EBA/Op/2020/17

21 October 2020

Opinion of the European Banking Authority on the prudential treatment of legacy instruments

Introduction and legal basis

1. In order to ensure that institutions had sufficient time to meet the required levels and definition of own funds set out in Regulation (EU) No 575/2013[1] (the Capital Requirements Regulation or CRR), this Regulation introduced in 2013 grandfathering provisions.[2] Certain capital instruments that, at that time, did not comply with the new definition of own funds (hereinafter referred to as 'legacy instruments') were grandfathered for a transition period, the objective being that they would be gradually phased out from own funds.[3]

2. The beneficial treatment provided by the grandfathering provisions will come to an end on 31 December 2021. In line with its mandate to monitor the quality of own funds and eligible liabilities instruments issued by institutions across the Union, the EBA has been working to assess the materiality of the outstanding amounts of legacy instruments and to understand institutions' actions and intentions regarding the phasing out of these instruments at the end of the grandfathering period. In 2019, the EBA announced its intention to provide clarity on the appropriate prudential treatment to ensure a high quality of capital for EU institutions and a consistent application of rules and practices across the Union.[4]

3. The EBA's competence to deliver this Opinion is based on Article 29(1)(a) of Regulation (EU) No 1093/2010,[5] as part of its tasks of building a common Union supervisory culture and consistent supervisory practices, ensuring uniform procedures and consistent approaches throughout the Union, including in the area of own funds and eligible liabilities requirements, and monitoring

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2012, p.1).

[2] Chapter 2, Title I, Part Ten of the CRR.

[3] Recital 119 of the CRR: 'In order to ensure that institutions have sufficient time to meet the new required levels and definition of own funds, certain capital instruments that do not comply with the definition of own funds laid down in this Regulation should be phased out between 1 January 2013 and 31 December 2021.'

[4] EBA press release: https://eba.europa.eu/eba-will-clarify-the-prudential-treatment-applicable-to-own-funds-instruments-at-the-end-of-the-grandfathering-period-expiring-on-31-december-2021

[5] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

the quality of own funds and eligible liabilities instruments issued by institutions across the Union, in accordance with Article 29(1), first subparagraph, of that Regulation and Article 80(1) of the CRR.

4. In accordance with Article 14(7) of the Rules of Procedure of the Board of Supervisors,[6] the Board of Supervisors has adopted this Opinion, which is addressed to competent authorities as defined in point (i) of Article 4(2) of Regulation (EU) No 1093/2010.

5. In preparing this Opinion, the EBA ensured appropriate interaction with key stakeholders through the organisation of a round-table meeting and by inviting institutions, from September 2019, to engage with their respective competent authorities to reflect on the magnitude and intended future treatment of outstanding legacy instruments in the context of supervisory dialogue on their capital planning.

Overview

6. In reviewing legacy instruments and examining clauses that led to their grandfathering, the EBA identified two main issues relating to the conditions governing those instruments that could create infection risk (defined as the disqualification of other layers of own funds or eligible liabilities instruments) by affecting the CRR eligibility of regulatory instruments. The first issue relates to interlinkages between capital instruments' distribution payment features and the principle of the flexibility of distribution payments. The second relates to clauses that might contradict the eligibility criterion of subordination.

7. Several aspects of the analysis presented below are illustrated by discussing grandfathered Additional Tier 1 (AT1) instruments that may be cascaded down to a lower category (i.e. Tier 2 instruments or instruments eligible for inclusion in total loss-absorbing capacity (TLAC) / minimum requirement for own funds and eligible liabilities (MREL)), given that such instruments seem to account for the majority of outstanding legacy instruments. However, the reasoning put forward would apply also to other types of instruments, including Common Equity Tier 1 (CET1) instruments, that may be cascaded down to a lower category.

