drafted; vague terms such as ‘to the extent required’ or the ‘relevant regulator’ should be avoided, now that the legislative framework has been finalised.

126. In those cases in which notes 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 not related), the instrument should also contain an explicit reference to the need to obtain the prior permission of the resolution authority.

127. In particular, in the event that the issuer transfers the instrument from its balance sheet to that of another entity, not only is prior permission according to Article 72(2)(j) in conjunction with Article 77(2) of the CRR required, but, if the other entity is subject to TLAC/MREL requirements and wants this instrument to qualify as an eligible liability, all the criteria for it to qualify as an eligible liability must also have been met at this point.

**Recommendations**

(13) Guidance (EBA reports and Q&A) to be developed in relation to incentives to redeem in the area of TLAC/MREL-eligible liabilities should be aligned with that developed for own funds.

(14) The terms and conditions of eligible liabilities instruments should contain an explicit reference to the need for prior approval from resolution authorities of reductions in eligible liabilities, as in the case of own funds instruments.

1.5 Other aspects

1.5.1 Governing law

128. Article 59(2) of the BRRD requires Members States to confer with their resolution authorities on the powers to write down and convert relevant capital instruments and eligible liabilities. If liabilities of an institution are governed by the law of a Member State, the application of the write-down and conversion powers will therefore be effective as a matter of law.

129. In practice, however, issuances can be governed by the law of a third country. In such cases, cross-border effectiveness of the application of the bail-in tool or write-down or conversion powers is dependent on foreign courts recognising the exercise of the write-down and conversion powers of EU resolution authorities.

130. This is why Article 55 of the BRRD requires instruments governed by third country law to include a contractual term by which the creditor or party recognises that the liability may be subject to the write-down and conversion powers and ‘agrees to be bound by any reduction
of the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority’. The requirement may be subject to an exemption or may not be applicable if either (i) the effectiveness of bail-in is achieved through the law of a third country or international treaty with the third country, or (ii) the resolution authority agrees that it is legally or otherwise impracticable to include the term, as notified by the institution.\(^{29}\) However, in the latter case the instrument cannot count towards MREL. Note that failure to include such a contractual term in a particular issuance according to Article 55(4) of the BRRD must not prevent resolution authorities from exercising their write-down and conversion powers in relation to that liability.

131. The purpose of this section is not to analyse the drafting of write-down and conversion clauses pursuant to Article 55 of the BRRD, as this is the subject of Section 3, alongside write-down and conversion clauses under Article 72b(2)(n) of the CRR. Instead, this section analyses whether the issuances are governed by third country law, how this regime is set out in the notes, and whether the corresponding governing law must be understood as third country law for the specific purpose of Article 55 of the BRRD.

Comparison of clauses

132. Most issuances reviewed at the beginning of the EBA monitoring were subject to a dual governing law.

133. In several cases, the notes are governed by the laws of an EU Member State and by English law, as the United Kingdom was an EU Member State at the time the notes were issued. In other cases, the notes are governed by the law of a third country (the law of New York) as well as the law of an EU Member State.

134. In all dual governing law cases, the notes are governed by a \textit{lex specialis} (a law applied to certain provisions of the contract) and a \textit{lex generalis} (a law governing all other provisions). In all cases, the \textit{lex specialis} would cover the ‘status’ of the notes, i.e. their ranking in insolvency. In some cases, the \textit{lex specialis} would also extend to the waiver of set-off rights or to some specific events as defined in the terms of the notes. In other cases, the institution might be able, under the usual substitution/variation clause, to change the governing law of the condition related to the acknowledgement of national statutory loss absorption powers from a third country law to national law.

135. That said, it is noticeable that, with regard to new issuances, and to achieve legal certainty with regard to the loss absorbency of MREL instruments in particular, some resolution authorities\(^{30}\) started to supervise and offer specific guidance, in more detail, regarding the requirement set out in Article 55 of the BRRD that issuances governed by third country laws include contractual clauses by which holders recognise that the liability may be subject to the write-down and conversion powers of EU resolution authorities. Institutions have also been

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\(^{29}\) Consultation Paper on impracticability of contractual recognition of bail-in under Article 55(6) of the BRRD.

\(^{30}\) Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – SRB Policy under the Banking Package, p.36.
encouraged to consider issuing under the governing laws of the EU-27 Member States. In this context, a trend towards moving from dual governing laws to one single governing national law, following the United Kingdom leaving the EU, has been observed in more recent issuances. The EBA will further monitor this recent development.

136. In addition, in accordance with Article 55(3) of the BRRD, some resolution authorities require institutions to provide legal opinions on the effectiveness and enforceability of contractual clauses.

