



DRAFT AT1 STANDARD TEMPLATES AND UPDATED MONITORING REPORT

Public hearing - 26 July 2016

Outline

- 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’ and, ‘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’.
- On 24 May 2015, the EBA published its first updated report on the monitoring of Additional Tier 1 (AT1) instruments of EU institutions.
- When publishing its report, the EBA announced that it would develop standardised terms and conditions for AT1 issuances which would cover the prudential parts of the terms and conditions.



1/ AT1 standard templates

2/ Second update of the AT1 monitoring report

AT1 STANDARD TEMPLATES

AT1 Draft Standard Templates - rationale

- Increased standardization through templates :
 - ✓ Helpful for small institutions;
 - ✓ Help the EBA in its monitoring role of issuances and supervisors in their assessment of the compliance of issuances;
 - ✓ Mitigate complexity of the AT1 instruments;
 - ✓ Prevent potential deterioration in the quality of AT1 instruments.
- Some jurisdictions are already using standard templates (when the fiscal authority made coupon deductibility conditional on the use of such templates).
- Some sort of standardisation is already taking place for some clauses (some issuances are already using similar terms and conditions).
- The use of these templates would bring a certain level of security to the issuing banks (reflect the expectations of the supervisory community on the practical implementation of the provisions of the CRR, RTS and Q&As) based on the experience gained with issuances already made.

AT1 Standard Templates - rationale

- To be proposed to institutions (and competent authorities where the case may be) on an opt-in basis :
 - ✓ The proposed standardised templates are not legally binding. Their use by institutions is optional and the absence of use of the templates does not render the concerned issuances (existing and future) non-compliant with regulatory requirements.
 - ✓ Issuers may continue to use their own terms and conditions, as locally applicable, provided those conditions are compliant with regulatory requirements and taking into account the regular EBA guidance given in particular via the AT1 monitoring report and the Q&As.
- The objective of the templates is only to cover the prudential provisions of the issuances (the generally so-called ‘Terms and conditions’ or ‘Principal terms of the notes/securities’ or ‘General description of the notes’ and corresponding definitions. Other aspects of the issuances (like ‘Risk factors’, ‘Use of Proceeds’, ‘Taxation’ etc) are not meant to be covered by the standard templates.

AT1 Standard Templates - structure

- The EBA has considered as a starting point the BCCS termsheet, completed and amended as far as necessary on the basis of the final CRR text, the technical standards on own funds, the AT1 monitoring report and the ongoing monitoring of issuances.
- The templates are organised as follows:
 - Essential provisions which are deemed to be necessary or recommended on the basis of the regulatory requirements and the ongoing monitoring of issuances.
 - Optional provisions which are considered acceptable but not necessary and which would need to be formulated in a specific way if included.
- Essential provisions cover provisions relating to flexibility of payments, permanence, loss absorbency, and in particular the following aspects:
 - For clauses common to conversion and write-down: definitions and main terms of the notes, status of the notes, cancellation of distributions, redemption, trigger event;
 - For clauses specific to conversion: definitions and consequences of a trigger event;
 - For clauses specific to write-down: definitions, consequences of a trigger event, write-up.

AT1 Standard Templates - structure

- Optional provisions cover the following aspects: gross-up clauses, substitution/variation clauses, pre-emption rights.

- EBA has based its work on the issuances most commonly observed in the markets for the time being. The standard templates contain 3 different forms of loss absorption mechanisms:
 - full conversion;
 - partial temporary write-down;
 - and full permanent write-down.

- The templates do not cover aspects related to BRRD/resolution issues, except for contractual bail-in language for instruments issued under third country law which is included on the basis of existing work from the EBA (regulatory technical standards on recognition of bail-in).

AT1 Standard Templates - challenges

- To strike the right balance between simplicity and coverage of all the relevant prudential issues.
- Difficult to foresee all possible cases (i.e. the templates may miss specific features or may contain a provision which is not perfectly fitted for specific structures).
- To update these templates through time, based on further monitoring and to take into consideration developments in market practices in order to ensure that they remain usable.

