Chapter Two.

The Definition of Common Equity Tier 1 Capital and of Contingent Capital

The Diversity of Capital Instruments issued by European Credit Institutions.

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2.1 Introduction

2.1.1 Banks' Capital in the Basel's Framework and its Underlying Philosophies

To properly understand what banks' 'capital' is, and how it is regulated, a brief introductory discussion of its underlying philosophies is necessary (for a more comprehensive and in-depth discussion the reader is however referred to Chapter 1, and in this chapter we focus only on few selected aspects which are useful to correctly frame the interpretation and application of Common Equity Tier 1 and Contingent Capital requirements). From a policy perspective, own funds requirements for credit institutions reflect at the same time market-reliant considerations - either as a justification of the basic structure of the rules as well as some of their inner mechanisms, or as a supporting force, or as a countervailing argument to prevent regulatory overreach – and a market design effort. We begin by briefly discussing the market-reliant considerations.

2.1.2 The market-reliant perspective

Existing market-reliant considerations are easier to perceive in current rules if we confront them with the rules that they came to replace. The post-World War II (WWII) financial structure was largely determined by restrictions for domestic institutions to undertake certain activities, and for foreign institutions to enter domestic markets. The current regulatory consensus on solvency rules resulted from competitive pressures and market failures. Post-WWII competitive forces challenged the previous institutional structure on both the liability side and the asset side of the bank's balance sheet. In the United States, Regulation Q limited the interest-rate of deposit accounts. In Japan, the highly-regulated environment of deposit-taking activities constrained competition from foreign firms, and allegedly provided Japanese firms with a competitive advantage.[1] On the banks' asset side, pre-Basel rules limited bank loans' interest rates (something that still counts for some Member States under the anti-usury laws).[2] In the United States, rules restricted the expansion of bank branches,[3] and the Glass-Steagall Act 1933 restricted banks' expansion into investment activities, and investment firms' inroads into banking (the Bank Holding Company Act 1956 extended these restrictions to groups). Other countries (Japan, France, Italy or the Netherlands) classified banks according to the kind of lending (e.g. short-term, long-term),[4] and others (United Kingdom) made it difficult for banks to expand into

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[1] It later revealed itself as a major problem. See E. J. Kane and Asli Demirguc-Kunt, 'Capital Positions of Japanese Banks', in Rosita P. Chang and S. Chon Rhee (eds), *Pacific Basin Capital Markets Research* (Amsterdam: Elsevier 1991), 125-41.

[2] In Italy, Law No. 108 of 7 March 1996. Similar provisions apply also in France and Germany.

[3] Daniel K. Tarullo, *Banking on Basel. The Future of International Financial Regulation* (Washington: Peterson Institute for International Economics 2008), 33-34.

[4] Rinaldo M. Pecchioli, *Prudential Supervision in Banking* (Paris: OECD 1987).

capital markets. Unsurprisingly banks pressed to dismantle these barriers when they failed to protect them from competition. In the United States, Regulation Q's interest rate cap, while acting as a de facto subsidy, exposed banks to competition from money market funds (MMFs) which offered the same withdrawal on demand, and from mutual funds, which, while not being perfect substitutes, still offered better returns, and was partly responsible for the rise of MMFs and the mutual fund industry.[5] Pro-competition views prevailed after a prolonged period of economic expansion and little instability, when the distortions of restrictive rules are more salient. Rules limiting territorial expansion prevent more efficient players from reaping the benefits of their superior skills. Interest rate loan caps nudge banks towards more creditworthy borrowers. Thus, interest-rate caps and activity restrictions were gradually suppressed: the Glass-Steagall Act 1933 prohibition was diluted by an increasing number of exceptions sanctioned by the US Supreme Court long before it was formally derogated by the Gramm-Leach-Bliley Act 1999.[6] Banks gradually expanded into other activities also in Germany, France, Italy or the United Kingdom (despite the fact that the prohibition had not been present there).

This process was coincident with the decrease in banks' capital levels, since there were no mandatory capital rules, nor any increase in the mandatory levels of reserve requirements. In the United States these had been relaxed to facilitate the roll-over of war expenses,[7] but were left low. Since the dismantling of anti-competitive rules was not accompanied by rules to ensure soundness and stability, the result was not socially optimal, something that was evidenced by crises on a macro-level, with the collapse of the Bretton Woods system, and the 1980s sovereign defaults in Latin America, and, on a micro-level, with Bank of Credit and Commerce International (BCCI), and other headline-grabbing individual bank failures.[8]

Capital began to be seen as the adequate measure of a bank's solvency in the 1970's, in the US and the EU, where the deepening of the internal market required some level of rule harmonisation, and capital requirements acted as a point of convergence, in the First Banking Directive.[9] Thus, the Basel I Framework of 1988 was not a top-down attempt to re-design banking, but a way to level the playing field, enhance competition, and replace the old micro-managing rules with an approach focused on the market failure that had been identified,[10]and was otherwise minimally intrusive: it is worth noting that Basel I had a total of 30 pages.[11]

Market-reliant arguments were also critical in the process between Basel I and II. Whereas Basel I's approach (a ratio of capital over risk-weighted assets greater than 4% for Tier 1 capital, and 8%, for Tier 2 capital) was considered sound, it was also blunt. If the goal was to risk-weigh the assets, the approach of Basel I, which consisted in classifying assets into four 'risk-buckets', each with a risk weight,[12] could mask major risk variations between same-class assets (e.g. a loan's risk-weight was 100% regardless of the borrower).

Basel II introduced a more detailed classification in its Standardised Approach for credit risk (with 13 categories (primarily) depending on the rating given by external credit assessment institutions (ECAI), i.e.

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[5] The restriction of bank activity via funding also had the effect of an extraordinary growth in the size and liquidity of the capital markets: as citizens became more used to invest in capital markets products, investment in listed companies, indirectly through funds, or directly, became more common. See Tarullo, *op. cit*.

[6] See the evolution from *Investment Company Institute v. Camp*, 401 U.S. 617 [1970] (expanded interpretation of the restriction) to *Board of Governors v. Investment Company Institute*, 450 U.S. 46 [1981] (restrictive interpretation, leaving discretion to supervisors).

[7] Tarullo, *op. cit*.

[8] In Europe this was the case of Hersttat. The United States had its example in Continental Illinois. Finally, the case of BCCI made the case not only for a more stringent regulation of solvency, but also for an enhanced cooperation at an international level. See Basel Committee on Banking Supervision (hereinafter: BCBS), *'Bank Failures in Mature Economies'* (2004) BCBS Working Papers No. 13 <https://www.bis.org/publ/bcbs_wp13.pdf%0Ahttp://www.bis.org/publ/bcbs_wp13.pdf%0Awww.bis.org%0Apapers3://publication/uuid/DBD3A85F-9842-402B-9483-CCE9FBD63E77> accesed 22 July 2020.

[9] First Council Directive (EEC) 77/780 of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions [1977] OJ L 322/30.

[10] Notably the failure of the German Herstatt bank contributed to the policy aim of establishing a globally consistent set of solvency requirements.

[11] BCBS, 'International Convergence of Capital Measures and Capital Standards' (1988) (hereinafter: Basel I).

[12] Being risk weights ranging roughly from 0% for sovereign exposures, 20% for exposures to other credit institutions, 50% for exposures to mortgages and 100% for corporate exposures.

credit rating agencies).[13] At the same time, under its Internal Ratings Based (IRB) approach, it left banks develop their own internal risk models, which, when validated by a supervisor, could be used to assign risk-weights to the assets/claims, subject to certain qualitative requirements[14] This was meant to achieve the seemingly impossible task of using mandatory rules to correct the socially sub-optimal solvency levels, while relying on the market's superior ability to gauge risk to determine those levels. This reliance was reinforced by a structure into 3 'Pillars', including capital requirements, supervisory review, and market discipline.

Be it as it may, a set of strict mandatory rules, like the Basel Framework, requires a great effort of justification from a perspective of market efficiency. The arguments can be classified under (1) an efficiency-enhancement logic; (2) an externalities logic; and/or (3) an opportunistic behaviour logic.

- Studies have suggested that a layer of capital enhances economic efficiency. Capital provides a cushion that helps an institution that suffers losses to continue functioning, and, by reducing the probability of default of the institution itself, also reduces borrowing costs, and introduces incentives for owners to monitor risky behaviour.[15] However, the needs of the owners may not be aligned with the needs of society. Furthermore, if capital levels are efficient for lenders and borrowers, the bank will be the first one interested in raising capital levels to reduce its borrowing costs. Yet there is no evidence that this level of capital should be coincident with the social optimum (evidence in pre-Basel years suggests the opposite).[16]
- For an externalities logic it is difficult to rely on notions of systemic risk because capital requirements are micro-prudential, while systemic risk has a macro dimension, plus there is no clear evidence to link capital levels and systemic stability. More micro-prudential views suggest that financial firms produce information, which is a social good that would be destroyed in case of a bank bankruptcy. Thus, rules that reduce the probability of bankruptcy are desirable.[17] The counter-argument is that ex-post rules on resolution of financial institutions can be better tools to ensure the survival of intangibles such as information, for example, by facilitating the acquisition by another firm. Others use the externalities logic against capital requirements, arguing that their reliance on risk-adjusted measures makes them pro-cyclical: more credit is granted during booms, as more claims may be considered and assessed creditworthy, whereas contractions are more stark in downturns, when firms switch to government bonds, while the economy is in desperate need of credit.[18] Yet other studies argue that there is no clear relation between capital requirements and output.[19]
- So far, the best justification for capital rules is probably found in the logic of opportunistic behaviour. The context of safety and soundness rules is one where the intrinsic instability of banking activity, which involves maturity transformation and credit intermediation, make public solvency and liquidity backstops (e.g. deposit insurance and lender-of-last-resort facilities) necessary, which, in turn, reduces the incentives of market players to monitor risky behaviour, and increases banks' incentives to take on risk, a moral hazard problem prompted by the rational assumption that they will be rescued.

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[13] The ratings by agencies were used at least for the categories of claims for which those institutions provide ratings (claims on sovereigns and public institutions, claims on banks and securities firms, and claims on corporates). BCBS, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework', first adopted in 2004 and supplemented with the Application to Basel II to Trading Activities and the Treatment of Double Default Effects of 2005 to establish the comprehensive version published in June 2006 (hereinafter: Basel II), paras 50-66.

[14] Basel II, 52-119, paras 211-537.

[15] Jean-Charles Rochet, 'Rebalancing the Three Pillars of Basel II' (2010) Economic Policy Review Vol. 10, <https://www.newyorkfed.org/medialibrary/media/research/epr/04v10n2/0409roch.pdf> accessed 22 July 2020, 7-21.

[16] Tarullo, *op.cit.,* 17, with reference to Allen Berger, Richard J. Herring and Giorgio P. Szego, 'The role of capital in financial institutions' (1995) Vol. 19 Journal of Banking and Finance, 393.

[17] Tarullo, *op.cit.,* 22.

[18] George G. Pennacchi, 'Risk-Based Capital Standards, Deposit Insurance and Procyclicality' (2005) Journal of Financial Intermediation Vol. 14, 432. They can also exacerbate contagion effects, by forcing internationally active firms to cut lending in countries that are not in crisis. Joe Peek and Eric S. Rosengren, 'The International Transmission of Financial Shocks: The Case of Japan' (1997) American Economic Review Vol. 87, 495.

