



**EBA REPORT ON THE MONITORING OF
ADDITIONAL TIER 1 (AT1) INSTRUMENTS
OF EUROPEAN UNION (EU) INSTITUTIONS
– THIRD UPDATE**

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EBA

EUROPEAN
BANKING
AUTHORITY

Reasons for publication

1. Pursuant to Article 80 of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR) on the continuing review of the quality of own funds, the ‘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 the EBA, forward all information that EBA deems relevant concerning new capital instruments issued in order to enable EBA to monitor the quality of own funds instruments issued by institutions across the Union’.
3. The purpose of this report is to inform external stakeholders about the continuing work performed by the EBA in terms of monitoring the issuances of Additional Tier 1 (“AT1”) capital instruments and to present the results of this monitoring.
4. The present report constitutes the third update of the first version of the report published in October 2014¹, the last update having been published in October 2016². Since the publication of the first report, the EBA has continued to monitor new issuances and has found that there are a few new notable provisions to be recommended or avoided.
5. This third update of the report is based on the review of 23 additional AT1 issuances from EU institutions, which took place between May 2015 and December 2017, for a total amount of EUR 11.41 billion. Eight issuances were made under a conversion mechanism and 15 under a write-down mechanism.
6. It may be recalled that, apart from the monitoring of hybrid capital issuances, the EBA has established, has published and maintains a list of Common Equity Tier 1 (CET1) instruments. This list was most recently published on November 2017 and accompanied with a CET1 monitoring report.

Content

7. The CRR lays down the eligibility criteria for AT1 instruments (particularly Articles 51 to 55). Those criteria are supplemented by Commission Delegated Regulation (EU) No 241/2014 (the regulatory technical standards (RTS) on own funds).
8. Over the past few years, the EBA has drafted the RTS and the implementing technical standards (ITS) 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 timings surrounding trigger events. Now that the EBA’s CRR mandate has been completed in this area (with submission to the European Commission) and has already been adopted as an EU-delegated regulation

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

² <http://www.eba.europa.eu/documents/10180/1360107/AT1+Report+October+2016.pdf>

(Commission Delegated Regulation (EU) No 241/2014), the EBA is placing 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 these selected issuances have been assessed against the regulatory provisions in order to identify provisions that the EBA would recommend avoiding.
10. This monitoring follows a dynamic approach, which has, up to now, resulted in several iterations. It cannot, however, be assumed that provisions/clauses not mentioned in this report can be considered as not raising any concerns.
11. This review makes no claims to be fully comprehensive, but highlights areas where the EBA believes it necessary to revise the wording of certain existing clauses for future issuances or where the EBA would recommend avoiding in the future the use of some clauses currently under consideration.
12. The EBA will continue to exchange views with institutions and market participants on the results of its ongoing monitoring.
13. It is to be recalled that the EBA published standardised terms and conditions for AT1 issuances in October 2016 that are meant to cover the prudential aspects of the terms and conditions³. The monitoring work performed by the EBA has successfully fed into the development of the standardised templates, which are a useful complement to the regular AT1 monitoring report.
14. This report is structured as follows:
 - the EBA's considerations summarising the main conclusions;
 - detailed analysis of some of the clauses reviewed, along with the EBA's views;
 - interpretation of some CRR provisions, particularly with the EBA's views on the provisions relating to triggers.

³ <http://www.eba.europa.eu/documents/10180/1360107/Final+AT1+standard+templates+.pdf>