Policy observations

137. A question might arise as to whether, in the case of notes governed by dual EU-third country laws, the requirement for write-down and conversion clauses under Article 55 of the BRRD is invariably applicable, or whether it depends on which parts of the contract are governed by the third country law.

138. In this regard, the fact that all issuances analysed consistently choose the law of the Member State of incorporation to govern the insolvency ranking of the note merely reflects the fact that, in international law, ‘the ranking of claims is always established by the lex fori concursus’\(^{31}\) (law of the forum). From that perspective, a reference to a Member State’s law in relation to the ranking in insolvency of the note does not serve per se to fully meet the condition set out in Article 55(1)(c) of the BRRD.

139. With regard to provisions other than ranking in insolvency, the case is more ambivalent.

140. On the one hand, Article 55 of the BRRD sets out the condition that ‘the liability is governed by the law of a third country’, without specifying which elements of the liability must be subject to third country law. Therefore, it can be argued that it is sufficient that some elements or aspects of the liability (e.g. enforceability or effects in insolvency), whatever they are, are governed by third country law in order to render Article 55 of the BRRD applicable. In this spirit, the fact that contracts refer to third country law only in relation to ‘non-contractual obligations’ or any ‘relevant clause’ is sufficient to conclude that, overall, the contract needs to contain a write-down and conversion clause.

141. On the other hand, the first subparagraph of Article 55(1)\(^{32}\), as well as recital (26) of BRRD\(^{33}\), demonstrates that that the article is specifically meant to ensure the enforceability of the write-down and conversion powers of resolution authorities in the EU. It could be argued on this basis that what matters for the purpose of Article 55 of the BRRD is whether a third country

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\(^{32}\) ‘Member States shall require institutions and entities to include a contractual term by which the creditor or party to the agreement or instrument creating the liability recognises that liability may be subject to the write-down and conversion powers.’

\(^{33}\) ‘The requirement to include a contractual recognition of the effects of the bail-in tool in agreements or instruments creating liabilities governed by the laws of third countries should facilitate and improve the process for bailing in those liabilities in the event of resolution.’
court or administrative authority would recognise the exercise of the write-down and conversion powers of resolution authorities in the EU. Such a purpose-driven interpretation would allow differentiating between provisions, with some aspects of the liability being governed by third country law without triggering Article 55 of the BRRD.

142. With regard to this question, the critical concern is whether a third country court or administrative authority would recognise the applicability of EU law to a write-down and conversion decision. However, resolution authorities also warned against taking a restrictive interpretation of Article 55 of the BRRD and have called instead for a prudent view to be taken. For example, MREL-eligible liabilities should ensure the enforceability not only of write-down and conversion action but also of any resolution action.

143. Finally, all eligible liabilities instruments will, in any case, have to include a reference to write-down and conversion, as per Article 72b(2)(n) of the CRR, when issued after 28 June 2021 (i.e. 2 years after the entry into force of that regulation).

144. As a conclusion, it would seem prudent to apply Article 55 of the BRRD strictly, whereby institutions should include write-down and conversion clauses in all circumstances in which part or all of the contract is governed by third country law to ensure TLAC/MREL eligibility.

1.5.2 Tax and regulatory calls

145. In its AT1 report, the EBA has laid down a number of elements of guidance regarding tax and regulatory calls. For example, the report pointed out that tax calls should occur only in the event of a material effect as a result of a change in tax treatment and if the change is non-foreseeable at the time of issuance.

146. Unlike the own funds framework, the CRR/BRRD does not lay down any particular provisions with regard to tax or regulatory calls in relation to TLAC/MREL. This is plausible because for own funds those provisions are meant to derogate from a strict 5-year ban on calls, which is not applicable to TLAC/MREL.

147. Nevertheless, the existing EBA recommendation should be kept in mind when using provisions relating to tax and regulatory calls within TLAC-/MREL-eligible liabilities instruments; given this, calls should not be drafted in such a way as to affect permanence or loss absorption.

Comparison of clauses

148. Although the issuances reviewed so far contain very few discretionary calls, most instruments reviewed provide for redemption based on tax or capital/regulatory circumstances.

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34 By definition, as per EU law, the bail-in powers do apply to instruments issued by institutions or entities established in the EU or by branches of EU institutions established outside the Union. This statutory competence would not necessarily be accepted by a third country court or administrative authority.
149. To the extent of the EBA’s assessments so far, it can be observed that institutions have extended to senior non-preferred notes their usual contractual language on redemption because of a change in tax treatment. In determining the trigger for a tax call, the vast majority of the issuances reviewed either define a tax event as or refer to ‘any change in, or amendment to, the laws and regulations of jurisdiction or any change in the official interpretation of such laws and regulations’ in a very similar form. In the case of redemption following a tax call, most MTNs require that the outstanding notes can be redeemed only in whole. The wording used to express this in general is clear and reads ‘redeem all but not some only’, as well as ‘in whole [but not in part]’.

