EBA REPORT

ON THE MONITORING OF ADDITIONAL TIER 1 (AT1), TIER 2 AND TLAC/MREL ELIGIBLE LIABILITIES INSTRUMENTS OF EUROPEAN UNION (EU) INSTITUTIONS – UPDATE

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EBA EUROPEAN BANKING AUTHORITY

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Abbreviations

AT1	Additional Tier 1
BOR	Bank Offering Rate
BRRD	Bank Recovery and Resolution Directive
CET1	Common Equity Tier 1
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
EMTN	Euro medium-term note
ESG	Environmental, Social and Governance
EU	European Union
Euribor	Euro Interbank Offered Rate
FVtPL	Fair value through profit or loss
FX	Foreign exchange
GBP	British Pound
G-SII	Global systemically important institution
ISIN	International Securities Identification Number
KPI	Key Performance Indicators
MDA	Maximum Distributable Amount
MREL	Minimum requirement for own funds and eligible liabilities
MTN	Medium-term note
NCWO	No Creditor Worse Off
Q&A	question and answer
RAC	Risk Adjusted Capital
SLB	Sustainability-Linked Bond
SNP	Senior non-preferred
SOFR	Secured Overnight Financing Rate
SONIA	Sterling Overnight Index Average
SP	Senior preferred

SRMR	Single Resolution Mechanism Regulation
TLAC	Total loss-absorbing capacity
USD	United States Dollar

1. Executive summary

1.1 Reasons for publication

1. In addition to its general market monitoring and assessment tasks in the areas of its competence (Article 8(1)(f) in conjunction with Article 32(1) of the EBA Regulation[1]), Article 80(1) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)[2] states that the 'EBA shall monitor the quality of own funds and eligible liabilities instruments issued by institutions across the Union and shall notify the Commission immediately where there is significant evidence that those instruments do not meet the respective eligibility criteria set out in this Regulation.'

2. Pursuant to the same article, 'competent authorities shall, without delay and upon request by EBA, forward all information to EBA that EBA considers relevant concerning new capital instruments or new types of liabilities issued in order to enable EBA to monitor the quality of own funds and eligible liabilities instruments issued by institutions across the Union'.

3. Furthermore, according to Article 25(2) of the EBA Regulation, 'the Authority [EBA] may identify best practices aimed at facilitating the resolution of failing institutions and, in particular, cross-border groups, in ways which avoid contagion, ensuring that appropriate tools, including sufficient resources, are available and allow the institution or the group to be resolved in an orderly, cost-efficient and timely manner'.

4. 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) and Tier 2 capital instruments as well as of TLAC/MREL[3] eligible liabilities instruments and to present the results of this monitoring.

5. The present report merges the contents of the AT1 monitoring report published in June 2021[4] and the EBA Report on the recent monitoring of TLAC/MREL eligible liabilities instruments published in October 2022[5]. The merger results from past comments from market participants to ease reading and is also meant to reflect the commonalities in terms of eligibility criteria

[1] Regulation (EU) 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.

[2] As amended by Regulation (EU) No 2019/876.

[3] TLAC and MREL eligible instruments' eligibility criteria are very similar, with a few exceptions, the main one being subordination. As stated in recital (16) of the CRR2 and recital (2) of the BRRD2, 'as the TLAC standard and the MREL pursue the same objective of ensuring that institutions have sufficient loss absorption capacity, the two requirements should be complementary elements of a common framework'. Moreover, 'the provisions introducing the TLAC standard in Regulation (EU) No 575/2013 should be read together with the provisions that are introduced into Directive 2014/59/EU and Regulation (EU) No 806/2014, and with Directive 2013/36/EU'.

[4] EBA updates on monitoring of Additional Tier 1 instruments and issues recommendations for ESG-linked capital issuances | European Banking Authority (europa.eu)

[5] EBA updates on the monitoring of total loss-absorbing capacity and minimum requirement for own funds and eligible liabilities instruments | European Banking Authority (europa.eu)

between own funds and eligible liabilities instruments and corresponding loss absorbency features. In this regard, it is recalled that the EBA seeks to ensure consistency, if appropriate, across instruments with similar loss absorbency features, taking into consideration the fact that the aim of TLAC/MREL is not limited to loss absorption, but is mainly recapitalisation or the implementation of other resolution tools. It might be the case that some details from the previous reports have not been fully replicated in this merged updated report, while, unless it is explicitly mentioned, there is no intention to change the substance of previous reports that would remain valid in this regard. It also includes some new recommendations based on recent findings, which relate in particular to TLAC/MREL disqualification events in own funds issuances, RAC Tier 2 instruments, alignment events, interest rate reset mechanisms linked to call options, calls and non-calls and valuation of non-CET1 instruments.

6. It may be recalled that, apart from the monitoring of AT1, Tier 2 capital and eligible liabilities issuances, the EBA publishes and maintains a list of Common Equity Tier 1 (CET1) instruments[6]. The list is accompanied by a CET1 monitoring report[7].

7. The report lays out findings that are applicable to AT1 instruments, Tier 2 instruments and eligible liabilities instruments for the purpose of loss absorbency needs. It further highlights aspects applicable only to one of these specific categories. In general, the vast majority of eligibility criteria are fully aligned for own funds and eligible liabilities and only particular differences exist.

8. The EBA monitoring aims to assess the application of the eligibility criteria and provide best practices and recommendations. It is not meant to analyse the final compliance of any given instrument, which will be determined by the relevant authority. This is particularly because some of the eligibility criteria (such as the absence of excluded liabilities on the balance sheet ranking *pari passu* to or below eligible liabilities of a holding company in the event of structural subordination) cannot be checked solely on the basis of the contractual documentation.

9. The EBA findings contain policy views on existing or new provisions, together with identified (non-)best practices. The report also provides an insight into areas for further scrutiny/monitoring or potential EBA guidance going forward.

10. In October 2020, the EBA published the Opinion on the prudential treatment of legacy instruments[8]. The EBA ensured transparency on the implementation of its Opinion and corresponding options to address infection risk by competent authorities and institutions. In this context, an analysis of how the Opinion on the prudential treatment of legacy instruments has been implemented across the EU was published in July 2022[9].

[6] EBA updates list of CET1 instruments | European Banking Authority (europa.eu)

[7] EBA Report on the monitoring of CET1 instruments issued by EU institutions - update.pdf (europa.eu)

[8] EBA Opinion on the prudential treatment of legacy instruments.

[9] EBA reports on the successful mitigation of possible infection risk stemming from legacy instruments | European Banking Authority (europa.eu)

11. Finally, this report integrates a dedicated part on environmental, social and governance (ESG) capital bonds (i.e., bonds issued for own funds or eligible liabilities purposes), that replicates the preliminary observations originally published in the previous TLAC/MREL and AT1 monitoring reports. This guidance is valid with no distinction between any type of loss-absorbing regulatory instruments.

1.2 Content

12. The CRR lays down the eligibility criteria as regulatory capital for AT1 instruments (particularly Articles 51 to 55 of the CRR), Tier 2 instruments (Articles 63 to 65 of the CRR) and eligible liabilities (Articles 72b to 72d of the CRR). Those criteria are supplemented by Commission Delegated Regulation (EU) No 241/2014 (the regulatory technical standards (RTS) on own funds and eligible liabilities[10]). The EBA had drafted the above-mentioned RTS in the area of regulatory capital. With regard to own funds and eligible liabilities instruments in particular, these RTS contain 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, the procedures and timings surrounding trigger events and the prior permission regime for own funds and eligible liabilities instruments.

13. The EBA has focused its work primarily on the assessment of selected issuances of AT1 and Tier 2, senior non-preferred (SNP), senior holding company and senior preferred (SP) MREL eligible liabilities instruments. The terms and conditions of these selected issuances were assessed against the regulatory provisions in order to identify provisions that the EBA would recommend and, in contrast, recommend avoiding.

14. 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.

15. In addition, the best practices mentioned in this report aim to shape market practices and should therefore pre-empt market practice (unless there is a material impossibility of applying the best practice demonstrated by the institution concerned).

16. This review makes no claims to be fully comprehensive, but highlights areas where the EBA believes it is 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. The original findings of the previous reports have in general been maintained in order to provide a full overview of the investigations led from the beginning of the monitoring, while it is acknowledged that some of the observations made initially have been taken into account by issuers in subsequent issuances and might no longer be found in current issuances. That said, it is deemed important to keep them alive in this report to ensure that they continue

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to be considered and respected in the issuance of new instruments, and that all findings can be found in a unique consolidated document.

17. The EBA will continue to exchange views with institutions and market participants on the results of its ongoing monitoring and will strive to provide guidance on possible new features it is made aware of, where necessary separately from this report[11], in order to provide certainty to issuers sufficiently in advance before the next update of the report.

18. A relatively new market that has been growing fast in recent years is the issuance of ESG bonds. The EBA has developed recommendations and best practices to ensure that the institutions' own funds and eligible liabilities instruments issued with ESG features are compliant with the CRR eligibility criteria and the BRRD requirements. The objective of this guidance is not to prevent or promote ESG issuances for capital/loss absorbency purposes, but to clarify the interaction between ESG features and regulatory eligibility criteria.

19. While there might always be a residual reputational risk for the issuer in associating ESG features with loss absorbency ones, the guidance is meant to mitigate possible risks from an issuer's perspective. The EBA continues to monitor ESG issuances for regulatory purposes going forward and in particular to further scrutinise links that could be possibly made between the performance of the underlying assets and the payments on the bonds.

20. Finally, 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 conditions[12]. The monitoring work performed by the EBA has successfully fed into the development of the standardised templates, which are a useful complement to this monitoring report. While these templates are based on the first version of the CRR and published in 2016, the EBA believes that their main content is still valid. The EBA will reflect on an update of these templates as appropriate.

21. This report is structured as follows:

- the EBA's considerations on AT1, Tier 2 and eligible liabilities instruments monitoring,
- follow-up on the EBA Opinion on legacy instruments,
- the EBA's considerations on own funds or eligible liabilities instruments with ESG features.

[11] In particular via Q&As

[12] EBA AT1 standardised templates.

2. The EBA's considerations on AT1, Tier 2 and eligible liabilities instruments monitoring

2.1 Introduction

22. Several general introductory remarks can be made with regard to AT1 instruments and eligible liabilities instruments respectively, which were the instruments more directly in the focus of the EBA monitoring and previous monitoring reports.

23. With regard to AT1 instruments, although they are complex, 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 due to the existence of quite prescriptive provisions in the CRR and RTS.

24. Nevertheless, the monitoring process has shown, especially at its starting point, that a few provisions of existing AT1 instruments, or of those AT1 instruments 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 originally proposed, 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. This may particularly be the case for some provisions related to regulatory calls, calls linked to specific events (e.g., rating events), share conversion mechanisms, contingent clauses and covenants.

25. Furthermore, this report provides the EBA's guidance in a few areas where there might be different interpretations. 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.

26. In the previous versions of its AT1 monitoring report, the EBA noted that the standardisation of the terms and conditions was still increasing, with some issuers using the provisions proposed in the EBA standardised templates published in October 2016 for some definitions or for some parts, or even to a larger extent. This trend has continued in recent years and 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.

27. Due to the well-established EBA monitoring work and consideration of this work by issuers, the observations made more recently are less impactful than previous ones in terms of substance.

28. Based on a recommendation from the EBA[13], the co-legislators have further acknowledged in Article 79a of the CRR that the substantial features of instruments, including separate arrangements that are not explicitly set out in the terms and conditions of the instruments themselves, shall be taken into consideration when assessing their compliance with the eligibility criteria[14]. This is valid for all types of instruments.

29. When assessing the eligibility of an instrument, institutions should further carefully assess the interaction between the different layers of regulatory capital/loss absorbency instruments and other instruments[15]. Having in mind the transitional period for grandfathered pre-CRR own funds instruments which ended at the end of 2021 and impacted mainly legacy AT1 instruments, combined with the transposition of Article 48(7) of the BRRD[16], the EBA will continue to analyse, as needed, the potential additional provisions that institutions will introduce in the terms and conditions of issuances with regard to ranking and the potential additional complexity introduced.

30. With regard to eligible liabilities instruments, the peculiarity of the monitoring work is that most of the necessary information is found in the MTN programmes, whereas the term sheets themselves are very concise. This contrasts with own funds issuances, where terms and conditions are quite detailed and can usually be analysed on a stand-alone basis. In general, provisions of TLAC/MREL eligible liabilities instruments are quite simple and standardised. This is conducive to legal certainty and reliability at the point of resolution. This convergence and standardisation are probably also due to the experience gained with AT1 instruments' clauses and EBA past guidance. Issuances typically include provisions that are not per se required by the eligibility criteria but are common in own funds issuances (regulatory and tax calls in particular).

31. In general, the contractual provisions of TLAC/MREL eligible liabilities instruments have shown to be less complex than those of own funds instruments. The main areas in which the EBA provides observations relate to availability, subordination, capacity for loss absorption, maturity and other aspects (for example governing law and tax and regulatory calls).

32. The EBA expects that forthcoming issuances will continue to retain a high level of standardisation. This appears desirable to mitigate the complexity of own funds and eligible liabilities instruments, and this report should help continue to promote convergence. If the EBA noted a significant deterioration in the quality of the instruments or a significant use of non-

[13] See EBA Opinion on the CRR review for own funds (Link), p. 12.

[14] The EBA has been applying this principle since the beginning of its assessment of own funds instruments (see also paragraph 121 of the CET1 Report (Link))

[15] See EBA Opinion on legacy instruments (Link), in particular paragraphs 14-17.

[16] Article 48(7) of the BRRD: '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.'

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.

33. The EBA also expects that issuers will continue to 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 own funds and eligible liabilities as inherently valuable and takes complexity into account when assessing them.

2.2 Detailed analysis of eligibility criteria common to AT1, Tier 2 and TLAC/MREL eligible liabilities instruments

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

2.2.1 Status of the notes – absence of guarantees and notion of 'fully paid-up'

35. Own funds and TLAC/MREL eligible liabilities instruments should provide genuine loss-absorbing capacity to the institution. In this regard, Articles 52(1)(a), (b) and (c), 63(a), (b) and (c), and 72b(2)(a), (b) and (c) of the CRR require own funds and eligible liabilities instruments to be (i) directly issued or directly raised and fully paid up, (ii) not owned by the institution or its subsidiaries (in the case of AT1 and Tier 2 instruments) or by an entity in the same resolution group (in the case of eligible liabilities instruments), or by an undertaking in which the institution has direct or indirect participation, and (iii) not funded directly or indirectly by the institution in the case of AT1 and Tier 2 instruments or by the resolution entity in the case of eligible liabilities. According to Articles 52(1)(e) and 63(e) of the CRR, AT1 and Tier 2 instruments are not secured or subject to a guarantee that enhances the seniority of the claims. In the same vein, Article 72b(2)(e) of the CRR requires that the liabilities are neither secured nor subject to a guarantee or any other arrangement that enhances the seniority of the claim. The RTS specify the applicable forms and nature of indirect funding of capital instruments and liabilities.

