EUROPEAN BANKING AUTHORITY

UPDATE OF THE ADDITIONAL TIER 1 REPORT

18 May 2015

Public hearing

The objectives of the report

- The broad policy objective remains unchanged; just as in the October version, the report focuses on the implementation of the eligibility criteria for Additional Tier 1 in practice, as part of the EBA's monitoring role pursuant to Article 80 of the CRR.

- There is a need to ensure effective compliance with the criteria in practice. The criteria are not only formal requirements; they have been laid down to result in the correct outcomes from a supervisory perspective. This means, for instance, that instruments should genuinely be loss-absorbing and payments genuinely discretionary.

- This objective can be impeded by unclear or unduly complex provisions as those create uncertainty about the ability of institutions to use the provision in the way intended when the need arises; for instance, poorly written loss absorption provisions may result in no loss absorption at all in practice. Unclear or complex provisions may restrict the ability to cancel payments in practice. Including new provisions that have not been tested may lead to unforeseen consequences.

- For those reasons, the EBA sees value in :
    - simplicity and clarity of AT1 provisions;
    - Ensuring a high level of convergence in AT1 provisions. This is without prejudice to the different forms of loss absorption (write down or conversion), or levels of triggers, permitted by the CRR.

Way forward from the final draft report presented today

- The draft final report published on 4 May contains final guidance on a number of topics that were identified in the October version as necessitating more work. It also introduces guidance on new issues that were identified while monitoring new issuances.
- The final version of the report will take into account technical comments made during the public hearing for the purpose of clarification where needed.
- Further updates can be expected to complement already published guidance, to tackle new issues stemming from new issuances of AT1 instruments. In that case new versions of the report may be published at a later stage, without a predetermined frequency, depending on whether needs are felt. GLs may also be considered.
- The report will be complemented by standardised provisions presented in a template similar to the 2011 BCCS – possibly with a mix of detailed language for some provisions and slightly higher level guidance for other provisions.

Summary of the changes to the October version

In the order of the report, the main changes are related to:

- The triggers for regulatory calls
- Tax gross up
- Preemption rights for shareholders
- Contingent clauses
- Triggers in a banking group;
- Loss absorptions by instruments with different triggers.

Those topics are presented in the next slides.

Triggers for regulatory calls

- After the publication of the October report, a question arose about the ability of issuers to call instruments which are grandfathered and therefore only partially eligible in regulatory own funds.

The expression “full regulatory call” mentioned in the October could be understood in two ways:

- A regulatory call on the **full amount** of the instrument
- A regulatory call where **the trigger is the full disqualification** of the instrument.

The May report clarifies that regulatory calls on the full amount of the instruments are acceptable regardless of whether the trigger for the regulatory call was a partial or a full derecognition of the instrument from Additional Tier 1. This clarification could be important for grandfathered instruments with partial de recognition under possible future grandfathering rules. It was clarified, for the avoidance of doubt, that this rule would not apply in the case of a partial eligibility as a result of a write down.

- In addition, it was clarified that a change in the regulatory assessment of the tax effects of a write down would also not be considered as a valid trigger for a regulatory write down.

Tax gross up

Tax gross up provisions could be seen as increasing the burden on the issuer as their activation would result in additional payments.

They are however considered acceptable if:

1. they get activated by a decision of the local tax of the institution, not of the investor.
2. Increased payments resulting from activation should only be possible if they do not exceed distributable items.
3. Gross up cases should also only be possible in relation to changes of withholding tax related to distributions (dividends/coupons).

Pre-emption rights for shareholders

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 October report indicated that 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.

The EBA's opinion is still that mitigating the risk of dilution should not be encouraged in principle; however, it was also noted that write down instruments, which are eligible under CRR, do not entail any dilution risk.

Furthermore, giving current shareholders a possibility to buy the shares resulting from the conversion could simplify the process regarding the application of fit and proper rules for qualifying holdings after the conversion and guarantee some stability in the shareholders structure.

Finally, the fact that shareholders may buy the shares does not jeopardise the loss absorption as the conversion will increase CET1 regardless of the identity of the investor paying for the shares.

This provisions is therefore deemed to be acceptable.

Contingent clauses

A contingent clause is a clause that makes interest payments mandatory in the event that AT1 status of the instrument is lost. A variant is a clause according to which there would be a permanent and compulsory change in status of the instrument to subordinated debt, with corresponding reduction in coupon and must-pay features, upon full disqualification from AT1.

Contingent clauses - for which the October report mentioned some reserves while underlining that the EBA would continue investigating this specific aspect – have been much debated, as there are pros and cons to allowing them.