[19] BCBS, 'Capital requirements and bank behaviour: the impact of the Basle Accord' (1999) BCBS Working Paper No. 1, < https://www.bis.org/publ/bcbs_wp1.pdf > accessed 22 July 2020.

The above summarises the rationale for solvency requirements. Its basic functioning, when focussing on credit risk, is based on an (apparently) simple formula:

$$CR = \frac{Capital}{Asset * Risk\ Weight} \geq 0{,}04\ (Tier\ 1)\ or\ 0{,}08\ (Tier\ 1 + Tier\ 2)$$

Using a simple example: imagine a very simple bank, with 3 assets, a sovereign bond worth €1.000, with an A- rating; a corporate loan of €1.000 to a firm with a BBB+ rating, and loans of €1.000 to individuals, guaranteed by mortgages over residential property that is occupied by the owners or rented. The bank does not have its own internal risk models, and thus relies on external ratings and fixed risk weights. The capital measure will be:

$$Capital = (1.000\ (bond) * 0{,}2 + 1.000 * 1 + 1.000 * 0{,}35) * 0{,}04 = 62€$$

The bank would need paid-up equity and retained benefits of at least €62.

2.1.3. The market-design perspective

Yet, to properly understand Basel rules on capital it is also necessary to adopt an interest-group perspective of the history leading towards Basel. This path resembled a trade negotiation, with a strong presence of national economic interests and horse-trading.[20] Unsurprisingly, Basel details reveal the compromises between *economic* and *political* interests. In Basel I, Japanese banks' rise and balance sheet growth was a major concern for Western countries, who fretted about unfair competitive advantages enshrined in domestic rules: the highly regulated Japanese deposit market made it very difficult for foreign firms to gain a foothold, while other rules permitted banks to recognise the unrealised gains of their massive portfolios of securities as 'capital'.[21] The reaction involved, first, the need to reach a consensus on solvency and capital within the United States, between its supervisory agencies, followed by a wider consensus with British supervisors, followed by their joint pressure on Japan, who partly joined under threat of unilateral sanctions. Whether the new rules would make the banks safer was less relevant than whether national banks would be at a disadvantage.[22]

Thus, although Basel I was a remarkable achievement, it had important flaws. Risk-measurement rules (the 'buckets') were too blunt, and influenced banks' behaviour, e.g. the requirement to hold capital only against loan facilities of one year maturity or longer spawned the practice of 364-days loans, and caused maturity mismatches in Asian banks' balance sheets.[23] Also, Basel dealt little with off-balance sheet activities, which contributed to securitisation's expansion,[24] and its diverging treatment of exposures in the banking book (credit risk) and trading book (market risk) created ample opportunity for replacing short-term loans with short-term commercial paper.[25]

These failings prompted the review process leading to Basel II, where, again, different interests jockeyed for position, but this time, with a lesser importance of political interests in favour of economic interests. A more open political agenda paved the way for the emergence of big banks as a major force in the process.[26] This was less patent in the first reform proposals, which reorganised Basel around the 'three pillars' of capital requirements, supervisory review and market discipline, to counterbalance the single-minded focus on capital,

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[20] Tarullo, *op.cit.*, 87-93 for a vivid account of that process.

[21] Tarullo, *op.cit.*, 46, 49.

[22] Tarullo, *op.cit.*, 51.

[23] Tarullo, *op.cit.*, 80. For the problem of maturity mismatches in Asian banks (which borrowed short-term in foreign currencies, and lent long-term in domestic currency) see John Drage and Fiona Mann, 'Improving the stability of the international financial system' (1999) Financial Stability Review Issue 6, 40-78.

[24] David Jones, 'Emerging problems with the Basel Capital Accord: Regulatory capital arbitrage and related issues' (2000) Journal of Banking & Finance Vol. 24, 35-58.

[25] Jackson, *op.cit*.

[26] See the references to the public statements by public officials in the years prior to 1999 and 2000 (when the first amendments were presented), which presented the need to change the existing Framework, but otherwise did not give a clear indication of the direction in which the process was moving, in Tarullo, *op.cit.,* 89-93.

and incorporated external ratings to supplement risk buckets. Yet, as the process advanced, large banks made sure that their internal models were accepted for risk-measurement purposes.[27] Supervisory agencies' reluctance towards banks' models required detailed rules on their requirements and validation: the Basel Framework passed from 30 pages (Basel I), to more than 450 pages, and was still incomplete. Diplomatic efforts by the Basel Committee chairman Jaime Caruana, and European members' willingness to compromise eased the way to the final consensus, which resulted in a remarkably ambitious text, which was criticised both for detailing too much, and leaving much open. Its micro-managing style, and the dominance of the process by US and European supervisory agencies and large banks makes it difficult to classify the approach as market-reliant.

The path towards Basel III was marked by the 2007-2009 financial crisis, which prioritised the need to enhance soundness, at the expense of clarity and simplicity. Capital rules now have a more restrictive definition of 'capital', but also introduce new ratios, such as the equity capital ratio, and the 'core capital' ratio, plus the new measures of contingent capital, and the leverage ratio. They all have complicated the definition of what 'solvency' means.

From a political perspective, the United States and Europe are opposed on the ideal capital measure. The US favours a simpler leverage ratio whereas Europe still favours the risk-weighted capital ratio. Simplicity has been the clear loser in the process.

2.2 Institutional choices in the definition of capital

The Basel Framework reflects two basic policy choices: first, it takes capital as the measure of solvency, second, it risk-weights the assets. To the purposes of this Chapter, this raises the question of what magnitudes should be included within the definition of capital.

Reaching a consensus on capital as a measure of solvency was much easier than agreeing on what 'capital' is, which has historically varied across supervisory practices. France, for example, wished to include within 'capital' the country-risk provisions, i.e. for potential problems with loans to a country outside loan-specific risks; the United States, for its part, included a number of preferred stock instruments. Japan included the unrealised gains of Japanese banks' securities portfolios accumulated in the 70s'-80s'.[28] Germany was reluctant to include any of those elements but pushed hard on risk-weighting for small-business lending.[29]

At the risk of oversimplifying it can be said that, in Basel negotiations, Tier 1 capital acted as the common denominator, i.e. the components that every country accepted as part of capital; while Tier 2 was used to leave flexibility to include their own components.

The Basel II definition of Tier 1 capital included equity capital and disclosed reserves. Equity capital is formed by issued and fully paid ordinary shares/common stock and non-cumulative perpetual preferred stock (but excluding cumulative preferred stock).[30] Thus, preferred stock paying a fixed percentage can be considered capital only if the unpaid amount does not accumulate for subsequent years. Yet, Tier 1 capital could include 'innovative capital instruments', up to 15% of its value, net of goodwill.[31] This opened the door to hybrid

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[27] Tarullo, *op.cit.,* 98-100.

[28] Tarullo, *op.cit.,* 51-52, 55-56. The holding of large portfolios of securities has long been a feature of the Japanese ownership structure of firms, characterized by multiple cross-shareholdings where banks sit in the middle of the system. By doing so, the banks benefitted from the appreciation of those securities during Japan's economic expansion (and, as reckoned with later, phenomenal asset bubble).

[29] Tarullo, *op.cit.,* 51, 56.

[30] Basel II, para 49(i).

[31] Annex I of the Basel II Framework clarified that 'to determine the allowable amount of innovative instruments, banks and supervisors should multiply the amount of non-innovative Tier 1 by 17,65%. This number is derived from the proportion of 15% to 85% (ie 15%/85% = 17,65%)'. It also put an example: 'take a bank with €75 of common equity, €15 of non-cumulative perpetual preferred stock, €5 of minority interest in the common equity account of a consolidated subsidiary, and €10 of goodwill. The net amount of non-innovative Tier 1 is €75 + €15 +€5 - €10 = €85. The allowable amount of innovative instruments this bank may include in Tier 1 capital is €85 x 17,65% = € 15. If the bank issues innovative Tier 1 instruments up to its limit, total Tier 1 will amount to €85 + €15 = €100. The percentage of innovative instruments to total Tier 1 would equal 15%'.

instruments, massively issued in the years prior to 2007;[32] and, whose issuance was related to solvency risk.[33] Tier 2 capital was included to accommodate domestic practices, though at least 50% of the bank's capital base would have to be Tier 1 capital.[34] Tier 2 included undisclosed reserves, revaluation reserves, general provisions/general loan-loss reserves, hybrid debt capital instruments, and subordinated term debt, with different limitations for each category.[35] Finally, supervisors could include a Tier 3 measure, comprising short-term subordinated debt, but for the sole purpose of meeting a part of capital requirements for market risk.[36]

The post-2007/2008 crisis mood was contrary to these compromises. Basel III thus introduced higher Common Equity Tier 1 (CET1) levels, introduced a sub-category of Tier 1 (Additional Tier 1 (AT1) but reduced its permissible use to 1.5% of the total 8%), strengthened the definitions for instruments to belong to each category, harmonised Tier 2 definitions, abolishing entirely Tier 3, and added new capital measures. The Table 2.1 summarises the changes:

Table 2.1 – Changes to Basel III

Capital measure	Current regime
Tier 1	Distinction between: - Common Equity Tier 1. - Ordinary common equity capital instruments satisfying strict criteria, retained earnings, accumulated income, immediately available to cover risk or losses.[37] - Additional Tier 1. - Stricter definition of instruments that may form part of this category: deeply subordinated, perpetual, non-cumulative preferred stock with no incentive to redeem.[38]
Tier 2	Subordinated instruments with a maturity in excess of five years, and coupon payments not to be modified based on the credit standing of issuer or its parent. Overall the requirements are stricter.[39]
Tier 3	Abolished

[32] Candemir Baltali and Joseph Tanega, 'Basel III: Dehybridization of Capital' (2011) NYU Journal of Law and Business Vol. 8(1).

[33] Peiyi Yu and Bac Van Luu, 'Lessons from the collapse in hybrid bank capital securities' (2012) International Journal of Management Practice Vol. 5(2) <http://www.euroframe.org/files/user_upload/euroframe/docs/2009/EUROF09_Yu.pdf> accessed 22 July 2020.

[34] Tier 2 elements would thus be limited to a 100% of Tier 1: Basel II, para 49(iii).

[35] Each category reflected some sort of 'victory' for its proponent. Thus, hybrid instruments were admitted, a concession to US views (and, to some extent, German ones). Japan, however, possibly scored the greatest victory: the category of revaluation reserves would permit banks to include as supplementary capital 'latent' revaluation reserves, provided they were subject to a 55% discount to reflect concerns about market volatility and the tax charge that would arise if the profits were realized. See Basel II, para 49(vi). With the benefit of hindsight, it is arguable whether including such reserves within the concept of capital was very wise. Besides the obvious procyclicality of the accounting of latent reserves as part of capital, which greatly exposed banks to the asset bubble, there were other practices that aggravated the crisis, including under provisioning for bad loans, generous accounting for tax credits (despite it was unlikely that there would be profits to effectively exercise them), and double gearing (banks acquired bonds of insurance companies, which, in turn, acquired subordinated debt (Tier 2) of banks. See Tarullo, *op.cit.,* 70-71.

[36] Basel II, para 49(xiii).

[37] Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms [2013] OJ L176/1 (hereinafter: CRR), art 26. See also Section 20(b), Subpart C Federal Reserve System (and all regulatory agencies), Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule (2013) 78 FR 62017 (hereinafter: US Final Rule 2013).

