

WORKING PAPER

REGULATORY CAPITAL REQUIREMENTS AND BAIL IN MECHANISMS

By Bart P.M. Joosen¹

Abstract:

With the introduction of the Capital Requirements Regulation (CRR) in the European Union, the qualitative requirements for bank regulatory capital have changed. These changes aim at implementing in Europe the Basel III principles for better bank capital that is able to absorb losses of banks, without hindering the continued operations of banks. The qualitative requirements introduced with effect from 1 January 2014 do not relate to the measures introduced in Europe for bank's recovery and resolution nor do they relate to the additional capital requirements imposed on systematically important banks. They also are not related to the newest requirements to be introduced in respect of total loss-absorbing capacity (TLAC) capital to assist with resolution of the largest G-SIB's. One of the topics researched in this contribution concerns the direct horizontal effect of European regulations. This topic is relevant to address the potential consequences of contractual provisions in bank capital instruments conflicting with the CRR rules and, similarly, conflicts with bank corporate organizational documents. We conclude that in view of the direct binding effect in European jurisdictions of regulations, the CRR provisions create direct binding effects between banks and their shareholders and bond investors. Another topic addressed in this contribution concerns the original concepts introduced by the Basel Committee on Banking Supervision as regards capital requirements for banks that are beyond a point of viability. The CRR qualitative requirements for bank's regulatory capital assume the bank's operations are continued on a going concern basis and therefore the bank's business is still viable. Measures to be taken gone concern and potential bail in mechanisms applied in that respect are regulated in other parts of European law. We observe in this contribution that the relevant regulations in Europe are misaligned and therefore create considerable uncertainties for banks in Europe.

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1. Introduction

In this chapter the new regulations concerning capital requirements for banks² are discussed from the perspective of crisis management in the banking sector. Specific attention will be paid to the European framework for banks. New capital requirements as they are introduced through the implementation in Europe of the Basel III standards must be placed in the context of a number of significant failures of individual banks occurring since the economic crisis spun off in the US-markets in the summer of 2007. Large and smaller individual institutions' failures demonstrated that the internationally agreed principles for capital requirements in the Basel II accord of 2004 contained significant gaps. In fact the Basel II accord contained only very few specific rules on qualitative capital requirements. The Basel II accord and its predecessors rather focused on regulating the 'asset-side' of the bank's balance sheet and provided not as much detailed rules on the 'liability-side'.

One of the lessons learnt of the financial crisis that developed in the international markets had been, that banks' funding mechanisms and internal policies that aimed at improving the rates of return on investments worsened the financial problems of banks. The financial crisis with banks was also caused by shareholders' activism distracting the focus of bank's management and resulting in a strong bias on investors' interests.³ Moreover, amidst the various severe incidents in the financial markets occurring, it became clear that banks had little statutory or contractual protection against claims raised by investors that had contributed to the regulatory capital base of the bank. Such claims often resulted into acceleration of mechanisms forcing banks to an early repayment or redemption. Such investors attempted to avoid with these actions that their investment in the bank's capital was lost and that the funds provided by such investors would actually contribute to absorbing losses.⁴

Moreover, the financial crisis also resulted into a shift in the paradigms with respect to dividend and interest payments and employee incentive schemes that result in obligations for banks whilst they are financially distressed. New principles had to be introduced in order to enable bank's management to hold off distributions of scheduled payments to external shareholders or creditors and, moreover, to pause the effectuation of employee incentive schemes and bonus payments. The latter was initially to be placed in the context of 'equality of the level playing field', where it would be seen as a wrong development that certain stakeholders would be withheld dividend or interest payments motivated by the need to improve the capital base of the bank, whereas other stakeholders would continue to benefit from interim distributions that impacted the same capital base. Politicians have, however, lost sight on the primary objective of reducing employee rights in the context of incentive schemes and debates on the need to restrict bankers' bonuses moved to another direction. In this contribution we will pay particular attention

² In this contribution I will address the subject matter of capital requirements referring to the commonly used term "banks", rather than to the European term "credit institution". Reference is made to the definition of this expression in article 4 of the Capital Requirements Regulation (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJEU L. 176 of 27 June 2013, p. 1-348 as this regulation has been subject to a full corrigendum published as an integral text in OJEU, L. 321 of 30 November 2013, p. 6-342.

³ See: John C. Coffee, Jr., 'Bail-ins versus Bail-outs: Using Contingent Capital To Mitigate Systemic Risk', The Centre for Law and Economic Studies, Columbia University School of Law, Working Paper No. 380, 22 October 2010, pp. 4-6 and 14-20.

⁴ See: D. Schoenmaker, "Banks were caught heavily undercapitalized at the time of the Great Financial Crisis. Some components of regulatory capital, like subordinated debt, were not found to absorb losses. Authorities were afraid to impose losses on subordinated bondholders out of fear for further contagion in the financial system. Moreover banks had been making large payouts to shareholders through dividends and share buybacks until early 2008, the onset of the Great Financial Crisis." In: 'Governance of International Banking: The Financial Trilemma', Oxford University Press, (2013), pages 10 and 11.

to the features of the laws addressing the original objective of restricting employee rights and we will not debate the broader aspects of bankers' bonuses.

Many state aid operations for individual banks in Europe resulted into fierce debates about the role governments should play if a bank is failing and is at risk to collapse. The motivation for governments to offer rescue packages to such banks by means of recapitalization or nationalization has often been based on the anxieties of systemic risks developing in the financial markets. Absent a rescue operation in the form of a bail out where the immediate capital needs of a bank would be fulfilled by means of funds made available by governments, the bank concerned could collapse and provoke a chain reaction of failures of other banks and financial institutions. Such chain reactions typically would become real, if the failing bank is significant in terms of balance sheet total or is closely interconnected with other financial institutions or operates a business that is difficult to be taken over by other financially sound banks or institutions. All these elements have been comprised in the definition of 'systemically important institutions' developed in the recent years by the international standard setting boards in order to provide for proper evaluation tools to regulators responsible to address systemic risks.⁵

Where bail out operations have been particularly applied for such systemically important banks—businesses that did not qualify as important in view of systemic risk have often been liquidated without governments offering too much assistance—politicians in Europe have used the examples of such bail out operations for larger banks to enhance the effects of the paradigm shift discussed here above in case a bank fails whether that bank is systemically important or not. In such case, also the rights of subordinated and ordinary creditors may be affected by new recovery and resolution techniques introduced to rescue the bank's business and that will apply to all banks, without distinction. The need for a public 'bail out' at the expense of tax payers money must be avoided as much as possible and private money contributions by means of a 'bail in' should be the desirable method for rescuing the bank, whether this bank will continue to operate 'going concern' but even in case the banks' business is 'gone concern'. In the latter case, bail in mechanisms are applied in order to accommodate an orderly winding down of the bank's business preventing a liquidation by application of an ordinary insolvency proceeding. In other words, the developments in respect of the recovery and resolution mechanisms for banks as these have been introduced in Europe, make the normal bankruptcy laws less relevant.

2. The Basel III objective of improving the resilience of banks

'Basel III: A global regulatory framework for more resilient banks and banking systems'⁶ ("Basel III-Capital") has been established as one of the two extensions to the Basel II accord of 2004⁷ and deals with the revisions to the capital requirements for internationally operating banks⁸. The other extension deals with principles for internationally harmonized liquidity management for banks. This second extension will not be discussed in this chapter. Basel III-Capital addresses in many respects the improvement of

⁵ See: Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, www.financialstabilityboard.org, BCBS, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement, BCBS, October 2011, www.bis.org and Financial Stability Board, Intensity and Effectiveness of SIFI Supervision, October 2011, www.financialstabilityboard.org.

⁶ Basel Committee on Banking Supervision, December 2010, revised version of June 2011, reflecting the changes to the section on Credit Valuation Adjustment, document to be consulted on www.bis.org.

⁷ Basel Committee on Banking Supervision, June 2006, 'International Convergence of Capital Measurement and Capital Standards; A Revised Framework. Comprehensive Version', document to be consulted on www.bis.org.

