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07 October 2014

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# EBA Report

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

## Reasons for publication

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

## Content

5. The CRR lays down eligibility criteria for AT1 instruments (in particular Articles 51 to 55). Those criteria are supplemented by the Commission Delegated Regulation (EU) No 241/2014 (Regulatory Technical Standards (RTS) on own funds).
6. Several AT1 instruments have now been issued by European institutions in accordance with those criteria.
7. Over the past few years, the EBA has drafted regulatory and implementing technical standards in the area of regulatory capital (around 20 have been delivered). In particular, the EBA has proposed a number of provisions in relation to the form and nature of incentives to redeem, the nature of a write-up of an AT1 instrument following a write-down of the principal amount on a temporary basis, and the procedures and timing surrounding trigger events.
8. Now that this work has been finalised with submission to the European Commission and already adopted as EU delegated Regulation for large parts (Commission Delegated Regulation (EU) No 241/2014), the EBA is putting more emphasis on the review of the implementation of the eligibility criteria applicable to capital instruments on the basis of the CRR and the technical standards.
9. The EBA has focused its work primarily on the assessment of selected AT1 issuances. The terms and conditions of selected issuances have been assessed against the regulatory provisions in order to identify provisions which the EBA would recommend avoiding.

10. This monitoring is at its preliminary stage. It follows a dynamic approach which will necessitate several iterations. Further experience will need to be gained on the basis of future issuances and the current review has been limited in terms of number of issuances and scope. Additionally, several areas are still under discussion. New issuances and new types of clauses in the future may also have an influence on the preliminary conclusions presented in this report. In addition, there is currently no experience available on the effectiveness of the different clauses in practice, in particular in relation to loss absorption mechanisms. Furthermore, it cannot be assumed that provisions/clauses not mentioned in this report can be considered as not raising any concerns.

11. This preliminary review makes no claims to be fully comprehensive but highlights areas where the EBA believes it necessary to revise the wording of some existing clauses for future issuances, or where the EBA would recommend avoiding the use of some clauses currently under consideration in future.

12. In addition, while assessing some issuances, the EBA identified a number of areas where further guidance might be necessary for a common interpretation of the CRR provisions. The EBA is investigating some of the issues and guidance will be communicated via the Q&A tool on the EBA website in due time. This report provides the EBA's views on some of these issues.

13. Finally, the EBA will continue exchanging views with institutions and market participants on the preliminary results of this monitoring and is ready to discuss the content of this report in more detail to assess whether further consideration should be given to some aspects and to collect opinions on the areas still under investigation.

14. This report is structured as follows:

- EBA's considerations summarising the main conclusions
- Detailed analysis with the EBA's views on some of the clauses reviewed
- Interpretation of some CRR provisions, in particular with the EBA's views on the provisions relating to triggers and underlining areas still under investigation

## EBA's considerations

15. The EBA has reviewed nine issuances, issued between August 2013 and May 2014, for a total amount of EUR 11.6 bn. Three issuances were made under a conversion mechanism, and six under a temporary write-down mechanism.

16. Although they are complex instruments, issuances are in general quite standardised, except for features which are by nature institutions' specific (such as, for example, the level of the triggers; the definition of the triggers at different applicable levels depending on the

structure of the groups). This is probably partly due to the existence of quite prescriptive provisions in both the CRR and the RTS.

17. Nevertheless, the monitoring process has shown that a few provisions of existing AT1 instruments or currently under consideration by prospective issuers should be avoided in the future, or revised wordings of those clauses should be used. Some provisions could be worded in a better way because as they stand, they may be the cause of uncertainty in relation to regulatory provisions, for instance on the effectiveness/implementation of the loss absorption mechanism, or they may increase the already high complexity of the instruments.
18. This may particularly be the case with some provisions related to regulatory calls, share conversion mechanisms, contingent clauses, and covenants.
19. Furthermore, this document provides EBA guidance in a few areas where there might be different interpretations.
20. This may particularly be the case for some provisions related to triggers for loss absorption where the appropriate level of application (solo, sub-consolidated or consolidated level) needs to be specified.
21. The EBA will continue working in a few areas, in particular on the recognition of the instrument at group level when the issuance is via a subsidiary and this subsidiary is located in a third country. In addition, there is the question of activation of loss absorption mechanisms in institutions which have issued different instruments with different trigger levels (e.g. 5.125% and 7%). Finally, the EBA will continue to consider aspects related to gross up clauses.
22. The EBA will continue monitoring selected AT1 issuances with the objective to promote/avoid the use of certain wordings in the terms and conditions.
23. The EBA hopes that forthcoming issuances will retain some level of standardisation. This appears desirable to mitigate the complexity of hybrid instruments and this report should help to promote further convergence. If the EBA noted a significant deterioration in the quality of the instruments or a significant use of non-standard or complex provisions which might raise doubts on, for example, the effectiveness of loss absorption of the instruments, the EBA would consider taking steps to address this situation.
24. The EBA also hopes that issuers will design issuances so that the terms and conditions are not unduly complex but rather as simple and clear as possible. The EBA views efforts to limit the complexity of AT1 instruments as inherently valuable and takes complexity into account when assessing AT1 instruments.

## Detailed analysis

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

### Provisions observed in existing issuances

#### Calls

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

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

28. Given that the CRR rules are now in force, the usefulness of a partial regulatory call can be questioned as there is no clear case of partial derecognition that could arise for fully compliant instruments. Therefore, it is unclear what that clause is intended for in the current environment. Issuers may expect that a future change in the eligibility criteria for AT1 would come with grandfathering provisions – which would include partial progressive phasing out during a predefined period. The view of the EBA is that the issuer should bear the risk of a potential change in the Regulation.