36. 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.

37. 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 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 (in case of AT1 instruments), 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/resolution authority should reassess the eligibility of the instrument after restructuring.

38. Similar to CET1 instruments[17], it can be observed that, depending on the statutory or contractual provisions, the status of the instruments as 'not fully paid up' and the requirement to fully pay up may differ. It should be recalled that only the part of instruments that is paid up can be counted as own funds or eligible liabilities. This is reinforced by the third subparagraph in Article 52(1) of the CRR, which states: 'For the purpose of point (a) of the first subparagraph, only the part of a capital instrument that is fully paid up shall be eligible to qualify as an Additional Tier 1 instrument', which is also reflected for Tier 2 and eligible liabilities instruments in Articles 63 and 72b(2)(a) of the CRR respectively.

39. Furthermore, provisions in national legislation or terms and conditions describing the different possibilities under which an instrument can be regarded as being paid up may differ in various jurisdictions. In this respect, an undertaking or commitment to pay cash to the institution on demand or at an identified or identifiable future date cannot be regarded as meeting the requirements for instruments being paid up.

40. For eligible liabilities instruments more specifically, instruments should be issued by the entity that is subject to the requirement, i.e., in the case of (external) TLAC/MREL, a resolution entity. By derogation, liabilities issued by a subsidiary established in the Union that belongs to the same resolution group as the resolution entity should qualify for inclusion in the consolidated eligible liabilities instruments of an institution under the conditions of Article 88a of the CRR (for TLAC) and Article 45b(3) of the BRRD (for MREL). In essence, this concerns liabilities issued to an existing shareholder, the conversion of which would not affect the control of the subsidiary by the resolution entity.

41. MTN programmes and/or terms and conditions usually provide indications related to availability criteria, stating that notes constitute direct, unconditional and unsecured obligations of the issuer. Nevertheless, availability criteria can generally not be verified solely on the basis of the contract. For example, a complementary analysis may be warranted to establish that the issuing entity is a resolution entity or that the holders are not themselves resolution group entities.

42. In relation to the requirement for the notes not to be secured by a branch of the institution issuing the liability, the EBA, in Q&A 2016_2966, assessed that debt securities issued under Section 3(a)(2) of the United States Securities Act of 1933 and, accordingly, guaranteed by a branch of an EU institution should not be considered eligible as MREL from the point of view of that institution. Since the publication of that answer, some stakeholders have conveyed to the EBA the view that such guarantees do not 'enhance the seniority of the claim' within the meaning of Article 72b(2)(e) of the CRR whereby investors have contractually waived their right to execute the guarantee. However, it remains that such arrangements set out a complex articulation between strict procedural requirements for the marketing of notes under US law, a restrictive range of exemptions to those requirements under strict conditions, and contractual provisions to rely on the exemption to marketing requirements while bypassing the conditions thereof. In

[17] See paragraphs 38 to 43 of the EBA report on the monitoring of CET1 instruments issued by EU institutions – Update, December 2021.

addition, considering the fact that the relevant provisions are governed by third-country law, which the EBA is not competent to interpret, the EBA does not see a reason, at this stage, to change the existing position expressed in the Q&A. That said, the EBA will continue to exchange views with stakeholders on this aspect.

43. The assessment above is without prejudice to notes that are issued under US law but under different grounds, such as 'Rule 114A' under Section 5 of United States Securities Act of 1933 concerning notes distributed to qualified institutional buyers to the extent that they are not guaranteed.

2.2.2 Incentives to redeem

44. In principle, incentives to redeem must be defined consistently across own funds and eligible liabilities, despite triggering different consequences. Both own funds and eligible liabilities are underpinned by an objective of permanence: they should offer stable funding, as otherwise, loss absorption capacity would tend to disappear ahead of financial distress. This is why incentives to redeem receive a restrictive regime across both categories. It is true that, although in the case of own funds incentives to redeem are subject to a strict prohibition and trigger ineligibility, in the case of eligible liabilities they instead cause a shortening of the maturity if combined with a call option. However, this is not linked to a different concept of incentives to redeem but is because maturity conditions are more stringent for own funds, which are meant to be of a higher loss absorption quality (and thus must be perpetual or meet a longer original maturity requirement).

Tax gross-up clauses

45. Regarding tax gross-up clauses, as a potential case of incentive to redeem, 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.

46. As indicated in its answer to a question received (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.

47. For own funds instruments, the idea behind restricting gross-up, as set out above, is to avoid the creation of a strong redemption incentive through a gross-up event. Although the CRR does not lay down requirements or restrictions with regard to calls of TLAC/MREL issuances, it is the EBA's view that the conditions set out for own funds (AT1 and Tier 2) apply to eligible liabilities instruments as well. Consistent with the own funds framework, tax gross-up can be accepted only under certain conditions, as applicable to eligible liabilities instruments, i.e., gross-up clauses can be considered acceptable if they are activated by a decision of the local tax authority of the issuer, and if they relate to interest and not to principal.

Interest rate reset mechanism

48. The interest rate reset mechanism allows instruments to switch from a fixed coupon to a floating interest rate based on a benchmark rate established by the contract plus a margin (or credit spread) at a determined reset date (which usually coincides with the first ordinary call date) if the instrument is not called. The mere reset from a fixed to a floating rate is not an incentive to redeem in itself, however, an interest rate reset mechanism combined with a call option could conflict with the regulatory provisions concerning incentives to redeem if the instrument's credit spread changes after the reset date.

49. Pursuant to Article 20(2)(c) of the RTS[18], which is a specific application of the general principle defined in Article 20(1) RTS[19], there is no incentive to redeem if the credit spread over the second reference rate at the reset date is equal or lower than the initial payment rate minus the swap rate. The "credit spread over the second reference rate" means the margin or (reoffer) spread as commonly used by market participants, the "initial payment rate" means the fixed rate if the instrument is issued at par or the yield otherwise, and "swap rate" means the fixed leg of a swap agreement, i.e., the rate that an issuer (swap payer) would have to pay as a fixed rate in order to receive a floating rate (i.e., floating leg[20]).

50. The demonstration of the absence of incentive to redeem must be made at a single point in time, which is at the moment of the issuance of the instrument.

51. It is common market practice to set the margin as the difference between the yield of the instrument (or fixed rate in case the instruments are issued at par) and a swap rate. In this way the credit spread will remain the same after the reset date. However, there are some divergences

[18] Article 20(2) RTS 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.

[19] Article 20(1) RTS states that "Incentives to redeem shall mean all features that provide, at the date of issuance, an expectation that the capital instrument is likely to be redeemed."

[20] The floating rate is the rate that the swap receiver pays which is based on the benchmark used in the contract (for example, if the benchmark defined in the contract is the Euribor, then the swap rate should also be based on the Euribor).

in practices regarding the terminology used[21] and the choice of the swap rate used for the marketing of the instruments[22]. Furthermore, it has been observed that issuers sometimes use a different benchmark rate for the marketing of the instrument than the one used for determining the contractual floating rate. For example, EU issuers tend to use the 6m Euribor variable leg of the EUR mid-swap rate for the initial marketing of the instrument (i.e., as component of the initial payment rate) whereas the benchmark rate used for the calculation of the floating rate is usually the 3m Euribor. The reason why the difference between the 6m Euribor and the 3m Euribor is not considered relies on the fact that the underlying risk remains the same while switching from one rate to the other and that the difference between the 3m/6m basis is considered by banks as non-significant in the overall pricing.

52. In addition, some MTN programmes contain minimum rate of interest and/or maximum rate of interest provisions which state that in case the rate of interest in respect of a reset period is lower than the minimum rate of interest indicated, the rate of interest for such period should be such minimum rate (which, unless otherwise specified in the documentation, is deemed to be zero). In the same way, in case the rate of interest with respect to a reset period is above the maximum rate of interest indicated by the contract, then the rate of interest for such reset period should be such maximum rate of interest. The EBA believes that the introduction of this type of clause creates complexity and additional optionality in instruments that may interact with the assessment of incentive to redeem. Only in the exceptional case of a floor being set to avoid investors having to pay a negative margin to the issuer should this type of clause be considered.

53. Overall, the EBA has observed that the market practices in relation to the interest rate reset mechanism are in general compliant with the principles set out in Article 20(2)(c) of the RTS to ensure that there is no incentive to redeem. However, some divergencies were identified in the practice of setting the margin. Some of these practices could result in an incentive to redeem. Banks should be able to demonstrate to supervisors that issuances of own funds and eligible liabilities instruments do not contain incentives to redeem as a result of setting the instrument's initial payment rate and the margin, as well as provide evidence of the calculations performed when required[23].

Tap issuances

54. The question is whether tap issuances — meaning subsequent issuances made fully fungible with an original issuance (same coupon, same frequency of payments, ISIN etc.) — with the same

[21] Some market participants consider as 'initial payment rate' the fixed rate at the moment of the pricing, while others consider the (reoffer) yield (which equals the coupon rate only in case the instrument is issued at par as for AT1).

[22] While agreeing on the use of the reset date as maturity of the swap rate, the benchmarks used for GBP- and USD-denominated instruments are usually the government bond rates (UK Gilt rate for GBP-denominated instruments and the US Treasury rate for USD-denominated instruments), apart from those, other cases where the use of different benchmarks (such as SOFR or SONIA swap rates) has been observed.

[23] In this regard, it should be recalled that the consequences of the existence of incentives to redeem differ depending on whether the instrument is meant to qualify as an own funds instrument or as an eligible liability instrument. In fact, whereas in the case of own funds, incentives to redeem are subject to a strict prohibition (Article 52(1)(g) and Article 63(l) of the CRR) and trigger ineligibility, in the case of eligible liabilities they instead cause a shortening of the maturity if combined with a call option (Article 72c(3) of the CRR).

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. As indicated in the answer to Q&A 2016_2848, such a tap issuance of an instrument is to be considered as a new issuance (see Q&A 2013_238).

55. More precisely, where a tap issuance of an instrument is priced at a lower credit spread than the credit spread of the original issuance due to movements of the benchmark rate (e.g., increase of the 6 months Euribor), this raises the question of whether or not the reset of the coupon rate for both the tap and the original issuance generally at the identical first call date on the basis of the initial spread of the original issue should be considered an incentive to redeem.

56. Same as for the interest rate reset mechanism, in its analysis of the specific situation of tap issuances, the EBA considered the compliance of such tap issuances with the provisions of Article 20(2)(c) of the RTS. 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, the application of Article 20(2)(c) of the RTS implies that there is an incentive to redeem if the credit spread for the tap issuance increased because it was lower than the credit spread of the original bond.

57. The EBA took the view that the current texts of the CRR and corresponding RTS 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.

58. That said, the clarification provided in paragraph 49 on the 'initial payment rate' referred to in Article 20(2)(c) of the RTS should be beneficial for tap issuances, given that it provides a broader scope to ensure compliance with the RTS. In addition, while the existing Q&A 2016_2848 remains unchanged, a certain degree of supervisory flexibility could be expected for small issuers[24], in particular, where it is warranted by volatile market conditions, and where the issuer can demonstrate to the competent/resolution authority that the credit spread for the tapped amount remained stable compared to the initial issuance. While it is expected that under normal market conditions the tap issuance would not be realised under a time window exceeding 6 months, a longer time window could be used in some cases, under the conditions that all necessary conditions continue to be met in the same manner (in particular the one related to the exercise of the first call date where applicable).

2.2.3 Calls, redemptions and repurchases

Calls below par

[24] For the identification of the institutions that could be granted flexibility criteria such as the size of the bank, the frequency of issuances, access to the market, or the amounts/number of instruments issued should be considered.

59. 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. Nonetheless, in the case of AT1 instruments, write-ups should be fully discretionary and no provision should link them to contractual, statutory or other obligations. 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.

Calls with long notification period

60. Some instruments might provide a call option for the issuer after five years from the date of issuance but with a substantial duration of the notification period (e.g., two years before redemption). It has to be recalled that Article 28(1) of the RTS stipulates that the call shall not be announced prior to receiving the competent authority's approval. In addition, in accordance with Article 28(2) of the RTS, the corresponding amount shall be deducted once it is sufficiently certain that the call will be exercised. Therefore, where the terms and conditions of issuances include an extended notification period, the deduction from regulatory capital should be operated within this timeframe. In addition, AT1 instruments cannot be called in their first five years of maturity (Article 52(1)(i) of the CRR) unless the conditions of Article 78(4) of the CRR are met, while Tier 2 instruments shall have a minimum original maturity of five years. As a conclusion, the EBA expresses reluctance on long notification periods that might undermine the permanence of the instruments and do not bring any prudential benefit.

Continuous call option

61. The EBA has observed that some issuances contain a continuous call option once the first five years since the issuance have passed[25]. The eligibility criteria do not prohibit the inclusion of a continuous call option as long as Articles 52(1) points (g) to (k), 63 points (g) to (k) and 72b(2) points (g) to (k) of the CRR relating to permanence are met. In accordance with Article 28(1) of the RTS, institutions should not announce the call of the instruments before they obtain prior supervisory approval and it should not be expected that the continuous call option on its own constitutes 'exceptional circumstances' rectifying a shortened application timeframe as specified in Article 31(4) and 32g(4) of the RTS.

Regulatory and tax calls

[25] See EBA Q&A 2020_5147 (LINK).

62. In its past AT1 monitoring report, the EBA has laid down a number of elements of guidance regarding tax and regulatory calls and has assessed in particular the provisions related to regulatory calls as set out in Article 78(4)(a) of the CRR. Unlike the own funds' framework, the CRR/BRRD do not lay down any particular provisions with regard to tax or regulatory calls in relation to TLAC/MREL eligible liabilities instruments. This is plausible because for own funds instruments these provisions are meant to derogate from the strict 5-year ban on calls, which is not applicable to TLAC/MREL eligible liabilities instruments. That said, the analysis made for regulatory and tax calls for own funds issuances is the starting point and reference for an equivalent assessment for eligible liabilities instruments when such clauses are used in their terms and conditions.

63. Some own funds 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. Only regulatory calls for the full amount of instruments are acceptable, regardless of whether regulatory changes trigger a full or partial derecognition from AT1/Tier 2 capital. Partial derecognition from AT1 capital owing to write-down or conversion should not be considered an eligible trigger for a regulatory call.

64. Article 78(4)(b) of 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.

65. 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.

66. 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.

67. Regulatory call provisions should not be read as if supervisory approval was 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.

