Client Alert

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EBA Second Monitoring Report of AT1 Instruments

On 11 July 2016, the European Banking Authority ("EBA") published a draft of its second Report[1] on the monitoring of Additional Tier 1 ("AT1") instruments of EU institutions. The Report was undertaken pursuant to Article 80 of the Capital Requirements Regulation ("CRR") which requires the EBA to monitor the quality of own funds instruments issued by EU institutions. The EBA published its initial monitoring report in May 2015[2].

The EBA notes that the CRR sets out eligibility criteria for AT1 instruments and that the CRR provisions are supplemented by Regulatory Technical Standards ("RTS"). There have been a number of issues of AT1 capital instruments by EU institutions based on such criteria. In preparing its Report, the EBA records that it has reviewed 33 AT1 issuances, issued between August 2013 and December 2015, and has assessed the terms and conditions of such issuances against the criteria specified in the CRR and the RTS.

In parallel with the Report, the EBA has also published draft standardised templates for certain terms and conditions contained within AT1 instruments which are intended to cover the prudential parts of such terms and conditions.[3]

The EBA remarks that although AT1 instruments are complex, the terms of most issuances are quite standardised with the exception of institution specific features, in particular the definition and calibration of relevant triggers. Despite this standardisation, the EBA concludes that some provisions of existing AT1 instruments or provisions being considered by prospective issuers should be avoided or reworded, largely because of the risk that such provisions could cause uncertainty (in this regard, the EBA makes specific reference to the loss absorption mechanism) or because they may increase the already high complexity of the instruments. The types of provisions highlighted by the EBA as causing concern include those related to regulatory calls, share conversion mechanisms, contingent clauses and covenants.

The EBA indicates that it supports continuing standardisation between instruments and expects issuers to design issuances so that terms and conditions are not unduly complex and are as simple and clear as possible.

Analysis of Provisions in Existing Issuances

Set out below are the principal types of clauses focused on by the EBA in the Report:

Regulatory calls: The EBA notes that criteria in respect of regulatory calls are set out in Article 78 of the CRR. It expresses concern that some issuances include partial regulatory calls so that only a portion of the instrument may be called if the corresponding part of the issue is no longer recognised as Tier 1 capital due to a regulatory

[1] EBA Report, https://www.eba.europa.eu/documents/10180/1360107/EBA+draft+report+on+AT1+templates+-+June+2016.pdf
[2] EBA Report, https://www.eba.europa.eu/documents/10180/950548/EBA+Report+on+the+Additional+Tier+1+instruments+-+May+2015.pdf
[3] EBA Standardised templates, https://www.eba.europa.eu/documents/10180/1360107/EBA+draft+AT1+templates+-+2016.pdf

change. The EBA states that only regulatory calls for the full amount of an instrument are acceptable. In relation to the exercise of calls at below par, the EBA also mentions that the terms of some issuances state that where an instrument has been partly written down, it must be written back up again before a call can be made. Although the CRR is silent on this issue, the EBA underlines that being able to call an instrument that has been written-down enables the write-down to be realised and increases common equity Tier 1 ("CET1"). It also expresses concern that requiring the instrument to be fully written-up may override tax/regulatory calls and may not allow the institution to call in an instrument which is no longer eligible. The EBA's view is that there is no specific concern in providing for a call below par in these circumstances.

Tax calls: The EBA asserts that under the CRR, a tax call is only permitted if there is a change in tax treatment giving rise to a "material effect". It indicates that partial calls could be acceptable where the effect is material. The EBA further states that provisions relating to tax calls should use precise terminology–it provides, as an example of an unacceptable trigger, language that a tax event will be triggered if "there is more than an insubstantial risk" that additional payments will be due on the next payment date. The trigger must be a material and non-foreseeable change in the applicable tax treatment.

Changes in the assessment of the competent authority regarding tax effects in case of a write-down: The EBA indicates that an example of such a change in assessment would be the relevant competent authority having considered that there would be no tax effect in the case of a write-down, but then subsequently determining that such tax effect would be triggered and disqualifying part of the instrument. The EBA expresses the view that potential changes in the regulatory assessment will not be valid triggers for regulatory or tax calls.