AT1 STANDARD TEMPLATES- Details

Essential provisions

1. Clauses common to conversion and write-down

Features and main remarkable points *(see separate templates)*

Definitions and main terms:

- Provisions of the templates meant to be used for all levels of application
- Slightly adapted definition of distributable items to exclude Tier 2 coupons from the calculation
- Tax law change: changes in the regulatory assessment of the CA is not a tax law change
- Use of terms: references to liquidation or bankruptcy may be replaced by equivalent terms depending on insolvency law applicable at national level
- Cancellation of distributions : both discretionary and mandatory
- Redemption: notice of redemption, issuer's call option on the basis of a call in full
- Statutory bail-in powers for third country law issuances (in line with EBA RTS)

2. Clauses for full conversion

Features and main remarkable points *(see separate templates)*

Definitions and trigger event:

- ‘CET1 instrument’ wording to be replaced by the appropriate relevant denomination.
- Conversion price: on a case by case basis with CRR minimum requirements.
- Trigger event: addition of a permanent write-down where conversion cannot be triggered (cf. para. 43 EBA AT1 monitoring report).

3. Clauses for partial temporary write-down

Features and main remarkable points *(see separate templates)*

Definitions and main terms:

- Redemption: calls below or at par (cf. para. 29 EBA AT1 monitoring report)
- Definitions of ‘loss absorbing instrument’ and ‘loss absorbing written-down instrument’;
- Sequencing on loss absorption between full/partial write-down/conversion of different categories of instruments;
- Trigger event: write-down not to be dependent on other instruments (cf. para. 44 EBA AT1 monitoring report)
- Calculation of the write-up amount (relevant also for the update of the AT1 report).
- Net Profit: lowest of net profit determined on a consolidated, sub-consolidated or individual basis.

4. Clauses for full permanent write-down

Features and main remarkable points *(see separate templates)*

Definitions and trigger event:

- Nothing specific to be mentioned

AT1 STANDARD TEMPLATES

Optional provisions

Optional provisions

Features and main remarkable points *(see separate templates)*

Definitions and main terms:

- Write-down amount: possibility to have a write-down amount higher than the amount strictly necessary to cure the trigger event
- Gross-up clause: to be activated by a decision of the tax authority of the issuer only, increased payment limited by distributable items, gross up only in relation to dividend/coupons withholding tax (cf. para. 38 EBA AT1 Monitoring report)
- Substitution/variation clause
- Pre-emption

AT1 MONITORING REPORT

Update of the AT1 report

- On 29 May 2015, the EBA published its first updated report on Additional Tier 1 instruments. Since the publication of the report, the EBA has continued to monitor new issuances and has found that there are new notable provisions to be recommended or avoided.
- This second update of the report is based on the review of 33 AT1 issuances from EU institutions, which took place between August 2013 and December 2015, for a total amount of EUR 35.5 bn.
- The objective is to publish the final updated version of the AT1 report along with the final AT1 standard templates.
- To be noted, some of the provisions included in the new version of the report have been integrated in the standard templates.

AT1 report – new provisions

Triggers

- Para. 45: **Provisions should not include curing a trigger event in two stages where the first stage is cancellation of coupons.** *In this case, the first remedy to the breach is the cancellation of coupons, and the write-down only happens 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 as soon as the trigger is breached. Nothing should prevent the loss absorption mechanism to take place, and it should not be conditional. It should happen even if the cancellation of coupons would be enough to cure the trigger event, the cancellation of coupons should happen in addition to the curing of the trigger event.*
- Para. 60: The final report already mentioned that ‘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 definition of the trigger event should be clear and simple. In particular, the definition should explicitly refer to the possibility to calculate ‘at any time’ and avoid making references to regulatory reporting dates.
- Para. 61: **An adequate formulation of the trigger** 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]’.

AT1 report – new provisions

Calls, repurchases, redemptions

- Para. 35: **Provisions should not include terms that seem to indicate that purchases of the instrument are possible at any time.** *Under the CRR and RTS, purchases are not possible at any time (art. 77 and 78 CRR). Further, they are subject to limits laid down in Article 29 of RTS on own funds Part 1 and 2. QA 2013_290 also provides an important reference as it makes clear that exchanges – but not other types of LMEs – are possible before five years under certain circumstances.*
- Para. 36: *That said, LMEs, and in particular a reference to the corresponding Q&As (Q&A 2013_290 in particular) should not be referred to/included in the terms and conditions. Reference to market making is on the contrary possible as this comes from a technical standard (see part on provisions to be usefully included).*
- Para. 37: *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 do not constitute an event of default. Provisions should not include terms that seem to indicate that non-payment of any amount that has become due may lead to an event of default. On the contrary, it is a best practice for the terms to make clear that such non-payment is not an event of default.*

AT1 report – new provisions

Tax events, gross up clauses

- Para. 31: **Provisions relating to tax calls should use a precise terminology** which should be 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.
- Para. 38: Where changes in the withholding tax are triggers for a tax event, terms should make clear that such an event would be subject to the conditions applicable to tax calls laid down in article 78 (4) (b) of the CRR. Further, this is subject to the condition that the change in the withholding tax results in an increase of 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 as a trigger for a tax event.**
- In addition, as per the recommendations of the AT1 report, it is to be reminded that gross up on principal is not allowed.