[38] CRR, arts 51-52. See also Section 20(c) Subpart C, US Final Rule 2013. In the US the instruments do not need to include a mandatory write off or conversion provision, which is triggered at the point of 'non-viability', whereas this requirement is present on European rules, which, on the other hand, are less detailed in terms of dividend requirements.

[39] CRR, arts 63-64. See also Section 20(d) Subpart C, US Final Rule 2013.

New capital measures[40]	Conservation buffer Countercyclical buffer
Specific rules	
Minority interests (instruments issued by subsidiaries and held by non-consolidated entities)	For CET1 capital: issuer must be financial institution, consolidated, and subject to capital requirements[41] For AT1 or T2 capital: In the EU minority interests will not qualify as consolidated capital if funded through SPVs of the parent or subsidiary[42]
Qualifying holdings outside financial sector	Risk-weights for holdings of non-financial companies determined in accordance with standardised or IRB approaches. However, a 1,250% risk-weight (equivalent to a capital deduction) will be given under EU rules to: - Holdings in any non-financial institution above 15% of the institution's capital - Total amount of holdings in non-financial institutions exceeding the institution's 60% of capital.[43]
Grandfathering of no- longer-qualifying instruments	EU: non-applicability to no-longer qualifying instruments issued before December 31, 2011, accompanied by gradual phasing out until December, 31, 2021.[44] US: shorter timeframe to phase out non-qualifying capital instruments, but instruments purchased by the US government (TARP instruments) are grandfathered (ie excluded from new rules) permanently.[45]
Supervisory discretion to approve new capital instruments	No ability in the EU to recognise other instruments if non-qualifying, whereas in the US there is the theoretical possibility.[46]

Other than the countercyclical buffer, the main changes were the stricter definition of Tier 1 Capital, and the distinction of 'Common Equity Tier 1', within Tier 1, as a 'core within the core'. This distinction is based on the instruments' loss absorption capacity and includes only common shares, stock surplus (share premiums), retained earnings and common shares of consolidated subsidiaries held by third parties (minority interest).[47]

The Framework also has a 14 conditions-list that an instrument must fulfil to be considered a 'common share', which include direct placement with investors (no indirect structures), fully paid in capital, perpetuity, discretionary nature of any distributions (e.g. payments/dividends), and total subordination in case of loss. The

[40] Given the relevance of these as measures to address procyclicality and systemic risk they will be addressed in next parts of the Book

[41] Arts 81-82 CRR. See also Section 21(c) US Final Rule 2013.

[42] Otherwise, US and EU rules are broadly consistent. See Arts 81-82 CRR, and Section 21(d)(e) US Final Rule 2013.

[43] CRR, arts 89(3) and 108-110, in line with Basel III (which does not change much with respect to Basel II). US Rules do not provide for such specific rules. This is a clear disincentive for banks to hold on to their traditional 'industrial portfolios'.

[44] CRR, arts 484-486.

[45] Section 300(c) Subpart G, Final US Rules 2013.

[46] Section 22(c) Subpart C US Final Rules 2013.

[47] Basel III, para 52.

Additional Tier 1 instruments are defined with another 14-point list of (more detailed) criteria, regarding the deeply subordinated character, the instruments' perpetuity (e.g. banks can redeem and pay-back at their own discretion after 5 years, under certain very strict conditions), a mandatory contingent convertible mechanism, coupon distribution, etc. This provides banks with a roadmap to the features that must be respected if the securities are to belong to Tier 1. Non-qualifying instruments shall be phased out. We will consider them in detail here below, as they currently stand in CRR Capital Requirements Regulation II (CRR II).[48]

Apart from the concept of 'capital', setting the optimal minimum requirements is also a complex task. Ideally, capital levels should equalise the benefits of capital requirements, i.e. reduced costs of bank failure, and their costs, i.e. opportunity cost of lost additional financing.[49] Bankers will tend to overlook the former, and regulators the latter. Capital measures did not vary much between Basel I and II (Tier 1 capital had to be 4% of risk-weighted assets, while Tier 2 should be 8%); but Basel III has enhanced the requirements, while introducing some complications, which are summarised in its Annex 1. We reproduce here the European implementation of Basel III (we also include a reference to Pillar 2 requirements, a possibility that was already present with Basel II, for the sake of completeness):

Table 2.2 – Capital requirements and buffers

Calibration of the capital framework Capital requirements and buffers			
	Common Equity Tier 1	Tier 1	Total Capital
Minimum	4,5%	6,0%	8,0%
Capital conservation buffer	2,5%	2,5%	2,5%
Minimum plus capital conservation buffer	6,0%	8,5%	10,5%
Countercyclical buffer range	0 – 2,5%	0 – 2,5%	0 – 2,5%
Systemic risk buffer range	0 – 3%	0 – 3%	0 – 3%
Systemically Important Institution buffer ranges	1-3.5%	1-3.5%	1-3.5%
Pillar 2 requirements	Depends on the supervisor	Depends on the supervisor	Depends on the supervisor

As to the 'combined' buffers, the 'conservation buffer' comes from the idea behind the US 'Prompt Corrective Action' (PCA) that banks deteriorate gradually and predictably.[50] This means that a bank that suffers losses that make its capital levels to be above minimum requirements, but below the sum of minimum requirements plus the conservation buffer the firm is subject to restrictions on the distribution of earnings (dividends, share

[48] Regulation (EU) 2019/876 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 [2019] OJ L150/1 (hereinafter: CRR II).

[49] Anthony M. Santomero and Ronald D. Watson, 'Determining an Optimal Capital Standard for the Banking Industry' (1977) Journal of Finance Vol. 32, 1267.

[50] Simon Gleeson, *International Regulation of Banking – Basel II: Capital and Risk Requirements* (OUP 2010), 94.

repurchases, bonuses), and needs to present a capital conservation plan (Articles 141-142 Capital Requirements Directive (CRD IV)).[51] The introduction of the entity-specific countercyclical buffer, illustrates Basel III's pivot towards a more macroprudential approach that considers risk dynamics. Countercyclical buffer is calculated specifically to account for the procyclical elements in valuation methods. Since methods to determine provisions for impaired assets or defaulted loans are likely to be based on empirical evidence, and such evidence will tend to give excessively optimistic estimates during good times, the countercyclical buffer introduces additional capital requirements consisting on the weighted average of countercyclical buffer rates applicable in the jurisdictions where relevant exposures are located (Arts. 130, 140 CRD), rates that shall be set by competent authorities (Arts. 135-139 CRD). Then, an additional systemically important institution risk buffer tries to account for the additional contagion risk resulting from global systemically important institutions (G-SIIs) or other systemically important institutions (O-SIIs). This is calibrated as an additional 1%, plus increases of 0,5% that take into account the entity's sub-category (there must be at least 5 types of SIIs) up until 3,5%. (Art. 131 (9) CRD). Finally, in Europe an additional "systemic risk" buffer has been introduced [article 133 CRD] The two macroprudential measures are considered for purposes of the "combined" buffer. All the additional buffers must be met with CET1 capital. Thus, a firm subject to, say, to a CET1 of 4,5%, plus capital conservation buffer, plus a countercyclical buffer of 2,5%, plus a systemic risk buffer of 1,5% would be subject to restrictions on distributions and a capital conservation plan upon underscoring a threshold of 10% CET1 capital.

Finally, on top of regulatory capital requirements, and the combined buffer requirements, supervisory authorities may impose additional capital requirements, whenever the entity faces risks that are not duly covered by the other capital requirements (Article 104 CRD IV). These are the so-called 'Pillar 2' requirements, which result from the exercise by competent authorities of their competences in the supervisory review process. The possibility to impose additional capital requirements is part of a vast array of competences, which are described, together with their implications, in Chapter 19 (where we discuss also the recommended Pillar 2 capital guidance).

2.3 The Definition of CET1 Capital in CRR and CRR II and CET1 Capital Instruments

CET1 items of a credit institution consist, pursuant to Article 26(1) CRR of the following: (a) capital instruments, provided that the conditions laid down in Article 28 or, where applicable 29, are met; (b) share premium accounts related to the instruments referred to in point (a); (c) retained earnings; (d) accumulated other comprehensive income; (e) other reserves; (f) funds for general banking risk. However, the funds referred to in points (c) to (f) are recognised as CET1 only 'where they are available to the institution for unrestricted and immediate use to cover risks or losses as soon as these occur". According to Article 26(2) institutions may include interim or year-end profits in CET1 capital also before the institution has taken a formal decision confirming the final profit or loss of the institution for the year only with the prior permission of competent authority, which shall grant permission where a) those profits have been verified by the auditing firm of the institution and b) the institution has demonstrated to the satisfaction of the competent authority that any foreseeable charge or dividend has been deducted from the amount of those profits.

As to the capital instruments (referred to in letter (a) of Article 26 CRR), CRR lays down specific eligibility criteria to account for CET1. These criteria are supplemented by Commission Delegated Regulation (EU) No 241/2014 as amended by subsequent delegated regulations.[52] This incorporates a wide array of draft Regulatory Technical Standards (RTS) on own funds that the European Banking Authority (EBA) delivered to the European Commission in this area.

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[51] Directive (EU) 2013/36 of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338 (hereinafter: CRD IV).

[52] Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013 on regulatory technical standards for Own Funds requirements for institutions [2013] OJ L74 (hereinafter: Delegated Regulation (EU) No 241/2014).

The eligibility criteria are set out in Article 28 (with further modifications resulting from Article 29 for mutual, cooperative societies, savings institutions and similar institutions), have not been amended by CRR II (but for a few precisions discussed below) and are as follows:

- **Issuance**. Article 28(1)(a) CRR The capital instruments must be issued directly by the institution, in accordance with the applicable company law and with the prior approval of the owners of the institution, and where permitted under applicable national law (e.g. via delegated capital increases) the management body of the institution. According to Article 68(2) Consolidated Company Law Directive (EU) 2017/1132 '…the statutes or instrument of incorporation or the general meeting, the decision of which is to be published in accordance with the rules referred to in paragraph 1, may authorise an increase in the subscribed capital up to a maximum amount which they shall fix with due regard for any maximum amount provided for by law.[53] Where appropriate, the increase in the subscribed capital shall be decided on within the limits of the amount fixed by the company body empowered to do so. The power of such body in this respect shall be for a maximum period of five years and may be renewed one or more times by the general meeting, each time for a period not exceeding five years'. National company laws implement, with variations, this principle. In turn, Article 68(3) provides that 'where there are several classes of shares, the decision by the general meeting concerning the increase in capital referred to in paragraph 1 or the authorisation to increase the capital referred to in paragraph 2, shall be subject to a separate vote at least for each class of shareholder whose rights are affected by the transaction'.
- **Disbursement**. Article 28(1)(b) CRR The instruments need to be fully paid up. This means that, although Article 48 of Consolidated Company Law Directive (EU) 2017/1132 permits that 'shares issued for consideration shall be paid up at the time the company is incorporated or is authorised to commence business at not less than 25 % of their nominal value or, in the absence of a nominal value, their accountable par' and national company laws are consistent with this provision, only the fraction of capital which is fully paid up can account for prudential purposes and is eligible to qualify as a CET1 instrument. The EBA has further clarified that an undertaking/commitment to pay cash to the institution on demand or at an identified or identifiable future date cannot be considered to meet the requirement of article 28(1)(b) CRR, because CRR requires that CET1 instruments are constantly available to the institution without the intermediary actions/decisions as the first backstop to losses as they occur.[54] In turn, 'equity financing', ie the situation where the institution either directly or indirectly, advances funds or makes loans or provides security, with a view to the acquisition of its shares by a third party, makes such shares not eligible to qualify as CET1 instruments, even if financial assistance is provided by the institution in compliance with the conditions set out in Article 64 of Consolidated Company Law Directive (EU) 2017/1132.
- **Accounting classification**. Article 28(1)(c) CRR The instruments simultaneously meet all the following classification criteria: (a) they qualify as 'subscribed capital' within the meaning of Article 22 of Bank Accounts Directive (BAD) ('all amounts, regardless of their actual

[53] Consolidated Version of Directive (EU) 2017/1132 of 14 June 2017 relating to certain aspects of company law [2017] OJ L169/46 (hereinafter: Consolidated Company Law Directive).

