Updated EBA report on monitoring Additional Tier 1, Tier 2 and TLAC/MREL eligible liabilities instruments

28 September 2023

On 21 July 2023, the European Banking Authority ("**EBA**") published its "*EBA Report on the monitoring of Additional Tier 1 (AT1), Tier 2 and TLAC/MREL eligible liabilities instruments of European Union (EU) institutions – Update*" (EBA/Rep/2023/23) (link) (the "**EBA Report**").

The EBA Report merges and updates the content of the two previous separate reports of the EBA in the fields of monitoring Additional Tier 1 ("**AT 1**")[1], as well as total loss absorbing capacity ("**TLAC**") and minimum requirement for own funds and eligible liabilities ("**MREL**") instruments.[2]

In addition, the EBA has added new recommendations/clarifications on certain contractual clauses of the terms and conditions it has reviewed (for further details see point 2 below). Moreover, the EBA Report contains numerous recommendations/clarifications for drafting and improving/amending the current market practice and wording of contractual clauses, which makes the EBA Report also useful for those issuers for which the newly introduced points are not (directly) relevant.

1 Introduction

1.1 Background

The CRR[3] lays down the eligibility criteria as regulatory capital for AT 1 instruments (Articles 52 to 54 CRR), Tier 2 instruments (Articles 63 CRR) and eligible liabilities (Articles 72b CRR). Those criteria are supplemented by the Commission Delegated Regulation (EU) No 241/2014.[4]

The EBA has focused its work primarily on the assessment of selected issuances of AT 1 and Tier 2, senior non-preferred ("**SNP**"), senior holding company and senior preferred ("**SP**") MREL eligible liabilities instruments. The terms and conditions of these selected issuances were assessed against the regulatory provisions in order to identify provisions that the EBA would recommend and, in contrast, recommend avoiding.

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1 I.e. the "*EBA Report on the monitoring of Additional Tier 1 (AT1) instruments of European Union (EU) institutions – Update*" (EBA/REP/2021/19) dated 24 June 2021 (link) (the "**EBA AT 1 Report**").

2 I.e. the "*EBA Report the monitoring of TLAC-/MREL eligible liabilities instruments of European Union (EU) institutions – Update*" (EBA/REP/2022/23) dated 7 October 2022 (link) (the "**EBA TLAC/MREL Report**").

3 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (*Capital Requirements Regulation* – "**CRR**")

4 Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for own funds and eligible liabilities requirements for institutions

1.2 Content

The EBA Report is structured as follows:

- the EBA's considerations on AT 1, Tier 2 and eligible liabilities instruments monitoring (i.e. detailed analysis of eligibility criteria common to/relevant for AT 1, Tier 2 and eligible liabilities instruments);
- a follow-up on the "*Opinion of the European Banking Authority on the prudential treatment of legacy instruments*" (EBA/Op/2020/17) dated 21 October 2020 (link); and
- the EBA's considerations on own funds or eligible liabilities instruments with ESG features.

2 New recommendations / clarifications

The below table contains a summary of the main new recommendations/clarifications by the EBA in the Report:

Topics	EBA Recommendation / clarification	EBA Report
TLAC/MREL disqualification events	The EBA considers TLAC/MREL disqualification events clauses contained in own funds instruments acceptable. It is not relevant whether the redemption can be exercised upon the occurrence of a TLAC/MREL disqualification event within the first five years after the issuance of AT 1 or Tier 2 instruments or later, as long as: (i) the conditions of Article 78(4)(d) of the CRR are met; and (ii) changes in the relevant regulations and the impact of these changes were not foreseeable at the time of the issuance.	points 91 to 93
RAC Tier 2 instruments	The EBA discourages the use/issuance of risk-adjusted capital ("**RAC**") Tier 2 instruments. RAC Tier 2 instruments, i.e. Tier 2 instruments with specific features including a "trigger event" and a "rating methodology event", are issued with the purpose of qualifying as equity capital under the methodology of a credit rating agency.	points 214 to 218
Alignment events	Alignment events – applicable to either own funds or eligible liabilities instruments – are meant to allow the issuer to absorb regulatory changes not directly causing a loss of qualification of the instrument in question. The EBA considers this type of clause to be a mere sub-form of a substitution and variation clause; therefore, for alignment events, the same principles as for substitution and variation clauses apply (e.g. the exercise of such clauses should be subject to prior permission of the relevant authority under Article 77 CRR; clauses	points 127 to 131

Topics	EBA Recommendation / clarification	EBA Report
	that foresee the possibility for holders to object to changes to the terms and conditions are seen as non-adequate practices).	
Interest rate reset mechanisms	The mere reset from a fixed to a floating rate is not an incentive to redeem in and of itself, however, an interest rate reset mechanism combined with a call option could conflict with the regulatory provisions concerning incentives to redeem if the instrument's credit spread changes after the reset date.	points 48 to 53
Tap issuances	The EBA introduces a certain degree of supervisory flexibility on tap issuances from small issuers,[5] in particular with regard to episodes of market volatility. While under normal market conditions the tap issuance should not be realised under a time window exceeding six months, a longer time window could be used in some cases, if all necessary conditions continue to be met (in particular those regarding the exercise of the first call date).	points 54 to 58
Valuation of non-CET 1 instruments	The EBA has launched an investigation to collect relevant information on current banks' accounting and prudential practices on non-CET 1 instruments, as well as on hedging strategies and associated interest rate and FX impact on the valuation of those instruments.	points 140 to 146
Instruments with ESG features	The EBA adds clarifications on the cancellations of coupons in the case of AT 1 instruments. In addition, the EBA remains very "sceptical" regarding step-ups of fees linked to specific ESG targets: In order to ensure that there is no incentive to redeem, it is the EBA's view that step-up and/or fees based on missing certain ESG targets, or other performance indicators, should not be allowed or encouraged. These aspects will be kept for further investigation depending on the precise features/structures that might appear in the future, specifically in relation to eligible liabilities.	points 246 to 290

[5] According to the EBA, for the identification of the institutions that could be granted flexibility criteria such as the size of the credit institution, the frequency of issuances, access to the market, or the amounts/number of instruments issued should be considered.

3 Conclusions and outlook

Overall, the EBA has observed convergence and standardisation in terms of drafting the terms and conditions of the instruments and issuance programmes. The EBA also considers this as a result of the implementation of recommendations contained in the previous EBA reports on the monitoring of AT 1 and TLAC/MREL instruments. Furthermore, the EBA expects that forthcoming issuances will continue to retain a high level of standardisation in their terms and limit complexity.

As such apart from also accepting MREL/TLAC disqualification events for own funds instruments, the EBA Report does not really contain surprising new requirements.

The EBA has also announced that going forward, it will not only continue to monitor the quality of the AT 1, Tier 2 and TLAC/MREL instruments, but also "*stand ready to provide additional guidance where necessary*".

About Wolf Theiss

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