⁸ Basel Committee on Banking Supervision, January 2013, 'Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools', document to be consulted on www.bis.org.

resilience of banks against shocks arising from economic downturn. In paragraph 4 of Basel III-Capital, the Basel Committee on Banking Supervision (“BCBS”) summarizes the main objectives of the revisions to the Basel II accord that was introduced only a few years before the crisis in the global economies commenced. The BCBS elaborates as follows:

“One of the main reasons the economic and financial crisis, which began in 2007, became so severe was that the banking sectors of many countries had built up excessive on and off-balance sheet leverage. *This was accompanied by a gradual erosion of the level and quality of the capital base (emphasis, author).* At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the reintermediation of large off-balance sheet exposures that had built up in the shadow banking system. The crisis was further amplified by a procyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were rapidly transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability. *Ultimately the public sector had to step in with unprecedented injections of liquidity, capital support and guarantees, exposing taxpayers to large losses (emphasis, author).*”⁹

The emphasized parts of this cited paragraph of Basel III-Capital highlight the scope of this contribution where we will discuss the revisions to the Basel capital accord as regards the ‘quality, consistency and transparency of the capital base’¹⁰ of banks. This subject matter is placed in the context of crisis management measures that are customarily placed in the context of avoidance of the need for the public sector to intervene in the banking sector with recapitalization measures or other measures that cost taxpayers’ money. As regards the quality of capital the BCBS notes the following:

“It is critical that banks’ risk exposures are backed by a high quality capital base. The crisis demonstrated that credit losses and writedowns come out of retained earnings, which is part of banks’ tangible common equity base. It also revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital between institutions.”¹¹

The BCBS places a particular emphasis on the ability of retained earnings to absorb losses that banks incur when writing down risk exposures on clients and in the trading portfolio of banks. In the philosophy of the new capital regime for banks, restrictions on distribution and allocation of profits made by banks plays an important role. Such profits should primarily serve to resolve constraints in the existing capital base of the bank and secondly they are to be made available to investors. This suggests that banks should develop and uphold strong policies as regards the distribution of profits, where the priority is to safeguard a strong capital base, rather than to satisfy investors in the capital of the bank.¹²

Basel III-Capital is therefore also promoting regime changes as regards the ability of banks’ management to apply discretion as regards the distribution of banks’ earnings to stakeholders. These measures aim to introduce mandatory rules for banks as regards conservation of capital. Basel III-Capital describes the background of these measures as follows:

⁹ Basel III-Capital, op.cit., page 1.

¹⁰ Basel III-Capital, paragraph 8, op.cit., page 2.

¹¹ Basel III-Capital, paragraph 8, op.cit., page 2.

¹² See for an in-depth discussion of this topic: R. Admati, P. Demarzo, M. Hellwig and P. Pfleiderer, (2011), ‘Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive’, Research Papers 2065, Stanford University, Graduate School of Business.

“At the onset of the financial crisis, a number of banks continued to make large distributions in the form of dividends, share buy backs and generous compensation payments even though their individual financial condition and the outlook for the sector were deteriorating. Much of this activity was driven by a collective action problem, where reductions in distributions were perceived as sending a signal of weakness. However, these actions made individual banks and the sector as a whole less resilient. Many banks soon returned to profitability but did not do enough to rebuild their capital buffers to support new lending activity. Taken together, this dynamic has increased the procyclicality of the system.”¹³

The regime changes relate to the improvement of the tools for supervisory authorities to intervene in case they require from the bank to change the policies applied with respect to distribution of earnings. These measures may affect both “external stakeholders”, such as shareholders and bondholders. They may also affect “internal stakeholders”, such as (senior) management and the workforce of the bank generally. The aim of application of these measures is to “increase resilience going into a downturn” and to “rebuild capital during economic recovery”¹⁴.

Another important element of the new capital rules for banks, relates to the need to create harmonized definitions of the components of bank capital base. Such harmonization serves to create better comparability of the capital base of banks upon disclosure, so as to manage the market perception as regards the strength of banks and their ability to resolve potential issues in the business, whether these issues were caused by external factors (economic downturn), or internal factors (failing risk management procedures).

During the financial crisis it appeared that the patchwork of national legal regimes to which internationally operating banks are subject, made it impossible to make proper comparisons about the quality and quantity of available bank capital. In other words, great uncertainty existed as to whether or not publically disclosed bank capital levels of individual banks actually represented sufficient robustness to absorb losses and to deal with the external and internal exposures to risk. Basel III-Capital is aiming to introduce an international legal framework to harmonize the legal regimes applicable to international banks. This harmonized legal framework includes rules for bank capital from a quantitative perspective, but more importantly from a qualitative perspective.¹⁵

Basel III-Capital intends to introduce harmonized rules for the quality of the so-called ‘Additional Tier 1’ (“AT1”) and Tier 2 capital instruments. Perhaps one of the most innovative elements of the new regime for AT1 instruments concerns the introduction of principles of exposures of bondholders to write down or convert their claims in the event of contingencies occurring with the bank. This particular element is not addressed in an elaborate way in the text of Basel III-Capital¹⁶. Most interestingly is, however, the fact that the BCBS, building on published exposure drafts published from the outset¹⁷, already introduced in 2010 some innovative elements to the set of requirements for AT-1 capital instruments. These form the

¹³ Basel III-Capital, paragraph 27, op.cit., page 6.

¹⁴ Both quotes from Basel III-Capital, paragraph 28, op.cit., page 6.

¹⁵ See for critics on the legacy Basel I and Basle II framework: R. Theissen, ‘EU Banking Supervision’, Eleven International Publishing, (2013), The Hague, pages 379-384.

¹⁶ The BCBS comments at the occasion of the publication of Basel III in 2010: “The Committee is introducing these changes in a manner that minimises the disruption to capital instruments that are currently outstanding. It also continues to review the role that contingent capital should play in the regulatory capital framework.” See: Basel III-Capital, paragraph 10, op.cit., page 3.

¹⁷ BCBS, Consultative Document, August 2010, ‘Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability’, to be consulted on www.bis.org.

basis for extensive rules developed in Europe for contingent capital instruments. These rules will be discussed in more detail in paragraph 7 of this Chapter.

3. The adoption of Basel III-Capital in Europe: Capital Requirements Regulation

Basel III-Capital has been transposed in Europe in the Capital Requirements Regulation (“CRR”)¹⁸ that entered into force on 28 June 2013. However, most of the provisions of this regulation—including certain important transitory law provisions permitting a phasing in of certain requirements—only apply from 1 January 2014¹⁹. Generally, as to the subject matter of capital requirements as discussed in this contribution, CRR transposed the main principles of Basel III-Capital without too many amendments. Europe has chosen to transpose the Basel III-Capital accord consistent with the agreed principles in the BCBS.²⁰

However, CRR applies to all banks (and furthermore certain investment firms) without distinction. This is different from the principles of Basel III-Capital that is adopted for large internationally operating banks only. In CRR systemically important banks and non-systemically important banks are covered by most of the provisions. Only a part of CRR is restricted to apply to systemically important banks. Therefore, banks with larger or smaller proprietary trading business are regulated in CRR, but also traditional banks with no trading activities for the own risk and account.

With the adoption of the CRR, Europe has made a significant step towards compliance with one of the recommendations of the De Larosière Report²¹ to establish a Single Rule Book for the financial sector. The High Level Group on Financial Supervision recommended the following:

“The EU participates in a number of international arrangements (e.g. Basel committee, FSF) and multilateral institutions (e.g. IMF) that cannot be unilaterally changed by the EU. If and when some changes in those global rules appeared necessary, Europe should “speak with one voice” [...].

[...] The European Institutions and the level 3 committees should equip the EU financial sector with a set of consistent core rules. Future legislation should be based, wherever possible, on regulations (which are of direct application). When directives are used, the co-legislator should strive to achieve maximum harmonisation of the core issues. Furthermore, a process should be launched to remove key-differences stemming from the derogations, exceptions and vague provisions currently contained in some directives. [...]”²²

The Single Rule Book intends to establish common and fully harmonized rules for all participants in the financial sector within the borders of the European Union (“EU”). CRR is an important part of this Single Rule Book as it establishes a very significant part of the laws and regulations applicable to banks

¹⁸ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJEU L 176 of 27 June 2013, p. 1-348 as this text has been subject to a complete corrigendum published in OJEU L 321 of 30 November 2013.

¹⁹ See for the entry into force and date of application provisions: article 521 CRR.

²⁰ See: Basel Committee on Banking Supervision, ‘Basel III regulatory consistency assessment (Level 2), Preliminary report: European Union’, October 2012, www.bis.org. In this report the Basel Committee has expressed some critical concerns about the lack of consistency of the adoption of Basel III-Capital to the European framework. As regards the subject matter of this contribution, some of the provisions of the draft text of CRR have been noted as being in conflict with the Basel III-Capital requirements. Some, but not all of the comments of the Basel Committee resulted into adaption of changed to the final CRR text.