The EBA's considerations

15. The EBA has reviewed 23 additional issuances, issued between May 2015 and December 2017, for a total amount of EUR 11.41 billion. Eight issuances were made under a conversion mechanism and 15 under a write-down mechanism. Since the publication of the first report, the EBA has reviewed in total 56 issuances for a total amount of EUR 44.68 billion.
16. Although they are complex instruments, issuances are in general quite standardised, except for features that are, by nature, institution specific (such as the level of the triggers and the definition of the triggers at different applicable levels depending on the structure of the groups). This is probably partly because there are existence of quite prescriptive provisions in both the CRR and the RTS.
17. Nevertheless, the monitoring process has shown, especially at its starting point, that a few provisions of existing AT1 instruments, or of those AT1 instruments currently under consideration by prospective issuers, should be avoided 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 for some provisions related to regulatory calls, share conversion mechanisms, contingent clauses and covenants.
19. Furthermore, this document provides the EBA's 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. In this last version of the report, and after more than three years of monitoring, the EBA notes that the standardisation of the terms and conditions is still increasing, with some issuers using the provisions proposed in the EBA standard templates published in October 2016 for some definitions or for some parts, or even to a larger extent. The EBA believes that this increased standardisation is partly due to the guidance regularly published by the EBA (via its AT1 report or via Q&As) and regularly communicated by supervisors. As a result, fewer observations have been added than in the previous versions of the report.
22. The EBA expects that forthcoming issuances will retain an even more increased 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 that might raise doubts over, for example, the effectiveness of loss absorption of

the instruments, the EBA would consider taking steps to address this situation.

23. The EBA also expects that issuers will design issuances so that the terms and conditions are not unduly complex, but as simple and as clear as possible. The EBA views efforts to limit the complexity of AT1 instruments as inherently valuable and takes complexity into account when assessing AT1 instruments.
24. Finally, it is to be noted that the first issuances of AT1 instruments after the implementation of the CRR in the EU took place in 2013 and would hence be callable, with the prior permission of the competent authorities, starting in 2018. The EBA will monitor AT1 calls and the rationale for calling/not calling instruments going forward.

Detailed analysis

25. The following sections of the report detail some of these provisions as observed in some contracts or that the EBA is discussing for potential forthcoming issuances (i.e. those not observed in current contracts that should nonetheless still be avoided in future contracts).

Provisions observed in existing issuances

Status of the notes – absence of guarantees

26. According to Article 52(1)(e) of the CRR, the instruments are not secured or subject to a guarantee that enhances the seniority of the claims. In this regard, it is welcome to have provisions in the terms and conditions specifying explicitly that no security or guarantee of whatever kind is, or shall at any time be, provided by the issuer or any other person securing rights of the holders.

Calls

27. The EBA has assessed the provisions related to regulatory calls as set out in Article 78 of the CRR.
28. Some issuances include partial regulatory calls, meaning that a portion of the instruments may be called by the institution if the corresponding part of the issuance is no longer recognised in Tier 1 capital because of a regulatory change.
29. Only regulatory calls for the full amount of instruments are acceptable, regardless of whether regulatory changes trigger a full or partial derecognition from AT1 capital. Partial derecognition from AT1 capital owing to write-down or conversion should not be considered an eligible trigger for a regulatory call.
30. The EBA has also assessed the provisions related to the exercise of calls below par. Some issuances specify that the instrument can be called only 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 that 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, 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. In addition, provisions relating to tax calls should use precise terminology that is in line with the provisions of Article 78 of the CRR. For instance, the terms cannot suggest that a tax event is triggered when ‘there is more than an insubstantial risk’ that additional payments are due on the next payment date. Instead, and in accordance with the CRR, the trigger can only be a material and non-foreseeable change in the applicable tax treatment.
33. Finally, a change in the applicable accounting standards, in particular where this change would not trigger a change in the applicable tax treatment, cannot be considered a valid trigger for a tax call, as this case is not laid down by Article 78(4)(b) of the CRR.

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

34. An example of change in regulatory assessment would be the following: when applying the answer to [Q&A 2013 29](#), the competent authority used to consider that there would not be a tax effect in the event of a write-down, as the institution would probably be facing losses even after taking into account the positive effect of the write-down on retained earnings. Subsequently, based on a specific assessment of the situation of the institution, the competent authority considers that there would be a tax effect and therefore disqualifies part of the instrument.
35. Potential changes in the regulatory assessment cannot be considered valid triggers for regulatory or tax calls.