68. An example of a change in regulatory assessment of an AT1 instrument 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 now considers that there would be a tax effect which would disqualify part

of the instrument. Potential changes in the regulatory assessment cannot be considered valid triggers for regulatory or tax calls.

69. As previously mentioned, with regard to eligible liabilities instruments, the EBA recommendations for own funds instruments should be kept in mind when using provisions relating to tax and regulatory calls within TLAC/MREL eligible liabilities instruments. Given this, calls should not be drafted in such a way as to affect permanence or loss absorption without resolution authorities' approval.

70. Institutions have generally extended their usual contractual language on redemption because of a change in tax treatment to senior non-preferred notes. That said, in determining the trigger for a tax call, the documentation usually does not include the more restrictive language that the trigger can only be a material and non-foreseeable change in the applicable tax treatment in accordance with Article 78(4) of the CRR whereas this should be seen as a best practice. In addition, it is observed that any redemption at the issuer's discretion due to regulatory changes is in whole, but not in part, for the outstanding notes of the respective series. This constitutes another difference from discretionary calls.

Make-whole clauses

71. The inclusion of make-whole provisions, which allow an issuer to redeem a bond prior to maturity on the basis of a make-whole redemption amount representing the present value of the principal amount and remaining interests, in the documentation and terms and conditions has been observed in third-country jurisdictions. In the EU, the EBA has observed that some issuers have introduced make-whole provisions in their MTN programmes, however, at this stage, none of those issuers has activated the make-whole call provision in the final terms of the own funds or eligible liabilities instruments. Furthermore, some MTN programmes limit further the possible use of the make-whole provision to some categories of instruments, for example excluding them for own funds or even for senior non-Preferred notes in order to limit their use to senior preferred notes only.

72. The EBA reviewed make-whole provisions in MTN programmes and believes these clauses are complex features. In the EBA's view, the potential benefits of make-whole provisions (optionality to redeem debt between par call dates) are marginal, while the drawbacks are many. If exercised, the redemption amount could be substantially higher compared to a par call. These clauses are made to be more favourable for the holders of the instruments compared to par calls. Also, the optionality embedded into the notes makes the pricing and valuation less transparent and the analysis of incentive to redeem more complex. Furthermore, the feature could potentially reduce the flexibility for the replacement or early call of the instrument where needed (case of grandfathered instruments for example) in cases where this would lead to a too high cost for the institution. In addition, for AT1 instruments, while coupons must in principle be cancellable, the make-whole clause, if exercised, would lead to a payment of all future coupons, which might be seen as reducing the flexibility of payment/ be considered as a cumulative feature, which would not be considered compatible with the CRR eligibility criteria.

73. While make-whole clauses might not always be automatically considered as incentives to redeem, however if exercised, they would always increase the amount ultimately redeemed at the call date compared to par, make the pricing and valuation of the notes less transparent, and in some cases lead to a higher cost of the issuance. They are seen as complex features, which do not bring any additional prudential value. In this context, the EBA welcomes the prudent approach retained to date by European issuers and is of the view that these clauses should not be allowed for own funds and eligible liabilities instruments. Issuers should use par calls instead.

Clean-up clauses

74. The EBA received questions on the compliance of instruments including 'clean-up clauses', i.e., a call option that would allow the issuer to redeem the outstanding notes in the situation where a specified threshold (measured against the initial amount) of instruments is redeemed. It was questioned whether such a clause would be acceptable in AT1, Tier 2 and eligible liabilities instruments, in particular if this would be compatible with a normal call option as specified under the CRR (Articles 52(1)(i), 63(j) and 72b(2)(j) of the CRR) and if it would raise concerns regarding incentives to redeem (Articles 52(1)(g), 63(h) and 72b(2)(g) of the CRR). In this context, the EBA clarifies that a 'clean-up clause' has to be regarded more as a way to exercise a call in a practical manner rather than as a specification of the conditions triggering a call option. In addition, 'clean-up clauses' are considered relevant mainly in the context of repurchases before 5 years (tender offers, buybacks, etc.) since calls after 5 years are normally exercised for the full amount (as specified in the EBA AT1 standardised templates clause). It is also believed that 'clean-up clauses' would be useful in cleaning the capital structure where necessary (legacy instruments for example).

75. In this context, the EBA considers that 'clean-up clauses' are acceptable for own funds and eligible liabilities under certain conditions. In particular, the 'clean-up clause' should always be linked to an action referred to in Article 77(1) of the CRR that has been subject to a competent authority's prior permission, which is still valid, independent of the exact timing of the exercise of the 'clean-up clause'. In addition, it is also not relevant whether this clause can be activated within the first 5 years after the issuance of an AT1 or Tier 2 instrument or after, as long as the provisions of Articles 77 and 78 of the CRR regarding the prior permission are fully met.

Calls aspects specific to TLAC/MREL eligible liabilities

76. The admissibility of call and put options for TLAC/MREL is different from that of own funds. This is linked to the fact that TLAC/MREL permanence is mainly based on residual maturity, whereas own funds must be either perpetual or compliant with minimum original maturity requirements.

77. Issuer call options have no effect on the calculation of the residual maturity, provided that the instrument does not contain an incentive to redeem. If, on the contrary, the notes contain an incentive to redeem, the residual maturity is defined as the first date at which the option can be exercised. In addition, put options (where the instrument terms confer upon its owner a right to

early reimbursement) are allowed. However, the maturity of that liability is defined as the first date where such a right arises[26].

78. In general, call options for TLAC/MREL eligible liabilities instruments are available from 1 year before maturity and usually correspond with a fixed to floating reset mechanism at the call date, with no subsequent call. Redemption is usually possible in whole or in part.

79. No holder put option provisions have been observed in the MTN programmes reviewed to date, which is welcome. Although some base prospectuses do not have any provisions on noteholder put options as a general rule, others do contain such provisions but put options are not applicable, as per the final terms. Among those MTN programmes that contain provisions on put options, some MTNs exclude put options for 'unsubordinated notes', whereas others restrict it to preferred senior notes; therefore, put options would never be applicable to subordinated and senior non-preferred TLAC/MREL eligible liabilities under those MTNs. The EBA will continue to monitor this aspect over time to ensure that put options could not be exercised at any time, and that the timing of the exercise of the put option by the holders does not lead to an infringement of the minimum maturity requirement and thus the eligibility of the instrument.

80. Finally, based on Article 78a of the CRR, which limits the capacity of institutions to redeem eligible liabilities instruments and requires the resolution authority's permission, the EBA will continue to monitor the wording of options carefully, as redemptions have the potential to hinder loss-absorbing capacity.

Regulatory permission to reduce instruments

81. In the area of own funds, the EBA holds the view that instruments should contain an explicit reference to regulatory conditions linked to prior permission. In this regard, the EBA's Q&A (Q&A 2013_544) states in particular that 'any call options, redemptions or repurchase transactions related to Tier 2 instruments must meet the requirements of Article 63(i), (j) and (k) of the CRR. For Tier 2 instruments, Article 63(j), in conjunction with Article 77 of the CRR, stipulates that the institution must not effect the call, redemption, repayment or repurchase prior to the date of an instrument's contractual maturity without the prior permission of the competent authority. Such instruments should therefore contain an explicit reference to these regulatory conditions in their terms'. Indeed, in the absence of contractual provisions acknowledging prior permission regimes, an institution might be seen as contractually allowed to redeem an instrument and yet not allowed to do so as per the CRR, which could lead to difficult litigation and costly damages.

82. For the same reasons, in order to ensure compliance with the CRR eligibility criteria, and as stated in Q&A 2021_6203, the terms and conditions of TLAC/MREL eligible liabilities instruments should contain an explicit acknowledgement of the requirement to obtain prior permission for any call, redemption, repayment or repurchase of eligible liabilities instruments from resolution authorities, as in the case of own funds instruments. For example, if an institution redeems a note whose terms and conditions do not include a clause requiring the resolution authority's

[26] Article 72c(2), (3) and (4) of the CRR.

prior permission, there could be disputes: the holder could seek to obtain an annulment; in the event of an annulment, the holder could engage the contractual liability of the issuer; and other investors could also seek annulments or the personal liabilities of bank managers. Therefore, this kind of provision only fully achieves its purpose if it is precisely drafted; vague terms such as 'to the extent required' or the 'relevant regulator' should be avoided.

83. One Tier 2 issuance presented to the EBA contained a call option that the issuer could exercise in the case of a rating event, subject to the competent authority's permission. The rating event was defined at the issuer's determination, after consulting the credit rating agency, which would notify that the instrument would cease to be included or count in whole or in part towards a specified capital category provided for under its methodology. Such a clause conflicts with the eligibility criteria of Article 63(k) of the CRR, which prohibits any 'indication that the instruments would be called, redeemed, repaid or repurchased early, as applicable, by the institution other than in the case of the insolvency or liquidation of the institution.' Defining the conditions under which a voluntary call can be exercised, such as a call option for a specific case, other than the conditions and circumstances set out in Articles 63, 77 and 78 of the CRR, would further create the holders' expectation that the call will be exercised and would limit the issuer's discretion and flexibility as required by Article 63(i) of the CRR.

84. The EBA has also published additional guidance via Q&A 2017 3277 in order to specify the notion of 'sufficient certainty' which relates to when an institution has to deduct from its own funds the amounts for which it has received a prior permission from the competent/resolution authority.

Redemptions and repurchases

85. 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 /resolution authority as per Articles 77 and 78 or 78a of the CRR. However, additional clauses may go further and protect regulatory own funds and eligible liabilities even if discretionary repurchases take place without the institution having obtained the prior permission of the competent authority as required. These clauses are welcome as they create an obligation for the holder to repay or return all amounts received from the issuer and thereby ensure a clawback of every amount that would have been repaid to the investor without the competent/resolution authority's permission.

86. 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 78/78a of the CRR in particular). Furthermore, own funds purchases are subject to the limits laid down in Article 78(1) subparagraph 2 of the CRR. Article 78(4)(d) of the CRR 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 and under certain conditions.

87. That being said, LMEs should not be referred to or included in the terms and conditions. On the contrary, reference to market making and the exchange with an instrument of same or higher

quality is possible, as this comes from Article 78 paragraphs (1) and (4)(d) and (e) of the CRR (with regard to the exchange of eligible liabilities instruments, Article 78a(1)(a) of the CRR). The drafting of the terms and conditions should mention the prior permission of the competent/resolution authority, and, regarding own funds, the limits referred to in Article 78(1) of the CRR.

88. The EBA has received a Q&A 2017_3587 asking if a subsidiary of an institution could purchase AT1 or Tier 2 instruments issued by this institution before five years from the date of issuance of the instrument. As indicated in the answer, one has to recall the eligibility criterion stipulated by Articles 52(1)(b) and 63(b) of the CRR, disqualifying instruments from being eligible as AT1 or Tier 2 in cases where those instruments are purchased by the institution or its subsidiaries, regardless of the nature and situation of the subsidiary. Therefore, the purchase by a subsidiary would qualify as a repurchase and would require prior permission by the competent authority. Within the first five years from the date of issuance, such permission would only be possible under the specific conditions of Article 78(4) of the CRR.

89. Article 78(4)(d) of the CRR gives the possibility, to replace AT1 or Tier 2 instruments if the competent authority permits it, in light of the benefits from a prudential point of view related to the action and in exceptional circumstances, with an instrument of same or higher quality. The EBA has received several Q&As on the notion of 'exceptional circumstances'. The EBA considers that flexibility should be left to the competent authorities to decide on a case-by-case basis whether the criterion of 'exceptional circumstances' is fulfilled, as this is very much a case-by-case assessment. However, the EBA is monitoring the application of Article 78(4)(d) of the CRR by competent authorities and has observed that the mere improvement of market conditions or reduction in the cost of the issuance is not considered an exceptional circumstance.

90. The EBA considers that it is appropriate to include in the terms of AT1 instruments 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 should automatically be revoked and be null and void and the relevant redemption should not be made.

TLAC/MREL disqualification event for own funds purposes

91. The EBA observed that a few recent AT1 and Tier 2 issuances contain a 'TLAC/MREL disqualification event'. This clause would in particular allow the institution to exercise a call once an instrument ceases to be eligible as an eligible liabilities instrument, while it still would be eligible as an own funds instrument.

92. The EBA maintains a restrictive approach to allow additional call options, other than the ones stipulated in the CRR. In addition, there is a risk to see a 'mushrooming' of different types of call options outside the limited ones foreseen by the CRR. This restrictive position should be upheld. Furthermore, the EBA recalls the need to ensure consistency across own funds and eligible liabilities where relevant. In this context, while it is understood that institutions would like to

keep flexibility for future changes in regulation, several considerations have to be taken into account. First of all, grandfathering rules are introduced to cater for a change in the regulatory provisions. Secondly, instruments containing this TLAC/MREL disqualification events are still fully eligible for own funds purposes and remain fully loss absorbing. Finally, the type of events covered by this clause should be very limited in practice.

93. All in all, while maintaining the principle of disallowing new types of call options, the EBA considers that TLAC/MREL disqualification events clauses contained in own funds instruments can be accepted as a logical consequence of amendments to the CRR with regard to eligible liabilities instruments, and with the view that it allows consistency to be kept between the own funds and TLAC/MREL frameworks. In this regard, it is also not relevant whether the redemption can be exercised upon the occurrence of a TLAC/MREL disqualification event within the first five years after the issuance of an AT1 or Tier 2 or after, as long as the conditions of Article 78(4)(d) of the CRR are met and as long as changes in the relevant regulations and the impact of these changes were not foreseeable at the time of the issuance of the own funds instrument. In such cases, TLAC/MREL disqualification events are considered as a case of exceptional circumstances under Article 78(4)(d) of the CRR (without a specific determination by the competent authority).

2.2.4 No right for holder to accelerate the payment of interest or principal for Tier 2 and eligible liabilities

94. Articles 63(l) and 72b(2)(l) of the CRR require that 'the provisions governing the instruments/liabilities do not give the holder the right to accelerate the future scheduled payment of interest or principal, other than in case of the insolvency or liquidation'.

95. In spite of the breadth of the term 'insolvency or liquidation', which can receive different definitions under national law, this requirement should be understood as precluding acceleration in any circumstances other than an insolvency proceeding, including insolvency liquidation but excluding resolution proceedings.

96. Indeed, the purpose of this prohibition is to make sure that instruments can play their role in gone concern and resolution, i.e., to absorb losses of an institution that is failing or likely to fail so that resolution authorities can maintain, inter alia, critical functions. This purpose would be defeated if counterparties could claim an anticipated payment on the ground that the institution is undergoing resolution or is subject to a moratorium. The situation is different when a bank is put under 'normal insolvency proceedings'[27] (also known as liquidation) leading to the discontinuation of the activities of the institutions. In normal insolvency, acceleration is not problematic, because it does not cause the bank to pay any amount to the counterparty but renders the liability due and enables the counterparty to file its claim with the insolvency estate.