²¹ The High-Level Group on Financial Supervision in the EU, Chaired by Jacques de Larosière, Brussels 25 February 2009, to be consulted via ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

²² De Larosière, op cit, p. 29.

established (or doing business) in Europe. CRR together with the CRD IV directive²³ (“CRD IV”) constitutes the main legislative framework for banks (and investment firms) in Europe. The entire part of the Single Rule Book for banks is completed with Binding technical Standards developed by the European Banking Authority based on approximately 100 mandates set forth in CRR and CRD IV. Commissioner Barnier who has been responsible for this significant part of legislative changes during his term as member of the European Commission noted the following:

"The development of the single rule book in banking is a vast undertaking. Its objective is to ensure all banks comply with one set of rules across the single market. This ensures good regulation and a level playing field wherever banks are based. The adoption of the Capital Requirements package created a framework. But to reap the full benefit of the single rule book, many aspects must be further developed by technical standards, delegated and implementing acts. What we are delivering today is a decisive step in that direction thanks to the excellent cooperation between the European Banking Authority and the European Commission."²⁴

CRR applies directly to banks and investment firms, but CRR also applies directly to stakeholders related to or having legal relations with such institutions. By this significant shift in the organization of banking laws in Europe from the use of the instrument of Directives to the legislative instrument of a Regulation, a rather unprecedented and very important step has been taken. With this development, Europe truly achieves the creation of a common and single body of law applicable to a significant part of the financial sector. One should not underestimate the impact of this development in European law.

The consequences of this significant change may be observed in an uncountable number of cases. In this chapter, one of the clear examples of these changes is discussed in more detail, being the requirements for regulatory capital and the manner in which regulatory capital requirements impacts crisis management with banks. In the De Larosière report, the lack of cohesiveness and the differences in the laws in Europe as regards the definition of capital and the connection to crisis management has been noted as one of the most important amplifiers of the financial crisis:

“[...] a number of important differences between Member States (different bankruptcy laws, different reporting obligations, different definitions of economic capital...) have compounded the problems of crisis prevention and management [...]”²⁵

There has been little debate in Europe about the need to transpose the principles of Basel III-Capital to European law in the most consistent way without creating too much differences. It is this (political) leverage that has been used by European politicians in the discussions in the global political community (most particularly the G-8 group of world leaders) to strive for the most consistent adoption of Basel III-Capital throughout the laws of the more than 160 countries that apply the Basel capital accords.

It is with a view of these considerations, that requirements for regulatory capital of banks may be explained by reference to the text of Basel III-Capital, which, more than ever has been transposed almost to the fullest extent in the text of the CRR. In this chapter, we will take Basel III-Capital provisions and descriptions as the main source of reference, where we will ensure that proper references to the parts of the CRR are included as well. However, when addressing the manner in which Europe has transposed the standards for contingent capital instruments laid down in Basel III-Capital, we will primarily discuss the

²³ Directive 2013/36/EU of the European Parliament and the Council 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, Pb.EU L. 176 of 27 June 2013, p. 338-436.

²⁴ Press release European Commission 13 March 2014, ‘Commission adopts nine Regulatory Technical Standards to implement the single rule book in banking’, IP/14/255.

²⁵ De Larosière, op cit, page 27.

provisions of the CRR. We will discuss the provisions to be applicable for banks only and will not discuss the position of investment firms.

4. Direct application and direct vertical and horizontal effect of the CRR

Before we discuss the requirements for regulatory capital in more detail, a technical point of European law must be highlighted that is of great importance for the subject matter of this chapter. European regulations have direct application. A regulation does not need to be transposed in national laws of member states of the EU. The CRR provisions therefore are firstly European law, but they also, secondly, constitute the laws of all the EU member states. They are the “law of the country”²⁶. If laws of member states would contain deviating principles that mitigate the provisions of a regulation, these national law provisions are set aside automatically. The national laws are, to the extent deviating from the regulation provisions, in fact void. If national laws of an EU member state would go further (they exceed the regulation provision), such provisions of national law supplement the provision of the regulation. Conflicting provisions of national laws and regulations however result in the regulation provision overruling the deviating provision of national law.

CRR is particularly addressed to the “institutions”²⁷ within the scope of application of the regulation provisions, national supervisory authorities and governments. A debate can be held as to whether or not the CRR provisions also apply directly to the stakeholders of such institutions or any person that directly or indirectly deals with the institutions, such as the financiers of banks. The debate is about the question whether or not requirements formulated in provisions of the CRR apply directly to such external stakeholders and (contracting) parties or that further agreements must be made with these parties in order to impose the requirements to them in a binding and enforceable respect. If a contractual provision agreed between an institution and an external creditor (for instance terms and conditions agreed in the context of an offer of bonds to external investors in the capital markets) deviates from requirements in the CRR, does this contractual provision apply or is the provision partially or wholly void and overruled by the CRR provision?

Based on Article 288 of the Treaty on the Functioning of the European Union²⁸ (“TFEU”) regulations are directly applicable in the member states of the EU. Regulations as a source of secondary union law have furthermore, firstly, vertical direct effect, in other words they apply directly in relations between individuals and a state. Regulations, however, also have, secondly, horizontal direct effect. The requirement for such vertical or horizontal direct effect is that regulation provisions must be (i) clear, (ii) precise and (iii) unconditional²⁹. But if these conditions are met, regulations have direct binding effect

²⁶ See: J.A. Winter, ‘Direct Applicability and Direct Effect; Two Distinct and Different Concepts in Community Law’ (1972) 9, Common Market Law Review, pp. 425-438.

²⁷ With “institutions” is, as per the definition of article 4, paragraph 1 (3) CRR meant the “credit institutions” as defined in article 4, paragraph 1 (1) CRR and certain investment firms as defined in article 4, paragraph 1 (2) CRR.

²⁸ Consolidated version of the Treaty on the Functioning of the European Union - Protocols - Annexes - Declarations annexed to the Final Act of the Intergovernmental Conference which adopted the Treaty of Lisbon, signed on 13 December 2007 - Tables of equivalence OJEU C 326, of 26 October 2012 p. 1-390.

²⁹ ECJ 5 February 1963, Van Gend & Loos, Case 26-62. See for instance: Andrea Biondi, Case Law, Common Market Law Review 40: 1241-1250, 2003 for a further discussion of this landmark case of the European Court of Justice. As regards regulations of the European Union the direct binding effect has been confirmed by the European Court of Justice in Case 39/72, *Commission v. Italy*, [1973] ECR 101 and Case C 253-00 [2002] ECR 2002 I-07289 Munoz, where the European Court of Justice reiterated: “Pursuant to the second subparagraph of Article 189 of the EC Treaty (now the second subparagraph of Article 249 EC) regulations have general application and are directly applicable in all Member States. Accordingly, owing to their very nature and their place in the system of sources of Community law, regulations operate to confer rights on individuals which the national courts have a duty to protect.”

between private parties. This *generally* means that contractual provisions that would deviate or would conflict from regulation provisions, are set aside.³⁰ The same would apply, in my view, to provisions of the constitutional documents of companies, such as the articles of association.

As regards the introduction of new capital instruments under the CRR regime, the European legislator has introduced mechanisms to control whether or not the terms and conditions offered by banks to its shareholders or bondholders when issuing new capital instruments comply with the CRR provisions. European supervisory authorities are given the power and authority to assess whether these terms and conditions meet the requirements and criteria prior to the use of such capital instruments. These powers and authorities can be found in various CRR provisions. This is the case, for instance in article 26, paragraph 3 CRR that determines:

“Competent authorities shall evaluate whether issuances of Common Equity Tier 1 instruments meet the criteria set out in Article 28 or, where applicable, Article 29. With respect to issuances after 28 June 2013, institutions shall classify capital instruments as Common Equity Tier 1 instruments only after permission is granted by the competent authorities, which may consult EBA.”

This provision clearly sets forth that a bank may not issue shares or comparable instruments, so-called Core Equity 1, (“CET1”) before permission is granted by the competent authority. The sanction imposed on an institution issuing capital instruments without such permission being granted, is that the capital instruments may not be comprised in the CET1 compartment of the regulatory capital base. Enforcement of compliance with CRR is made *ex ante*, by means of a preliminary review of the terms and conditions governing the capital instruments to be issued by the bank. Such enforcement mechanism applies directly to the institution concerned, but it may be debated whether or not a formal decision of a supervisory authority to clear the terms and conditions of the capital instruments to be issued, does have direct effect to other parties as well. The question therefore arises, how a positive assessment by a supervisory authority of terms and conditions of a capital instrument to be issued impacts the relationship between a bank and its shareholders or external creditors.

Certainly if there is a deviation between the language of the terms and conditions and the corresponding CRR-requirement or criterion, the question arises how the relevant relationship between the bank and the stakeholder concerned is regulated. In my view, the language of the CRR provision prevails over provisions of contractual or other provisions conflicting with CRR provisions, even if there is regulatory approval for such deviating terms and conditions.