Redemptions and repurchases

36. The EBA considers that it is appropriate to include in the terms of the instrument a condition stating that the institution should not give a notice of redemption after a trigger event notice has been given. The provisions should also make it clear that, if a trigger event notice is given after a notice of redemption has been given but before the relevant redemption date, this notice of redemption shall automatically be revoked and be null and void and the relevant redemption shall not be made.
37. The possibility of the issuer redeeming or repurchasing the instrument in the context of ordinary, regulatory and tax calls is usually well framed in the terms and conditions, including reference to the necessity of obtaining prior permission from the competent authority as per Articles 77 and 78 of the CRR. However, additional clauses observed in certain issuances go further and protect regulatory own funds even if discretionary repurchases take place without the institution having obtained the prior permission of the competent authority as required. These clauses, which ensure a clawback of every amount that would have been repaid to the investor without the competent authority’s permission, create an obligation for the holder to repay or return all amounts received from the issuer, are welcome.
38. Provisions should not include terms that seem to indicate that purchases of the instrument are possible at any time. Under the CRR and the RTS, purchases are not possible at any time (see Articles 77 and 78 of the CRR in particular). Furthermore, they are subject to the limits laid

down in Article 29 of Commission Delegated Regulation (EU) No 241/2014 (the RTS on own funds Parts 1 and 2). [Q&A 2013_290](#) also provides an important reference, as it makes clear that exchanges — but not other types of liability management exercises (LMEs) — are possible before five years under exceptional circumstances.

39. That being said, LMEs and particularly a reference to the corresponding Q&As (especially [Q&A 2013_290](#)) should not be referred to or included in the terms and conditions. On the contrary, reference to market making is possible, as this comes from a technical standard that is binding and of direct application, and not from a Q&A. In this last case, the drafting of the terms and conditions should mention the prior permission of the competent authority and the limits referred to in the Article 29 of the RTS.

Cancellation of distributions

40. As formulated in the AT1 standardised templates, the EBA considers that it is appropriate to include in the terms of the instrument a mention that, upon the issuer electing to cancel (in whole or in part) any distribution payment of the instrument, any failure to give notice shall not affect the validity of the cancellation and shall not constitute a default for any purpose.

Event of default

41. Some issuances provide a reference to national bankruptcy acts according to which noteholders may take legal action if the issuer for more than [xx] days has failed to pay any amount that has become due. It is not clear why this condition is needed, while at the same time it is clear from the provisions that interest cancellation and/or conversion does not constitute an event of default. Provisions should not include terms that seem to indicate that the non-payment of any amount due may lead to an event of default. On the contrary, it is best practice for the terms to make it clear that such non-payment is not an event of default.

Tax gross-up clauses

42. Regarding tax gross-up clauses, the EBA is of the view that:
- It should be clarified that the gross-up clause is activated by a decision of the local tax authority of the issuer, not of the investor.
 - Increased payments should be possible only if they do not exceed distributable items.
 - Gross-up cases should be allowed only in relation to dividend/coupon withholding tax (gross-up on principal is not allowed).
 - Where changes in the withholding tax are triggers for a tax event, the terms should make clear that such an event would be subject to the conditions applicable to the tax calls laid down in Article 78(4)(b) of the CRR. Furthermore, this is subject to the condition that the change in the withholding tax results in an increase in the cost of the issuance for the institution. If that is not the case, the tax change will not be considered to be material. In practice, this means that a withholding tax change without a gross-up on dividends/coupons

cannot be considered a trigger for a tax event.

43. In addition, it is to be noted that the EBA received a Q&A asking if gross-up clauses on Tier 2 instruments should be allowed and if so under which conditions. The submitter of the question referred in particular to the content of the AT1 Monitoring Report and asked if such an interpretation would apply in the same manner to Tier 2 instruments.
44. As indicated in its answer to the question (see [Q&A 2016 2849](#)), the EBA has provided the view that the same interpretation should be applied to AT1 and Tier 2 instruments, save for the provisions which are not relevant to the latter (e.g. the reference to distributable items). More precisely, Tier 2 gross-up clauses can be considered acceptable if (i) they are activated by a decision of the local tax authority of the issuer and (ii) they relate to dividends and not principal.