[54] European Banking Authority, 'Report on the monitoring of CET1 instruments issued by EU institutions. Second Update' (22 July 2019), 11, para 39, <https://eba.europa.eu/sites/default/documents/files/documents/10180/2551996/51a39b9d-a68d-476a-b2c6-e2c21527a05f/EBA%20Report%20on%20the%20monitoring%20of%20CET1%20instruments%20issued%20by%20EU%20Institutions.pdf>, accessed 22 July 2020 (hereinafter: EBA, 'Report on the monitoring of CET1').

designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed by the shareholders or other proprietors'); (b) they are classified as equity within the meaning of the applicable accounting framework; (c) they are classified as equity capital for the purposes of determining balance sheet insolvency, where applicable under national insolvency law.[55] According to national company law, there may be different classes of shares which could account for 'subscribed capital' and could therefore, in principle, meet the eligibility criteria for CET1: common shares are the standard, but also non-voting shares may, under some circumstances, be issued with equivalent loss absorbing capacity and distributions rights compatible with those set out for CET1 instruments. Likewise, mutuals and cooperative societies may issue a second type of CET1 instrument in addition to cooperative shares (as it will further be discussed below).[56]

- **Accounting Disclosure**. Article 28(1)(d) CRR The instruments are clearly and separately disclosed on the balance sheet in the financial statements of the institution.
- **Permanency (Perpetuity)**. Article 28(1)(e) CRR The instruments are perpetual. In this context, however, perpetuity is a relative concept, because in several Member States (in compliance with Article 3, letter (f) of Consolidated Company Law Directive (EU) 2017/1132) it is possible for an institution to have a defined duration of the institution, set either via national legislation or via articles of association, or have its capital subject to withdrawal rights (in specific circumstances).[57] Perpetual, in this context, means that the maturity of capital instruments is with the end of life of the issuer: as EBA pointed out there is no sense in providing an indefinite, explicit 'eternal' maturity for capital instruments that would survive the liquidation of the company itself.[58] This means, however, that in cases in which the duration of the instrument would be shorter than the duration of the institution, instruments which dissociate their maturity from the life of the issuer cannot be considered CET1 instruments, irrespective of their possible admissibility under applicable company law.[59] This principle, however, is further specified (and subject to some derogations) in the context of redemption or repayment after withdrawal from the institution, as discussed immediately below.
- **Permanency (Maintenance of principal)**. Article 28(1)(f) CRR The principal amount of the instrument may not be reduced or repaid except in either of the following cases: (a) the liquidation of the institution or (b) discretionary repurchases of the instruments or other discretionary means of reducing capital, where the institution has received the prior permission of the competent authority in accordance with Article 77 CRR. The need to reconcile applicable company law provisions and CET1 eligibility criteria has significant implications in this context. Indeed, in order to preserve CET1 eligibility, the right of the institution to redeem own shares in accordance with Consolidated Company Law Directive (EU) 2017/1132 must be exercised in a manner compliant with the prudential principle that such redemption decision of the issuer must remain fully discretionary. This means, for instance, that buybacks cannot result, factually or legally, arranged in such a way as to

[55] Directive (EEC) No 86/635 of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions [1986] OJ L372/1 (hereinafter: BAD).
[56] Compare, e.g. in Italy, *azioni di finanziamento* (financing actions) under Art 150-ter of the Consolidated Banking Act.
[57] In Italy, for example, if the articles of association do not set a final date for the duration of the company, permanence of capital is weaker and any shareholder is granted, by law, a withdrawal right with prior notice from the company.
[58] EBA, 'Report on the monitoring of CET1', para 89.
[59] It may be the case, for instance, of an Italian institution, whose duration were undefined, and would for this reason legislatively grant to each shareholder a withdrawal right with prior notice whose exercise would be fully discretionary from the part of the shareholder.

practically vest in advance to the shareholders a right to have their shares redeemed to the maximum extent permitted under applicable company law for buybacks. This would however not prevent, in our view, the institution from adopting a policy on buybacks, fully respecting and duly authorised ex ante by the competent authority under Articles 77 and 78 CRR and Article 32 of Delegated Regulation (EU) No 241/2014, even where this is reinforced by a provision of the articles of association whereby part of the yearly profits, if any, is to be allocated in a special reserve to be used to support any (but still fully discretionary) program of authorised buy backs. Facilitating the occurrence of the economic and legal conditions for a buyback is, in our view, not tantamount as cancelling the discretionary nature of the institution's decision of redemption. The same principle should apply where the institution issues redeemable shares (as foreseen in Article 82 of the Consolidated Company Law Directive (EU) 2017/1132), if redemption is and remains fully discretionary for the institution. It must be noted, however, that the EBA investigated a case in which the share capital was equally split among ten classes of shares following an alphabetical share structure, each shareholder holding at all times the same proportion in each class (stapling mechanism). Redemption and cancellation of the alphabetical classes of shares was to be made, with the prior approval of the competent authority, pursuant to a decision of the general shareholders' meeting, following reverse alphabetical order. The EBA considered such a structure as non-compliant with the requirement of permanence of CET1 instruments.[60]

— **Permanency (Maintenance of principal and design peculiarities of specific instruments such as corporate shares and cooperative banks' capital)**. Article 28(1)(g) CRR. Likewise, the provisions governing the instruments must not indicate expressly or implicitly that the principal amount of the instruments would or might be reduced or repaid other than in the liquidation of the institution and the institution does not otherwise provide such an indication prior to or at issuance of the instruments, except in the case of capital instruments issued by mutual, cooperative societies, savings institutions and similar institutions where the refusal by the institution to redeem such instruments is prohibited under applicable national law. This quite categorical requirement is, to some extent, overinclusive, because also any compulsory withdrawal of shares (as provided for in Article 79 of Consolidated Company Law Directive (EU) 2017/1132) and/or any repayment of shares following the legitimate exercise of a withdrawal right or a right to dispose of the shares for adequate cash compensation[61] in all cases where this is mandated by applicable national law would not disqualify the instrument, per se, from eligibility as CET1 capital, although prudential consideration may still limit or require the postponement of the effectiveness of such withdrawal.[62] This requires however further specifications. First, the provision in the articles of association of additional cases of withdrawal at the initiative of the relevant shareholder, other than those mandated by applicable company law, may indeed contradict the requirement of permanence for prudential purposes, even if these additional cases are enabled by applicable company law. Moreover, the EBA considered that eligibility of common shares for CET1 could be questioned also where national company law foresaw that, in the event the

[60] EBA, 'Report on the monitoring of CET1', paras 85-87.
[61] Compare on this Art 86(i) of Consolidated Company Law Directive for cross border conversions, Art 126(a) for cross border mergers and Art 160(i) for cross border divisions.
[62] Bart P.M. Joosen, 'Regulatory capital requirements and bail in mechanisms' in Matthias Haentjens and Bob Wessels (eds), *Research handbook on crisis management in the banking sector* (Edward Elgar Publishing 2015), (hereinafter: Joosen 'Regulatory capital'), 175.

shareholders' meeting would decline a motion to distribute a predetermined share of the annual profits of the company, any shareholder who voted in favour was given the right to dispose of its shares to the company for adequate compensation. In the EBA's view, this was potentially in conflict with both permanence of capital and flexibility of the distributions attached hereto.[63] Second, in any case when national company laws envisage a right of shareholders to redemption, Articles 77 and 78 of CRR apply and the possibility of the institution redeeming/repurchasing its shares under such circumstances is and remains still subject to prior supervisory approval.[64] This issue is particularly thorny for cooperative institutions, for which Article 29(2), whilst acknowledging that the principles of variable capital and 'open door' may be coessential to the form of the cooperative under applicable company law, also provides that the institution shall either be able to refuse the redemption of the instruments or, where this is prohibited under applicable national law, shall have nonetheless the ability to limit their redemption and neither option may constitute an event of default of the institution. The European Commission further implemented this principle with Delegated Regulation (EU) No. 241/2014, whose Article 10 specifies that the limitation to redemption may consist either in the deferral of the redemption or in the limitation of its amount to be redeemed for an unlimited period of time depending on the prudential situation of the institution concerned. This provision has been challenged in Italy as to its national implementation on ground of an alleged conflict with the fundamental right of property. The Italian Constitutional Court first, with its judgment 99/2018, and the CJEU then, in judgment of 16 July 2020, case C-686/18 OC & Adusbef (following Advocate General Hogan's opinion) rejected the claim, finding that Italian legislation which prohibits people's banks (banche popolari) from refusing redemption of shares but which allows those banks to (indefinitely) defer redemption in time, and to limit the amount to be redeemed is legal pursuant to Article 29 CRR, and Articles 16 and 17 of the Charter (freedom to conduct a business and right to property) provided that the limitations on redemption are proportionate, i.e. they do not go beyond what is necessary to ensure that the capital instruments qualify as CET1 instruments, having regard, in particular, to Article 10(3) of Delegated Regulation No 241/2014. The ultimate decision on whether such necessity-proportionality was respected was left for the domestic court to ascertain, but not before the Court had laid a framework where there no intrinsic problem between the goals pursued by the provisions (ensuring that a bank's core capital is not unexpectedly withdrawn) and the 'essence' of the right to property in cooperative shares.