Direct horizontal effect therefore also applies, even if there is a decision or viewpoint to the contrary of a supervisory authority that cleared the terms and conditions concerned. This viewpoint is consistent with the objectives of the European legislator as regards the adoption of a Single Rule Book for the financial industry. These objectives are motivated by the wish to abolish as much as possible exercise of national discretions and introduction of own national interpretations of union law. The use by the European legislator of the impactful legislative instrument of a regulation setting forth the rules as regards the important topic of capital adequacy, must be seen in this perspective.

The qualitative capital requirements as they are introduced by the transposition of Basel III-Capital into the CRR raise, therefore, the fundamental question as to whether or not legal relationships between shareholders and a bank or bondholders and a bank are directly regulated by the CRR provisions. Or do

³⁰ See: Arthur Hartkamp, ‘The Effect of the EC Treaty in Private Law: On Direct and Indirect Horizontal Effects of Primary Community Law’, *European Review of Private Law* 3-2010, p. 530.

the CRR provisions need to be transposed into (amended) contractual terms and conditions or (amended) articles of association of the bank concerned? Are, in other words, the rights and obligations of shareholders or bondholders or comparable creditors of a bank, directly stemming from the CRR-provisions or not? For this particular issue of European law, little guidance can be found in literature or public statements of regulators or the European legislator thus far.

Certainly, an issue of shares or bonds based on terms and conditions that conflict with CRR provisions, results into these capital instruments not qualifying to be comprised in the relevant tier of regulatory capital. This is explicitly regulated in article 30 CRR for CET1 capital instruments, in article 55 for AT1 capital instruments or loans and in article 65 CRR for Tier 2 capital instruments. Potentially, such capital instruments when issued with approval of the competent authority but ceasing to meet the conditions for that tier of capital instruments during the term could qualify for classification in a lower tier of the regulatory capital. For instance a capital instrument issued as CET1 that ceases to meet the conditions of article 28 or 29 CRR may perhaps be qualified as AT1 capital instrument. But such transitory provisions are not included in the CRR for new capital instruments to be issued after 1 January 2014 under the scope of application of the CRR. Rather the CRR regime suggests a rigid disqualification of capital instruments not conforming to the CRR requirements for the specific Tier. For capital instruments issued prior to the entry into force of CRR specific grandfathering rules have been developed. One of those grandfathering rules (article 487 CRR) indeed permits the 'versatile' application of the requirements, by classifying certain instruments that cannot be recognized as CET1 capital as AT1 or as Tier 2 instruments.

From the current interpretation of the manner in which directly and horizontally binding provisions of union law it follows, undoubtedly, that in the event a contractual or corporate constitutional provision conflicts with a clear, precise and unconditional provision of the CRR, that contractual or corporate constitutional provision may not be enforced against the counterparty. Hartkamp expresses it as follows:

"Direct horizontal effect means that a Treaty provision creates, modifies, or extinguishes rights and duties between individuals. The entitled person has the right to require that the other party complies with its obligation, irrespective of a court judgment. Apart from that, he is entitled to enforce the obligation in court, and [...] in order to obtain a positive judgment, he will not be dependent on the way in which the court will interpret its national law."³¹

The topic discussed by Hartkamp concerns the primary law of the Union. But an equivalent application of the rules determining the rights and obligations of private parties stemming from European regulations may be concluded as well.³²

Contractual provisions and even company constitutive provisions conflicting with the CRR regulations on regulatory capital are null and void and the rights and obligations between the parties must be determined in accordance with the direct binding CRR provision. For most of the CRR provisions determining the qualitative requirements for regulatory capital (articles 28 CRR for CET1 capital instruments, article 52 for AT1 capital instruments and article 63 for Tier 2 capital instruments) the conditions of the Van Gend & Loos judgment are met. They are clear, precise and unconditional and therefore may be enforced directly in horizontal relationships. This is important, as banks must be able to seek protection against

³¹ Hartkamp, op. cit., p. 527. See also on this subject matter: Paul Verbruggen, 'The impact of Primary Law on Private Law Relationships: Horizontal Direct Effect under the Free Movement of Goods and Services, European Review of Private Law 2-2014, p. 201-216. Both publications discuss the entire case law development referring to the up to date status of jurisprudence of the European Court of Justice.

³² See: Steiner & Woods EU Law, Chapter 5, 'Principles of direct applicability and direct effect', Oxford University Press, 11th edition (2012) edited by Lorna Woods and Philippa Watson and S. Weatherhill (2007). Cases & Materials on EU Law 8th Edition. New York: Oxford University Press, p. 127.

shareholders' or bondholders' claims if a crisis with the bank occurs and such claims would result into the undesirable effect that the mechanisms of the regulatory capital instruments could not be enforced effectively because of unclear or multi interpretable contractual or corporate organizational provisions.

Finally it should be noted that in the event conflicting interpretation of CRR provisions would arise, the ultimate resolution of such conflicting interpretation shall be with the European Court of Justice applying article 263 TFEU (direct resolution) in case the relevant conflict on interpretation is between the European Central Bank exercising authorities within the context of the Single Supervisory Mechanism³³ rather than the provision of article 267 TFEU (judgments upon preliminary questions by national courts). For matters where the national courts in a member state are required to provide for a judgment, the procedures of article 267 TFEU apply.

5. Quantitative capital requirements

Basel III-Capital raised the bar for the absolute quantitative levels of capital that banks must maintain. This was not as much realized by increasing the absolute percentage of 8% (the "BIS-ratio" introduced in 1988) of the regulatory capital level to be held by banks to address the ordinary risks in the banking book and the trade portfolio of banks. Rather, the absolute levels are increased as a result of the introduction of additional capital buffers that banks must maintain, both to address micro-prudential objectives as well as macro-prudential objectives. Furthermore, specific rules are introduced for systemically important financial institutions ("SIFIs") that increase the levels of capital to be held by those banks qualifying as SIFI. Finally, a general backstop regulatory capital rule is introduced to address the leverage of bank balance sheets in the form of a new "leverage ratio".

An important element of the Basel III-Capital principles concerns the shift in the relative weight of the various components of the ordinary regulatory bank capital buffer filling in the "8%-ratio". In the old regime, a proportion of 50% Tier 1 and 50% Tier 2 was customarily applied in the regulations imposed on banks in all parts of the world. In Europe this 50%/50% division was laid down in the Capital Requirements Directive of 2006³⁴. Basel III-Capital brings a new division in the proportions of the various tiers of regulatory capital serving to meet the ordinary ratio, where a substantial increase is introduced of the CET1 component of regulatory capital.

After the phased-in introduction of the new regime, banks must maintain a minimum of 4.5% of CET1 instead of the original 2% core capital requirement in the old regime. This increase in proportion of the CET1 level necessarily reduced the ability of banks to meet the minimum capital requirements with lesser quality capital, being AT1 and Tier 2 capital. According to the new regime, the aggregate of CET1 and AT1 capital instruments must be 6%. The effect of the new rules is that if a bank maintains exactly 8% capital against ordinary bank risk exposures, that bank is required to maintain 4.5% CET1, 1.5% AT1 and the remainder of 2% may be filled in with Tier 2 capital instruments. Tier 3 short term regulatory capital instruments to cover for the risks in the trading portfolio that was permitted under the Basel II rules are completely banned in the new regime.

³³ The Single Supervisory Mechanism based, among other legislative instruments, on Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJEU L 287 of 29 October 2010, p. 63 and further is not discussed in this chapter.

³⁴ The relevant rules are to be derived from the somewhat blurred and difficult to read provisions set forth in Chapter 2 (Technical instruments of prudential supervision) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up of the business of credit institutions (recast), OJEU L. 177, of 30 June 2006, p. 1-200.

The effect of these new rules is a substantial shift in the nature of the capital components of banks from debt to equity. By definition, CET1 may only be maintained by banks in the form of equity, either ordinary share capital or 'qualifying' retained earnings. The rules introduced by Basel III-Capital therefore aim at increasing the levels of equity of banks and, moreover, they address the need to test the 'quality' of such components of the bank's balance sheet by applying prudent valuation techniques to the relevant items of bank equity. These valuation techniques, for instance, require bank's management to apply conservative rules as to the quantification of retained earnings before such earnings are eligible to be comprised in the CET1 compartment of bank's regulatory capital.