Write-down or conversion

45. 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.
46. However, it might be thought that an instrument with such a feature could not be fully written down and, therefore, the condition laid down in Article 54(4) of the CRR would not be met.
47. The EBA considers that the instrument can still be seen as fully written down on condition that the amount that cannot be written down (i.e. one cent per note) is not included in AT1 capital. Alternatively, it may be possible to use reserves to avoid an explicit floor for 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 the reserves/retained earnings and assigned to each AT1 note. In this case, the instrument would also be considered fully written down on condition that the amount that cannot be written down (i.e. one cent per note) is not included in the CET1 capital (more specifically, in the reserves/retained earnings).
48. In any case, the maximum floor should be the one required by commercial/civil law (assuming that this would be an insignificant amount).
49. Some provisions specify that there would be a permanent write-down rather than a conversion in the event that an institution was unable to deliver the CET1 instruments into which the instruments would have been converted. 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, which requires authorised capital to be, at all times, sufficient to ensure the conversion. In other words, this type of clause is acceptable only if it does not entail relaxing the requirements for the conversion but simply guarantees

that loss absorption would happen in different possible situations. Another form of that provision, which is deemed to be equivalent, waives the obligations of the issuer before conversion with respect to the repayment of the principal amount of the AT1 instruments and to the payment of interest or any other amount in respect of those instruments.

50. 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 they are not converted or written down for any reason, this should not prevent the AT1 instrument itself from being converted or written down. More generally, a conversion or write-down of the instrument should depend only on a breach of the trigger and should not be prevented by any other event.
51. Provisions should not include curing a trigger event in two stages, where the first stage is the cancellation of coupons. In this case, the first remedy to the breach is the cancellation of coupons, and the write-down (or conversion) happens only if the cancellation of coupons is not sufficient to cure the trigger event. This provision should be avoided, as there should be an automatic write-down (or conversion) as soon as the trigger is breached. Nothing should prevent the loss absorption mechanism from taking place and it should not be conditional. It should happen even if the cancellation of coupons is enough to cure the trigger event (i.e. the cancellation of coupons should happen in addition to the curing of the trigger event).
52. The terms and conditions of the instrument shall use the calculation for the write-up as provided in the RTS and not a different one (i.e. the correct formula and the correct definition of 'profits').
53. Provisions 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 (pre-condition). Failure to provide a notice shall not prevent the exercise of the loss absorption mechanism, and the mention of notices should not show any order (e.g. the notice first and then the write-down or conversion). Article 54(5) of the CRR does not list the different steps as cascading events.
54. In cases where the conversion is not made in shares of the issuing entity but is made in shares of the holding company, it is prudent for convertible instruments to have an emergency permanent write-down provision available in case the conversion cannot take place as intended. Generally, any provision complicating the conversion makes the inclusion of the emergency permanent write-down more pressing. Therefore, for instruments with a specific type of conversion where the first step is conversion into shares of another entity of the group, this entity then subscribing to the shares of the issuer shall include an emergency permanent write-down in case the conversion fails. This is all the more necessary because the CRR does not provide for the direct conversion into shares of an entity other than the issuing entity.