Principle of the flexibility of distribution payments

8. With reference to the issue of the flexibility of distribution payments, the EBA considered and assessed various arguments expressed by stakeholders with regard to different mechanisms restricting the flexibility of payments, in particular 'classic' dividend pushers[7] / dividend

[6] Decision of the European Banking Authority concerning the Rules of Procedure of the Board of Supervisors of 22 January 2020 (EBA/DC/2020/307).

[7] A dividend pusher is a requirement in the conditions governing AT1 instruments for distributions on the instruments to be made in the event of a distribution being made on an instrument issued by the institution that ranks to the same degree as, or more junior than, an AT1 instrument, including a CET1 instrument (Article 53(a) of the CRR).

stoppers,[8] as well as reverse stoppers[9] and similar mechanisms. Those arguments were assessed against the letter and the spirit of the CRR provisions with reference to the objectives of the eligibility criteria set by that Regulation for CET1, AT1 and Tier 2 instruments.

9. Regarding the effects of the existence of such mechanisms in CET1 and AT1 legacy instruments after the grandfathering period, the EBA is of the opinion that the CRR is clear in determining the ineligibility of those instruments. In particular, it should be recalled that Article 28(1)(h)(vii) of the CRR requires that '*the cancellation of distributions [on CET1 instruments] imposes no restrictions on the institution*'. This condition, along with other eligibility conditions under the same Article,[10] is meant to ensure full flexibility of payments with regard to CET1 instruments. An identical condition is also found in Article 52(1)(l)(v) of the CRR in relation to AT1 instruments, while Article 53(a) and (b) of the CRR[11] makes explicit reference to dividend pushers and dividend stoppers and sets a clear requirement that instruments must not include such clauses in their Terms and Conditions if they are to be eligible as AT1 instruments.

10. The EBA carefully considered various arguments regarding the admissibility of 'classic' dividend pushers / dividend stoppers in Tier 2 instruments and how these interact and affect their eligibility, and finds that such features can be tolerated and do not pose a risk of infection of higher capital tiers under certain circumstances explained below. This conclusion was reached mainly on the basis that there are no explicit eligibility criteria in the CRR preventing dividend pushers / dividend stoppers for Tier 2 instruments, as is the case for AT1 instruments, although the EBA is of the view that the reasoning that applies to the prohibition on these mechanisms for these latter might in substance be valid also for Tier 2 instruments. The EBA also reflected on the overall features of Tier 2 instruments and their fundamental differences from those of AT1 instruments. In particular, it took into account the fact that Tier 2 instruments are 'must pay' instruments, in relation to which failure to pay the coupons may be regarded as an event of default.

11. That being said, the EBA considers that the debate on if 'classic' dividend pushers / dividend stoppers included in the relevant instruments might interfere with Tier 2 eligibility is mostly driven by the potential reclassification of currently grandfathered AT1 instruments as fully eligible Tier 2 instruments when the grandfathering period expires.

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[8] A dividend stopper is a requirement in the conditions governing AT1 instruments for distributions on CET1, AT1 or Tier 2 to be cancelled in the event that distributions are not made on those AT1 instruments (Article 53(b) of the CRR).

[9] A reverse stopper is a requirement in the conditions governing institutions' instruments for the cancellation of distributions on those instruments in the event that distributions are not made on AT1 instruments (Article 52(1)(l)(v) of the CRR and EBA Q&A 2013_21) or CET1 instruments (Article 28(1)(h)(vii) of the CRR).

[10] For example under Article 28(1)(h)(iii), (v) and (vi) of the CRR.

[11] 'For the purposes of points (l)(v) and (o) of Article 52(1), the provisions governing Additional Tier 1 instruments shall, in particular, not include the following: (a) a requirement for distributions on the instruments to be made in the event of a distribution being made on an instrument issued by the institution that ranks to the same degree as, or more junior than, an Additional Tier 1 instrument, including a Common Equity Tier 1 instrument; (b) a requirement for the payment of distributions on Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments to be cancelled in the event that distributions are not made on those Additional Tier 1 instruments'.