Redemptions and purchases: The EBA believes it is appropriate to include in the terms of an AT1 instrument, a condition stating that the institution should not give a notice of redemption after a trigger event notice has been given, and that if a trigger event notice is given after such notice of redemption, but before the redemption date, the notice of redemption should be null and void.

Tax Gross-up Clauses: In relation to tax gross-up clauses, the EBA is of the view that (i) it should be clarified that the gross-up clause is activated by a decision of the relevant tax authority, not the issuer; (ii) increased payments should only be possible if they do not exceed distributable items; (iii) gross-up clauses should only be allowed in relation to dividend/coupon withholding tax and not payments of principal; and (iv) where changes in withholding tax are triggers for a tax event, the terms should make it clear that such an event would be subject to the conditions applicable to tax calls set out in Article 78(4)(b) of the CRR.

Write-down or conversion: The EBA notes that some instruments have a "one cent floor" so that the instrument can never be written down below this amount. This is to avoid the risk of the instrument legally disappearing if written down to zero (which would then preclude it being able to be written back-up again). Although Article 54(4) of the CRR requires the possibility of the instrument being fully written down, the EBA does not believe the one cent floor should be regarded as breaching this requirement provided that the amount that cannot be written down is not included in AT1 capital.

The EBA also remarks that some provisions state that there will be a permanent write-down rather than a conversion in the event that an institution is unable to deliver the CET1 instruments that the AT1 instruments would have been converted into. The EBA concludes that this provision is useful to address any concerns about the feasibility of conversion in the longer term and therefore has the effect that, in the worst case scenario, there will still be loss absorption in the form of a permanent write down. However, the EBA highlights the requirement under Article 54(6) of the CRR that authorised capital should at all times be sufficient to ensure the conversion can occur. The EBA therefore concludes that this type of clause is only acceptable if it does not entail relaxing the requirements for conversion, but guarantees that loss absorption would happen in different possible scenarios.

Other recommendations of the EBA in the context of write-down or conversion are that the terms of the instrument should not envisage a two stage trigger event where the first stage is the write-down of coupons, the terms should use the calculation for any write-up as provided in the RTS and provisions should not give the impression that a write-down or conversion notice has to be given to investors before any write-down or conversion is made.

Contingent clauses: The EBA considers the potential use of contingent clauses such as provisions making interest payments mandatory in the event that AT1 status is lost. It notes that current AT1 issuances without this clause are generally classified as equity under IFRS standards by European institutions. It expresses concern, however, that contingent clauses introduce complexity and could give rise to unintended consequences (e.g. they may constrain regulatory changes that would have the effect of triggering the clause). The EBA states that although equity classification is not a requirement in respect of AT1 instruments, the accounting treatment should derive from genuine reasons. It expresses the view that it would need to be demonstrated that AT1 instruments with temporary write-down features that are accounted for as debt under IFRS would create CET1 for the full amount of the instrument when written down. The EBA's conclusion is that although there are some benefits in the use of contingent clauses, their use gives rise to prudential concerns which outweigh the benefits. Accordingly, the EBA believes that contingent clauses should be disallowed in EU issuances of AT1.

Contingent Conversion Convertibles

The EBA believes that some EU institutions are looking into the possibility of issuing contingent conversion convertibles whereby the AT1 instrument would be structured with a loss absorption feature through conversion to CET1 and that there would be a conversion option for the holder if the share price of the institution goes above a certain price (referred to as an "upside conversion"). Some issuers consider that the upside option may help expand the investor base for these instruments and reduce coupons. The EBA notes that there has been at least one such issuance in the EU, but prior to the CRR coming into force.