Other issues

55. Regulatory call provisions should not read as if supervisory approval were a given. Furthermore, the fact that the issuer determines, at its own discretion, that the instruments are subject to ‘any other form of less advantageous treatment’ cannot be a trigger for a regulatory call.
56. No provision should link a change in payments to contractual, statutory or other obligations, as payments are fully discretionary. Payments should also not be linked to payments on other AT1 instruments.
57. In the same vein, no provision should link the write-up of the instrument to contractual, statutory or other obligations, as write-ups are fully discretionary.
58. It would be appropriate to specify the interaction between the loss absorption of AT1 and Tier 2 instruments in the terms in order to provide clarity to holders. In the same vein, it would be appropriate to insert sequencing on loss absorption between full or partial write-downs or conversions of different categories of instruments.
59. Provisions stating that an institution will have to provide for its guarantee if a subsidiary of the institution substitutes to the institution for all obligations of the institution under the AT1 notes should be carefully assessed. The guarantee could be necessary to cover some restructuring of the issuer, but this can be accepted only if (i) the guarantee is subordinated, (ii) there is no guarantee on the cancelled coupons, so that flexibility of payments is kept at any time, and (iii) the guarantee is specific enough and its scope is restricted to a change affecting the issuer, such as a restructuring or a merger (general guarantees cannot be accepted). In addition, the competent authority should reassess the eligibility of the instrument after restructuring.
60. The inclusion of provisions that would allow AT1 holders to propose changes to the terms and conditions of an instrument could be acceptable from an own funds perspective only where the issuer has the right to refuse the changes and the competent authority has the possibility to object where necessary, as long as the changes may affect the prudential aspects. It should be recalled that [Q&A 2013_16](#) introduces the general principle that a material change in the terms and conditions of a pre-existing instrument shall be considered in the same way as the issuance of a new instrument. More generally, it is recommended that any changes foreseen in the terms and conditions of an issuance are notified in advance to the competent authority, as such changes may affect the eligibility criteria for classification as regulatory own funds instruments, so that the competent authority has the opportunity to express a view on these changes, in particular with regard to their materiality.

Pre-emption right for shareholders

61. Some issuances include share conversion clauses that give shareholders the chance to buy the shares from the conversion (i.e. pre-emption right to shareholders) and give cash to AT1

holders as compensation.

62. The EBA initially expressed some reservations about this type of clause, raising questions about its necessity for an institution listed on a stock exchange where shares can be bought on the market, and particularly underlining that clauses mitigating the risk of dilution should not be encouraged.
63. On the other hand, the EBA also considered that writing down instruments does not result in a dilution of the shares. Furthermore, giving current shareholders the possibility of buying the shares resulting from the conversion could simplify the process regarding the application of ‘fit and proper’ rules for qualifying holdings after the conversion and guarantee some stability in the shareholders’ structure. Finally, the fact that shareholders may buy the shares does not jeopardise the loss absorption, as the conversion will increase CET1 regardless of the identity of the investor paying for the shares.
64. In the end, despite initial reservations, the EBA agrees that this feature is acceptable.

Formal issues

65. 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 that makes it unclear whether or not they do actually apply (e.g. ‘it is expected that’, ‘if required by the regulation’, etc.). Provisions should be worded clearly.
66. 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 that may create confusion with the Level 1 provisions (the CRR or the 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 laid down in the CRR (1 month).
67. 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. The EBA noted a need for further guidance in that respect, as exemplified by recent issuances, for which the wording used was not always satisfactory. The definition of the trigger event should be clear and simple. In particular, the definition should explicitly refer to the possibility of calculating ‘at any time’. In addition, it should avoid making references to ‘as determined by the bank’ or to regulatory reporting dates.
68. An adequate formulation for the trigger event is the following: ‘capital adequacy trigger means, at any time, that the CET1 capital ratio of the Issuer is below [xx%]; whether the capital adequacy trigger has occurred at any time shall be determined by the Issuer, the Competent Authority [or any agent appointed for such purpose by the Competent Authority]’. This wording is used accordingly in the proposed standard AT1 templates. It should be noted that having a reference to the competent authority is seen as prudent, as the competent authority could also determine that a trigger event has occurred.

69. 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 cause uncertainty regarding the application of the CRR and could be understood as questioning its applicability.
70. Terms should refer to associated arrangements (such as covenants) only when they make clear what those arrangements are, either by a description of the terms of the arrangement that affect the terms of the instrument or by using a hyperlink to the text of the arrangement, or simply by attaching the terms of the arrangement. In any case, it is desirable to exclude any reference to associated arrangements that affect the prudential terms of the instruments.
71. It is preferable not to have detailed lists of situations where the institution will not make distributions, as it creates the impression that the list covers all eventualities when this may not be the case.