12. With all these considerations in mind, the EBA is of the view that the existence of 'classic' dividend pushers / dividend stoppers clauses could be acceptable for legacy instruments that institutions plan to cascade down to a lower tier of capital or as eligible liabilities instruments at the end of the grandfathering period. However, the EBA wishes to make clear that this is acceptable in the context of legacy instruments and that institutions are expected not to issue new Tier 2 (or eligible liabilities) instruments with dividend pushers / dividend stoppers.

13. With regard to reverse stoppers, and in the light of the guidance that has been issued by the EBA in the past in relation to Tier 2 instruments (Q&A 2013_21[12]), the EBA maintains the view that reverse stoppers pose an infection risk to higher capital tiers, given that they create restrictions (e.g. stopping distributions of Tier 2 instruments) on institutions when they decide to cancel distributions on higher capital tiers; therefore, they contradict the criterion of full flexibility of payments for CET1 and AT1 instruments. The consequence should be the disqualification of higher layers of regulatory capital even where the Tier 2 instrument itself might be eligible. This analysis applies to all types of capital instruments and liabilities issued by the institution and not only to Tier 2 instruments.

Eligibility criterion of subordination

14. As regards the eligibility criterion of subordination, the EBA believes that the CRR provisions covering the ranking of CET1, AT1 and Tier 2 instruments – in particular Article 28(1)(j), Article 52(1)(d) and Article 63(d) of the CRR, respectively – are clear. In a nutshell, CET1 instruments are subordinated to all other claims, AT1 instruments are subordinated to Tier 2 instruments, and Tier 2 instruments are subordinated to any claims from eligible liabilities instruments. If the statutory or contractual provisions governing legacy instruments do not satisfy those ranking rules, allowing them to be classified as fully eligible AT1 or Tier 2 instruments, then it might be assessed if the instruments could still be eligible for TLAC[13]/MREL[14] purposes, provided that the instruments meet all the eligibility criteria under Article 72b of the CRR, including the criterion of subordination as applicable, or the applicable conditions set out in Directive 2014/59/EU[15] (BRRD), respectively.

15. In any case, the EBA is of the opinion that the existence of infection risk should be carefully assessed in either possible scenario, i.e. where (i) the instrument might in principle meet all eligibility criteria for it to be reclassified as a fully eligible own funds instrument in a lower tier

[12] https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2013_21

[13] Referring to the own funds and eligible liabilities requirements that resolution entities that are global systemically important institutions (G-SIIs) or parts of G-SIIs and material subsidiaries of non-EU G-SIIs must comply with in accordance with Articles 92a and 92b of the CRR, respectively.

[14] Referring to the own funds and eligible liabilities minimum requirement that institutions and entities referred to in points (b), (c) and (d) of Article 1(1) of Directive 2014/59/EU must meet in accordance with Articles 45 to 45i of that Directive.

[15] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

or as a fully eligible liabilities instrument for TLAC/MREL purposes, or (ii) the instrument is to be disqualified from own funds and TLAC/MREL. In this context, the EBA underlines that the subordination provisions covering the instrument should be assessed not only against the ranking rules of the specific tier of own funds, or eligible liabilities, in which the instrument is to be placed at the end of the grandfathering period but also against the ranking rules across all tiers of own funds. The same applies also where a legacy instrument is to be placed in one of the categories of excluded liabilities under Article 72a(2) of the CRR, as, in that case, the institution would still need to assess if the instrument poses an infection risk for eligible liabilities instruments, given that these are expected to be wholly subordinated to claims arising from the excluded liabilities referred to in Article 72a(2) of the CRR.

16. In this context, the EBA considers that the second subparagraph of Article 28(1) of the CRR and the second subparagraph of Article 52(1) of the CRR have softened this ranking requirement across the tiers of own funds, but only regarding legacy instruments and up to the end of the grandfathering period. In the EBA's view, those articles reflect the fact that the required ranking of CET1, AT1 and Tier 2 instruments cannot be fully achieved owing to the existence of legacy instruments, but this is tolerated because of the CRR grandfathering provisions and only until the end of 2021.