What is also new in Basel III-Capital is the great detailed attention to capital instruments issued by banks that are not organized in the form of a corporation but rather in the form of a cooperative. The mere fact that legal regimes for cooperative banks substantially deviate from those of (publicly traded) public companies was not addressed or acknowledged in predecessors of the Basel III-Capital accords at all. In certain jurisdictions in Europe, particularly Austria, Germany, France and the Netherlands, banks being organized in the form of cooperatives play a very important role in the market³⁵. Capitalization of cooperatives follows different rules and concepts which are relevant for the assessment of the quality of regulatory capital. The specific regimes for cooperative banks also brings constraints in the application of certain concepts and rules that apply to companies organized in the form of a (listed) public company. The increased attention for this subject matter, particularly in the European legislation transposing Basel III-Capital, is to be considered an important new development in the supervision of banks as regards capital adequacy rules.

6. Qualitative capital requirements

6.1. The adoption of Basel III-Capital in Europe: Capital Requirements Regulation

Improvement of the quality of regulatory capital for banks is one of the main innovations of Basel III-Capital. The BCBS summarizes all these new measures in the following paragraph:

"To this end, the predominant form of Tier 1 capital must be common shares and retained earnings. This standard is reinforced through a set of principles that also can be tailored to the context of non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Deductions from capital and prudential filters have been harmonised internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies. The remainder of the Tier 1 capital base must be comprised of instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither a maturity date nor an incentive to redeem. Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses, currently limited to 15% of the Tier 1 capital base, will be phased out. In addition, Tier 2 capital instruments will be harmonised and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated."³⁶

The quality of capital is particularly to be measured against the fulfillment of certain core principles underpinning the legal relationship between a bank and an investor making the capital available to a bank. I summarize these core principles as follows:

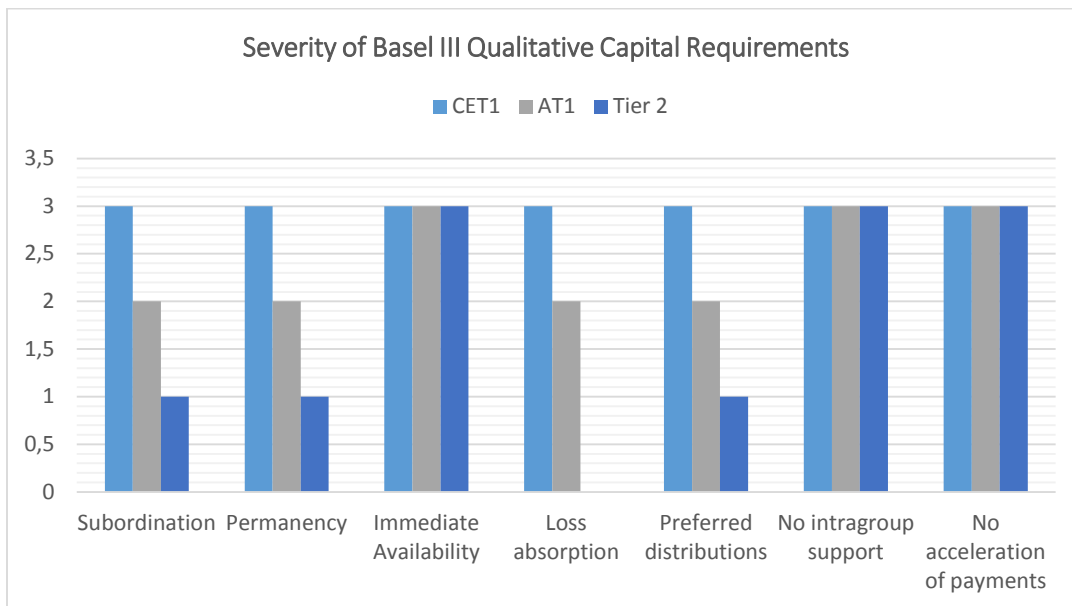
- Bank capital must represent the most fully subordinated claim [in liquidation of a bank];
- Bank capital must be permanently available;

³⁵ See for an overview of market shares of cooperative banks in these (and other European) jurisdictions: European Association of Co-operative Banks, Key Statistics as on 31-12-2012 (Cooperative Indicators), www.eacb.coop.

³⁶ Basel III-Capital, paragraph 9, op.cit., page 2.

- Investors may not delay committed contributions of bank capital;
- Bank capital must have the ability to absorb losses;
- (Preferred) distributions of dividends and interest must be aligned to the requirements of mandatory levels of regulatory capital;
- The quality of banks’ regulatory capital may not be diluted as a result of intra-group support;
- Banks’ creditors may not accelerate repayment by the bank of capital instruments before the (long term) maturity date.

These principles form the basis of long lists of requirements set forth in Basel III-Capital for each of the components of the regulatory capital, being CET1, AT1 and Tier 2. Variations as regards the stronger or weaker application of these principles, constitute the differences between the three components. For CET1 capital instruments, the strongest application of these principles result in this component constituting the highest quality of banks’ regulatory capital. For Tier 2 the core principles are either applied with certain permissible deviations or variations, or they are not applied at all. Tier 2 therefore constitutes the lowest quality of bank’s regulatory capital. In the below graphic prepared by me a weighted overview is provided as to severity of application of the requirements for the three compartments of bank regulatory capital with a scoring of 1 to 3, where 3 represents the strongest applicability of that requirement and 1 the weakest applicability of that requirement:



As may be observed from the graphic, there is one requirement for regulatory capital instruments as determined by the CRR that does not apply to Tier 2 instruments, being the ability to absorb losses. This requirement has not been considered by me for Tier 2 instruments, as there is little language to be found in the relevant CRR provisions determining the requirements for Tier 2 instruments, that suggests that these instruments need to be able to absorb losses in a going concern situation of a bank.³⁷ The concept of loss absorption of Tier 2 instruments does, however, play an important role in the regulations on bail in of

³⁷ It is particularly this point that forced the Basel Committee to make critical comments in its consistency assessment of October 2012. See: op cit, p. 26.

creditors in case a resolution plan is adopted for a specific institution, and the resolution authority decides to apply the bail in tool. We will discuss this in more detail in further paragraphs.

6.2. Prudential filters and deductions from regulatory capital

In the following paragraphs we will discuss the various criteria as they have been formulated in Basel III-Capital and the CRR. We will refrain, however, from elaborating on the technical details of application of prudential filters or the requirements for deductions from regulatory capital components.

Both measures intend to introduce further corrections to the regulatory capital base of banks with the effect, that the levels of banks' regulatory capital are measured applying the most careful weighting and the most conservative valuation of certain capital components. A prudential filter is a mechanism to eliminate certain amounts from the regulatory capital base that could be itemized in the bank's balance sheet if certain accounting principles (for instance IFRS) would be applied. Notwithstanding the possibility for a bank to increase its equity based on application of accounting principles, a prudential filter removes such increase in order to apply the most conservative measurement.³⁸ Prudential filters particularly relate to the valuation of future income and realization of future profits or losses.

Deductions from regulatory capital are also meant to make corrections on balance sheet items in order to improve the intrinsic weight of the equity components of the bank's balance sheet. Deductions from capital are in addition to prudential filters based on the same principle. This principle is that for regulatory capital purposes certain items on a bank's balance sheet may not be comprised in the calculation of the level of regulatory capital where for accounting purposes they may be included in the bank's balance sheet. Deductions for regulatory capital purposes also aim to anticipate on the incurring of future losses, even if these losses are not yet being accounted for in the running accounting year. Where the establishment of annual accounts always results into a presentation of the bank's balance sheet with a certain delay and with views on the position in the past, regulatory capital deductions attempt to make measurements of potential losses more often and if and as soon as they are incurred.

6.3. Subordination

The subordinated nature of claims exercisable by holders of bank capital instruments qualifying as 'regulatory capital' is the most important and central criterion outlined in the regulations of this subject matter. For all three compartments of regulatory capital instruments, CET1, AT1 and Tier 2, the subordinated character of the capital instruments is imposed pursuant to the criteria developed in Basel III-Capital as they are reiterated in CRR.

What is important to note, is that the Basel III-Capital criteria for all three compartments of bank regulatory capital introduce principles of 'layered subordination' among the three compartments. CET1 capital is more subordinated than AT1 and Tier 2 is less subordinated than AT1. The manner in which these layers of subordination are introduced can be explained as follows.

6.3.1. Subordination of CET1 capital instruments

For CET1 capital instruments Basel III-Capital states as criterion:

³⁸ In this way regulators attempt to address the potential arbitrage between application of favorable accounting and regulatory requirements, particularly in those instances where institutions underestimate the risk of losses to be born in respect of certain assets. See for a fundamental discussion on this topic: Charles W. Calomiris and Richard J. Herring, 'Why and How to Design a Contingent Convertible Debt Requirement', April 2011, pp. 7-8.