Contingent clauses

72. 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 the AT1 status was lost (contingent settlement mechanisms). It is to be noted that current AT1 issuances without this clause are generally classified as equity under IFRS standards by European institutions.
73. The EBA is aware of the potential benefits of such clauses, as argued by market participants. In particular, this is believed to be the only practicable way to ensure that an AT1 instrument is treated as debt under IFRS. This, in turn, ensures the possibility of using hedge accounting.
74. In particular, using contingent clauses would allow (via debt accounting) cover against volatility in own funds due to foreign exchange risk or interest rate risk. In addition, in some jurisdictions, an issuer’s ability to deduct interest payments for tax purposes may be undermined if the AT1 is classified as equity instead of debt. Finally, not allowing contingent clauses may render issuances more difficult and expensive for some non-Eurozone institutions in particular.
75. On the other hand, there are drawbacks to allowing the use of contingent clauses by EU institutions. These are of a different nature.
76. Contingent clauses introduce complexity and there may be unintended consequences from the existence of such provisions. They might, for example, constrain regulatory changes — as those would lead to disqualification and the activation of the clause — making a whole array of instruments ‘must pay’.
77. While the CRR does not require equity classification for AT1 instruments, the accounting treatment should be derived from genuine reasons. In addition, if the accounting rules change, the contingent clause may become useless and issuers may need a new type of provision to ensure a debt treatment. In addition, it is expected that issuers will be inclined to use an additional specific clause in order to trigger a debt classification for pre-existing issuances currently classified as equity.

78. It would need to be demonstrated that AT1 instruments with temporary write-down features accounted as debt under IFRS would create CET1 for the full amount of the instrument when written down with regard to the CRR provisions, which require that write-down or conversion of an AT1 instrument shall, under the applicable accounting framework, generate items that qualify as CET1 items. With this in mind, a haircut for the inclusion of the instruments in own funds could be introduced in order to take this possibility into account.
79. After having considered all the benefits and drawbacks of such clauses, it is the EBA's view that, while presenting some benefits (particularly in terms of hedge accounting), contingent clauses present the prudential concerns as expressed above and these are deemed to outweigh the potential benefits.
80. In addition, the EBA is of the view that opening the door to this type of clause will lead to the acceptance of other types of clauses and will undermine the EBA's expectation expressed in the report that terms and conditions should be kept simple. This will probably lead to a new round of financial innovation around AT1 instruments.
81. The EBA thus recommends disallowing the use of contingent clauses in the terms and conditions of EU issuances.
82. Finally, alternatives to the contingent clause in which the concept of coupon payment is shifted to a concept of principal payment (i.e. where the institution would be obliged to redeem the principal amount of the instrument following a full loss of AT1 regulatory capital treatment) are also not acceptable, as this would make the redemption of the instrument mandatory.

Provisions for potential forthcoming issuances

83. 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.
84. 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 a provision such as this would fall into that category.

Contingent conversion convertibles

85. It seems that some EU institutions are studying the possibility of issuing contingent conversion convertibles. Simply described, the idea is to structure an AT1 instrument with a loss absorption feature through conversion and to add a conversion option for the holder if the share price of the institution is above a certain price (upside conversion). The presence of the option for the holder would potentially help in reaching a new type of investor and would reduce coupons.
86. There has been at least one issuance of this type in the EU, but it has to be recalled that the issuance was made before the entry into force of the CRR and the related RTS.
87. One of the forms of incentives to redeem as identified in Article 20(2) of Commission Delegated Regulation (EU) No 241/2014 (the RTS on own funds Parts 1 and 2) is '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’.