29. The EBA considers that only full regulatory calls but no partial regulatory calls should be acceptable since Article 78(4) of the CRR sets down that the condition for regulatory calls is that the instruments (i.e. in whole and not in part) are excluded from own funds or reclassified to a lower tier of capital.

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

31. For tax calls, contrary to regulatory calls, the CRR indicates that the condition for a tax call to take place is a 'material effect' of the change in the tax treatment. Changes in tax

treatment will not affect the regulatory treatment but will affect the cost of the issuance. Partial calls could therefore be acceptable if the effect is material.

32. Finally, the EBA will continue working on additional issues regarding regulatory or tax calls as well as issues related to changes in tax treatment in general.

### Write-down or conversion

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

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

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

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

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

38. A reference to prior loss absorbing instruments, where the conversion or write-down of the AT1 instrument is linked to the prior activation of a similar mechanism for other

instruments, including senior instruments can be problematic. The EBA considers that there should be an additional provision in the contract specifying that if there is any issue with the senior instruments and that they are not converted or written down for any reason, this should not prevent the AT1 instrument itself being converted or written down. More generally, write-down/conversion should not be linked to any event other than a breach of the trigger.

39. Some issuances include share conversion clauses which give shareholders the chance to buy the shares from the conversion (pre-emption right to shareholders) and give cash to AT1 holders as compensation. The EBA considers that this type of clause should be avoided. Shareholders may have a right to pre-emption. Nonetheless, it is unclear why this type of clause is needed, especially for an institution listed on a stock exchange where shares can be bought on the market. In addition, clauses mitigating the risk of dilution should not be encouraged. Dilution is not a prudential concern and the threat of dilution is a strong incentive for shareholders. In addition, any feature that unduly complicates the terms of the instrument, notably regarding the loss absorption mechanism, should be discouraged.

#### Formal issues

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

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

42. The terms should make clear that the trigger event may be calculated at any time. Therefore, the definition of the CET1 ratio should not refer to the last quarterly financial date or any extraordinary calculation date.

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

44. Terms should only refer to covenants when they make clear what those covenants are, either by a description of the terms of the covenant that affect the terms of the instrument, or by using a hyperlink to the text of the covenant, or simply by attaching the terms of the

covenant. In any case, it is desirable to exclude any reference to covenants that affect the prudential terms of the instrument.

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

### **Provisions for potential forthcoming issuances**

46. The EBA also assessed the potential use of contingent clauses, which might include language that would, for example, make interest payments mandatory in the event that AT1 status was lost (contingent settlement mechanisms). Generally, it is deemed that contingent clauses are not necessary and that the terms should not include this type of provision which could complicate the terms and conditions. The EBA will nevertheless continue investigating this specific aspect.

47. The EBA also considered issuances where the issuer included a provision whereby the trigger level of the AT1 instrument could be increased by the issuer at any time.

48. The EBA considers that a change in the trigger level might be viewed as a new issuance. In addition, and as indicated earlier, features that unduly increase the complexity of an instrument should be discouraged, and that a provision such as this would fall into that category.

### **Interpretation of some CRR provisions**

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

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

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

51. The EBA considers that when there are triggers on the basis of more than one level of solvency, the relevant available amount for the write-up should be the lower of the net



income arising from the different levels. For instance, assuming that the net income calculated on a solo basis is lower than the net income calculated on a consolidated basis, the relevant amount for the purposes of the write-up should be capped at the level of the net income calculated on a solo basis.

### **Triggers for instruments issued by institutions that are parent companies or subsidiaries**

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

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

54. The EBA considers that there should be a trigger on the basis of all levels of solvency applicable to the institution (or the banking group). This means that there should be a trigger on the basis of consolidated CET1 when the entity is supervised on a consolidated basis, sub-consolidated when the entity is supervised on a sub-consolidated basis, and solo when the entity is supervised on a solo basis, and any applicable combination of those three cases. The inclusion of triggers referring to the application scope of supplementary supervision pursuant to the Financial Conglomerates Directive (FICOD) is possible but not mandatory.

55. For issuances by subsidiaries, the question is whether an additional trigger at group level is needed for the issuance to be recognised at group level and not only at subsidiary level. The EBA is currently carrying out additional work on this aspect.

### **Eligibility criteria for instruments issued by subsidiaries in third countries (calculation of third country CET1)**

56. In addition to the issue of triggers – which is present both for EU and non-EU issuances – there are specific issues relating to the issuance of AT1 instruments in third countries, notably because the CRR is more stringent or more specific than the Basel III framework with regard to some eligibility criteria. In particular, the CRR rules prohibit dividend stoppers for AT1 instruments and require a 5.125% triggers for all AT1 instruments regardless of their accounting treatment. In third countries, the mechanism of write-down/write-up may also differ from that prescribed by the RTS. Those rules do not necessarily exist in third countries even if the AT1 instruments issued by institutions in those third countries are Basel III compliant. An instrument issued in a third country with, for instance, a dividend stopper, could be eligible as AT1 in the third country but would not be recognised as AT1 for the purposes of the consolidated solvency position of an EU banking group.

57. This EBA is currently carrying out additional work on this issue.

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

58. The EBA is continuing to work on how to operate the conversion or write-down mechanism where an institution has issued instruments with different triggers (e.g. 5.125% CET1, or 'low' trigger; and 7% CET1, or 'high' trigger) which may be hit simultaneously.