— **Distributions**. Article 28(1)(h) CRR The instruments meet the following conditions as regards distributions: (a) there is no preferential distribution treatment regarding the order of distribution payments, including in relation to other CET1 instruments, and the terms governing the instruments do not provide preferential rights to payment of distributions; (b) distributions to holders of the instruments may be paid only out of distributable items; (c) the conditions governing the instruments do not include a cap or other restriction on the maximum level of distributions, except in the case of the instruments referred to in Article 27 CRR concerning mutuals, cooperative societies, saving institutions and similar institutions; (d) the level of distributions is not determined on the basis of the amount for which the instruments

[63] EBA, 'Report on the monitoring of CET1', para 84.
[64] EBA, 'Report on the monitoring of CET1', para 83.

were purchased at issuance, except in the case of the instruments referred to in Article 27 CRR; (e) the conditions governing the instruments do not include any obligation for the institution to make distributions to their holders and the institution is not otherwise subject to such an obligation; (f) non-payment of distributions does not constitute an event of default of the institution; (g) the cancellation of distributions imposes no restrictions on the institution. The requirement on (no) preference in the order of payment clarifies that in order to qualify for CET1 all classes of common shares (if more than one) shall provide equal rights to the payment of distributions, although Article 28(4) CRR introduces an exception (the only one), whereby 'differentiated distributions shall only reflect differentiated voting rights", meaning that CET1 instruments with fewer or no voting rights can be subject to higher distributions, but higher distributions are only justified in that case.. This is further specified in Delegated Regulation (EU) No. 241/2014, which allows (Articles 7 a and 7 b) multiple dividends for shares with limited or no voting rights, under strict conditions. Yet, in one case, the EBA considered contrary to the provisions of Articles 28(1)(h) and 28(4) CRR that profits were allocated among different classes of shares carrying the same voting rights, based on different nominal values for each class of shares: the fact that these classes of shares were held in the same percentage of each class of shares by each shareholder was considered irrelevant, because what matters are the features of the instrument and not the holders' situation.[65] Delegated Regulation (EU) No. 241/2014 also regulates (Article 7 d) priority in the order of distributions. The EBA, consistently, found that a second class of shares which is granted priority in the distributions is not eligible for CET1, even if, in past practise, at the end, both categories received the same amount of distributions.[66] The EBA also held that 'loyalty shares' (common shares whose dividend or voting rights are increased if the same person holds them continuously for a set period of time), do not meet the conditions under Article 28(4) CRR, and that the loyalty premium may act as a barrier to recapitalisation and to the entry of new shareholders in the capital of the institution if needed,[67] while loyalty shares with increased voting rights are eligible as CET1. Obligations (usually in the articles of association) to pay minimum dividends out of the distributable profits, even if permitted under applicable company law, would make common shares not CET1-eligible, and the same applies to dividend caps, on the assumption that such caps may render more difficult, if need be, to attract new investors to recapitalise the institution. This requirement, however, does not in our view prohibit provisions in the articles of association which require that a significant portion of yearly profits be allocated to reserves (including special reserves to support impact banking, if the institution is engaged in sustainable finance) absent a contrary resolution by the shareholders' meeting. Such provisions would indirectly and de facto limit to some extent the amount of yearly distributable profits, but the shareholders meeting's still fully discretionary power to deviate from such provision would preserve the necessary degree of flexibility of payments. For cooperative societies, in turn, Article 29(3) CRR expressly grants the possibility to include a cap or restrictions on the maximum level of distributions when 'set out under applicable national law or the statute of the institution'. Finally, as to the requirement that 'the cancellation of distributions imposes no restrictions on the institution', the EBA

[65] EBA, 'Report on the monitoring of CET1', para 99.
[66] EBA, 'Report on the monitoring of CET1', paras 95-96.
[67] EBA, 'Report on the monitoring of CET1', para 107.

found that a provision whereby the institution which does not declare an annual dividend on CET1 instruments would, for this reason, also cancel the interest payments on AT1 instruments is not compliant with Article 28[68] because the concept of restrictions on the institution must be interpreted giving prevalence to substance over form. Likewise, the reinstatement of voting rights to non-voting shares in the absence of dividends has not been considered in line with the eligibility criteria of Articles 28(1)(h)(v) and 28(4) CRR.[69]

— **Loss absorbency**. Article 28(1)(i) and (j) CRR Compared to all the capital instruments issued by the institution, each CET1 instrument absorbs the first and proportionately greatest share of losses as they occur to the same degree as all other CET1 instruments. Therefore, the instruments rank below all other claims in the event of insolvency or liquidation of the institution These provisions are consistent with the common understanding of common shareholders are the first line of loss absorbers and implies that, if several classes of shares are issued, the ranking in loss absorption is a key element in their assessment as to their eligibility for CET1. This is particularly important when considering 'preference shares' or any other classes of shares with special rights. Yet, although CET1 instruments must absorb losses following the same ranking, they may be second, in loss absorption, to other CET1 items, e.g. reserves, which are usually affected by losses before capital. A peculiar case is represented by deferred shares, i.e. shares that are usually given to executives and venture capitalists and do not normally have any rights to the assets of a company undergoing bankruptcy until all common and preferred shareholders are paid. In the case of banks, this usual feature needs, in principle, to be made modified in compliance with the principle of equal loss absorption, if common shares must remain eligible for CET1.[70]

— **Loss absorbency (Residual claim)**. Article 28(1)(k) CRR The instruments entitle their owners to a claim on the residual assets of the institution, which, in the event of its liquidation and after the payment of all senior claims, is proportionate to the amount of such instruments issued and is not fixed or subject to a cap, except in the case of the capital instruments referred to in Article 27 (mutuals, cooperative societies, savings institutions or similar institutions). Consistently, the EBA required amendments to a provision in the articles of association of an institution, whereby liquidation proceeds were based 'on the pro rata share of the enterprise value at the time of the issuance'.[71] There is only one exception. Capital instruments subscribed by public authorities in emergency situation under Article 31 can be included in the CET1 (if the conditions set out in Article 31 are met) but they do not necessarily carry a residual claim, because they can entitle to a claim on the residual assets of the institution after the payment of all senior claims, but prior to common shareholders (expect for in mutual or cooperative societies). For mutual and cooperative societies, moreover, Article 29(4) and Article 29(5) permit that capital instruments may provide to the owner with rights to the reserves of the institution in the event of insolvency or liquidation that are limited to the nominal value of the instruments or claim on the assets that is fixed or subject to a cap, provided that, however, such a limitation apply to the same degree to the holders of all other CET1 instruments issued by the institution.

[68] EBA, 'Report on the monitoring of CET1', para 108.
[69] EBA, 'Report on the monitoring of CET1', para 115.
[70] Gleeson, *op.cit.*, para 4.26.
[71] EBA, 'Report on the monitoring of CET1', para 91.

— **(Non) Security or Guarantee**. Article 28(1)(l) CRR The instruments are not secured, or subject to a guarantee that enhances the seniority of the claim by any entity of the same group and undertaking having close links with such entities nor the instruments are subject to any arrangement, contractual or otherwise, that enhances the seniority of claims under the instruments in insolvency or liquidation. This requirement is particularly sensitive, and needs to be applied in light of new Article 79 CRR introduced in 2019 whereby substance prevails over form and its assessment must take into account all arrangements related to the instruments, in order to determine their combined economic effects. The EBA found in several cases that swap agreements, promissory notes issued by an intermediate holding company to its parent, side letters and side agreements may in fact need to be considered in order to capture the overall substance of the instrument. This issue, and the effects on capital requirements of side letters and secret indemnities, was recently discussed in a major criminal judgment of the Tribunal of Milan in the Monte dei Paschi saga, concerning the issuance of FRESHES in 2008.[72]

The (minor) changes adopted by CRR II on the eligibility criteria are the following. In Article 28 (1), letter b) was rephrased to further clarify that CET1 instruments must be fully paid up and the acquisition of ownership of those instruments is not funded directly or indirectly by the institution. This is complemented by the further clarification (already considered above) that only the part of a capital instrument that is fully paid up shall be eligible to qualify as a CET1 instrument. In Article 28 (3) the requirement that the instrument should not include any obligation for the institution to make distributions to their holders is qualified, in the context of groups, by specifying that this requirement is considered to be met notwithstanding a subsidiary being subject to a profit and loss transfer agreement with its parent undertaking, according to which the subsidiary is obliged to transfer, following the preparation of its annual financial statements, its annual result to the parent undertaking, where certain conditions are met (the parent undertaking owns 90 % or more of the voting rights and capital of the subsidiary; the parent undertaking and the subsidiary are located in the same Member State; the agreement was concluded for legitimate taxation purposes; in preparing the annual financial statements, the subsidiary has discretion to decrease the amount of distributions by allocating a part or all of its profits to its own reserves or funds for general banking risk before making any payment to its parent undertaking; the parent undertaking is obliged under the agreement to fully compensate the subsidiary for all losses of the subsidiary; the agreement is subject to a notice period according to which the agreement can be terminated only by the end of an accounting year, with such termination taking effect no earlier than the beginning of the following accounting year, leaving the parent undertaking's obligation to fully compensate the subsidiary for all losses incurred during the current accounting year unchanged). Where an institution has entered into a profit and loss transfer agreement, it shall notify the competent authority without delay and provide the competent authority with a copy of the agreement. The institution shall also notify the competent authority without delay of any changes to the profit and loss transfer agreement and the termination thereof. An institution shall not enter into more than one profit and loss transfer agreement. These additions have been introduced in 2019 to deal with the "internal MREL" requirements stemming from the larger BRRD II revisions.

2.4 EBA CET1 list and national differences

Yet, the most important change brought about by CRR II in this context is that in Article 26(3), inspired by the EBA Opinion on own funds in the context of the CRR review,[73] regarding EBA powers in relation to the CET1 instruments. Indeed, to ensure a harmonised and consistent application of the eligibility criteria, CRR II

[72] Judgments of 8 November 2019 and 12 May 2020.

[73] European Banking Authority, 'Opinion of the European Banking Authority on Own Funds in the Context of the CRR Review' (EBA/OP/2017/07, 23 May 2017), 40, <https://www.eba.europa.eu/documents/10180/1853903/EBA+Opinion+on+own+funds+in+the+context+of+the+CRR+review+%28EBA-Op-2017-07%29.pdf> accessed 22 July 2020 (hereinafter: EBA, 'Opinion on own funds').

reinforces the EBA's role in terms of CET1 instruments: the EBA must be consulted ex ante by competent authorities before granting permission for new forms of capital instruments to be classified as CET1 instruments. In doing so, they must have due regard to the EBA's opinion and, should they decide to disregard it, they must communicate to the EBA the reasons for doing so. Moreover, the EBA may also disqualify existing CET1 instruments, making an announcement to that effect. It must be noted, in this respect, that Article 26(3) also provides that, by way of derogation from the principle whereby competent authorities shall evaluate whether issuances of capital instruments meet the criteria set out in Articles 28 or 29 and institutions shall classify issuances of capital instruments as CET1 instruments only after permission is granted by the competent authority, subsequent issuances of a form of CET1 instruments for which permission had been already granted in the past, do not need a new permission, provided that: (a) the provisions governing the new issuances are substantially the same as the provisions governing those precedent issuances for which the institution has already received permission and (b) these subsequent issuances are nonetheless notified in advance of their classification as CET1 instruments.

In line with the requirement in Article 26 CRR, the EBA first published a list of CET1 instruments on 24 May 2014, based on information received from the (at the time) 28 competent authorities across the European Union on existing types of capital instruments as at 28 June 2013. The list included eligible and grandfathered instruments. The most recent update of the list is as at Q4 2019-Q1 2020, and comprises well over one hundred different instruments. In three jurisdictions (Austria, Germany and France), there are up to 10 different types of CET1 instruments.

Institutions established in a minority of Member States issue as CET1 instruments only common shares, fully eligible under Article 28, and no instruments pre-existing CRR, grandfathered under Article 484 CRR. This is the case for Cyprus, Estonia, Slovenia. In a majority of Member States institutions issue as CET1 instruments two or three classes of shares (Belgium, Croatia, Czech Republic, Denmark, Hungary, Latvia, Lithuania, Malta, Portugal, Romania, Slovak Republic, Spain, Sweden, The Netherlands), in a number of Member States four or five classes (Finland, Greece, Ireland, Poland, or Italy where however the instruments now permitted for cooperatives by Article 150-ter of the Consolidated Act on Banking are not mapped into the list) and more in Austria (12), France (10), Germany (15) and Luxembourg (7). The high number of classes of CET1 instruments mapped in these countries depends, however, in Germany and Luxembourg mostly on the number of different legal forms what can be used to exercise banking activity and in France on the varieties of instruments that can be issued by cooperatives. In the vast majority of Member States where institutions issue more than on class of CET1 instruments, one (or more) of them is issued by mutual or cooperative societies or saving institutions under Article 29 CRR. In Greece in addition to common shares and cooperative shares, there are two classes of CET1 instruments subscribed by the Hellenic Financial Stability Fund (including Contingent Convertible Bonds (CoCos)).