“Represents the most subordinated claim in liquidation of the bank.”³⁹

To a certain extent this requirement as set forth in Basel III-Capital is confusing and may also lead to discussions about the intentions of the BCBS as regards the nature of the liabilities of the holders of CET1 qualifying capital instruments. The requirement as cited here above is confusing, as it attempts to confirm on the one hand a principle that already applies based on common company law principles. Shareholders of a company are usually referred to as creditors holding the most subordinated claim in any event. In this respect there is no need for the reiteration of that principle in the regulations concerning bank regulatory capital. The confusing part of the requirement as set forth in Basel III-Capital concerns the qualification that the claims are subordinated “in liquidation of a bank”. This seems to conflict with other requirements set forth in this part of Basel III-Capital for CET1 capital instruments. For instance requirements as regards “loss absorbing abilities” of CET1 capital instruments. That ability must also be effective “going concern” which suggests that the rights of shareholders are also restricted outside a situation of a bank being liquidated. See for a further discussion on this requirement paragraph 6.5 below. Another criterion for CET1 capital instruments conflicting with the criterion “subordination in liquidation of a bank” concerns the rules applicable for distributions of dividend or comparable floating distributions. Basel III-Capital for CET1 determines in respect of such distributions:

“Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.”⁴⁰

With this requirement, the subordination of claims of holders of CET1 capital instruments is confirmed even outside a liquidation of a bank. Distributions to CET1 capital instrument holders may only be made after the fulfilment of all obligations towards more senior creditors and payments to CET1 capital instrument holders are never preferred. With this requirement, subordination of claims of holders of CET1 capital instruments (even) outside liquidation is regulated to the fullest extent.

In other words, in my view the Basel III-Capital requirement wrongfully suggests that shareholders’ equity is only subordinated when a bank is “gone concern” and is being liquidated. This subordination also applies “going concern”.

The European law transposing the Basel III-Capital requirements has not reiterated literally the language set forth in criterion 1 for CET1 capital instruments. Article 28, paragraph 1 (j) CRR rather confirms this principle as follows:

“the instruments rank below all other claims in the event of insolvency or liquidation of the institution”

In this respect the CRR provision is, however, as confusing as the Basel III-Capital language used, for the same (or comparable) reasons set forth here above. The language of CRR adds some complexity, however, when referring to both “liquidation” as to “insolvency”. Liquidation is not a defined concept in CRR, rather “liquidation” is used in many different ways, for instance the expression is also used in the context of “liquidation of positions” which has another meaning. It is unfortunate that this reference to “insolvency or liquidation” is made in this context without a further determination of the instances in which the relevant principle of subordination must apply. As we will discuss in later paragraphs when discussing the

³⁹ Requirement 1 of the criteria for inclusion in Common Equity Tier 1 capital, Basel III-Capital, paragraph 53, op.cit., page 14.

⁴⁰ Requirement 7 of the criteria for inclusion in Common Equity Tier 1 capital, Basel III-Capital, paragraph 53, op.cit., page 14.

new bail in regime set forth in the Bank Recovery and Resolution Directive (“BRRD”)⁴¹, the mismatches between the CRR language and BRRD language creates considerable confusion.

6.3.2. Subordination of AT1 capital instruments

For AT1 capital instruments Basel III-Capital states as criterion for subordination:

“Subordinated to depositors, general creditors and subordinated debt of the bank.”⁴²

In the CRR provisions, other language is used to establish the subordinated character of AT1 capital instruments. The relevant provisions of article 52, paragraph 1 (d) and (f) determine:

“the instruments rank below Tier 2 instruments in the event of the insolvency of the institution”

and

“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”

Clearly, the language used in Basel III-Capital is simpler and confirms in a clearer fashion that AT1 capital instruments in any event rank below the claims of depositors and other general creditors. The subordination is also towards other creditors with subordinated claims, which refers to the claims of holders of Tier 2 capital instruments. The latter is also confirmed in the language of article 52, paragraph 1 (d) CRR which explicitly refers to Tier 2 instruments rather than the generic language “subordinated debt” of Basel III-Capital. In respect of the subordinated character of AT1 capital instruments in relation to Tier 2, a layered subordination ranking has been established as a result of these provisions.

The language in article 52, paragraph 1 (f) CRR is difficult to read and to be interpreted. This criterion of the CRR does, however, refer to the subordinated nature of AT1 capital instruments. The provision aims to address the timing of the subordination of claims of holders of AT1 capital instruments. The subordinated character of these instruments extends until after a liquidation or insolvency proceeding has been enacted towards the bank. This means that holders of AT1 capital instruments are required to participate in the loss absorption after the liquidation of insolvency proceeding towards the bank has been enforced. Loss absorption in this context means that a holder of an AT1 capital instrument must accept that in the event of liquidation or insolvency of the bank, no distributions of principal may occur as the whole sum of AT1 capital instruments outstanding is likely to be set off with losses incurred by the bank prior to liquidation or insolvency. In legal terms, in the waterfall of distributions in the event of liquidation or insolvency, claims of holders of AT1 capital instruments rank at the penultimate level just prior to the providers of CET1 capital.

As regards distributions of interest or comparable compensation to the investors in AT1 instruments, Basel III-Capital and the CRR use different language as well. In Basel III-Capital the requirement is phrased as follows:

“Dividend/coupon discretion:

⁴¹ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJEU L. 173 of 12 June 2014, pages 190-348.

⁴² Requirement 2 of the criteria for inclusion in Additional Tier 1 capital, Basel III-Capital, paragraph 55, op.cit., page 15.

- a. the bank must have full discretion at all times to cancel distributions/payments
- b. cancellation of discretionary payments must not be an event of default
- c. banks must have full access to cancelled payments to meet obligations as they fall due
- d. cancellation of distributions/payments must not impose restrictions on the bank except in relation to distributions to common stockholders.”

Article 52, paragraph 1 (l) CRR determines:

“Distributions under the instruments 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 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;”

In both instances, the expression “subordination” is avoided when determining the rights of holders of AT1 capital instruments to distributions, particularly interest payments on the issued bonds that qualify as AT1 capital instrument. But in all material respects the regulations concerned enhance the subordinated character of the debt obligations of the banks towards holders of AT1 capital instruments. The requirements as set forth in the CRR provision also confirm that AT1 capital instruments qualify as “quasi-equity” instruments, in view of the reference to company law concepts of distributions from “distributable items”. With this expression reference is made to concepts of company law regulating capital preservation. Under common company law principles⁴³, shareholders are not entitled to distributions of dividend, if the company has not made earnings in the relevant book year attributable to the “free reserves” of the company. This principle is now also equally applied to holders of AT1 capital instruments, consequently the regime for equity providers under ordinary company law provisions is extended to providers of the bank’s debt financing.

The provisions determining that a bank may apply the sums withheld from distribution to holders of AT1 capital instruments to meet “its obligations as they fall due” is also a reference to subordination of claims of holders of AT1 capital instruments. By regulating that the available monies for distribution of interest to bondholders, may be used for fulfilment of payment obligations towards other creditors (such as depositors), the regulations confirm that there is a ranking of obligations of the bank towards various creditors, where holders of AT1 capital instruments are granted a lower ranking.

In summary, the various provisions determining the criteria for AT1 capital instruments cited here above, confirm, sometimes with opaque expressions, that obligations of the bank in respect of AT1 capital instruments rank, at all times, lower than the payment obligations to other (subordinated) creditors, but higher than the obligations towards holders of CET1 capital. The language used in the various requirements, confirm the status of AT1 capital instruments as hybrid obligations of the bank, they usually classify as a debt instrument for accounting and tax purposes, but the relations between the bank and holders of these capital instruments also contain features as if the instruments qualify as an equity instrument. This is particularly the case for the distribution of interest mechanisms applicable to AT1

⁴³ See: article 15 of Directive 77/91/EEC, OJEEC, L. 26 of 31 January 1977 (Second Company Directive).

capital instruments. Basel III-Capital however confirms in a clearer fashion, that holders of AT1 capital instruments will always rank lower than the creditors depositing (saving) monies with the bank.

6.3.3. Subordination of Tier 2 capital instruments

For Tier 2 capital instruments, Basel III-Capital states as criterion:

“Subordinated to depositors and general creditors of the bank.”⁴⁴

In the CRR provisions concerned, the expression “subordination” is clearly expressed in the determination of the criteria, other than is the case in the list of criteria for AT1 capital instruments.