[27] See Article 2(1)(47) of the BRRD: "the term 'normal insolvency proceedings' means collective insolvency proceedings that entail the partial or total divestment of a debtor and the appointment of a liquidator or an administrator normally applicable to institutions under national law and either specific to those institutions or generally applicable to any natural or legal person."

97. In the same vein, Directive 2001/24/EC[28] on the reorganisation and winding up of credit institutions, which sets out intra-EU cross border recognition of insolvency proceedings of credit institutions, distinguishes between 'reorganisation measures', which are 'intended to preserve or restore the financial situation of a credit institution' and 'winding up measures', which means the 'realisation of assets of an institution'. When the BRRD was adopted in 2014, Directive 2001/24/EC was explicitly amended to specify that reorganisation measures 'include the application of the resolution tools and the exercise of resolution powers'.

98. Issuances generally contain clauses according to which acceleration rights are granted to the noteholders in the case of 'liquidation', 'winding-up' or 'bankrupt[cy]' of the issuer. The terms vary, as insolvency terminology is different from one Member State to another and considering the fact that, as recital (45) of the BRRD recalls, 'a failing institution should in principle be liquidated under national insolvency proceedings'. That said, resolution is not always explicitly excluded from the grounds for acceleration in the documentation, and in this case, the eligibility assessment of those clauses is dependent on the assumption that the procedures described above cannot be understood as comprising resolution. In this regard, it should be clear from the notes that acceleration can occur only on the ground of insolvency or liquidation, and that, in particular, it cannot occur in resolution or a moratorium under the BRRD[29]. A best practice would be that 'resolution' and 'moratorium' are mentioned explicitly by the notes as not giving rise to acceleration.

2.2.5 Absence of set-off or netting arrangements

99. In accordance with Articles 52(1)(r), 63(p) and 72b(2)(f) of the CRR, capital instruments and liabilities shall qualify as own funds or eligible liabilities when they are not subject to set-off or netting arrangements that would undermine their capacity to absorb losses. In general, set-off and netting is not permitted in an insolvency proceeding, unless certain requirements for set-off and netting have been met prior to the insolvency declaration and comply with specific national insolvency legislation.

100. As clarified in recital (26) of the CRR2[30], the prohibition of set-off and netting rights 'should not mean that the contractual provisions governing the liabilities should contain a clause explicitly stating that the instrument is not subject to set-off or netting rights'. Although this is not a legal requirement and the absence of such a clause does not mean that the instrument concerned needs to be grandfathered and ultimately disqualified as own funds or eligible liabilities as explained in Q&A 2020_5146, an explicit waiver of set-off and netting rights seems to be conducive to legal certainty, and, in the light of market practice, the inclusion of such a waiver is seen as best practice and would reportedly meet market expectation.

[28] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.

[29] See Article 33a of the BRRD.

[30] 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.

101. That said, the instrument concerned would need to be subject to an effective absence of set-off or netting arrangements that would undermine its capacity to absorb losses. In this context, it is observed that some instruments, while containing explicit clauses on the absence of set-off or netting, include a reference to the applicable national law. Such formulations might not be effective in some cases because national law provisions may take precedence over the CRR-compliant contractual provisions and affect their eligibility and effectiveness in the absence of netting.

102. The EBA has further monitored the interaction between contractual clauses in the terms and conditions of the issuances and the provisions of the relevant national laws, in particular to form a view on clauses referencing to national laws as a possible limitation to the effectiveness of the absence of netting and set-off. It appears that in the very vast majority of EU jurisdictions, set-off and netting rights can be waived effectively. However, in some jurisdictions, there might be specific circumstances (insolvency) or certain parties (consumers) for which statutory set-off or netting rights cannot be waived contractually. There is much uncertainty given the lack of case law. In a couple of jurisdictions these limitations explicitly do not apply to institutions, which can be considered as the most transparent way forward to clarify this interaction. It is in particular for resolution authorities, which are more naturally placed in this regard, to monitor how set-off and netting rights would work in practice under the respective national laws and assess how to resolve at best any potential issue in this respect. The EBA will continue to liaise with resolution authorities in this respect.

103. In addition, some terms and conditions contain a provision whereby if an amount payable by the issuer in respect of any note to any holder is discharged by set-off or netting, the holder must pay an amount equal to the amount of such discharge to the issuer, and the discharge must be deemed not to have taken place. This is seen as best practice where this is compatible with national law.

104. Finally, the language found in the contractual terms of the issuances reviewed to date is clear and precise on the waiving of set-off or netting rights by the holder. However, in some cases, the word 'counter-claim' is used instead of 'netting'. However, in some of the provisions assessed, the terminology used does not mirror the one provided in the CRR and the BRRD. As a best practice, the wording used should be, where possible, in accordance with that in the CRR and the BRRD.

2.2.6 Issuances governed by third-country law

105. Article 72b(2), point (n)[31] of the CRR requires the relevant contractual documentation of eligible liabilities instruments and, if applicable, the prospectus to explicitly refer to the possible exercise of the write-down and conversion powers in accordance with Article 48 of the BRRD. Similarly, Articles 52(1), point (q) and 63, point (o) of the CRR, for Additional Tier 1 and Tier 2, respectively,

[31] All eligible liabilities instruments will have to include a reference to write-down and conversion when issued after 28 June 2021 (i.e., 2 years after the entry into force of that regulation).

foresees criteria on the recognition of the exercise of write-down and conversion powers referred to in Article 59 of the BRRD.

106. Write-down and conversion, triggered upon intervention of the resolution authority in the context of the bail-in tool[32], must not be confused neither with the automatic (i.e., without authorities' intervention) write-down and conversion at the going concern 'trigger event' within the meaning of Article 54 of the CRR for AT1 instruments, nor with the power to write-down or convert relevant capital instruments and eligible liabilities exercised independently of resolution action pursuant to Article 59(1)(a) of the BRRD.

107. MTNs programmes generally provide contractual language whereby noteholders acknowledge, accept, consent to, and agree to be bound by bail-in and include a reference to the exercise of write-down and conversion powers by the relevant resolution authority, although the requirement in Article 72b(2), point (n) of the CRR only applies to instruments issued after 28 June 2021.

108. Articles 59(2) and 63(1), points (e) to (h) of the BRRD requires Member States to confer on their resolution authorities the powers to write down and convert relevant capital instruments and eligible liabilities. If capital instruments or liabilities ("instruments") of an institution are governed by the law of a Member State, the application of the write-down and conversion powers will therefore be effective as a matter of law.

109. Conversely, in cases where the instruments or eligible liabilities are subject to the laws of a third country, the cross-border effectiveness of the application of the bail-in tool or the write-down or conversion powers might be subject to such third-country laws and remains dependent upon domestic or foreign courts asked to recognise the exercise of the write-down and conversion powers by EU resolution authorities under the scope and provisions of the relevant third-country law. To that end, Articles 52(1), point (q) and 63, point (o) of the CRR, as introduced by the CRR2, set out new eligibility criteria for such third-country law instruments in order to ensure the exercise of those write-down and conversion powers as foreseen in the relevant provisions of the BRRD will be effective and legally enforceable also under the third-country law, on the basis of statutory or contractual provisions[33].

110. Moreover, Article 55 of the BRRD requires liabilities governed by third-country law to include a contractual term by which the creditor or party recognises that the liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction in the principal or outstanding amount due, conversion or cancellation that is affected by the exercise of those powers by a resolution authority.

[32] When referring to bail-in, this report focuses on own funds and eligible liabilities instruments, even though the scope of application of this tool might be broader, encompassing also bail-inable liabilities, different from own funds and eligible liabilities.

[33] Article 52(1), point (p) also covers issuances of AT1 instruments where the issuer is established in a third country and has not been designated as part of a resolution group, the resolution entity of which is established in the Union. For those issuances, the Level 1 text requires the law or contractual provisions governing the instruments to recognise the decision by the relevant third-country authority to write down the instruments on a permanent basis or to have them converted into CET1.

111. An important element of the discussion on third-country law issuances is that institutions should consider the additional complexity when issuing own funds or TLAC/MREL eligible liabilities instruments under third-country law. The EBA has observed that some competent authorities regard all issuances subject to third-country law as complex and require assurance of compliance with the criteria, such as a legal opinion confirming the effectiveness and enforceability of the write-down and conversion powers of EU resolution authorities as required by Articles 52(1), point (q) and 63, point (o) of the CRR. While the delivery of a legal opinion is not a legal requirement under the CRR provisions, it is an option given by Article 55(3) of the BRRD.

112. In the context of the new criteria, and in particular concerning issuances under English law[34], the EBA was asked whether the introduction of the contractual recognition of the write-down and conversion powers in the terms of issuance of AT1 and Tier 2 instruments issued prior to 27 June 2019, in order to avoid grandfathering in accordance with Article 494b of the CRR, would be considered a 'material change' within the meaning of EBA Q&A 2013_16 and therefore as a new issuance. The EBA confirms that any change in the terms and conditions of an already issued instrument, that might have an impact on the eligibility criteria should be considered a 'material change', and that any change made should aim at full eligibility of the instrument under the CRR applicable provisions. That said, under the exceptional circumstances of the UK's departure from the EU, the residual time to maturity/first call date would not be affected and the original date of issuance would remain unaltered.

113. Among the observed issuances subject to a dual governing law, the notes are either governed by the law of an EU Member State (for the insolvency ranking) and by the law of a third country (e.g., English or New York law) as well as the law of an EU Member State.

114. In all dual governing law cases, the notes are governed by a *lex specialis* (a law applied to certain provisions of the contract) and a *lex generalis* (a law governing all other provisions). In all cases, the *lex specialis* would cover the 'status' of the notes, i.e., their ranking in insolvency. In some cases, the *lex specialis* would also extend to the waiver of set-off rights or to some specific events as defined in the terms of the notes. In other cases, the institution might be able, under the usual substitution/variation clause, to change the governing law of the condition related to the acknowledgement of national statutory loss absorption powers from a third country law to national law, or vice versa.

115. In this regard, the fact that all issuances analysed consistently choose the law of the Member State of incorporation to govern the insolvency ranking of the note merely reflects the fact that, in international law, 'the ranking of claims is always established by the *lex fori concursus*' (law of the forum). From that perspective, a reference to a Member State's law in relation to the ranking in insolvency made by the terms of issuance of the instruments governed by the law of a third country may be deemed insufficient to meet the condition set

[34] Since 01.01.2021, the UK has to be considered a third country and therefore own funds and TLAC/MREL eligible liabilities instruments issued under English law have to be considered third country issuances.

out in Article 55(1) of the BRRD and for AT1 and Tier 2, in Articles 52(1), point (p) and 63, point (n) of the CRR, respectively.

116. With regard to provisions other than ranking in insolvency, the practices are more varied.

117. On the one hand, Article 55 of the BRRD sets out the condition that 'the liability is governed by the law of a third country', without specifying which elements of the liability must be subject to third-country law. Therefore, it can be argued that it is sufficient that some elements or aspects of the liability (e.g., enforceability or effects in insolvency), whatever they are, are governed by third-country law, for Article 55 of the BRRD to apply. In this spirit, the fact that contracts refer to a third-country law only in relation to 'non-contractual obligations' or any 'relevant clause' may be sufficient to conclude that, overall, the contract needs to contain a write-down and conversion clause.

118. On the other hand, the first subparagraph of Article 55(1) of the BRRD[35], as well as recital (26) of the BRRD2[36/37], demonstrate that that Article is specifically meant to ensure the enforceability of the write-down and conversion powers of resolution authorities in the EU. It could be argued on this basis that what matters for the purpose of Article 55 of the BRRD is whether a third-country court or administrative authority would recognise the exercise of the write-down and conversion powers of resolution authorities in the EU[38]. Such a purpose-driven interpretation would allow for differentiating between provisions, with some aspects of the liability being governed by third-country law without triggering Article 55 of the BRRD.

119. In such cases, the cross-border effectiveness of the application of the bail-in tool or write-down or conversion powers is dependent on foreign courts recognising the exercise of write-down and conversion powers of EU resolution authorities. The critical concern is whether EU resolution authorities' write-down and conversion powers are effective and enforceable within the third country, i.e., whether they breach the laws of that third country (all laws, not just contract law) and whether the courts will uphold the write-down/conversion of the liability, should any holder of the liability (typically investors/creditors from the third country) challenge that write-down/conversion (either on the basis of a contractual recognition clause or otherwise), as there may be no international law for the recognition of the exercise of foreign governmental powers.

[35] 'Member States shall require institutions and entities to include a contractual term by which the creditor or party to the agreement or instrument creating the liability recognises that liability may be subject to the write-down and conversion powers.'

[36] Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC.

[37] 'The requirement to include a contractual recognition of the effects of the bail-in tool in agreements or instruments creating liabilities governed by the laws of third countries should facilitate and improve the process for bailing in those liabilities in the event of resolution.'

[38] By definition, as per EU law, the bail-in powers do apply to instruments issued by institutions or entities established in the EU or by branches of EU institutions established outside the Union. This statutory competence would not necessarily be accepted by a third country court or administrative authority.

120. In the case of contracts which are governed by the laws of a third country (i.e., non-EU law governed contracts), there is a risk that the effectiveness or enforceability of a bail-in or resolution decision may be challenged under the law of the contract. For example, under a contract governed by New York law, a creditor might argue in the US courts that a conversion to equity was not agreed to under the contract or that the agreement is unenforceable or that the write-down and conversion powers otherwise breach or are unenforceable/ineffective under the laws of that third country, and that the EU bank is in default of a payment obligation, notwithstanding the resolution action.

121. That said, it is notable that, with regard to new issuances, and to achieve legal certainty, some competent and resolution authorities have started to supervise and offer specific guidance regarding the requirements set out in Article 55 of the BRRD that issuances governed by third-country laws include contractual clauses by which holders recognise that the liability may be subject to the write-down and conversion powers of EU resolution authorities. Institutions have also been encouraged to consider issuing under the governing laws of the EU-27 Member States. In this context, the trend towards moving from dual governing laws to one single governing national law, following the United Kingdom leaving the EU, has continued in more recent issuances. The EBA will further monitor this development.

122. As a conclusion, it would seem prudent to apply Article 55 of the BRRD and Articles 52(1), point (p) and 63, point (n), of the CRR strictly, thus requiring institutions to include write-down and conversion clauses in all circumstances in which part or all the contract is governed by a third-country law to ensure own funds and TLAC/MREL eligibility.