88. In order to comply with the provisions of the RTS, some proposals could feature an upside conversion up to the first call date in order to avoid the possibility of a conversion following a call date. 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.
89. It has to be noted that, in this type of structure, the reset at the first call date would probably always be an increase in the coupon, whereas a normal reset could also drive the coupon down. A conversion option itself before 5 years is not a problem, but should not be featured with the sole objective of reducing the cost of issuance (as this would be seen as an incentive to redeem at the first call date).
90. Conditions that could be considered for accepting this type of instrument are cases where the subscriber is an existing shareholder or cases where the conversion option is to be exercised as a result of change in the ownership of the institution. Even in these cases, the terms of the conversion option should be carefully assessed and, as stated previously, there should not be a direct link with a reduction of the coupon.
91. In theory, a conversion option in an issuance with no call date could be acceptable, although it is likely that the interest in such structures would be low, as there would be no subsidy of the coupon in this case (the cost of the issuance at inception would be higher).

Interpretation of some CRR provisions

92. 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 for 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

93. The existence of different triggers raises the question on the 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 a (sub-)consolidated or a solo basis (sometimes called the 'maximum write-up amount') and when the triggers on the solo and the (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 the total Tier 1 capital.
94. 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 amount of the profits (or net income) arising from the different levels. For instance, assuming that the profit calculated on a solo basis is lower than the profit calculated on a consolidated basis, the relevant amount for the purposes of the write-up should be capped at the level of the profit calculated on a solo basis.
95. While the maximum amount to be used for the write-up based on the use of the 'lower of the profits' is usually before the application of the write-up formula, the EBA would not prevent using the 'lower of the write-up amount' obtained after the application of the write-up formula. This is particularly relevant in cases where comparing the results of the formula using, on the one hand, the profits on a solo basis and, on the other hand, the profits on a consolidated basis would lead to more conservative results.

Triggers for instruments issued within a banking group

96. Under the 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 (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, particularly when the issuer is not the head of the group.
97. Different situations may arise: banking groups with a parent institution; banking groups with a parent holding company; and mutual groups with a central body.
98. 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, based on sub-

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

99. Where an institution is subject to Article 11(2) of Regulation (EU) No 575/2013 — i.e. in cases where an institution is controlled by a holding company — in order for AT1 instruments to be included as qualifying Tier 1 instruments in the consolidated Tier 1 capital of the holding company within the limits laid down in Article 85 of the CRR, the terms and conditions of the instruments issued by that institution should include a trigger event on the basis of the consolidated CET1 of the parent financial holding company or parent mixed financial holding company. The absence of this trigger would make the issuance ineligible for the purpose of the computation of the consolidated Tier 1 of the holding company. However, the issuance would still be eligible at the sub-consolidated and solo levels if it included triggers at these levels.
100. It is worth specifying that it would not be possible for an AT1 instrument issued by a subsidiary to have only a trigger based on the consolidated solvency of the parent holding company: the trigger at the level of the issuing entity is mandatory, except in cases where Article 7 of Regulation (EU) No 575/2013 is applied. Without that trigger, the instrument would be disqualified at all levels, based both on a reading of Article 54 of the CRR and on concerns that the absence of this trigger would not be prudentially sound.

Group/solo triggers for the eligibility criteria for instruments issued by subsidiaries in third countries (calculation of third-country CET1)

101. In addition to the issue of triggers — which is relevant for both 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 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.
102. 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.
103. More generally, and as mentioned in [Q&A 2013 385](#), instruments issued by subsidiaries in third countries shall comply with all requirements that are specified under the CRR and associated implementing regulations in order to be eligible at the level of the group. In particular, for the purposes of the definition of the trigger event, the CET1 capital shall be calculated in accordance with the provisions of the CRR.

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

104. When an institution issued instruments with different triggers (e.g. 5.125% CET1 or ‘low’ trigger and 7% CET1 or ‘high’ trigger), it is possible for all the triggers to be hit *simultaneously* (e.g. the CET1 of the institution is reduced to 4.5% from over 7%).
105. In that specific case, losses corresponding to the amount required to go back to 5.125% should be absorbed by both the low-trigger and high-trigger instruments on a pro rata basis. Losses above 5.125% will be supported by only the high-trigger instrument.