Under the CRR, AT1 and Tier 2 instruments cannot contain any incentive for the issuer to redeem the instrument. The relevant RTS provides examples of incentives to redeem, including a call option combined with a requirement or an investor option to convert the instrument into a CET1 instrument where the call is not exercised. In the Report, the EBA states that to comply with the RTS, instruments could feature an upside conversion up to the first call date to avoid the possibility of a conversion following the call date. The EBA indicates that giving the conversion option to investors results in a subsidy of the coupon and reduces the instrument's cost for the period from the issue date to the first call date. The initial credit spread or margin will result from the comparison with the non-subsidised coupon level agreed between investors and the issuer. In that case, the coupon subsidy would disappear at the first "reset date", which would have a material effect on the coupon.

The EBA states that conditions that could be considered for accepting this type of instrument are cases where the subscriber is an existing shareholder or in cases where the conversion option is to be exercised in the case of change in the ownership of the institution. Even in these cases, the EBA cautions that the terms of the conversion option should be carefully assessed and that there should not be a direct link with the reduction of the coupon.

Interpretation of Certain CRR Provisions

The EBA records that its monitoring has shown some differences in interpretation of provisions of the CRR, particularly in relation to the triggers for loss absorption. In the Report, it provides its views on some of these issues:

Calculation of the amount available for write-up when the instrument contains a double trigger: The EBA states that the existence of different triggers raises questions about the calculation of the amount available for the write-up. The EBA considers that when there are triggers on the basis of more than one level of solvency, the write-up should be the lower of the profit (or net income) arising from the different levels.

Triggers for instruments issued within a banking group: The CRR provides that triggers for the loss absorption of AT1 instruments shall be based on a level of at least 5.125% of the CET1 of the institution. In relation to group entities, the EBA believes that there should be a trigger on the basis of all levels of solvency applicable to the institution or the banking group. Accordingly, it believes that there should be a trigger on the basis of consolidated CET1 when the entity is supervised on a consolidated basis, sub-consolidated if it is supervised on a sub-consolidated basis and solo if the entity is supervised on a solo basis.

Group / solo triggers for eligibility criteria for instruments issued by subsidiaries in third countries: The EBA highlights that there are specific issues relating to the issuance of AT1 instruments in non-EU countries, particularly where the CRR is more stringent than the Basel III framework. It highlights that the CRR rules prohibit dividend stoppers for all AT1 instruments and require a 5.125% trigger for all AT1 instruments regardless of their accounting treatment. These rules do not apply in some non-EU jurisdictions. The EBA indicates that an instrument issued in a non-EU jurisdiction with a dividend stopper could be eligible as AT1 in such jurisdiction, but would not be recognised as AT1 for the purpose of the consolidated solvency position of an EU banking group.

Loss absorption in institutions that have issued instruments with different triggers: The EBA remarks that it is possible that an institution has issued instruments with different triggers, e.g. a 5.125% and 7% trigger, which are all triggered simultaneously. In such a case, the EBA states that losses corresponding to the amount required to go back to 5.125% should be absorbed by both the low trigger and the high trigger instruments on a pro rata basis. Losses above 5.125% will only be supported by the high trigger instrument.

EBA Standardised Templates for AT1 Instruments

As referred to above, on the same day that it issued the Report, the EBA also published draft standardised templates for AT1 instruments. Its rationale for doing so is that increased standardisation through templates could be helpful to the investor community, particularly smaller institutions. The templates are aimed at the most common loss absorption mechanisms. The EBA also expresses its view that standardisation of terms will help the EBA in its monitoring role and supervisors in their assessment of the compliance of issuances. It also believes it may prevent a potential deterioration in the quality of AT1 instruments. The templates include standard definitions for common terms in many AT1 instruments (e.g. “Capital Event”, “Capital Regulations”, “Distributable Items” and “Tax Law Change”.)

Other terms covered by the templates include:

- Status of the Notes.
- Discretionary Cancellation of Distributions on the Notes.
- Cancellation of Distributions.
- Redemption.
- Bail-in.
- Trigger Events.
- Consequences of a Trigger Event.
- Write-up.

Next Steps

Comments should be submitted to the EBA by 26 October 2016. It is expected that the EBA will publish final revised Guidelines by early 2017.

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