123. Article 55 of the BRRD requires an explicit recognition of bail-in powers and that the creditor or party to the agreement or instrument agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation' whereas Article 72b(2)(n) of the CRR provides for an 'explicit reference' to the possible exercise of the write-down and conversion powers. In the case of AT1 and Tier 2 instruments, Articles 52(1), point (p) and 63, point (n), respectively, allow for either the law or the contractual provisions to recognise write-down and conversion powers. To ensure MREL and TLAC eligibility and, where applicable, own funds eligibility, the terms and conditions governing the relevant instruments should fulfil the recognition requirements set in Article 72b(2)(n) of the CRR and, where applicable, Articles 52(1), point (p) and 63, point (n) of the CRR, and Article 55 of the BRRD, including the technical standards related on impracticability of contractual recognition of the bail-in clause[39]. Therefore, from a policy and practical point of view and in the interests of institutions and authorities, drafting that meets the purpose of both provisions is considered more efficient.

[39] Commission Delegated Regulation (EU) 2021/1527 of 31 May 2021 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards for the contractual recognition of write down and conversion powers.

124. The AT1 standardised templates[40] recommend standard drafting for bail-in clauses under Article 55 of the BRRD. Furthermore, the EBA provides guidance on this aspect (paragraphs 160-172[41]). A similar standardisation effort should be envisaged in relation to TLAC/MREL eligible liabilities instruments to ensure compliance with Article 55 of the BRRD, as well as Article 72b(2), point (n) of the CRR (considering that the latter refers to all the eligible liabilities instruments and not only to the ones issued under a third country law) taking into account their specificities. Where the provisions governing the instruments provide for an investor notification mechanism by the issuer of the exercise of the bail-in power by the resolution authority, the inclusion of a clause whereby any delay or failure by the issuer to notify in advance the noteholders will not affect the validity and enforceability of the bail-in or write-down and conversion powers is considered a best practice.

125. With regard to the liabilities governed by English law, on 22 March 2021, a resolution authority communicated that it will consider, for a specific time period, those liabilities without a contractual bail-in recognition clause as eligible for MREL if certain criteria are met[42].

2.2.7 Other issues

Holders' right to amend terms and conditions

126. The inclusion of provisions that would allow instrument holders to propose changes to the terms and conditions of an instrument could be acceptable from an own funds and eligible liabilities perspective only where the issuer has the right to refuse the changes and the competent or the resolution 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 is to 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 or resolution authority, as such changes may affect the eligibility criteria for classification as regulatory own funds and eligible liabilities, so that the competent or resolution authority has the opportunity to express a view on these changes, in particular with regard to their materiality.

Substitution and Variation (including alignment event)

127. Frequently issuances include substitution and variation clauses, whereby the issuer may, at any time, without the consent of the holders either: (a) substitute new notes to the existing ones; or (b) vary the terms of the notes, so that the notes may become or remain compliant with the regulatory provisions applicable to the issuer and that such substitution or variation do not result

[40] EBA standardised templates for Additional Tier 1 (AT1) instruments, October 2016.

[41] These refer to Article 54 of the CRR but could equally be applicable for the purposes of Article 55 of the BRRD.

[42] Communication on SRB approach to eligibility of UK law instruments without bail-in clauses after Brexit.
The SRB stated that to ensure alignment with the prudential grandfathering of the requirement to introduce contractual recognition clauses in own funds instruments provided for in Article 494b of the CRR this policy will remain in place until 28 June 2025.

in terms that are materially less favourable to the holders. Some documentation provides for the possibility of substituting the debtor with the consent of the noteholders or with a guarantee of the original issuer, by transferring the instrument to another entity (related or not related).

128. Substitution and variation clauses should be understood as comprising only clauses which allow for the possibility for the issuer (or trustee) to modify or change contractual features (including governing law), whose purpose is to ensure that the notes comply with the regulatory eligibility criteria. Some of the documentation might also contain 'alignment events', applicable to either own funds or eligible liabilities instruments, that are meant to allow the issuer to absorb regulatory changes not directly causing a loss of qualification of the concerned instrument. This clause would in particular allow the institution to substitute or vary the terms of the instruments, so that the amended instruments present a continuous compliance with eligibility criteria. This type of clause is considered to be a mere sub-form of substitution and variation clauses, hence the same principles as the ones described below apply.

129. Exercise of substitution and variation clauses in both own funds and eligible liabilities instruments should as a minimum be subject to receiving prior consent from the relevant authority (the reference to consent being adapted to local specificities, i.e., this might mean a prior approval under Article 77 of the CRR in some jurisdictions). Where these clauses would lead to material changes that would affect the eligibility criteria of the instruments, their exercise should always be subject to the prior approval (under Article 77 of the CRR) of the relevant authority. In addition, general clauses that would foresee the possibility for holders to object to changes to the terms and conditions or to articles of association affecting their rights that could be understood in a way for holders to get additional protection in resolution are seen as non-adequate practices.

130. In those cases, in which notes might cease to be eligible as a result of one of the parties enforcing a contractual option (e.g., an option to substitute the debtor with another entity that is not related), the instrument should also contain an explicit reference to the need to obtain the prior permission of the competent/resolution authority.

131. Furthermore, in the event that the issuer transfers the instrument from its balance sheet to that of another entity, not only prior permission according to Article 72b(2)(j) in conjunction with Articles 52(1)(i), 63 (j) and 77(2) of the CRR is required, but if the other entity is subject to own funds/TLAC/MREL requirements and wants this instrument to qualify as an own funds/eligible liabilities instrument, all the criteria for it to qualify as an own funds/eligible liabilities instrument in accordance with Articles 52, 63 or 72b of the CRR must also have been met at this point.

Negative pledges

132. A negative pledge can be defined as 'a covenant by the issuer in the terms and conditions of the issue which restricts the freedom of the issuer (and possibly other entities related to the issuer) to grant security for other debts without granting equal security for the debt in question'. The most common practice in international bond issues is that the negative pledge prohibits granting security for only other listed bonds. Such an issuer is then not able to issue secured listed

bonds without granting equal security for the existing bonds but could secure different kinds of its debt, for example by taking out secured bank loans. Nevertheless, the scope of the negative pledge may vary substantially from issuer to issuer. The existence of a negative pledge, therefore, only means that the freedom of the issuer to grant security for its other debts is limited rather than unlimited.

133. With regard to eligible liabilities more specifically, some programmes allow for a negative pledge to apply to senior preferred notes, whereas senior non-preferred notes do not have the benefit of the negative pledge covenant. That such a clause is not applicable to senior non-preferred issuances seems reasonable, as it disturbs the allocation of losses and possibly impedes resolvability, which contradicts the objective of MREL. That said, some MTN programmes go further and exclude very explicitly any negative pledge, regardless of the type and ranking of the notes (i.e., for both senior preferred and senior non-preferred notes).

134. Although the CRR does not require an explicit clause to include a no negative pledge provision, many notes already explicitly exclude negative pledges as a standard practice, it is appropriate to recommend such exclusion as best practice for own funds and eligible liabilities instruments.

Anti-circumvention principle

135. Terms of the instruments 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. In this regard, it is now stressed in addition that Article 79a of the CRR explicitly stipulates that 'the assessment of the substantial features of an instrument shall take into account all arrangements related to the instruments, even where those are not explicitly set out in the terms and conditions of the instruments themselves, for the purpose of determining that the combined economic effects of such arrangements are compliant with the objective of the relevant provisions.'

Formal issues

136. Prudential provisions or clauses of importance from a prudential point of view should 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.

137. 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).

138. 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.

139. 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.

Valuation of non-CET1 instruments

140. The EBA has launched an investigation to collect relevant information on current banks' accounting and prudential practices on non-CET1 instruments, as well as on hedging strategies and associated interest rate and FX impact on the valuation of those instruments.

141. In particular, the EBA is looking at four main areas of investigation:

- Accounting treatment, including the classification of AT1 instruments as equity or debt, accounting classification of debt instruments, use of hedge accounting, and foreign currency denomination.

- Prudential treatment, including alignment of accounting and prudential valuations. This also encompassed how banks reflect FX movements in the value of AT1 instruments accounted for as equity, the prudential measurement basis used, and the exclusion from the carrying value of certain accounting items (e.g., accrued interest, hedge adjustments).

- Hedging practices on interest rate and FX risk, including the use of derivatives and hedge accounting (or election at FVtPL), natural hedging, and other practices.

- Impact of the increase in interest rates and FX movements on AT1, Tier 2 and MREL/TLAC.

142. The EBA has observed, at the current stage of its investigations, different practices among institutions including regarding the way institutions reflect for prudential purposes FX movements of AT1 instruments classified as equity for accounting purposes.

143. In the majority of cases, the amounts recognised of the AT1 instruments recognised for prudential purposes are based on their accounting value (net of any further regulatory provisions) determined under IFRS standards using the exchange rate at the date of issuance. In those cases, the value of the AT1 instruments remains unchanged (i.e., not reflecting any FX movements after issuance) both from the accounting and prudential perspectives. Using this treatment, any accumulated losses or gains related to FX movements would be realised if the institution were to exercise a repurchase or redemption of the AT1 instruments, and only be reflected in the institutions CET1 capital at that point in time.

144. In contrast, other approaches have been observed aiming at reflecting on a continuous basis the FX movements occurred after the issuance of the AT1 instruments in the prudential figures. While some institutions reflect FX movements of their AT1 instruments only in their prudential figures, others have made use of accounting options (e.g., making use of own accounting policy choices). In both kind of approaches, the AT1 instruments are recognised using the current exchange rate at the reporting date. This implies that any variation in the AT1 instruments value due to the FX movements would also be reflected in the CET1 capital.

145. These approaches ensure a timely recognition of FX gains or losses that would otherwise materialise in full at the moment of eventual redemption of the instruments. At this stage of its reflections, the EBA views that when one of these approaches is used, its consistent application over time should be ensured to demonstrate the absence of any opportunistic behaviour. In addition, such practices should not be associated with an expectation that the call will be automatically exercised at the first callable date. The EBA will continue to investigate the practices in this regard.

146. The EBA will further communicate any other results of its ongoing investigations and possible ways of action where deemed needed.

2.3 Detailed analysis of eligibility criteria relevant for AT1 instruments

147. 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.

148. Although they are complex instruments, AT1 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 due to the existence of quite prescriptive provisions in the CRR and the RTS.

149. Nevertheless, the monitoring process has shown, especially at its starting point, that a few provisions of existing AT1 instruments, or of those AT1 instruments 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 originally proposed, 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. This may particularly be the case for some provisions related to regulatory calls, calls linked to specific events (e.g., rating events), share conversion mechanisms, contingent clauses and covenants.

150. Furthermore, this report provides the EBA's guidance in a few areas where there might be different interpretations. 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.

151. In the previous versions of the AT1 report, the EBA noted that the standardisation of the terms and conditions was still increasing, with some issuers using the provisions proposed in the EBA standardised templates published in October 2016 for some definitions or for some parts, or even to a larger extent. This trend has been continuing during the more recent years and the EBA believes that this increased standardisation is partly due to the guidance regularly published by the EBA (via this report or via Q&As) and regularly communicated by supervisors.

152. Finally, the EBA has been monitoring AT1 calls and the rationale for calling/not calling instruments. At this stage of its monitoring, the EBA observes that the majority of calls have been exercised at the first call date, while only a few calls have not been exercised based on prudential and/or economic considerations.

153. The EBA views favourably the non-automaticity of the exercise of the call at the first opportunity for AT1 instruments in particular, as AT1 instruments are meant to be perpetual. Furthermore, at this stage, the EBA does not express a preference for a specific frequency of subsequent call dates, but it will continue to monitor the exercise of calls and a potential link between the frequency of these subsequent call dates and a potentially different pressure to redeem the instrument.

154. In this respect, it is also recalled that the CRR provisions are quite prescriptive in terms of calling/repurchasing/redeeming an instrument and refer in particular to costs aspects, and notably to the replacement of an existing instrument at terms that are sustainable for the income capacity of the institution. This aspect is further defined in the RTS as meaning that the profitability of the institution continues to be sound or does not see any negative change after the replacement at that date and for the foreseeable future, including in stress situations.

Trigger events

155. In the case of AT1 instruments, 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.

156. 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.

Cancellation of distributions

157. 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 does not affect the validity of the cancellation and does not constitute a default for any purpose. On the contrary, the effectiveness of the cancellation should not be made subject to a notification. In the absence of any notice of cancellation being given, non-payment of the relevant distributions payment on the relevant distributions payment date should be evidence of the issuer having elected or being required to cancel such distributions payment[43].

158. 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.

Event of default

159. 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.

Write-down or conversion

160. 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.

161. 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.

162. 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

[43] See also EBA AT1 standardised templates, page 16.

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).

163. In any case, the maximum floor should be the one required by commercial/civil law (assuming that this would be an insignificant amount).

164. 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.

165. 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.

166. 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).

167. The terms and conditions of the instrument should 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’).

168. 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 should 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.

169. 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 should 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.

170. No provision should link the write-up of the instrument to contractual, statutory or other obligations, as write-ups are fully discretionary.

171. It would be appropriate to specify the interaction between the loss absorption of AT1, Tier 2 and eligible liabilities 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.

172. 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. 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.

Calculation of the amount available for the write-up when the instrument features a double trigger

173. 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 1capital.

174. 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.

175. 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

176. Under the CRR provisions, triggers for the loss absorption of AT1 instruments should 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.

177. Different situations may arise: banking groups with a parent institution; banking groups with a parent holding company; and mutual groups with a central body.

178. 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.

179. Where an institution is subject to Article 11(2) of the CRR— 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.

180. 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 the CRR 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)

181. 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 (at least) 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.

182. 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.

183. More generally, and as mentioned in Q&A 2013_385, instruments issued by subsidiaries in third countries should 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.

184. For the purposes of the definition of the trigger event, the CET1 capital should be calculated in accordance with the provisions of the national law or contractual provisions governing the instrument in accordance with Article 54(1)(e) of the CRR, provided that the competent authority, after consulting the EBA, is satisfied that those provisions are at least equivalent to the requirements set out in Article 54 of the CRR.

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

185. 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%).

186. 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

187. 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.

188. 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 Article 21(1) of the RTS 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.

189. In case of the existence of other similar loss-absorbing instruments, a clause clarifying the following is considered as a best practice: that these instruments, which may be written down or converted into equity in full but not in part only, will be treated for the purposes only of determining the relevant pro rata amounts as if their terms permitted partial write-down or conversion into equity.

Contingent clauses

190. 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.

191. 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.

192. In particular, using contingent clauses would allow (via debt accounting) to 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.

193. On the other hand, there are drawbacks to allowing the use of contingent clauses by EU institutions. These are of a different nature.

194. 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'.

195. 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.

196. 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, under the applicable accounting framework, generates 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.

197. 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.

198. 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.