In many Member States institutions issuing more than one class of CET1 instruments issue, in addition to common shares eligible under Article 28 or cooperative or other shares eligible under Article 29, preference shares: most of them are not fully compliant with Article 28 and are grandfathered under Article 484 CRR (in Croatia, in Italy, in Malta, orin Romania) but some are (in Ireland, in Poland, in the Slovak Republic, orin Sweden). In Austria there are several instruments with preference rights: some, like Vorzugaktien, are grandfathered, and some (like non-voting CET1 instruments – Stimmrechtlose CET1 Instrumente or participation capital - Partizipationskapital) are eligible under Article 28. This confirms that one of the major policy choices made by Basel and CRR – and namely to create strong incentives for banks to raise capital in the form of homogenised shares[74] - is achieved.

2.5 Contingent Capital, its Philosophy and its Regulatory Design

[74] Gleeson, *op.cit.,* para 4.09.

One of the fundamental changes in approach to capital regulation brought about by Basel III was a reconsideration of hybrid instruments, which were already largely admitted under Basel I (after the adoption of the so-called Sydney Press Release, 27 October 1998[75]) and Basel II, but as 'gone concern' capital instruments, namely as securities situated somewhere between debt and equity which would absorb losses before senior creditors and depositors in the event of an institution's failure, and thus only in insolvency or liquidation. Basel III redesigned these hybrid instruments as 'going concern' capital, and thus as capital which could be used outside of insolvency to reduce the chance of an institution's failure (and at the same time deducted from regulatory capital previous 'gone concern' hybrid instruments if they are not eligible as AT1 capital under the new provisions).[76] These instruments are therefore qualified as additional Tier 1 (AT1) capital.

Under Basel III CoCos must be, like common equity, deeply subordinated, perpetual and must pay non-cumulative coupons out distributable profits, payable at the discretion of the issuer. In addition, they must have a (contractual) loss-absorption trigger, which activates automatically when the CET1 capital ratio of the bank falls below a set level.[77] In principle, CoCos are hybrids which do not share in profits in good times (they receive a fixed coupon, payable however out of the profits and are usually treated as debt for fiscal purposes)[78] but automatically share in losses (and non-cumulative suspension of payment of the coupons) in bad times.[79] The rationale for their regulatory design was a compromise between a stricter approach to capital advocated by Admati, Hellwig and others, whereby only common equity could count as regulatory capital[80] and market needs, on the assumption that these instruments could be favourably issued to strengthen capital position at a time when raising equity would otherwise be difficult and would be less costly for the institutions than CET1 instruments.

European rules implementing Basel III further require that the loss-absorption trigger is set at CET1 not lower than 5.125 % Total Risk Exposure Amount (Article 54 CRR) triggering (automatic) contingent convertible or write off mechanisms and that coupon payment on CoCos is conditional on the institution's meeting the combined buffer requirement (i.e. the sum of the capital conservation buffer and, when applicable, the countercyclical capital buffer, the G- SiII and O-SII buffer and the systemic risk buffer), see: article 141 CRD. A further element of complexity is given by the applicability of the loss absorption trigger either on a solo level or at sub-consolidated or consolidated level.[81]

The initial market experiences spurred the development of CoCos market in Europe. At a time when there were difficult market conditions for equity in the preparatory phase of the Single Supervision Mechanism (and after the Asset Quality Review completed in October 2014) European banks almost tripled their CoCos issuances between 2014 and 2016.[82] Later, uncertainties emerged and they soon morphed into market disturbances, related i.a. to the restrictions on distributions and the expectation of early redemption, exemplified respectively by Deutsche Bank and Santander (discussed below). Market expectations aside,

[75] Instruments eligible for inclusion in Tier 1 capital see: https://www.bis.org/press/p981027.htm.

[76] Compare Andreas Cahn and Patrick Kenadjian, 'Contingent convertible securities: from theory to CRD IV' (2014) Institute for Law and Finance Working Paper Series 143/2014, <https://www.ilf-frankfurt.de/fileadmin/_migrated/content_uploads/ILF_WP_143.pdf > accessed 23 July 2020; Danny Busch and Guido Ferrarini (eds), *European Banking Union* (2nd edition, OUP 2020), paras 9.03-9.04.

[77] Stefan Avdjiev, Anastasia Kartasheva and Bilyana Bogdanova, 'CoCos: a primer' (2013) BIS Quarterly Review 43-49, <https://www.bis.org/publ/qtrpdf/r_qt1309f.pdf > accessed 23 July 2020.

[78] Gera Kiewiet, Iman Lelyveld and Sweder van Wijnbergen, 'Contingent Convertibles: Can the Market Handle Them?' (2017) DNB Working Paper No. 572, 1.

[79] Avdjiev, Kartasheva and Bogdanova, *op.cit.,* para 9.06.

[80] Anat R. Admati and others, 'Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive' (2013) Stanford Business Working Paper No. 2065/2010.

[81] European Banking Authority, 'EBA Report on the monitoring of additional Tier 1 (AT1) instruments of European Union (EU) institutions – Third update' (20 July 2018) < https://eba.europa.eu/sites/default/documents/files/documents/10180/2087449/179534d8-3b95-44c2-8532-eca822d3bf76/AT1%20report%20Q2%202018%20update.pdf > accessed 23 July 2020 (hereinafter: EBA, 'Report on the monitoring of AT1 instruments'), paras 20, 96-100.

[82] Pierluigi Bologna, Arianna Miglietta and Anatoli Segura, 'Contagion and CoCos market? A case study of two stress events' (2018) Temi di discussione Economic Working Paper No. 1201, 9, < https://www.bancaditalia.it/pubblicazioni/temi-discussione/2018/2018-1201/en_tema_1201.pdf > accessed 23 July.

regulatory choices significantly added in terms of disincentives to a further development of CoCos. First, the amount of CoCos in the capitalisation of any institution is restricted to 1.5% of Total Risk Exposure Amount until the institution's own funds exceed 13% or for G-SIBs 18%[83]: in so doing, it reduces CoCos' space in the institution's capital and the actual prospect, for CoCos holders, of severely diluting controlling rights of existing shareholders in a going concern scenario, if conversion is triggered. Second, the relationship between CoCos and bail-inable instruments, i.e. instruments subject to write-down and conversion (bail-in) under the Directive on the recovery and resolution of credit institutions and investment firms (BRRD),[84] and in particular with the conversion and write down tool, leaves blind spots.[85] Nonetheless, several studies still confirm that in principle CoCos may have positive financial stability implications and replacing unsecured interbank debt in the EU financial system by CoCo securities would improve systemic risk.[86] Only the future can tell what will be their fate, but judging from their current volume of > 150 billion outstanding in the market and seemingly (much) more to come, these instruments appear to be far from their often predicted, but never materialised, crepuscular end.

CRR lays down specific eligibility criteria to account for AT1 in Article 52. These criteria are supplemented by Delegated Regulation (EU) No 241/2014 as amended by subsequent regulations. This incorporates a wide array of draft RTS on own funds that the EBA delivered to the European Commission in this area. The EBA also published a very useful AT1 standardised template, to promote via supervisory guidance more market standardisation of the instruments. The following qualitative requirements apply:

- **Issuance**. and disbursement Article 52(1)(a) CRR. The AT1 instruments, like CET1 instruments, must be directly issued by an institution and fully paid up; only the part of a capital instrument that is fully paid up is eligible to qualify as an Additional Tier AT 1 instrument. In turn, further to a CRR II amendment, the acquisition of ownership of the instruments cannot be funded directly or indirectly by the institution.
- **Ownership**. Article 52(1)(b) CRR The instruments cannot be not owned by any of the following: (i) the institution or its subsidiaries; (ii) an undertaking in which the institution has a participation in the form of ownership, direct or by way of control, of 20 % or more of the voting rights or capital of that undertaking.
- **Ranking**. Article 52(1)(d) CRR Perhaps the trickiest aspects of these instruments are those concerning their ranking and priority upon insolvency, and their corresponding relationship with CET1 instruments (the lower step in the pecking order) and Tier 2 instruments and/or those subject to write-down and conversion upon the entity's resolution. The instruments rank below Tier 2 instruments in the event of the insolvency of the institution. The provisions governing the instruments require that, upon the occurrence of a trigger event, the principal amount of the instruments be written down on a permanent or temporary basis or the instruments be converted to CET1 instruments. The provisions governing the instruments include no feature that could hinder the recapitalisation of the institution. The instruments are not subject to set-off or netting arrangements that would undermine their capacity to absorb losses. In principle AT1 instrument absorb losses after CET1 instruments and this is consistent with a company law overarching principle, whereby shareholders, as residual claimants,

[83] Cahn and Kenadjian, *op.cit.,* para 125.

[84] Directive (EU) No 2014/59 of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council [2014] OJ L173/190 (hereinafter: BRRD).

[85] Also write down and conversion can be used, under BRRD, in a going concern context and CoCos, in turn, must also have a PONV trigger (Cahn and Kenadjian, *op.cit.,* para 9.126): this may blur a bit the distinction between CoCos as contractual instruments and bail-inable liabilities as statutory instruments. This is even more so if one considers that the 5.125% is very low indeed, if compared with the historical data, which show that during the financial crisis all rescued banks had still capital ratios above 8% at the time of state intervention (Cahn and Kenadjian, *op.cit.,* para 9.128). Kiewiet, Lelyveld and Wijnbergen, *op.cit.*, 13.

[86] Zachary Feinstein and T. R. Hurd, 'Contingent Convertible Obligations and Financial Stability' (2020) Cornell University Working Papers, < https://arxiv.org/pdf/2006.01037.pdf> accessed 23 July 2020.

must also be the first line loss absorbers. This principle, however, appears not always fully implemented in this context. Indeed, AT1 instruments absorb losses either by converting into common equity or through a principal write down (which, according to the EBA standardised template,[87] may be eventually followed by a write up, if certain conditions are met). In a conversion context, respecting the principle that shareholders must bear first losses, means that AT1 conversion should be applied only once CET1 items have been fully used to absorb losses and in a way that CoCos are converted to restore, through conversion, the going concern regulatory capital. Since conversion may take place, in this context, well before the minimum capital required by general company law is lost, it is essential that first losses are absorbed through the existing CET1 items and then CoCos conversion takes place at a conversion rate which is contractually set, and can be based (i) on the market price of the stock at the time the conversion trigger is breached, (ii) at a prespecified price (often, the share price at the time of issuance), (iii) or a combination of different criteria, with the floor set out by Article 54 CRR. Yet, if conversion is done before losses are absorbed, AT1 instruments would de facto absorb losses pari passu with shareholders. A write down should, in theory, follow the same principles, but it does not necessarily do so. Indeed, the contractual arrangements may be conducive to CoCos holders to bear the first loss in full before any shareholder is wiped out.[88] This is, in our view, problematic, because it may de facto contradict one of the basic requirements for CET1 instruments.[89] Indeed, whilst the conversion of CoCos always takes place in full, write down can be either partial or in full, as the contract specifies.[90] Moreover, it is important to bear in mind the additional issues raised by company law, which concern primarily the requirement of prior shareholder approval of every capital increase, and the need to respect shareholders' pre-emption rights. First, the capital increase necessary to service the conversion (like the preceding capital reduction) needs prior shareholders' approval (Article 68(1) of Consolidated Company Law Directive (EU) 2017/1132). As already clarified by the CJEU in Panagis Pafitis (judgment of 12 March 1996, case C-441/93, EU:C:1996:92) the existence of exceptional circumstances does not affect the existence of the requirement. Thus, in a crisis scenario, where such authorisation would be needed to effect the conversion, some shareholders (or CoCo holders) might conceivably build blocking positions to use holdout strategies to extract better terms. The way to sidestep this obstacle would be through a provision in the articles of association (which can be resolved by the shareholders' meeting) authorising 'an increase in the subscribed capital up to maximum amount' and delegating the implementation of such authorised increase to the board of directors, for a maximum period of five years, which may renewed one or more times by the general meeting, each time for a period not exceeding five years (Article 68(2) of Consolidated Company Law Directive (EU) 2017/1132). Article 68(4) of the Consolidated Directive further specifies that 'this Article shall apply to the issue of all securities which are convertible into shares or which carry the right to subscribe for shares, but not to the conversion of such securities, nor to the exercise of the right to subscribe". Furthermore, EU company law requires shareholders to have a pre-emption right in case of capital increases, in accordance with Article 72(1) of the Consolidated Company Law Directive (EU) 2017/1132. Again, the CJEU clarified in Evangelikis (judgment of 24 March 1992, case C-381/89, EU:C:1992:142) that this requirement cannot be sidestepped because the company is in a situation of crisis. Furthermore, in Pafitis (supra 67-70) the Court held a very restrictive stance towards the possibility that domestic courts could exclude the protection of the requirement of approval by the general meeting (although the approach can be extrapolated to the requirement of pre-emption rights) because the shareholder had recourse to it in a situation of abuse of rights (e.g. if he