17. If a legacy instrument passes the Tier 2 eligibility criteria, including the ranking rules under Article 63(d) of the CRR – meaning all relevant provisions of the CRR and of regulatory technical standards, as supplemented by related guidance on the consistent and effective application of the regulatory framework provided by EBA Q&As and reports (currently, the most recent available version of the EBA AT1 monitoring report is the relevant product), as explained in Q&A 2018_4417,[16] but excluding the conditions grandfathered by Regulation (EU) 2019/876 (CRR2)[17] (e.g. regarding the effectiveness and enforceability of write-down and conversion actions or the absence of set-off or netting arrangements[18]) – and its clauses in terms of ranking do not create an infection risk for higher layers of capital, then a final test is performed. This test assesses the instrument against the new eligibility criteria introduced by the CRR2. If the legacy instrument passes this test, then and only then can it be classified as a fully eligible Tier 2 instrument; if it does not, then it can be grandfathered for a second time under the new CRR2 grandfathering provisions, until June 2025 at the latest.

Options to address infection risk

18. When a legacy instrument poses an infection risk to other layers of own funds or eligible liabilities instruments, due to clauses contradicting either the principle of the flexibility of distribution payments or the eligibility criterion of subordination, the EBA envisages the

[16] https://eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2018_4417

[17] Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (OJ L 150, 7.6.2019, p. 1).

[18] Now included in the new Article 494b of the CRR.

following options for institutions to address this: (i) to call, redeem, repurchase or buyback the instrument, (ii) to amend the Terms and Conditions of the relevant instrument, or (iii) to keep the legacy instrument disqualified from own funds and TLAC/MREL -eligible instruments but to retain it in the balance sheet as a non-regulatory instrument, under strict conditions.

19. These options are discussed in more detail below.

i. **to call, redeem, repurchase or buyback the instrument.** Institutions are expected to undertake all possible efforts to execute any action that leads to the redemption of legacy instruments. In addition to the possibility to buyback, repurchase or redeem the instruments, call options, when available, are expected to be exercised for grandfathered instruments. In this context, for instruments with an issuer's call option in the short to medium term, the EBA reasonably anticipates that institutions will use this possibility as a first option to address infection risk and will call/redeem the instrument. It is the EBA's assumption that the elimination of such legacy instruments from institutions' balance sheets has been an important element reflected in their capital planning since 2014 when the first CRR grandfathering provisions entered into force. To avoid any ambiguity, institutions are reminded that all own funds instruments containing call options combined with step -ups are to be fully disqualified at the end of the grandfathering period.

   For instruments with regulatory event clauses in their Terms and Conditions, the EBA expects that institutions will reflect on the exercise of such regulatory calls and assess the details of the relevant clauses to determine if the exercise of a regulatory call under those specificities is feasible and legally sound. The EBA will monitor this aspect.

ii. **to amend the Terms and Conditions.** Another option is for institutions to amend the relevant Terms and Conditions, where possible. In particular, institutions might attempt to address the infection risk arising from contractual provisions contradicting the subordination requirement by 'promoting' the instrument in the hierarchy of creditors, for example by amending a legacy AT1 instrument to rank *pari passu* with Tier 2 instruments, although this would not exclude the need to assess any other relevant eligibility criteria, including those introduced by CRR2, beyond the criterion of subordination.

iii. **to keep the instrument in the balance sheet as a non-regulatory instrument.** When it is not possible for institutions to pursue either of the two previous options, or in case of residual amounts remaining from legacy instrument buybacks, this option might be considered. Under this option, the instrument would be excluded from own funds and TLAC/MREL - eligible instruments while remaining in the balance sheet of the institution.