Firstly, CRR makes in article 63 a distinction between “capital instruments” and “subordinated loans” which distinction stems from interpretation issues in practice in the past. Under the CRD I regime, some supervisory authorities did not acknowledge a bilateral loan between a bank and an investor as eligible “Tier 2-capital”. By putting considerable emphasis on the fact that Tier 2 capital may consist either of “capital instruments” or “subordinated loans”, these interpretation issues should be resolved for the future. The distinction between the two types of debt obligations of the bank concerns the manner of raising the funds from the (subordinated) creditors. The reference to “capital instruments” is to the practice of raising funds through a bonds issue in the public capital markets rather than by means of a bilateral loan between a lender and the bank. The “subordinated loan” refers to a bilateral or multilateral privately placed loan. Both types of raising funds by banks may end up in the debt of the bank qualifies as Tier 2 capital.

It can be debated whether the introduction of this distinction for Tier 2 capital instruments only is justified. In my view a privately placed bilateral or multilateral subordinated loan (provided it meets all the other criteria) may also be used to create AT1 qualifying regulatory capital.

The subordinated character of Tier 2 instruments is expressed in the following criteria set forth in article 63 CRR:

“(d) the claim on the principal amount of the instruments under the provisions governing the instruments or the claim of the principal amount of the subordinated loans under the provisions governing the subordinated loans, as applicable, is wholly subordinated to claims of all nonsubordinated creditors”

With this clear language (one would have hoped similar clear language was used for the criteria of AT1 instruments), the ranking of obligations of the bank to the holders of Tier 2 capital instruments or loans is set out in a comprehensive way. Claims as regards the *principal* of AT1 instruments or loans are subordinated at any time to claims of all non-subordinated creditors, for instance depositors, common creditors of the bank, tax authorities and any other creditors. One could also argue whether it would have been justified to determine that Tier 2 capital instrument holders or lenders should be holding subordinated claims towards creditors holding a subordinated claim that *does not* qualify as CET1, AT1 or Tier 2 capital. This particular scenario has not been covered by the criteria of Tier 2 instruments but may, in practice, be a relevant topic. Banks may raise subordinated debt that is not structured as AT1 or Tier 2 capital and, because of the obscurity as to the ranking of obligations as follows from the CRR language cited above, possible constraints may occur in practice as regards the ranking of obligations (in other words when will which creditor be receiving payments) between Tier 2 capital providers and ordinary subordinated loan providers.

⁴⁴ Requirement 2 of the criteria for inclusion in Tier 2 capital, Basel III-Capital, paragraph 58, op.cit., page 18.

As regards distributions of interest or comparable distributions the subordinated character of the debt obligations of the bank towards Tier 2 capital instrument holders or lenders, CRR does not restrict such payments in a similar way as is the case for AT1 capital instruments. Therefore, there is no true subordinated character of such interim payments, giving the bank the opportunity to distribute interest and similar payments on Tier 2 capital instruments or loans without too many restrictions. Such payments, however, must always be made at the discretion of the bank and absent the fulfilment of payments scheduled (for instance an annual interest coupon becoming due) resulting into the bank defaulting under the capital instruments or loan terms and conditions, Tier 2 creditors may not accelerate future scheduled payment of interest or principal, other than in the insolvency or liquidation of the bank. This is regulated as criterion in article 63 (l) CRR. Creditors' rights are restricted in such a way that in the event a bank defaults under a capital instrument or loan qualifying as Tier 2 instrument, such loan may not be cancelled prematurely.

6.4. Permanency

As has been noted in paragraph 3, CET1 forms the main part of the regulatory capital base for banks to be held against the risks in the banking business. With this measure regulators seek to enhance the principle of 'permanence' of the capital made available to banks. Shareholders or any other party that may exercise claims in respect of CET1 capital should make the capital available without statutory law, corporate organizational or contractual provisions giving these parties rights to cancel the commitment towards the bank, whether the bank is financially sound or not. CET1 capital must be provided to banks for an indefinite term and may not be subject to rights to redeem or cancel at the discretion of the shareholder or creditor. Permanency, or indefinite term availability, of CET1 capital is therefore an important concept of the Basel III-Capital rules.

This concept is also important for other components of the regulatory capital base, such as AT1 and Tier 2 capital, albeit that for these capital components permanency is one of the criteria explaining the differences of the legal relationship between bank and investor as regards the three components of banks' regulatory capital. AT1 and Tier 2 capital may be available to banks on a less permanent basis. In other words it is permitted that the terms and conditions of the capital instruments contain provisions as regards the term of availability of the capital. For instance by means of a defined term that the capital will remain outstanding. This is particularly the case for Tier 2 capital instruments, where AT1 capital instruments are to be shaped in principle in the form of perpetual obligations of the bank, however with possibilities, after expiration of relatively long terms, to initiate a redemption or repayment by the bank through the application of a call mechanism.

AT1 capital instruments must be "perpetual, there is no maturity date and there are no step-ups or other incentives to redeem"⁴⁵. With this criterion, the permanent availability of AT1 capital instruments is safeguarded as follows. AT1 capital instruments must be issued for an indefinite term, they are perpetual obligations of the bank towards investors. AT1 capital instruments may, therefore, no longer be issued with long term maturity dates, for instance a term of 30 years or a 'centennial' term, where the maturity date is set at 100 years after the issue of the instrument. Such terms have been customary in the debt capital markets in the past for so-called 'hybrid capital instruments'. By emphasizing that the AT1

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Requirement 4 of the criteria for inclusion in Additional Tier 1 capital, Basel III-Capital, paragraph 55, op.cit., page 15.

instruments must be perpetual, the practices of the past for structuring the contractual terms of these instruments have to be abolished.

This does not mean that AT1 capital instruments may not be redeemed or repaid at a certain point of time. However, the bank issuing such capital instruments may not build into the contractual terms and conditions incentives to such redemption or repayment. In the past, hybrid capital instruments often contained such “incentives to redeem”. For instance the terms and conditions of the capital instrument contained a mechanism that the bank was permitted to exercise an option to redeem if after the expiration of an interest term, the rate of interest payable to the holders of the capital instruments was to be revised (so called “interest step up” mechanism). If market interest rates would require the bank to increase the rate of interest payable to the investors in the hybrid capital instrument, it was permitted in such circumstances to cancel the capital instruments term, and redeem or repay the principal outstanding to the investors. Such incentives to redeem are no longer permissible for AT1 capital instruments after the application of Basel III-Capital regulations.

AT1 capital instruments may be “callable”, however, but only after the expiration of a term of five years and only if certain strict conditions are met. This means that the bank issuing the capital instruments that qualify as AT1 capital may exercise a call (option) to redeem or repay the instruments to the investors effectively reducing the term of the outstanding obligations. Such call may only be exercised subject to the fulfillment of certain strict conditions. These conditions are:

- The bank must receive prior supervisory approval to exercise a call option;
- The bank may not create expectations to the market and to the investors that it contemplates to use the call option, in other words the bank may not commit publicly that early redemption or repayment will take place;
- The bank may not exercise the call option unless replacement issues of capital of same or better quality take place prior to or concurrent with the exercise of the call option;
- The bank may not exercise the call option unless it has demonstrated that its regulatory capital position is well above the minimum capital requirements after the call option is exercised.⁴⁶

This list of strict conditions imposed on banks that desire to terminate the term of an AT1 capital instrument being distributed in the capital markets is an important new element of Basel III-Capital. Particularly it must be emphasized that the new rules on maintenance of capital adequacy of banks have broadened the powers of supervisory authorities to a great extent. Banks have little discretionary powers to make decisions as to the organization of their capital base and they have little discretion as to the determination of the terms and conditions of the funding instruments to be purchased by private parties. A call to terminate an instrument outstanding in the capital markets is subject to prior regulatory approval.

Calling the end of the term of the capital instrument that is outstanding in the market may only be done, if alternative funding instruments are being placed in such markets that meet the criterion of being of “same or better quality” than the instrument being cancelled. This suggests that the bank concerned may only place capital instruments qualifying as AT1 capital, if they contain same terms and conditions as the instrument being called to be replaced. Or the terms and conditions are, from the perspective of investors,

⁴⁶ This list of requirements set forth in this contribution is rephrased from the language of the original list contained in Requirement 5 of the criteria for inclusion in Additional Tier 1 capital, Basel III-Capital, paragraph 55, op.cit., page 16. The same requirements are set forth in article 52, paragraph 1 (j) CRR and the procedure for authorization by the supervisory authorities is set forth in article 77 CRR.

worse than the ones of the instrument outstanding if the bank wishes to achieve the objective to improve the quality of the capital instrument compared to the one being placed in the past. Consequently, a replacement of an AT1 instrument with a new issue of capital instruments will, in principle, only be successful (from the perspective of compliance with the requirements) if the bank issues CET1 capital instruments instead of the to be replaced AT1 capital instruments.