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[87] European Banking Authority, 'EBA standardised templates for Additional Tier 1 (AT1) instruments – Final' (10 October 2016), <https://eba.europa.eu/sites/default/documents/files/documents/10180/1360107/8ce7e7df-6cb9-46e5-beec-8d6ff2f0c2c9/EBA%20draft%20AT1%20templates%20-%202016.pdf?retry=1> accessed 23 July 2020.

[88] Cahn and Kenadjian, *op.cit.,* para 9.126.

[89] This is even more so if one considers that the EBA sees as problematic a reference in the contractual arrangements to prior loss-absorbing instruments whereby the conversion or write down of the AT1 instrument is linked to the prior activation of a similar mechanism for other more senior instruments: EBA, 'Report on the monitoring of AT1 instruments', para 50.

[90] Kiewiet, Lelyveld and Wijnbergen, *op.cit.,* 8.

were using it opportunistically to leverage a better deal from the company). In its later judgment of 18 December 2008 in case C-338/06, Commission v Spain the CJEU held that national company law provisions vesting pre-emption rights to convertible bondholders pari passu with shareholders infringe European law because in so doing they dilute a right in principle pertaining solely to them. The combined effect of these provisions is to strengthen the position of shareholders, but to conversely weaken the position of holders of convertible instruments. The issues associated to the constraints of Pafitis and the like on situations of bank reorganisations were raised in in Dowling (judgment of 8 November 2016, case C-41/15, EU:C:2016:836) and the Court seemed more open to arguments that could result in sidestepping the requirements of a shareholders' meeting resolution (and, by extension, of pre-emption rights). Yet, the arguments used were troubling, as the Court justified the exception to the general company law requirements on the fact that the case concerned "extraordinary reorganisation measures […] designed to avoid, in a situation where there is a serious disturbance of the national economy and of the financial system of a Member State, the failure of a bank and thereby to maintain the financial stability of the European Union" whereas Pafitis "concerned the insolvency of a single bank"; and thus "the Second Directive continues to apply in the case of 'ordinary reorganisation measures'" (Dowling at 53). Likewise, the company law requirement is derogated (with complementary, specific, safeguards) by BRRD for the resolution context, any time the statutory conversion and write down tool is exercised by the competent authority (in which case the authority's decision replaces shareholders' approval). Yet, the BRRD conversion and write down tool can only be applied if an alternative private market solution, like a capital increase, is not available, and must be accompanied by the safeguards of ex post valuation and compensation. The write-down and conversion framework does not apply, and the capital increase requirements are not derogated when CoCos' conversion takes place outside of the conversion and write down tool, according to the contractual arrangement incorporated in the AT1 instrument. In this latter case, conversion still requires a capital increase in compliance with the general provisions of applicable company law, implementing Article 68 of the Consolidated Company Law Directive (EU) 2017/1132. Likewise, in such a context (unlike with the BRRD conversion and write down tool, which cannot be applied if an alternative private market solution, like a capital increase, is still available and is accompanied by the safeguards of ex post valuation and compensation) company law right of preemption applies in accordance with Article 72(1) of the Consolidated Company Law Directive. Thus, the only alternative left would be for the right of pre-emption to be withdrawn by decision of the general meeting (the same approving the authorised capital increase necessary to serve conversion) a withdrawal that can be delegated to the board of directors, in accordance with Article 72(4) and Article 72(5) of the said Directive. Failing this authorisation (whose, sometimes crucial, specificities may be implemented differently in several Member States)[91] any conversion (outside the cases set out in the BRRD) not respecting the pre-emption right of the existing shareholders would violate European and national law and the fundamental right of property. To practically facilitate the process, the AT1 standardised template allows conversion without granting a pre-emption right to existing shareholders, followed however by the offer to acquire the shares issued on conversion upon payment to the converted CoCos holders of their value.[92] Some AT1 instruments, moreover, provide a worst case scenario, whereby AT1 may be subject to permanent write down rather than a conversion in the event that the institution is unable to deliver the CET1 instruments into which the instruments would be converted.[93] On the other hand, CoCos interaction and intersection with bail-inable instruments under the BRRD, and in particular with the conversion and write down tool, leaves blind spots. In principle, bail-in (the write-

[91] Cahn and Kenadjian, *op.cit.,* paras 9.81-9.96.
[92] EBA, 'Report on the monitoring of AT1 instruments', paras 61-63.
[93] EBA, 'Report on the monitoring of AT1 instruments', para 49.

down and conversion of instruments) is used as a resolution tool,[94] which requires the entity to be put in resolution, while CoCos' convertibility clause is triggered in a going concern situation. In practice, however, write down and conversion can be used, under BRRD, before resolution (i.e. on a 'going concern' situation),[95] while CoCos, in turn, must also have a "point of non-viability" trigger.[96] This may blur a bit the distinction between CoCos as contractual instruments and bail-inable liabilities as 'statutory instruments'.[97] A way to ensure that the instruments are triggered on a sequential basis, which truly reflects their difference in ranking, would be to rely on the bail-in as a 'last resort' to be used once CoCos have been used, and exhausted.[98] Yet, in a crisis stage, with the situation is rapidly deteriorating, there may be little margin to implement such sequence. Moreover, the fact that the point of non-viability (PONV) is now a mandatory trigger event also for CoCos and has to be determined by supervisors has caused credit rating agencies to adopt a quite conservative stance in rating CoCos.[99]

— **(Non) Security & guarantees**. Article 52(1)(e) CRR. Like for CET instruments, the instruments are neither secured nor subject to a guarantee that enhances the seniority of the claims by any of the following: (i) the institution or its subsidiaries; (ii) the parent undertaking of the institution or its subsidiaries; (iii) the parent financial holding company or its subsidiaries; (iv) the mixed activity holding company or its subsidiaries; (v) the mixed financial holding company or its subsidiaries; (vi) any undertaking that has close links with entities referred to in points (i) to (v) nor the instruments are not subject to any arrangement, contractual or otherwise, that enhances the seniority of the claim under the instruments in insolvency or liquidation.

— **Permanency (perpetuity) & redemption**. Article 52(1)(g) to (k) CRR. The instruments are perpetual and the provisions governing them include no incentive for the institution to redeem them; where the instruments include one or more early redemption options including call options, the options are exercisable at the sole discretion of the issuer; the instruments may be called, redeemed or repurchased only where the conditions laid down in Article 77 are met, and not before five years after the date of issuance except where the conditions laid down in Article 78(4) are met; the provisions governing the instruments do not indicate explicitly or implicitly that the instruments would be called, redeemed or repurchased, as applicable, by the institution other than in the case of the insolvency or liquidation of the institution and the institution does not otherwise provide such an indication; the institution does not indicate explicitly or implicitly that the competent authority would consent to a request to call, redeem or repurchase the instruments. The EBA clarified that the institution cannot give a notice of redemption after a trigger event notice has been given.[100] Yet, the differences between the legal framework of redemption and market expectation may still cause market disruptions. In February 2019, for the first time, Banco Santander was the first European bank to fail to call its CoCos on their first call date, breaking a long-lasting practice of early redemptions. Investors became, this time, acutely conscious, thus, that their perpetual contingent convertibles face the actual possibility of not been redeemed after the minimum required five-year non-call period. This added further uncertainty to the situation created by the restrictions on distributions caused by coupon triggers in the case of Deutsche Bank (see next point).

— **Distributions**. Article 52(1)(l) CRR Distributions under the instruments must meet the following conditions: (i) they are paid out of distributable items; (ii) the level of distributions made on the instruments will not be amended on the basis of the credit standing of the institution or its parent

[94] BRRD, art 43.
[95] BRRD, art 59.
[96] Cahn and Kenadjian, *op.cit.,* para 9.126.
[97] This is even more so if one considers that the 5.125% is very low indeed, if compared with the historical data, which show that during the financial crisis all rescued banks had still capital ratios above 8% at the time of state intervention. Cahn and Kenadjian, *op.cit.,* para 9.128.
[98] In reality, this seems to be the meaning of Art 59 BRRD, which allows the write-down and conversion to be triggered if the bank is failing-or-likely to fail (FOLTF) and there is no alternative *other than* bail-in to restore the balance.
[99] Kiewiet, Lelyveld and Wijnbergen, *op.cit.,* 13.
[100] EBA, 'Report on the monitoring of AT1 instruments', para 36.

undertaking; (iii) the provisions governing the instruments give the institution full discretion at all times to cancel the distributions on the instruments for an unlimited period and on a non-cumulative basis, and the institution may use such cancelled payments without restriction to meet its obligations as they fall due; (iv) cancellation of distributions does not constitute an event of default of the institution; (v) the cancellation of distributions imposes no restrictions on the institution. Some of the market disturbances referred to above were related to the potential restrictions on distributions. The EBA published an opinion in 2015,[101] eventually followed by the ECB in 2016, clarifying that the level of capital requirements below which the institution would have to restrict its pay-outs also to AT1 instruments included Pillar 2 requirements. It became apparent that the CoCos market, which was relatively immature, had not paid much attention to coupon triggers, which determine the maximum distributable amount of the institution. Since the threshold for such coupon triggers is set higher than the triggers for the more extreme measures of conversion or write down, therefore restrictions on coupon payments can materialise first, and well before a risk of conversion. The effect of this materialised in 2016 when two Deutsche Bank stress events occurred (the announcement of extraordinary losses of about 6.7 billion and the subsequent USD 14 fine received by the US Justice Department): although Deutsche Bank used its cash available to make its CoCos coupon payments, CoCos prices dropped dramatically and this rapidly spread contagion to the rest of the European banks, abruptly halting CoCos issuances.[102]