Loss absorption in cases where the definition of loss-absorbing instruments is extended beyond AT1 instruments

106. It was observed in some issuances that the definition of (Other) Loss-Absorbing Instruments contains other obligations or capital instruments (apart from the AT1 instruments that are subject to the issuance or other AT1 instruments) which are intended to absorb losses on a pro rata basis and which contain a loss absorption mechanism activated by an event equivalent to the trigger event for the AT1 instruments subject to the issuance and with a threshold for such activation which may be identical to, higher than or lower than the trigger event threshold as defined for the AT1 instruments subject to the issuance.
107. In cases where the definition of (Other) Loss-Absorbing Instruments includes non-AT1 instruments (for example Tier 2 instruments) and where trigger levels can vary rather than being identical, the principle of the pro rata basis laid down in the RTS on own funds (Article 21(1) of the RTS on own funds Part 1) for operating the write-down of several instruments among all holders of AT1 instruments that include a similar write-down mechanism and an identical trigger level could not be implemented. Hence, this type of extensive definition should be avoided.

Tap issuances

108. The question is whether or not tap issuances — meaning subsequent issuances made fully fungible with the original issuance (same coupon, same frequency of payments, ISIN etc.) — with the same reset mechanism applied to the tap leading to a different result from that for the original issuance may be considered as creating incentives to redeem.
109. More precisely, where a tap of an instrument is priced at a lower credit spread than the initial spread of the original issue, this raises the question of whether or not the reset of the margin for both the tap and the original issuance at the identical first call date to the initial spread of the original issue should be considered an incentive to redeem.
110. In its analysis of the specific situation of tap issuances, the EBA had regard to Article 20(2)(c) of the RTS on own funds Parts 1 and 2. This provision clearly states that ‘a call option combined with a change in reference rate where the credit spread over the second reference rate is greater than the initial payment rate minus the swap rate’ constitutes an incentive to redeem. From this it follows that, if the reset mechanism of the original bonds is set to apply

more than five years after the tap issuance and also applies to the latter, there is an incentive to redeem if the credit spread for the tapped amount increased because it was lower than the credit spread of the original bond.

111. The EBA Banking Stakeholder Group (BSG) has also been consulted on this issue, in particular with a view to assess in more detail current market practices and issuances and any potential impact of disallowing tap issuances.
112. BSG representatives argued that the position taken by the EBA in the previous point could disincentivise institutions from making tap issuances, whereas tap issuances limit the costs of making a completely new issuance and allow the institution to take the chance of benefiting from certain market opportunities that may arise shortly after the original issuance was placed. Obviously, this is on the assumption that the tap issuance would present exactly the same terms and conditions as the original issuance, would be fully fungible and would have a call date a minimum of five years after the date of the tap issuance.
113. Furthermore, tap issuances in the future may concern not only own funds instruments but also issuances of eligible liabilities. It is also to be noted that tap issuances for AT1 instruments are not a common practice at the moment (unlike tap issuances for senior bonds).
114. As indicated in the answer to [Q&A 2016 2848](#), a tap of an instrument (being an AT1 or T2 instrument) shall be considered as a new issuance (see [Q&A 2013 238](#)). If the reset mechanism of the original bonds is set more than five years after the tap issuance and the mechanism also applies to it, there is an incentive to redeem in the sense of Article 20(2)(c) of Commission Delegated Regulation (EU) No 241/2014 if the credit spread for the tapped amount increased because it was lower than the credit spread of the original bonds.
115. In providing this answer, the EBA took the view that the current texts of the CRR and corresponding technical standards on own funds do not leave much room for manoeuvre. In addition, the EBA was concerned about introducing increased complexity to the own funds framework by setting possible criteria for allowing tap issuances (e.g. a given timeframe for the tap to take place or amount constraints in terms of complementary amount to the original issuance) whereas it seems, based on the outstanding issuances, that the impact of not allowing them would be limited.



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