The main argument in favour of that provision is that it ensures that an AT1 instrument with a temporary write down feature is treated as debt under IFRS. This in turn ensures the possibility to use hedge accounting or to achieve tax deductibility in some countries.

However, contingent clauses introduce complexity and there might be unintended consequences from the existence of such provisions. It might for example constrain regulatory changes as those would lead to disqualification and activation of the clause, making a whole array of instruments 'must pay'.

Contingent clauses

While the CRR does not require equity classification for AT1 instruments, the accounting treatment should derive from genuine reasons. In addition, if the accounting rule changes, the contingent clause may become useless and issuers may need a new type of provision to ensure a debt treatment. It would also 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 .

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.

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

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

Therefore, the EBA confirms its previous reserves, and recommends disallowing contingent clauses.

Triggers in a banking group

Principle : one trigger for each solvency test applicable at the level of the issuing entity (solo, subconsolidated, consolidated)

On this basis , the conclusions of QA 385 still hold:

[…] Additional Tier 1 instruments issued by a subsidiary institution should include a trigger based on the solvency requirements applicable to the subsidiary. If those requirements are on a solo basis, then the trigger should be on a solo basis. If those requirements are on a sub-consolidated basis, then the trigger should be on a sub-consolidated basis. If the subsidiary is subject to solvency requirements on both solo and sub-consolidated level, then it should have triggers on both a solo and sub-consolidated basis.

A trigger on the basis of the solvency requirement of the group is not mandatory, however, such a trigger is possible. Even if an instrument issued by a subsidiary includes such a trigger, it will not be included in full in the consolidated Tier 1 of the group as it will not be able to absorb losses at the level of the group. The provisions of Article 82 and 85 of the CRR would apply.

Instruments issued by subsidiaries 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.

Triggers in a banking group

However, the report deals with the specific case of Article 11(2) which was not covered in QA 385.

As a result of the application of article 11(2) (i.e. in cases where an institution is controlled by a holding company), issuances from a subsidiary should include a trigger at the level of the holding company, in addition to other relevant triggers in particular at the level of the issuing institution.

The absence of this trigger would render the issuance non eligible for the purpose of the computation of the consolidated Tier 1 of the holding company. However, the issuance would still be eligible at subconsolidated and solo levels if it includes triggers at these levels.

On the contrary the presence of this trigger would render the issuance eligible at the level of the consolidated Tier 1 of the holding company, however within the limitation of the minority interest rules.

This is only the case when Article 11(2) is applicable, i.e. when the parent is a holding company.

This guidance also does not affect the issuances from the parent (holding or institution).

The next slide summarises the possible cases for issuances out of a subsidiary.

Triggers in a banking group

The parent is…	A bank		A holding company	
The instrument issued by the subsidiary includes a group trigger (i.e. a trigger based on the solvency of the parent)	Yes	No	Yes	No
Recognition of the instrument at the level of the subsidiary (solo and subconsolidated)	Yes	Yes	Yes	Yes
Recognition at the level of the parent	**Yes, but minority interest rules apply**	**Yes, but minority interest rules apply**	**Yes, but minority interest rules apply**	**No**

Loss absorption by instruments with different triggers

An institution may issued instruments with a 5.125% trigger in combination with instruments with a 7% trigger. The terms and conditions shall explain how losses would be allocated to those two different types of instruments if they coexisted.

It shall be noted that the loss absorption is relatively straightforward when the CET1 is subject to a gradual erosion, meaning that only the 7% trigger is hit. In that case, instruments with lower triggers would not absorb losses.

However if there is a sudden loss and the CET1 drops below 5.125% from above 7%, then both types of instruments should absorb losses as both triggers have been hit. In practice, the low trigger instruments should only absorb losses up to the point where the CET1 of the institution is back above the low trigger (5.125%), whereas the high trigger instrument should absorb losses up to the point where the institutions CET1 is above 7%.

Others topics added to the report

In addition to the main issues mentioned above, the following topics have been added to the report:

- Trigger events take precedence over redemptions
- Trigger events should not be prevented by other events
- Unambiguous language should be used regarding the supervisory approval
- Payments and write ups not linked to other obligations but truly discretionary
- Clarity about the interaction of loss absorption of AT1 and Tier 2 instruments – if Tier 2 instruments have explicit loss absorption provisions.
- The relevant amount for the write up should be the lower of the amounts at the applicable levels of solvency (could be individual, sub-consolidated, consolidated).

Any questions?

Thank you!

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