24 November 2020

Opinion of the European Banking Authority (“The EBA”) on the Prudential Treatment of Legacy Instruments

1. Introduction

In order to ensure that institutions had sufficient time to meet the required levels and definition of own funds set out in Regulation (EU) No 575/2013[1] (the Capital Requirements Regulation or CRR), this Regulation introduced in 2013 grandfathering provisions.[2] Certain capital instruments that, at that time, did not comply with the new definition of own funds (hereinafter referred to as ‘legacy instruments’) were grandfathered for a transition period, the objective being that they would be gradually phased out from own funds. [3] The beneficial treatment provided by the grandfathering provisions will come to an end on 31 December 2021.

2. Overview

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

3. Principle of the flexibility of distribution payments

With reference to the issue of the flexibility of distribution payments, the EBA considered and assessed various arguments expressed by stakeholders with regard to different mechanisms restricting the

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2012, p.1).
[2] Chapter 2, Title I, Part Ten of the CRR.
[3] Recital 119 of the CRR: ‘In order to ensure that institutions have sufficient time to meet the new required levels and definition of own funds, certain capital instruments that do not comply with the definition of own funds laid down in this Regulation should be phased out between 1 January 2013 and 31 December 2021.’

flexibility of payments, in particular 'classic' dividend pushers[4]/ dividend stoppers,[5] as well as reverse stoppers[6] and similar mechanisms.

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

With respect to the admissibility of 'classic' dividend pushers / dividend stoppers in Tier 2 instruments and how these interact and affect their eligibility, the EBA finds that such features can be tolerated and do not pose a risk of infection of higher capital tiers under certain circumstances. The EBA also reflected on the overall features of Tier 2 instruments and their fundamental differences from those of AT1 instruments.

4. Eligibility criterion of subordination

As regards the eligibility criterion of subordination, the EBA believes that the CRR provisions covering the ranking of CET1, AT1 and Tier 2 instruments – in particular Article 28(1)(j), Article 52(1)(d) and Article 63(d) of the CRR, respectively – are clear. In a nutshell, CET1 instruments are subordinated to all other claims, AT1 instruments are subordinated to Tier 2 instruments, and Tier 2 instruments are subordinated to any claims from eligible liabilities instruments. If the statutory or contractual provisions governing legacy instruments do not satisfy those ranking rules, the eligibility of the instruments for the classification as AT1 or Tier 2 instruments shall be assessed vis-a-vis eligibility criteria under Article 72b of the CRR, including the criterion of subordination as applicable, or the applicable conditions set out in Directive 2014/59/EU15 (BRRD), respectively.

The EBA document can be accessed through this link.

[4] A dividend pusher is a requirement in the conditions governing AT1 instruments for distribution on the instruments to be made in the event of a distribution being made on an instrument issued by the institution that ranks to the same degree as, or more junior than, an AT1 instrument, including a CET1 instrument (Article 53(a) of the CRR).
[5] A dividend stopper is a requirement in the conditions governing AT1 instruments for distributions on CET1, AT1 or Tier 2 to be cancelled in the event that distributions are not made on those AT1 instruments (Article 53(b) of the CRR).
[6] A reverse stopper is a requirement in the conditions governing institutions' instruments for the cancellation of distributions on those instruments in the event that distributions are not made on AT1 instruments (Article 52(1)(l)(v) of the CRR and EBA Q&A 2013_21) or CET1 instruments (Article 28(1)(h)(vii) of the CRR).

5. Conclusion

Any queries regarding the above-mentioned subject should be directed to the Securities and Market Supervision function for attention of the Investment Firms Team (investmentfirms@mfsa.mt).