199. The EBA thus recommends disallowing the use of contingent clauses in the terms and conditions of EU issuances.

200. 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.

201. Separate considerations are also provided in paragraph 145 of this report with regard to some observed practices on the valuation of FX effects for AT1 instruments accounted as equity.

Pre-emption right for shareholders

202. 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.

203. 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.

204. 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.

205. In the end, despite initial reservations, the EBA agrees that this feature is acceptable.

Contingent conversion convertibles

206. Simply described, the rationale for contingent conversion convertibles 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.

207. 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.

208. One of the forms of incentives to redeem as identified in Article 20(2) of the RTS 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'.

209. 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.

210. 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).

211. Conditions that could be considered for accepting this type of instrument should refer to cases where the subscriber is an existing shareholder or cases where the conversion option is to be exercised as a result of a 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.

212. 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).

2.4 Detailed analysis of eligibility criteria relevant for Tier 2 instruments

Event of default

213. In order to avoid a No Creditor Worse Off (NCWO) issue and to ensure the insolvency hierarchy is not hampered, the acceleration right needs to concern all *pari passu* instruments as well as all instruments ranking senior to them. In this regard, a Tier 2 instrument cannot contain a clause that grants the holders the right to request the acceleration of their claims against the institution other than in case of insolvency or liquidation.

RAC Tier 2

214. The EBA observed that recently a few institutions issued so-called Risk-Adjusted Capital Tier 2 instruments (RAC Tier 2), i.e., Tier 2 instruments with specific features including a 'trigger event' and a 'rating methodology event'. Those RAC Tier 2 instruments are issued with the purpose of qualifying as equity capital under the methodology of a credit rating agency. While for some institutions this instrument is the most junior one issued immediately after CET1 (i.e., ranking only senior to CET1 instruments), for others it is issued in addition to AT1 instruments.

215. The existence of several triggers in different types of own funds instruments creates uncertainty on the effectiveness of the write-down or conversion between the different types of instruments. In addition, in the context of the transposition of Article 48(7) of the BRRD, this setting of the triggers may conflict with the insolvency hierarchy as a Tier 2 with a higher trigger than an AT1 might absorb losses before AT1, which produces uncertainty regarding the precise write-down or conversion order, and may as well create compliance issues with Article 63(d) of the CRR and infection risk concerning AT1 instruments (Article 53(1)(d) of the CRR). This might also create uncertainty with regard to the bail-in powers as set out in Article 55(3) of the BRRD.

216. In general, links or references to a credit rating agency should be avoided in the terms and conditions of own funds instruments to ensure that there is no link between the payments and the credit rating. It has to be recalled that call options with reference to rating events are conflicting with the eligibility criteria of Article 63(k) of the CRR (see paragraph 83). In the same vein, rating methodology events, which are triggered by an instrument no longer being recognised under a specific rating methodology due to a change applied by the rating agency, causing a subsequent trigger event and a reduction of the interest to be paid, need to be carefully assessed on a case-by-case basis as these events could conflict with various eligibility criteria.

217. In particular, Article 63(m) of the CRR requires that the level of interest or dividends payments, as applicable, due on the instruments will not be amended on the basis of the credit standing of

the institution or its parent undertaking. In this regard, it needs to be determined whether a rating methodology event is clearly and only linked to a change in the holistic methodology applied by the rating agency without any link to the specificities of the issuing institution. In addition, given that a rating methodology event renders the instrument ineligible under its initial capital category for rating purposes, a potential incentive to redeem exists, which would conflict with Article 63(h) of the CRR.

218. All in all, the aspects described above in relation to RAC Tier 2 instruments pose risks in terms of the eligibility of the instruments and, therefore, the EBA discourages the use of these instruments. In a more general manner, it is confirmed that provisions creating a link with some criteria from credit rating agencies methodologies need to be avoided. In addition to the complexity and potential correlation between AT1 and Tier 2 instruments, such structures give rise to legal uncertainty and NCWO risks in resolution, therefore they should be avoided.

2.5 Detailed analysis of eligibility criteria for eligible liabilities instruments

Subordination

219. Pursuant to Article 72b(2)(d) of the CRR, eligible liabilities instruments may only be eligible provided that the claim on the principal amount is 'wholly subordinated to claims arising from the excluded liabilities' referred to in Article 72a(2) of the CRR. Three types of subordination are admitted in points (i) to (iii):

(i) Contractual subordination: this refers to notes subordinated to claims arising from any of the excluded liabilities referred to in Article 72a(2) of the CRR as a result of the contract.

(ii) Statutory subordination: this refers to notes subordinated to claims arising from any of the excluded liabilities referred to in Article 72a(2) of the CRR as a result of applicable law.

For example, Article 108 of the BRRD, as amended by the Creditor Hierarchy Directive[44], introduces a harmonised level of statutory subordination in all Member States by providing for an intermediary ranking between subordinated claims and ordinary unsecured claims, and therefore meeting, depending on the national insolvency applicable regime, in principle the subordination criteria of Article 72b(2)(d)(ii) of the CRR. Senior non-preferred claims must refer to the intermediary ranking under the new provision.

By convention, the EBA designates as 'statutorily subordinated' instruments, the ranking of which in the event of normal insolvency proceedings is mandatorily governed by legislation, even if the decision to elicit that insolvency ranking is provided

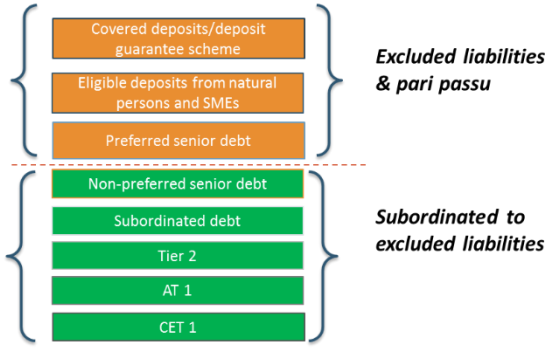
[44] Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017

for in the contract. Along with the transposition of the Creditor Hierarchy Directive by EU jurisdictions, statutory subordination has progressively replaced contractual subordination.

(iii) Structural subordination: this refers to notes issued from a resolution entity that does not have on its balance sheet any excluded liabilities referred to in Article 72a(2) of the CRR that rank *pari passu* with or junior to eligible liabilities instruments.

220. Issuers should set out unambiguous terms on the ranking of notes in insolvency, and in particular, there should be no doubt that the notes are subordinated to excluded liabilities within the meaning of Article 72a(2) of the CRR. A description of instruments ranking junior and senior to a note under consideration constitutes best practice, particularly if the note is not statutorily subordinated as a result of the application of the national measures implementing Article 108 of the BRRD, as amended by the Creditor Hierarchy Directive.

Figure 1: Simplified stack - statutory subordination for the purpose of MREL



221. In general, senior non-preferred notes rank in insolvency below liabilities excluded pursuant to Article 72a(2) of the CRR, meaning they meet the subordination criterion in Article 72b(2)(d) of the CRR. Also, recital 10 of the BRRD provides that "Member States should be allowed to create several classes for other ordinary unsecured liabilities provided that they ensure, without prejudice to other options and exemptions provided for in the TLAC standard, that only the non-preferred senior class of debt instruments is eligible to meet the subordination requirement". However, Article 72b(3) to (5) of the CRR permits senior preferred liabilities also to qualify as eligible liabilities instruments, under the conditions specified therein and up to a certain ceiling. In addition, according to Article 45b of the BRRD, senior preferred liabilities also may count towards the MREL requirement in principle, however, the resolution authority may impose a minimum subordination requirement to institutions. On the status of the notes, the EBA has observed that some programmes define the MREL eligible senior notes as a category separately identified, while others do not provide for any differentiation with other senior notes. The EBA will continue monitoring market practices on MREL eligible senior notes going forward.

Contractual subordination

222. When it comes to contractual subordination other than by reference to SNP legislation, the question of how subordination should be defined arises. Indeed, notes classically define subordination by reference to a higher class, such as 'senior notes'. However, the notion of subordination for the purpose of the CRR is not defined in terms of commonly defined class but in terms of subordination to 'claims arising from … excluded liabilities[45]' (Article 72b(2)(d) of the CRR). In this regard, when faced with a note that specifies that it is subordinated to senior claims or ranks *pari passu* with senior non-preferred claims, one could wonder if it is without any doubt subordinated to excluded liabilities. As a conclusion, explicit language mentioning subordination 'to excluded liabilities' within the meaning of the CRR could achieve legal certainty if banks rely purely on contractual subordination.

Statutory subordination

223. Subordinated notes are generally subordinated under statutory terms and mention a national law transposing the Creditor Hierarchy Directive. Statutorily subordinated notes do not only cross-refer to the SNP legislation but also usually proceed to describe the SNP ranking in the hierarchy of claims. In general, notes extend the subordination status to both principal and interest and therefore go beyond Article 72b(2)(d) of the CRR, which refers only to the principal. In rare cases, the provisions used might give the impression that interest claims are more subordinated than principal claims. Clarity on the status of both principal and interest is welcome.

224. As SNP notes sit at an intermediate level between common subordinated notes and ordinary unsecured notes, practice varies as to whether or not SNP notes are presented as a specific subcategory of notes with senior status (this is the case for most base prospectuses) or as a stand-alone category between senior and subordinated. Some prospectuses present the notes as being 'unsubordinated' – which is counterintuitive, as SNP is meant to ensure a form of resolution-driven subordination – but they explain that SNP notes are in fact senior to classic forms of subordinated debt. This is confirmed by other notes that describe themselves as being senior to 'ordinarily subordinated'.

225. In principle, unless otherwise specified under national insolvency frameworks, reference to SNP legislation should give a clear description of where the notes sit in the hierarchy of claims and should not raise any doubt that those liabilities are genuinely subordinated to 'excluded liabilities' within the meaning of Article 72a(2) of the CRR. This is because Article 108 of the BRRD has been especially amended by the Creditor Hierarchy Directive with a view to meeting subordination criteria for eligible liabilities instruments. Nonetheless, from the moment that notes do attempt to describe the ranking of SNP notes, they would ideally also make clear that the notes are 'wholly subordinated to claims arising from the excluded liabilities within the meaning of Article 72a(2) of the CRR', as seen in some contractual documentation taking into

[45] Excluded liabilities are listed in Article 72a(2) of the CRR and essentially cover non-bail-inable liabilities, which may in certain cases also be exempt from losses in liquidation, for example covered deposits and secured liabilities.

account the third subparagraph of Article 72b(2) of the CRR[46]. In this regard, the EBA believes that labelling SNP as 'unsubordinated' could be misleading and it would be preferable to simply describe and clearly state the status on how they rank vis-à-vis senior unsecured and other subordinated debt. Also, it is considered clearer for investors if SNP were presented as a stand-alone category, rather than as a subcategory of senior notes.

226. Having interest subordinated to excluded liabilities is not a CRR eligibility criterion. However, the ranking of interest is an important issue, as interest can only be counted towards the loss absorption capacity of the bank if it is subordinated and, as per Article 72c(1) of the CRR, has a residual maturity of at least 1 year. In addition, as per Article 108 of the BRRD (as amended by the Creditor Hierarchy Directive), debt instruments with variable interest derived from a broadly used reference rate and debt instruments not denominated in the domestic currency of the issuer, provided that principal, repayment and interest are denominated in the same currency, must not be considered to be debt instruments containing embedded derivatives solely because of those features. Given this, there should always be clarity in the terms and conditions of the bonds of the ranking of interest in the insolvency hierarchy. Furthermore, interest subordination can be seen as best practice for subordinated instruments when this is compatible with the creditor's hierarchy according to national insolvency law. It appears, based on the issuances analysed following the publication of the first TLAC/MREL monitoring report, that this best practice has become market standard.

Structural subordination

227. In the case of structural subordination, subordination does not stem from contractual or legal provisions that would govern the respective ranking of investors in the entity. Instead, in this configuration, excluded liabilities are essentially located at a lower level in the group in a separate entity. In the event of bail-in at the level of the parent issuer (identified as resolution entity), creditors of the issuer will absorb losses first. The notes issued by the parent issuer are thus labelled 'senior' but are in effect structurally subordinated to all (excluded and other) liabilities of subsidiaries. This structural subordination is provided if there are effectively no excluded liabilities ranking junior to or *pari passu* with MREL eligible liabilities instruments on the balance sheet of the parent issuer, or for non-significant amounts of such liabilities ranking *pari passu* or junior (less than 5% of the amount of the own funds and eligible liabilities of the institution) where the conditions under Article 72b(4) of the CRR are fulfilled.

228. For this type of subordination, the analysis of eligibility depends not on the formal insolvency ranking set out in the note but on the actual liability structure of the entity and the issuance of subordinated internal MREL at the level of operating subsidiaries. This means that, purely on the basis of the notes, it might be difficult to conclude that the issuing entity is 'clean' from excluded

[46] For the purposes of point (d) of the first subparagraph of this Article, where some of the excluded liabilities referred to in Article 72a(2) are subordinated to ordinary unsecured claims under national insolvency law, inter alia, due to being held by a creditor who has close links with the debtor, by being or having been a shareholder, in a control or group relationship, a member of the management body or related to any of those persons, subordination should not be assessed by reference to claims arising from such excluded liabilities.

liabilities and that the liabilities are structurally subordinated to the operating liabilities of the subsidiaries.

229. The contractual documentation might explicitly state that the notes are structurally subordinated to the operating liabilities of the subsidiaries. Such a statement acknowledging the structural subordination to creditors in subsidiaries appears to be best practice, as it clarifies the intended status of the note vis-à-vis investors and authorities and provides high-level information on the liability structure.

230. Nevertheless, this kind of statement does not in itself solve the question of whether or not the notes meet the CRR subordination criteria, because it does not guarantee that, within the balance sheet of the holding company, no excluded liabilities rank or will rank junior to or *pari passu* with the issued note. Therefore, reaching a conclusion on eligibility necessitates precise information on the presence of excluded liabilities on the balance sheet and on their relative ranking vis-à-vis eligible liabilities. A best practice would be clarifying, for investor awareness purposes, the structural subordination mechanism and risks. This may, for example, be described in the risk factors and does not imply that the notes should be contractually subordinated. The assessment is also time-dependent, as the liability structure of the entity may also evolve after the issuance.

231. It is the responsibility of institutions to ensure compliance at all times, under the surveillance of resolution authorities in cooperation with competent authorities and following the relevant reporting requirements as specified by the ITS on reporting[47].

'Flipper' bonds

232. When starting its monitoring before the enactment of a statutory SNP regime in the relevant jurisdiction, the EBA has observed a few flipper clauses that were meant to automatically convert the ranking of the notes from either contractual subordination or senior ranking to statutory subordination from the entry into force of the national SNP legislation.