150. In addition, redemption due to changes in regulatory classifications is likely to play an important role until the entire framework on TLAC/MREL eligibility (CRR, BRRD, SRMR and corresponding technical standards or additional EBA guidance, as well as authorities’ approaches) is fully settled. As a result, the MTNs examined explicitly provide redemption upon the occurrence of ‘eligible liability events’, a ‘loss absorption disqualification event’, ‘TLAC/MREL criteria’ or a ‘TLAC/MREL disqualification event’, i.e. changes in the framework that would result in the notes not being qualified as eligible liabilities. The wording used in MTNs to define such events is quite standard and typical for such clauses, referring to a change leading to the exclusion of the instrument from the issuer’s minimum requirements.

151. Most MTNs reviewed specify that redemption on the ground of regulatory changes is not permitted solely on the basis that the notes are not meeting the minimum maturity any more (e.g. it is the last year of the contract). Some specify, in addition, that a restriction on the quantum of eligible liabilities admissible for the bank (e.g. 3.5% of senior debt for G-SIs) cannot be seen as a regulatory change. Another one establishes that the exclusion of all or part of a series of notes from the MREL or TLAC requirements because there is insufficient headroom for such notes within a prescribed exception to the otherwise applicable general requirements for eligible liabilities does not constitute an MREL or TLAC disqualification event. This is a noticeable difference from discretionary calls, which, according to current observations, are precisely timed to cater for de-recognition of an instrument in the last year of maturity.

152. As for tax calls, any redemption at the issuer’s discretion due to regulatory changes is in whole, but not in part, for the outstanding notes of the respective series in all cases observed. This is consistent with the EBA AT1 report and constitutes another difference from discretionary calls.

1.5.3 Tax gross-up clauses

153. The AT1 standardised templates as well as the AT1 report set up requirements for tax gross-up clauses to be deemed acceptable as part of the terms and conditions of own funds instruments. In the response provided to Q&A 2016_2849, the EBA confirmed that part of the AT1 reasoning also applies to Tier 2 instruments, and that Tier 2 gross-up clauses can be considered acceptable only if (i) they are activated by a decision of the local tax authority of the issuer, and not of the investor, and (ii) they relate to dividends and not to principal.
Most issuances contain tax gross-up clauses. However, gross-up clauses differ widely between issuers. The differences include whether the issuer is liable for principal and/or interest or not, and whether the clause can be activated by a tax decision or change in law in the jurisdiction of the issuer only or whether it could also be activated by the same circumstances occurring in other jurisdictions (e.g. a tax decision in the country of the investor).

Some MTNs explicitly have a criterion excluding additional payments on principal, such as ‘the issuer shall pay such additional amounts of interest [...] except that no Additional Amounts shall be payable [...] (a) in respect of payment of any amount of principal’. The scope of this restriction on gross-up to interest varies among issuances: although some MTNs specifically restrict the gross-up to interest for senior non-preferred notes (in addition to subordinated notes), others explicitly foresee the possibility of gross-up on principal and interest. In one case, the additional amounts to be paid by the issuer to compensate any withholding or deduction of taxes on principal can only be made if permitted by the MREL and TLAC requirements. It should be noted here that the terms and conditions define ‘MREL or TLAC Requirements’ in a much broader way than applicable regulation, extending them to ‘any regulations, requirements, guidelines, rules, standards and policies ... adopted by the specific country, a competent authority, a relevant resolution authority or the European Banking Authority’.

For own funds, the idea behind restricting gross-up, as set out above, is to avoid the creation of a strong redemption incentive through a gross-up event. Although the CRR does not lay down particular requirements or restrictions with regard to calls of TLAC/MREL issuances, it is the EBA’s view that the conditions set out for own funds (and Tier 2 instruments in particular) should also apply for eligible liabilities instruments. Alignment between own funds and eligible liabilities instruments is desirable, since it might be worthwhile to avoid incentives to reduce maturity/permanence for TLAC/MREL instruments as well. Bearing in mind that, in a non-negligible number of cases, the abovementioned criteria are already met by market participants, the own funds guidance should be extended to eligible liabilities instruments.

**Recommendations**

(15) Consistent with the own funds framework, tax gross-up should be accepted only under certain conditions, as applicable to eligible liabilities instruments, i.e. gross-up clauses can be considered acceptable if they are activated by a decision of the local tax authority of the issuer, and if they relate to interest and not to principal.
2. Areas for further work

157. The EBA is reflecting further on several aspects.

2.1 Further comparison with own funds clauses

158. Further work will be performed on general consistency with own funds clauses and existing recommendations from the EBA in this field (including those provided via the AT1 standard templates, for example) if deemed relevant to eligible liabilities instruments.