   The EBA is aware of the limitations of this option given that the risk of infection of fully eligible own funds instruments is not completely addressed by the exclusion of legacy instruments from own funds and TLAC/MREL -eligible instruments. Notwithstanding this, the EBA believes that it might be reasonable, taking into account all the relevant circumstances, to allow a certain level of flexibility and tolerance under strict conditions, for a limited number of cases, where neither of the other two options can be pursued by institutions and where this is duly demonstrated by the institutions concerned to the competent authority. The EBA also recognises that the presence of non-regulatory instruments in the balance sheets of institutions and the associated infection risk are not issues that are expected to arise solely as a result of the approaching end of the grandfathering provisions; they already existed at the moment the CRR entered into force. That being the case, the EBA considers that this option is rather in the same spirit as the objectives of the second subparagraphs of Article 28(1) and Article 52(1) of the CRR. The EBA also holds the view that the tolerance and flexibility associated with this option are compensated for, to some extent, by the exclusion of a legacy instrument from own funds and TLAC/MREL -eligible instruments, which is a strong consequence for the issuing institution, while the instrument could still be used as a source of funding, if need be.

Nevertheless, the EBA advises that this last option should be treated as a last resort option; it is intended as a backstop measure for legacy instruments if neither of the other options is available. To ensure this, competent authorities are encouraged to engage with institutions and assess the details of the instruments in question and the limitations and challenges preventing the implementation of either of the other options.

Finally, the EBA clarifies that tolerance of the infection risk under the last resort option is recognised only in the context of legacy instruments. It is not the EBA's intention to give a general signal that it is desirable for institutions to issue new instruments that might rank *pari passu* with regulatory instruments while not being part of own funds or TLAC/MREL - eligible instruments.

20. An additional aspect that the EBA has discussed in detail with various stakeholders is if national legislators might alleviate concerns about infection risk through the manner in which they transpose Article 48(7) of the amended BRRD[19] into their legislation. The transposition of the amended BRRD into national legislation is to be done by 28 December 2020. Where the relevant national legislation introduces mandatory insolvency rules whereby ranking in insolvency is automatically amended based on instruments' regulatory categories, this could provide an additional solution to the risk of infection. This could be the case in particular for instruments where the issuer is established in a Member State, as mandatory insolvency rules transposing Article 48(7) of the BRRD will eliminate the risk for own funds instruments.

21. However, the EBA also recognises that, at this stage, there is uncertainty about how Member States are or will be transposing Article 48(7) of the BRRD into their legislation, and about the level of detail that national legislation will enter into. In particular, it is uncertain if national legislation will introduce mandatory insolvency rules only relating to own funds and any other claims that do not result from own funds items or if it will also detail ranking rules in relation to

[19] 'Member States shall ensure that, for entities referred to in points (a) to (d) of the first subparagraph of Article 1(1), all claims resulting from own funds items have, in national laws governing normal insolvency proceedings, a lower priority ranking than any claim that does not result from an own funds item. For the purposes of the first subparagraph, to the extent that an instrument is only partly recognised as an own funds item, the whole instrument shall be treated as a claim resulting from an own funds item and shall rank lower than any claim that does not result from an own funds item.'

the different layers of own funds instruments (CET1, AT1 and Tier 2) – an approach that is favoured by the EBA.

22. In addition, and regardless of how Article 48(7) of the BRRD is transposed in national law, it cannot be ruled out that, depending on the circumstances and the exact terms and conditions of the instruments concerned, some ranking issues relating to legacy instruments, for example with regard to their ability to absorb losses in going concern situations, may still remain.

23. Finally, as part of its mandate to monitor the quality of own funds and eligible liabilities instruments in accordance with Article 80 of the CRR, the EBA will continue to closely monitor the situation until the end of the CRR1 and CRR2 grandfathering periods. It will in particular monitor the use of the options referred to above across the EU, with a view to ensuring consistent application, while also considering the details of national legislation implementing Article 48(7) of the BRRD and the extent to which it provides an additional remedy to infection risk arising from ranking issues.

This opinion will be published on the EBA's website.

Done at Paris, 21 October 2020

[signed]

[José Manuel Campa]

Chairperson
For the Board of Supervisors