233. Some MTN programmes might also provide a mechanism for notes to convert from 'senior preferred' to 'senior non-preferred notes'. Two different possibilities are provided: either an optional conversion triggered by a notice given by the issuer or an 'automatic conversion' triggered by the occurrence of an 'automatic conversion date' to be set out in the applicable supplement. In both cases (automatic and optional conversion), the MTN specifies that a conversion does not constitute an event of default.

234. Preliminarily, flipper clauses were conducive to the quality of eligible liabilities instruments, since they increase the level of subordination or elicit a statutory regime that has been designed on purpose to meet TLAC/MREL subordination. Until the moment that the notes are converted, they should be analysed under their current regime, for example a senior ranking or contractual subordination. From the point of conversion, considering the fact that investors were informed

[47] ITS on supervisory reporting and public disclosure of own fnds and eligible liabilities

and agreed to be bound by the conversion ex-ante, such conversion should not in principle be considered prejudicial to the interests of the noteholders, even though the conversion might downgrade the claim in the insolvency hierarchy of claims.

235. In the case of optional or automatic conversion, the EBA assessed that, in principle, this should not be problematic, as long as all eligibility criteria are or continue to be met at the point of conversion. However, there must be no ambiguity about the fact that, if it is not guaranteed that the eligibility criteria are or continue to be met at the point of conversion, the instruments should not be qualified or should be disqualified as TLAC/MREL eligible liabilities instruments respectively. Furthermore, in one case the national law implementing the SNP directive explicitly provided for the recognition of flipper clauses, which should be seen as an additional element of certainty.

3. Follow-up of the EBA Opinion on legacy instruments

3.1 Background

236. In October 2020, the EBA published its Opinion on the prudential treatment of legacy instruments[48]. When reviewing EU institutions' legacy instruments and examining the clauses that led to their grandfathering, the EBA identified two main issues which could create so-called infection risk, i.e., the risk of other layers of own funds or eligible liabilities instruments being disqualified.

237. Since the publication of its Opinion, the EBA has started monitoring the situation of the legacy instruments, placing particular focus on the use of the proposed options across jurisdictions with a view to ensuring consistent application. In addition, the EBA considered the transposition of specific provisions of the BRRD (in particular, Article 48(7)) into national legislation and looked at how this might alleviate concerns about the existence of infection risk linked to subordination aspects.

238. Transparency on the implementation of the options envisaged in the Opinion by institutions and competent authorities was ensured in due time by the EBA. In this regard, on 7 July 2022, the EBA published a report on the outcome of the implementation of the Opinion in which the successful mitigation of possible infection risk stemming from legacy instruments was highlighted[49].

239. During the implementation period, the EBA received questions on different aspects of the proposed options aimed at addressing the infection risk. Some institutions intend to cascade down grandfathered AT1 instruments as fully eligible Tier 2 instruments under the rationale that their terms and conditions satisfy the ranking rules of Article 63(d) of the CRR, i.e., rank below eligible liabilities instruments. In addition, and in order to ensure that the ranking rules between different tiers of own funds are respected, some institutions suggested amending the ranking of current and future AT1 instruments issued so they are always subordinated in liquidation to the legacy AT1 intended to be treated as fully eligible Tier 2. While this approach might mitigate the infection risk in the higher tiers of own funds, i.e., CET1 and AT1, it raises concerns on the eligibility of already issued Tier 2 instruments. As the EBA has underlined in its Opinion, the subordination provisions covering the instruments should be assessed not only against the ranking rules across the tiers of own funds and eligible liabilities, but also within the specific tier of own funds in which the instruments are placed.

[48] EBA-Op-2020-17 Opinion on legacy instruments.pdf (europa.eu).

[49] EBA reports on the successful mitigation of possible infection risk stemming from legacy instruments | European Banking Authority (europa.eu)

240. While the eligibility criteria of the CRR do not explicitly prohibit Tier 2 instruments not ranking *pari passu*, the EBA emphasises that it does not consider it appropriate for institutions to implement a multiple-layered structure for Tier 2 instruments. Such an approach would add complexity to the own funds structure and would give rise to legal risk in the case of a bail-in due to the NCWO principle, in particular taking into account that the sequence established in Articles 48(1) and 60(1) of the BRRD refers to CET1 followed by AT1 and Tier 2, which implies a *pari passu* principle of loss absorption between instruments pertaining to the same category. In addition, it is recalled that any instrument that would be reclassified in the Tier 2 category would need to meet not only all relevant provisions of the CRR and the RTS, but also all the related guidance on the consistent and effective application of the regulatory framework provided via EBA Q&As and reports, including this report[50].

241. Other institutions were concerned whether a change in the terms and conditions in order to mitigate the infection risk would be considered a material change within the meaning of EBA Q&A 2013_16 and would lead to the instrument being treated as a new issuance, therefore, affecting its maturity. As already pointed out in EBA Q&A 2017_3299, changes made to pre-CRR instruments should aim at ensuring full eligibility under the applicable provisions. EBA Q&A 2018_4417 further clarifies that the *'terms and conditions need to be assessed against the rules which are applicable at the moment of the reclassification of the instrument. These rules encompass the relevant regulatory provisions stemming from Part Two (Own funds) and Part Ten, Title I (Transitional Provisions) of the CRR (legislative act) and Regulatory and Implementing Technical Standards (delegated and implementing acts), as supplemented by related guidance for the consistent and effective application of the regulatory framework provided via EBA Q&As or reports available at the time of reclassification.*' That being said, given that one of the options envisaged in its Opinion for addressing infection risk is the amendment of the terms and conditions of legacy instruments, then to promote legacy AT1 instruments ranking, *pari passu* with Tier 2 instruments, for example, the EBA clarifies that such amendments will not be seen as affecting the residual maturity of the instrument or its original date of issuance. This is under the condition that, except for the maturity aspect, any change made should aim for full eligibility of the instrument under the provisions applicable to the own funds or eligible liabilities layer where the instrument is to be placed and where the changes are made in order to continue classifying the instrument as own funds or as eligible liabilities.

3.2 Outcome of the implementation of the Opinion on legacy instruments

242. Overall, the monitoring of the implementation of the EBA Opinion shows that institutions have made significant efforts to address the issues related to legacy instruments. In general, institutions demonstrated willingness to clean up their balance sheets and ensure a strengthened loss absorbency capacity. Based on the input collected, a significant number of instruments has been resolved in the course of 2021 by either: (i) calling, redeeming,

[50] See paragraph 17 of the Opinion.

repurchasing, and buying back (option used in the very vast majority of cases) or (ii) amending their terms and conditions. In addition, in a few jurisdictions, the transposition of Article 48(7) of the BRRD helped mitigating the infection risk. Finally, for a limited residual number of instruments, actions are still ongoing/under consideration, with call options planned to be exercised later on, while a few will be kept in a lower category of own funds or as eligible liabilities or in the balance sheet as non-regulatory capital.

243. The primary objective of the EBA's Opinion was to address possible challenges in the quality of institutions' own funds and eligible liabilities posed by the end of the CRR1 grandfathering period (which ended in December 2021). That said, it is acknowledged that a new generation of legacy instruments has been created by the new grandfathering period running until June 2025 and resulting from the provisions of the CRR2. In this context, the EBA expects that institutions and competent authorities would apply consistently the guidance and principles of the EBA's Opinion for identifying potential issues and actions to address them. The EBA will re-assess in due time the need for additional scrutiny on these actions and on the remaining stock of legacy instruments.

244. As a conclusion, the EBA considers that necessary actions have been taken by institutions and competent authorities. These latter will continue to monitor the residual limited and specific cases and the implementation of the actions planned, also in the context of the CRR2 legacy instruments, where applicable, and report to the EBA.

245. Finally, in January 2023, the EBA published a response to a new enquiry[51] from a law firm regarding the case of the prudential classification as Tier 2 instruments of legacy perpetual bonds (so-called 'Discos'). After a careful consideration of the concerns raised and a scrutiny of the detailed terms and conditions of the Discos, the EBA assessed that the Discos could not count as fully eligible Tier 2 instruments in the case at hand.

[51] Similar enquiries had been received in the past on similar types of instruments.

4. EBA's considerations on own funds and eligible liabilities instruments with ESG features

4.1 Introduction

246. Banks have started issuing ESG' bonds[52] for MREL purposes since 2018, and an increasing number of issuers are looking at green capital as an opportunity to both finance and capitalise their green portfolios. More recently, the ESG trend has crossed to other capital products (own funds) with a first-ever Tier 2 issuance and AT1 issuance, both issued in July 2020.

247. This relatively new market segment has been growing and developing fast in recent years and months. ESG bonds are issued by entities that seek to have positive environmental, social and governance characteristics, the proceeds of which are meant to be invested in ESG assets. These bonds are usually marketed as green bonds or social bonds, commonly follow green[53] or social impact standards[54], and are certified by an independent verifier following the climate bond standard and certification scheme[55].

248. As highlighted in the EBA's TLAC/MREL monitoring report of October 2020[56] and in the AT1 report of June 2021[57], the EBA only conducted preliminary work on ESG bonds for TLAC/MREL purposes at the time of its publication and identified this area for future work and recommendations. After the publication of its initial guidance, the EBA has continued to exchange with some stakeholders on some possible structures. In particular, in relation to Sustainability-Linked Bonds (SLB – see developments below), reflections are still ongoing and the EBA will continue the exchanges on this matter.

249. The purpose of this guidance is to i) give an overview of the identified risks, ii) comment on identified differences of clauses based on a larger set of regulatory ESG transactions in comparison to the TLAC/MREL monitoring report and iii) discuss policy observations on how the clauses used for ESG issuances and the eligibility criteria for own funds and eligible liabilities instruments interact, with the ultimate aim of identifying best practices or practices/clauses that should be avoided. Therefore, the analysis is not meant to address potential compliance issues of ESG bonds with ESG requirements themselves, but it is aimed at clarifying the extent to which

[52] For the purpose of this report 'ESG' bonds means any type of own funds or eligible liabilities instrument that has been classified or labelled as 'Green', 'Social', 'ESG', etc. by the issuer. For the avoidance of doubt, to date there is no 'ESG' regulatory bond standard or label.

[53] https://www.icmagroup.org/green-social-and-sustainability-bonds/green-bond-principles-gbp .

[54] https://www.icmagroup.org/green-social-and-sustainability-bonds/social-bond-principles-sbp/ .

[55] https://www.climatebonds.net/certification .

[56] EBA Report on the monitoring of TLAC/MREL eligible liabilities instruments of EU institutions.

[57] Report on the monitoring of Additional Tier 1 instruments of EU institutions.pdf (europa.eu)

some provisions included in ESG bonds may raise regulatory concerns in the context of the eligibility criteria for own funds and liabilities instruments[58].

250. To perform its monitoring function, the EBA has focused its work on the assessment of selected ESG own funds and TLAC/MREL eligible liabilities instruments.

251. Furthermore, the EBA received input during a roundtable held with different stakeholders in April 2021 regarding findings and possible best practices on ESG bonds for own funds and eligible liabilities. Overall, stakeholders welcomed the EBA providing clarity on the compatibility between ESG features and regulatory eligibility criteria and shared the analysis presented on the identified risks and possible mitigants. The recommendations were well understood and shared. Participants urged the EBA to continue working on the aspects relating to the use of ESG performance targets (Key Performance Indicators - KPI) for bond remuneration in a context where Sustainability-Linked Bonds are expected to grow in the next few years.

252. Although this guidance provides current policy views, the monitoring of new ESG bond issuances will continue to enrich the observations and recommendations going forward as far as needed. The EBA will continue to monitor the developments of Sustainability-Linked Bonds and possible related KPI if issued for regulatory purposes.

253. In performing its monitoring function, the EBA ensures consistency with its other connected mandates and current developments in the broader developments at EU level of ESG standards.

4.2 Main observations

254. The EBA has observed that there are some divergences in the documentation (EMTN programmes) of issuers. While some documentation remains quite general, stating on the one hand the ESG requirements and on the other hand the requirements for own funds or eligible liabilities instruments, being silent on possible interactions between the two, others include, more or less extensively, specific provisions on these interactions. Recent issuances have proven to be more explicit in this regard.

255. Overall, explicit provisions in the documentation on these interactions with regard to several aspects such as loss absorbency, status of the notes/subordination, event of default, early redemption or acceleration rights are welcomed by the EBA. They are deemed to reinforce certainty on the nature of the bonds from a regulatory perspective and to mark more clearly the difference with other types of more common bonds such as senior debt or covered bonds that could be used for ESG financing purposes.

[58] In this regard it should be noted that the Commission is working on a legislative proposal on Green Bond Standards (following the recommendations of the Technical Expert Group on Sustainable Finance), which should include an EU definition of green bonds and specify the requirements that these instruments should have in order to comply with the EU Standards (link). Since this proposal is not yet known, the present guidance does not prejudge on the compliance of the regulatory ESG transactions with the forthcoming Green Bond Standards. The EBA will continue to monitor the interaction between these forthcoming Standards and the regulatory eligibility criteria.

256. An area where caution is warranted is the link between the performance of the ESG capital bonds and the performance of the underlying ESG assets. At this stage of its monitoring, it is the EBA's view that step-up and/or fees based on missing certain ESG targets or other performance indicators should not be allowed or encouraged, as they could be regarded as incentives to redeem, hence contradicting the eligibility criteria for own funds and eligible liabilities. That said, the EBA will continue to monitor and assess these features going forward.

4.3 Detailed analysis

257. The following sections provide an analysis of the possible risks of ESG bonds from an own funds and eligible liabilities perspective, followed by a section with provisions observed in existing ESG bonds issuances, how they match the CRR eligibility criteria and the BRRD requirements as well as policy recommendations and best practices.

Overview of identified risks

258. ESG bonds have been marketed, sold and labelled as 'green/social' bonds and give investors certain expectations on the conduct of the issuer and performance of the bonds. ESG bonds in general increase the reputational risk for the issuer compared to normal bonds, particularly in cases where something unexpected happens. Identified risks include:

From an issuer perspective:

- risk of earmarking the proceeds for ESG projects or activity with impediments to use the proceeds to cover losses from other assets/all parts of the business of the bank;
- risk that a change in the allocation of proceeds/a potential disqualification of the original assets as green assets might be perceived by investors as an obligation for the issuer to redeem the instrument;
- risk of having the maturity of green assets not matching the minimum duration of the instrument (in particular for perpetual ones)/subsequent lack of new green assets and related perception by investors as an obligation for the issuer to redeem the instrument at the maturity of the assets;
- more generally, risk of having features of predefined sustainability or ESG objectives directly impacting the eligibility criteria of the instrument, in particular with regard to:
    - permanence (early redemption or other incentives to redeem like step-up or fee linked to specific ESG targets),
    - loss absorption (write-down or conversion, acceleration rights, possibility of bail-in etc.),
    - flexibility of payments.