159. This is the case, for example, for substitution and variation clauses, which are usually included in the TLAC/MREL issuances analysed so far. These clauses provide the issuer with the possibility of substituting the notes or modifying their terms without the consent of the noteholder, subject to certain conditions, to ensure the effectiveness or enforceability of bail-in, so that the notes become or remain (fully eligible as) eligible liabilities instruments. One of the objectives will be to examine consistency with similar types of clauses for own funds.

2.2 Environmental, social and governance bonds

160. Environmental, social and governance (ESG) bonds are issued by entities that have positive ESG characteristics, the proceeds of which are meant to be invested in green assets. This is a relatively new market that has been growing fast in recent years. These bonds are usually marketed as green bonds or social bonds, usually follow green or social impact standards\textsuperscript{35}, and are certified by an independent verifier following the climate bond standard and certification scheme\textsuperscript{36}.

161. Institutions have been issuing ESG 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.

Comparison of clauses

162. Looking at MREL green or social bonds terms and conditions, usually the only reference to ‘green’ or ‘social’ is in the ‘use of proceeds’ section in which the bank commits to allocating the proceeds to specific green/social assets (e.g. green loans or buildings, infrastructure projects, renewable energy projects, social infrastructure). It is, for example, specified that the net proceeds of the issuance will be allocated or reallocated from time to time to the financing and/or refinancing, in whole or in part, of eligible green assets, as separately defined and described in the issuer’s Green Bond Framework. It can also be specified that an amount

\textsuperscript{35} ICMA Green Bond Principles (GBP) and ICMA Social Bond Principles (SBP).

\textsuperscript{36} Certification under the Climate Bonds Standard.
equivalent to the net proceeds of the green bonds issuances will be exclusively used to finance and/or refinance, in whole or in part, the portfolio of eligible loans.

163. The green commitment, however, is not a legal and binding commitment, and not allocating (sufficient) funding to green assets does not constitute an event of default. The documentation usually provides flexibility in the use of proceeds. The clauses observed might specify for example that, pending the allocation or reallocation, as the case may be, of the net proceeds to eligible green assets, the issuer will invest the balance of the net proceeds, at its own discretion, in cash and/or cash equivalent and/or other liquid marketable instruments. In addition, it is sometimes specified that the issuer will use its ‘best efforts’ to substitute any redeemed loans that are no longer financed or refinanced by the net proceeds, and that cease to be eligible green assets, as soon as practicable once an appropriate substitution option has been identified.

164. The issuer also usually commits to informing investors about the allocation and positive environmental and/or social impact of the green, social and sustainability bonds issued by reporting the amount that has been invested in the earmarked ‘green’ or ‘social’ assets and by providing reports on the environments and/or social impact of those assets.

165. Finally, it is noted that the payment of principal and interest in respect of the bonds is generally made from general funds and is not directly or indirectly linked to the performance of the green assets.

Policy observations

166. In general, based on a small number of issuances analysed so far, it seems that the proceeds of the issuance are not segregated and that the issuer uses an amount equivalent to the net proceeds to finance or refinance green or social assets, whereas the performance of the assets has no impact on the payment of principal and interest on the notes.

167. Although the EBA has only conducted preliminary work on assessing the relevant clauses and documentation, several points of attention need to be raised with regard to ESG bonds in the form of eligible liabilities instruments. They pertain, for example, to a possible perception by investors that green assets and green capital could be segregated from the rest of the assets and capital of the institution and possible challenges around the ‘no creditor worse off’ principle if the resolution authority decides to bail in the instrument while the green assets are still performing. Guaranteeing that there is no direct link between the green assets and the notes is needed to ensure that the issued capital is available to absorb losses incurred on not only green and social assets but all types of assets if needed.

168. In addition, there may be other areas of attention relating to the degree of clarity of the associated risk factors, the definitions used for green assets and bonds, a perceived obligation for the institution to reinvest the funds in new green assets or the consequences of a potential disqualification of the assets as green assets, without the possibility of concomitantly redeeming the instruments (reputational risk/conduct risk aspects).
169. Although no recommendation is expressed at this stage by the EBA, ESG TLAC/MREL issuances (as well as own funds instruments recently issued) will be further monitored, in particular to possibly provide further guidance on the interaction between the clauses used for ESG issuances and the eligibility criteria for eligible liabilities instruments, with the objective of ensuring that these eligibility criteria for the instruments are not affected.