AT1 report – new provisions

Conversion and write-down mechanisms

- Para. 46: **Terms and conditions shall use the calculation for the write-up as provided in the RTS on own funds and not a different one** (i.e. correct formula, correct definition of profit).
- Para. 87: Further, the report already clarified 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 profit (or net income) arising from the different levels.*
- Para. 47: *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 mention of notices should not show any order (notice first and then write down or conversion). Art 54(5) CRR does not list the different steps as cascading events.*
- Para. 48: **In cases where the conversion is not made in shares of the issuing entity but 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 making the conversion more complex makes the inclusion of the emergency permanent write down more pressing. Therefore, instruments with a specific type of conversion where the first step is conversion in the shares of another entity of the group, this entity then subscribing shares of the issuer, shall include an emergency permanent write down in case the conversion fails. This is even more needed as the CRR does not foresee the case of direct conversion in the shares of an entity other than the issuing entity.*

AT1 report – new provisions

Follow-up on contingent clauses

- Para. 75: Alternatives to the contingent clause *where the concept of coupon payment is shifted to a concept of principal payment, i.e. the institution would be obliged to redeem the principal amount of the instrument following a full loss of AT1 regulatory capital treatment, is not acceptable as this would make the redemption of the instrument mandatory.*

Other issues - guarantees

- Para. 53: Provisions stating that, “in case a subsidiary of the institution substitutes to the institution for all obligations of the institution under the AT1 notes, the institution will have to provide for its guarantee”, 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, like a restructuring or a merger (general guarantees cannot be accepted). In addition, the competent authority should re-assess the eligibility of the instrument after restructuring.*

AT1 report – new provisions

Other issues – Contingent Conversion Convertibles

- *Para. 78: AT1 instrument with a loss absorption feature through conversion with a conversion option for the holder if the share price of the bank is above a certain price (upside conversion). The presence of the option for the holder would potentially help reaching a new type of investors and would reduce coupons.*
- *Para. 80: One of the forms of incentive to redeem identified in article 20(2) of RTS on own funds Part 1 and 2 is ‘a call option combined with a requirement or an investor option to convert the instrument into a Common Equity Tier 1 instrument where the call is not exercised’.*
- *Para. 81: Some proposals 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 issue date to first call date. The initial credit spread or margin will result from the comparison between the non-subsidised coupon level agreed between investors and issuer. In that case, the ‘coupon subsidy’ would disappear at the first reset which would have a material effect on the coupon.*

AT1 report – new provisions

Other issues – Contingent Conversion Convertibles (ct'd)

- *Para. 82: It has to be noted that the reset at the first call date will probably always be an increase in the coupon, whereas a normal reset could also drive the coupon down. A conversion option itself before the 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.*
- *Para. 83: 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 bank. 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.*
- *Para. 84: 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).*

AT1 report – new provisions

Other issues – write-up calculation

- Para. 88: **The maximum amount to be used for the write-up ('lower of')**: the recommendation of the AT1 report based on the use of the 'lower of the profits' before application of the write-up formula is maintained, while not preventing using the 'lower of the write-up amount' obtained after application of the write-up formula comparing the results of the formula using on one hand the profits on a solo basis and on the other hand the profits on a consolidated basis, which would lead to more conservative results (see AT1 standard templates).

Provisions which could be usefully included (best practices)

- Para. 36: **Provisions on purchases, including market making could be usefully included**. In this case, *the drafting used should mention the prior permission of the CA and the limits under Article 29 of the RTS Part 1 and 2 as granted by the CA (as these limits may be lower than the ones mentioned in the RTS).*
- Para. 52: Where possible, *it is also appropriate to **insert sequencing on loss absorption** between full/partial write-down/conversion of different categories of instruments (see AT1 standard templates).*

Next steps

- Amending where needed the AT1 standard templates and updated report following public hearing discussions.
- Final versions of the standard templates and updated AT1 report to be published ideally by October 2016.



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