From an investor perspective:

- risk that investors do not realise that the instruments absorb losses from all activities of the bank or that coupons might be skipped in AT1 instruments due to losses/issues not related to green assets, even if the ESG targets are reached.

259. Overall, the above-mentioned risks can be grouped into four distinct areas, namely:

I. fungibility of the use and management of proceeds (i.e., no segregation of assets and liabilities);

II. clear description of the status of the notes (i.e., hierarchy, subordinated nature, no impediment for resolution, etc.);

III. absence of link between performance or use of assets and notes (i.e., no acceleration, no event of default, lack of assets not being an incentive to redeem, no performance fees or ESG targets linked to the premiums);

IV. reputational risk for the issuer (i.e., in addition to previous risks, legal definition of ESG, loss of green bond label, loss of third-party verification, etc.).

260. The purpose of this guidance is to cover areas I to III. It is focused only on ESG capital bonds (bonds issued for own funds or eligible liabilities purposes).

Observations and provisions observed in existing issuances

Fungibility of the use and management of proceeds

261. There are many articles in the CRR (including Article 52(1)(o), Article 52(1)(f), Article 63(f), Article 72b(2)(e) Article 51(1)(r), Article 63(p) and Article 72b(2)(f)), the ultimate aim of which is to ensure that own funds and eligible liabilities instruments cover all losses in the balance sheet of an institution, regardless of whether the bonds are labelled ‘Green’ or ‘ESG’ and regardless of whether the losses stem from Green or ESG assets or other assets including non-eligible assets (as further explained below).

262. Furthermore, Articles 45 and 45c of the BRRD provide the minimum requirements for own funds and eligible liabilities (MREL) and the criteria to set the MREL based on the total risk exposure amount of the institutions.

263. Bearing this in mind, most EMTN programmes highlight that ‘an amount equivalent or equal to the net proceeds from the issue of any tranche of notes will be applied by the Issuer for the general funding purposes of the Issuer’ or have similar language in the documentation regardless of whether the notes are ESG or not. However, in some of the ESG bonds, the final terms include drafting whereby the issuer commits to allocate an amount equal to the net proceeds primarily towards the financing or refinancing of eligible Green or Social loans or projects (‘eligible assets’).

In rare cases, EMTN programmes explicitly exclude the proceeds from being used as finance, such as for nuclear power generation, large-scale dams, defence, mining, carbon-related or oil and gas activities.

264. The level of commitment by the issuers varies across EMTN programmes. Some issuers commit to a full allocation or a certain percentage of the use of proceeds to the eligible assets and include language such as 'the (a percentage of the) net proceeds of the green bonds issued under this framework will be allocated to Eligible Assets' or similar wording. However, other EMTN programmes use softer language such as 'It is the Issuer's intention to apply an amount equivalent to the net proceeds of the issue to finance or refinance (via direct expenditures, via direct investments or via loans), in part or in full, on eligible activities' or 'While it is the intention of the Issuer to apply the net proceeds of any Green Notes, as described in use of proceeds section, there can be no assurance that the Issuer will be able to do this.'

265. Furthermore, most EMTN programmes clarify that in some/limited instances, the issuer could temporarily hold the balance of net proceeds not yet allocated to eligible assets in its treasury portfolio, in cash or other short-term and liquid instruments at its own discretion and in accordance with the institution's liquid portfolio investment policy, while some restrict the investments for the treasury portfolio to bonds with a sustainable character (such as green and social bonds).

266. All in all, some issuances seem more precautionary than others. Where EMTN programmes mention that the proceeds might not be used for financing certain assets identified as harmful to the environment, it would need to be clear to the investor that losses on these assets will also be absorbed by these funds as far as necessary. In addition, some issuances seem less committed than others when mentioning that 'an amount equal to the net proceeds' would be used to finance ESG assets while others would 'exclusively' dedicate the net proceeds to finance ESG assets. Finally, the risk around a possible reallocation of the proceeds in a treasury portfolio or liquidity portfolio, with an additional obligation in some cases to be in cash/instruments with a sustainable character, potentially creating substantial maturity mismatches between green assets and bonds, might not always be well covered in the documentation.

267. From a regulatory perspective, it is key to guarantee that there is no direct link between the ESG assets and the notes. An appropriate clarification in the documentation is needed to ensure that the issued capital is available to absorb losses incurred not only on ESG assets but also on all types of assets in the balance sheet of the institution, if needed.

268. In this regard, explicit provisions in the documentation stating that proceeds from own funds and eligible liabilities issuances should cover all losses in the balance sheet regardless of whether the bonds are labelled Green or ESG and regardless of whether the losses stem from Green/ESG assets or other assets, should be seen as best practice. In the same manner, a clear statement/provision that transactions with an ESG or Green label are fully subject to the application of the CRR eligibility criteria and the BRRD requirements for own funds and eligible liabilities instruments and related risks as loss-absorbing instruments should be seen as best

practice. The investor should be made well aware that there is no arrangement in place that enhances the performance of the notes. The EBA will continue to monitor and assess ESG-labelled capital bonds with the CRR eligibility criteria and the BRRD requirements going forward.

269. While different types of wording with regard to the commitment to invest in ESG assets have been observed, it is essential that short-term ESG projects or the lack of ESG assets have no consequence on the instruments' permanence and loss absorbency and that this is made clear to investors. Stronger commitments to fund eligible assets might be seen as contradicting the necessary fungibility of proceeds.

Clear description of the status of the notes

270. Several articles in the CRR (in particular Articles 52(1)(d), (n), (l)(iii) and (r), 63(k) and (p), 72b(2)(d), (f) and (k)) govern the ranking, loss absorption, permanence and flexibility of payments, aiming to ensure that own funds and eligible liabilities instruments provide genuine loss-absorbing capacity to the institution and preserve the necessary amount of capital at all times (i.e., going concern and in resolution or a moratorium under the BRRD). Furthermore, these provisions ensure that in an event of bail-in, the own funds and eligible liabilities instruments function following the creditor's hierarchy according to national insolvency law. This principle should always be upheld regardless of whether the bonds are labelled Green/ESG or not.

271. In light of this, the EBA observes that only a minority of EMTN programmes (in particular recent ones) clarify that failure by the issuer with regards to the use of proceeds or the expected performance of the eligible assets will not jeopardise the qualification of the notes as AT1 or Tier 2 or eligible liabilities instruments of the institution and/or the group.

272. In the same context, a minority of EMTN programmes also clarify that the risk of subordinated notes becoming subject to a write-down when the issuer is failing or likely to fail or the issuer becomes insolvent or subject to resolution applies equally to subordinated notes which are issued as ESG bonds.

273. All in all, the majority of the issuances do not recall the risks associated with the regulatory nature of the instruments, although more recent issuances/documentation are starting to incorporate this risk in the wording.

274. It is essential for the documentation of the issuances to provide full clarity on the status of the notes in terms of hierarchy/subordination, risks associated with bail-in and resolution, as well as risks associated with coupon payments for the more subordinated instruments.

275. In particular, it should be seen as best practice to clearly state in the documentation that the ESG, Green or Social classification does not affect the status of the notes in terms of subordination, loss absorbency features and regulatory classification as own funds or eligible liabilities instruments. Reference to the subordinated nature and ranking of the instruments compared to more senior claims is also recommended.

276. For investor awareness purposes, it should be highlighted in the documentation that the resolution tools, write-down mechanisms and bail-in powers apply equally to all notes, including those that are issued as ESG bonds (i.e., no impediment to resolution).

277. For the avoidance of doubt, for AT1 instruments, the documentation should explicitly specify that the features of the coupons that may be cancelled at any time up to the institution's discretional decision and other circumstances (i.e., MDA rules) apply equally to notes that are issued as ESG bonds and that this does not constitute an event of default.

No link between performance of assets and notes

278. Several articles in the CRR (including Article 52(1)(g), Article 52(1)(j), Article 63(h), Article 63(j), Article 63(l), Article 72b(2)(g), Article 72b(2)(j) and Article 72b(2)(h)) aim to ensure that own funds and eligible liabilities instruments do not include any incentive to redeem the bonds or give rights to the note holders to accelerate future payments, in the case of AT1 on a perpetual basis and in the case of Tier 2 and eligible liabilities prior to the stated maturity subject to certain specific conditions. Furthermore, in order to preserve capacity for loss absorption, Article 52(1)(l)(ii), Article 63(m) and Article 72b(2)(m) of the CRR ensure that the level of interest or dividends payments, as applicable, due on the instruments does not change due to the creditworthiness of the issuer at any time. This principle should always be upheld regardless of whether the bonds are labelled Green/ESG or not.

Event of default

279. Most EMTN programmes clarify that no event of default will occur in cases where the net proceeds of the notes are not used as set out and described in the use of proceeds section of the documentation, and they specify that there can be no assurance that the ESG projects financed or the use of the proceeds related to the eligible assets will i) be capable of being implemented in the manner as described in the prospectus, ii) be implemented within any timing schedule, or iii) result or lead to an outcome (whether or not related to the environment) as originally expected or anticipated by the issuer. Any such event or failure by the issuer will not constitute an event of default.

280. In addition, many EMTN programmes clarify that failure by the issuer to provide or publish any reporting, any (impact) assessment or to obtain any (third) opinion or certification will not constitute an event of default under the notes or give rise to any obligation or liability of the issuer or other claim of noteholders against the issuer.

281. Rarely, it is specified that the remedies available to holders of subordinated notes or of senior notes with restricted events of default apply equally to ESG bonds and the enforcement rights of holders in respect of these notes are extremely limited.

282. All in all, not all issuances mention the failure to apply the proceeds to ESG assets or to publish related certifications as not being an event of default. It should be clear to the investor that the performance of the eligible assets cannot be linked to the performance of the notes and that

failure to comply with general ESG targets set at company (issuer) level cannot be linked to the performance of the notes or lead to an event of default.

283. Explicit provisions in the documentation clarifying that not meeting any ESG target or objective does not constitute an event of default are welcome. Furthermore, a reference is recommended whereby an event of default is not triggered if the amount equivalent to the proceeds is not used for funding eligible assets or if the performance of those eligible assets is not as expected.

284. In addition, stating in the documentation that failure by the issuer to provide or publish any reporting, any (impact) assessment or to obtain any (third) opinion, certification or label should not constitute an event of default is best practice.

Acceleration and (early) redemption

285. A minority of EMTN programmes clarify that failure by the issuer with regards to the use of proceeds or with the expected performance of the eligible assets will not i) lead to an obligation of the issuer to redeem the notes, ii) be a relevant factor for the issuer in determining whether or not to exercise any optional redemption rights in respect of any notes and/or iii) give a right to the holders to request the early redemption or acceleration of the notes. Among these programmes, some refer only to early redemption, some to redemption in general, rare ones refer to both. In addition, there is no full clarity on whether the trigger related to the use of proceeds is related to, inter alia, the initial allocation of the funds, the reallocation and the loss of the ESG feature of the original project.

286. One recent issuance clearly states that failure by the issuer will not give a right to the holders to request acceleration on the notes. In general, it seems that the more recent issuances have included more explicit wording on the absence of obligations to (early) redeem or accelerate.

287. It should be clear to investors that failure to invest in eligible assets does not lead to the ESG bonds being redeemed or repaid under any circumstances. In the same vein, it should be clear that the notes will not accelerate due to the ESG nature of the notes in any circumstance and that the holders cannot exercise any rights due to failure by the issuer to comply with any ESG target.

288. In addition, the risk of having the maturity of ESG assets not matching the minimum duration of the instrument should be highlighted to investors, stressing that this mismatch will not lead to an incentive/obligation to redeem the instrument.

289. In this regard, it is preferable to insert explicit provisions in the documentation that failure by the issuer with regards to the use of proceeds at whatever point in time (i.e., being initial allocation of the funds, subsequent reallocation) or with regard to the expected performance of the eligible assets (including the loss of the green/ESG feature of the original project, for example), as well as the existence of a potential mismatch between the duration of the eligible assets/projects and the duration of the instrument will not lead to an obligation for the issuer to redeem the notes, be a factor in determining whether or not to exercise any optional redemption

rights, and/or give a right to the noteholders to request the early redemption or acceleration of the notes or give rise to any claim against the issuer.

Step-up or fee linked to specific ESG targets

290. Most of the EMTN programmes do not mention anything relating to the step-up premiums or discounts in cases where specific ESG targets have been missed (which is positive in the sense that *a priori* such step-ups could not occur). That said, one recent EMTN programme states that for the avoidance of doubt, 'it is specified that payments of principal and interest (as the case may be) on the notes shall not depend on the performance of the relevant eligible assets', which is a welcomed clarification.

291. Many stakeholders are seeking clarification from the EBA on this feature, as for ESG bonds in the corporate sector, it is quite common to have ESG bond coupons linked to performance targets of the eligible assets or general (ESG) targets of the issuer (sustainability-linked bonds).

292. In general terms, the EBA does not see favourably a link being established between payments on a regulatory instrument and any performance of assets/fulfilment of specific targets (that could be of a varied nature, including outside the ESG world).

293. The existence of a call, associated with a step-up or a fee triggered by a specific target being missed, will be assessed as contradicting the regulatory eligibility criteria as well as the provisions on incentives to redeem contained in the technical standards on own funds. This is even more true for AT1 instruments which are perpetual instruments. Even in the absence of a call, some of these features could still be assessed as incentives to redeem, since they could lead to repurchases or buybacks. A weak performance of the ESG bond may, in the long run, produce similar effects as a step-up clause. This element may be particularly dangerous, as the existence of incentives to redeem is normally assessed at the moment of the issuance.

294. Furthermore, due to the incorporation of ESG factors into the issuers' ratings by credit rating agencies, missing ESG targets might reduce the credit standing of the issuer, potentially creating a link between the interest on the bond in cases of step-up/fees and the issuer's own credit standing, which could also lead to non-compliance with the CRR requirements.

295. As a result, in order to ensure that there is no incentive to redeem, it is the EBA's view that step-up and/or fees based on missing certain ESG targets or other performance indicators should not be allowed or encouraged. While these indicators would understandably need to be defined at the level of the company (issuer), the EBA would need to understand better why they could not be operationalised in a different manner than using regulatory capital and eligible liabilities instruments.

296. That said, these aspects will be kept for further investigation depending on the precise features/structures that might appear in the future, in particular in relation to eligible liabilities. The EBA will continue to monitor developments in this area and will stand ready to provide further guidance where and when needed.

297. In terms of documentation, specifying explicitly that payments of principal and interest on the notes will not depend on the performance of the relevant eligible assets or ESG targets of the issuer is best practice.

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