— **Insolvency test**. Article 52(1)(m) CRR The instruments do not contribute to a determination that the liabilities of an institution exceed its assets, where such a determination constitutes a test of insolvency under applicable national law. It remained uncertain, however, to what extent in calculating the respect of the level of capital requirements also potential losses should be considered.
— **Loss absorbency – recapitalisation & third countries**. Article 52(1) (n), (o) (p) and (q) CRR. The provisions applicable to AT1 not only require a specific insolvency ranking, but also, as said above, that upon the occurrence of a stipulated trigger, AT1 instruments are susceptible to effectively absorb the losses of the institution. This 'loss absorbency' is implemented through the requirement that, upon the occurrence of a trigger event, the principal amount of the instruments must be written down, or the instruments converted into CET1 instruments (letter (n), and the catch-all requirement that "the provisions governing the instruments include no feature that could hinder the recapitalisation of the institution;" (letter (o). To these the amended CRR provisions have added specific requirements for cases involving third countries. Where the issuer is established in a third country and has been designated in accordance with Article 12 of BRRD as part of a resolution group the resolution entity of which is established in the Union or where the issuer is established in a Member State, the law or contractual provisions governing the instruments require that, upon a decision by the resolution authority to exercise the write-down and conversion powers referred to in Article 59 of that Directive, the principal amount of the instruments is to be written down on a permanent basis or the instruments are to be converted to CET 1 instruments; where the issuer is established in a third country and has not been designated in accordance with Article 12 of BRRD as part of a resolution group the resolution entity of which is established in the Union, the law or contractual provisions governing the instruments require that, upon a decision by the relevant third-country authority, the principal amount of the instruments is to be written down on a permanent basis or the instruments are to be converted into CET 1 instruments. Where the issuer is established in a third country and has been designated in accordance with Article 12 of BRRD as part of a resolution group the resolution entity of which is established in the Union or where the issuer is established in a Member State, the instruments may only be issued under, or be otherwise subject to the laws of a third country where, under those laws, the exercise of the write-down and conversion powers referred to in Article 59 of that Directive is

[101] European Banking Authority, 'Opinion of the European Banking Authority (EBA) on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions' (EBA/Op/2015/24, 16 December 2015).
[102] Bologna, Miglietta and Segura, *op.cit.*, 30.

effective and enforceable on the basis of statutory provisions or legally enforceable contractual provisions that recognise resolution or other write-down or conversion actions. The provisions are necessary because CRR is more stringent and more specific than the Basel III framework (Basel III) with regard to the eligibility criteria (e.g. dividend stoppers are prohibited and the trigger at 5.125% if for all AT1 instruments regardless of their accounting treatment; write down may operate differently in third countries).[103]

2.6 Tier 2 (T2) capital instruments

Tier 2 instruments were used as a bargaining chip of sorts in earlier versions of the Basel Framework. Compromising on a common, relatively simple definition of "Tier 1 capital" was made easier by the possibility to include other instruments, which could vary across different jurisdictions, within a second (Tier 2) category. The financial crisis accelerated the push towards simplification, thus removing Tier 2 one level from banks' core capital and making them lose relevance as a yardstick of solvency. Conversely, the interplay between T2 and CET1 (and AT1) instruments, including the cases where T2 instruments may be subject to conversion (comprising instances of bail-in), has become a new source of complexity.[104]

As per the requirements for an instrument to qualify as T2, under Article 63 CRR, some are similar to those already examined under CET1 or AT1 (supra para. 2.3.3.), while others specifically concern T2. These requirements concern:

- **Issuance and disbursement**. Article 63 (a) CRR The instruments must be issued and fully paid-up (supra 2.3.3. nos. (1) and (2)). The Banking Package has changed from the original reference to "capital instruments and subordinated loans" (which included within T2 instruments the debts owed under instruments raised in capital markets, as well as loans concluded bilaterally) to a narrower reference to "capital instruments" that are "issued" by the institution.[105]
- **Ownership**. Article 63 (b), (c) CRR The instruments cannot be owned by the entity or its subsidiaries, nor by undertakings where the entity has a significant participation or influence (of 20% or more) (letter (b)).[106] This is completed with the requirement that the instruments cannot be funded by the institution (letter (c)).
- **Ranking**. Article 63 (d), (e), (f) CRR The incorporation of write-off and conversion tools, and the concept of Minimum Requirement of Capital and Eligible Liabilities (MREL) originally in bank resolution rules',[107] into banks' prudential rules,[108] has led to change the language of the provision, which now places T2 instruments below eligible liabilities (article 63 letter (d).[109] One possible doubt may arise about the relationship between T2 instruments and subordinated instruments that do not qualify as "eligible liabilities".[110] The rules also require the instruments not to be secured, or subject

[103] EBA, '*Report on the monitoring of AT1 instruments*', para 101.
[104] The interplay is not limited to cases of conversion, though. European Banking Authority, 'Q&A on Grandfathering of own funds' (2013_54, 2013) concerned instruments that went beyond CRR T2 requirements, and included a provision that *"the institution has the right to defer the payment of interest because the institution has not paid dividends on ordinary shares (Core Equity Tier 1 – CET1) and on hybrid instruments (Additional Tier 1 – AT1)"*. EBA's answer is that this did not disqualify such instruments as T2, but their concrete design could affect CET1 or AT1 instruments, if this 'right to defer' for T2 instruments was accompanied (or could be read as implying) a restriction on the company's ability to cancel distributions.
[105] See Art 63(a) as drafted by CRR II. Former Art 63(a) required that: *"the instruments are issued or the subordinated loans are raised, as applicable, and fully paid-up"*.
[106] This requirement is aligned with that of eligible liabilities under article 72b(2) CRR. The EBA has clarified that this includes instances where a bank's T2 instruments are purchased by an insurance subsidiary (or related company) even if that insurance undertaking places the instrument in unit-linked funds within life insurance policies, so that the beneficial ownership (economic risk) of the instrument is transferred to investors. See European Banking Authority, 'Q&A on Own funds – underwriting of own funds instruments' (2014_1687, 2014).
[107] Arts 59, 45 BRRD.
[108] Arts 72a and ff CRR, drafted by CRR II.
[109] Former article 63(d) CRR required T2 instruments (or loans) to be "wholly subordinated to claims of all nonsubordinated creditors;" Current rules on "eligible liabilities" (EL), such as articles 72(a) and 72(b) CRR, introduce a further layering, by excluding certain categories of debt from the category of EL (deposits, secured liabilities, short-term liabilities, etc.) and subordinating EL to them (article 72(b)(d) CRR). Article 63(d) CRR in turn subordinates T2 instruments to EL.
[110] E.g. subordinated loans or instruments that do not fulfil some of the requirements under articles 72(a) or 72(b) CRR.

to guarantees by the institution, its subsidiaries, or related entities (letter (e)) or any arrangements that enhance their seniority (letter (f)).

- **Ranking (Interest – Distributions)**. Article 63 (d), (l), (m) CRR The reference to the T2's ranking is restricted to the instruments' "principal", and, it seems to be contemplated for a situation of insolvency or bail-in. Yet, although the entity is free to structure interest payments to holders of T2 instruments on a level with holders of non-subordinated debt on a pay-as-you-go basis (i.e. holders of both types of instruments would receive their payments without any sequencing), the entity seems to have discretion to cancel said interest payments without any risk of acceleration,[111] which would result in a de facto subordination also on a 'going concern' basis. At the same time, credit-sensitive interest features (i.e. increase in the interest rate payable as a result of the revision of the institution's credit rating) are forbidden.[112]
- **Permanency (Long-term)**. Article 63 (g) – (l) Rules on T2 instruments show a vocation for permanence, but with important differences. No 'perpetuity' is required (supra 2.3.3. no. (5)). Instruments can qualify as T2 provided that their maturity is of at least 5 years (article 63 letter (g)).[113] Nonetheless, as the instruments' maturity falls below 5 years, they will be de-recognised as T2 following a linear amortisation scheme.[114] The emphasis on permanency, but not perpetuity, also places the focus on other constraints (supra 2.3.3. nos. (6) and (7)). For example, the instruments cannot include an incentive to redeem or repay the principal prior to maturity (letter (h), such as clauses that combine a call option with an interest rate revision, which e.g. leaves the institution the option to increase the interest rate or redeem the principal.[115] Yet, options for repayment, including call options, are not to be considered as such 'incentives' provided they are exercisable at the sole discretion of the issuer (letter (i)).[116] For the same reason, early calls, redemptions or repurchases are subject to the regime of article 77 CRR, which regulates its authorisation by the competent authority (letter (j)[117]) no earlier than five years after the instrument's issuance. Furthermore, the provisions governing the instrument can neither indicate explicitly or implicitly that the instruments would be called, redeemed, repaid or repurchased early, except in case of insolvency (letter (k), nor give the holder the right to accelerate the future scheduled payment of interest or principal, other than in the case of the insolvency or liquidation (letter (l), nor amend the interest rate on the basis of the institution's credit standing (letter (m).
- **Loss absorbency – recapitalisation & third countries**. Article 63 (n), (o), (p) CRR One of the features that was left implied in the early provisions on T2 instruments was loss-absorbency. Since this is not a "separate and distinct legal concept",[118] but rather a consequence of the application of the provisions on ranking, one could argue that the concept was implied. However, it would have been doubtful, and added an unnecessary uncertainty in a situation of financial distress. Therefore, the reformed provisions add to the rules on ranking etc discussed above the requirement that the "instruments are not subject to set-off or netting arrangements that would undermine their capacity to

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[111] Art 63(l) CRR. See also Joosen, *op.cit.*, p. 195.

[112] Art 63(m) CRR.

[113] Yet, there is no requirement that T2 instruments have a fixed maturity. Perpetual instruments can qualify as T2. See European Banking Authority, 'Q&A on Own funds – Subordinated loans as Tier 2 instruments' (2014_1220, 2014).

[114] Art 64 CRR. If the institution effects a partial reimbursement of the principal, equivalent to the percentage that ceases to qualify as T2, that does not exempt the entity from calculating the percentage that is 'written off' as T2. E.g., if an entity has issued an instrument with 100 of principal value, which this year crosses the 5-year maturity threshold, the entity needs to de-recognize 20 (20% of 100). If the entity has redeemed or reimbursed 20, it will still need to de-recognize 20% of 80 (i.e. 16) as T2. See European Banking Authority, 'Q&A on Own funds' (2013_314, 2013). Interactive Rulebook.

[115] See, e.g. European Banking Authority, 'Q&A on Instrumenty w Tier II / Tier 2 instruments and incentives to redeem or repay subordinated bonds prior to their maturity' (2016_3076, 2016) and European Banking Authority, 'Q&A on Own funds – Taps on callable instruments' (2016_2848, 2016), *Single Interactive Rulebook.*

[116] The issuer cannot escape this constraint by 'deducing' the amount subject to early redemption from the full amount of the issuance, under article 66 CRR. If the instrument contemplates a partial early redemption the full instrument is disqualified as T2. See European Banking Authority, 'Q&A on Eligibility of subordinated loans for classification as Tier 2 instruments when the rules governing their issue contemplate an obligation of the issuer to repurchase a percentage of them (eligibility limited to the amount of subordinated loans not subject' (2014_1226, 2014), *Single Interactive Rulebook.*

[117] This means that the instruments must contain a reference to such regulatory conditions in their terms to qualify as T2. See European Banking Authority, 'Q&A on Own funds – Tier 2 instruments' (2013_544, 2013).

[118] Joosen, *op.cit.*, 200.

absorb losses" (letter (p). In addition, specific provisions are contemplated for the case where the issuer is established in a third country, but forms part of a resolution group headed by an EU entity, or issues instruments subject to the laws of a third-country, which require that the powers of write-down and conversion (which ensure that) are properly recognised, with a language analogous to the one discussed for AT1 instruments (supra 2.5.5. no. (8)).