Considering the other requirements for the permissible replacement call, it is fair to conclude that banks will only conclude to exercise this right in circumstances of optimistic market perception of the financial soundness of the institution concerned. Investors will not be willing to purchase capital instruments issued by a bank that they perceive to be weak. They certainly will not be willing to purchase new to be issued instruments with less favorable conditions than the ones issued in the past, unless there is a firm belief in a prosperous development of the bank's business.

For Tier 2 capital instruments comparable, yet deviating requirements apply. Tier 2 instruments need not to be issued with a perpetual term. They may be issued with a minimum original maturity of at least five years. However, Tier 2 instruments with a short maturity of five years only will only be partially recognized in the qualifying regulatory capital base. Tier 2 is recognized only subject to a straight-line amortization scheme. For each year remaining before maturity the principal sum of Tier 2 instruments outstanding is derecognized ratably.

The concept of absence of incentives to redeem as explained here above for AT1 capital instruments, applies equally for Tier 2 capital instruments. This is also the case for the requirements imposed on banks that wish to terminate the capital instrument outstanding in the capital markets. Similar requirements apply, that effectively mean that Tier 2 instruments may only be replaced under strict conditions. The only particular deviation from the requirements imposed in respect of replacement of AT1 capital instruments, is the fact that the regulations for Tier 2 acknowledge and permit that the terms and conditions of a Tier 2 instrument explicitly contain a call option exercisable after the expiration of five years, but before the amortization scheme commences without such option being considered an incentive to redeem.⁴⁷

In conclusion, the principle of 'permanency' of capital granted to banks by (external) investors is enforced by a number of mechanisms governing the relation between the bank and its investors. These mechanisms are applied with variations, depending on the "quality" of the capital instrument concerned. The higher the quality, the less favorable the conditions are for investors. For CET1 capital instruments meeting the highest quality, the term of the instruments issued must be indefinite and there is no possibility to cancel or abbreviate this term. Holders of CET1 capital are effectively funding the bank until the point in time the bank is being voluntarily or compulsorily liquidated. The same applies for AT1 capital instruments, however certain mechanisms for replacement of outstanding instruments (therefore breaching the principle of permanency) may be applied under strict conditions after the first five years the capital instruments have been outstanding in the market. Tier 2 instruments may have a definite term, as long as this term is at least 5 years as from the original issue date.

⁴⁷ Footnote 19 with requirement 5(b) of the criteria for inclusion in Tier 2 capital, Basel III-Capital, paragraph 58, op.cit., page 18. This interpretation cannot be found in the CRR-text, but it may be assumed that this interpretation is also applicable within the European Union.

6.5. No delay in committed contributions

One of the least complex requirements imposed in Basel III-Capital for all three types of capital instruments, is the requirement of such instruments being issued and (fully paid-in). Contractual or other arrangements where partial or conditional payments are agreed between a bank and the investors, will not be eligible for inclusion in the regulatory capital of the bank.

The rules concerning CET1, AT1 and Tier 2 capital instruments suggest that all of the requirements listed in the regulations concerned must be fulfilled in order for these instruments to be recognized as qualifying component of the regulatory capital.⁴⁸ This means that instruments placed in the market with delayed payment obligations of investors will not be recognized at all as regulatory capital. Consequently, a transaction where a bank issues, for instance, shares to a private party agreeing that the shareholder commits to pay in a certain percentage of the nominal value of the shares at a later stage, will not pass the test of article 28 CRR and shares issued will therefore not qualify as CET1 capital for regulatory purposes.

There is also no mechanism available that instruments not fully paid in qualify as lower quality capital, for instance a share issue where investors are permitted to contribute the capital to the bank in a number of tranches, will not be eligible for inclusion in the CET1 part of the regulatory capital nor in a “lower quality level”, for instance in the AT1 or Tier 2 compartment.

As regards the immediate availability of capital contributed by investors, Basel III-Capital enforces the criteria applicable to all three compartments in a different way. As regards CET1 instruments, the criteria of direct issue of capital instruments suggests, that there may not be indirect capitalization of the bank by means of structured finance vehicles. The use of such vehicles could result in delays of capital contribution based on discretionary powers of the (indirect) investors in the capital as regards payments to be made to the bank on the capital instruments issued. An indirect investment in CET1 capital is for this reason not permitted.⁴⁹ For Tier 2 instruments, such indirect and layered structure of investment is permitted, however subject to certain conditions. Basel III-Capital determines:

“If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle – “SPV”), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.”⁵⁰

With this difference in approach (CET1 may never be issued indirectly, where Tier 2 instruments may be issued indirectly, subject to certain strict conditions) another clear example of the strictness of requirements between the various types of instruments is explained.

6.6. Loss absorbing ability

The capacity to absorb losses is to be placed in the context of the rescue operations offered by the public sector to distressed banks during the financial crisis. The relevant issue has been described by the BCBS as follows:

⁴⁸ See: Basel III-Capital, paragraphs 53, 55 and 58 op.cit., pages 13, 15 and 17 and articles 28, 52 and 63 CRR that must be read to address that the requirements set forth in these provisions must all be met as a minimum requirement.

⁴⁹ See: requirement 11 of the criteria for inclusion in CET1 capital, Basel III-Capital, paragraph 53, op.cit., page 14, where it is determined: “It is directly issued and paid-in and the bank cannot directly or indirectly have funded the purchase of the instrument”.

⁵⁰ See: requirement 9 of the criteria for inclusion in Tier 2 capital, Basel III-Capital, paragraph 58, op.cit., page 18.

“During the recent financial crisis a number of distressed banks were rescued by the public sector injecting funds in the form of common equity and other forms of Tier 1 capital. This had the effect of supporting not only depositors but also the investors in regulatory capital instruments. Consequently, Tier 2 capital instruments (mainly subordinated debt), and in some cases non-common Tier 1 instruments, did not absorb losses incurred by certain large internationally-active banks that would have failed had the public sector not provided support.”⁵¹

The capacity to absorb losses is therefore a mere confirmation that nothing in the legal terms and conditions of the regulatory capital instruments, prevents that the holders of these capital instruments contribute proportionally to the losses of the bank as and when they occur. The terms and conditions may not, consequently, contain conditions callable by the holders of the capital instruments, which would permit that their share in the contribution to loss absorption is delayed until other financing or funding is made available to the bank in order to absorb losses. If this effect is not implemented fully in the terms and conditions of the capital instrument concerned, it is not qualifying as regulatory capital at all.

Loss absorption must therefore be interpreted as being closely related to the ranking of obligations of a bank as discussed in earlier paragraphs of this contribution. The difficulty of the concept of loss absorption, from a legal perspective, is that it does not in its nature add more or other requirements imposed on a bank than to ensure that regulatory capital instruments contain the proper arrangements as regards the ranking of obligations of a bank. Loss absorption is, in my view, not a separate and distinct legal concept; rather imposing the requirement that capital instruments must be able to absorb losses is a metaphoric concept that on the one hand confirms applicability of the customary company law principles as regards CET1 capital instruments and on the other hand forms the ‘statement of principle’ for the introduction of a new mechanism imposed on bondholders holding AT1 capital instruments.

The requirement of loss absorption is set forth in various places of Basel III-Capital for CET1 and AT1 capital instruments, all with language that contains certain variations. The two parts of the requirements in this respect may be cited as follows.

As regards CET1 instruments, Basel III-Capital notes:

“It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.”⁵²

As regards AT1 instruments, Basel III-Capital notes:

“Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects: a. Reduce the claim of the instrument in liquidation; b. Reduce the amount repaid when a call is exercised; and c. Partially or fully reduce coupon/dividend payments on the instrument.”⁵³

For Tier 2 capital instruments Basel III-Capital does not specifically address the capacity of loss absorption emphasizing the lower quality level of this compartment of the regulatory capital of banks. Loss

⁵¹ BCBS, ‘Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability’, August 2010.

⁵² Basel III-Capital, paragraphs 53, criterion 8 op.cit., page 14.

⁵³ Basel III-Capital, paragraphs 55, criterion 11 op.cit., page 17.

absorption capacity is therefore a characteristic primarily attributed to CET1 and AT1 capital instruments. The loss absorption mechanism works, however, in a different way for both types of capital instruments.

As regards CET1 capital instruments the metaphoric nature of this requirement is perhaps the clearest. The requirements imposed on banks as regards the loss absorption of CET1 instruments rather form a confirmation of the rights and obligations generally attached to CET1 capital instruments. Share capital and claims of shareholders to retained earnings (these two represent the most common elements of CET1 capital for regulatory purposes) will be, from a perspective of application of ordinary corporate law principles, usually primarily exposed to mechanisms resulting into absorption of losses. If shareholders may not exercise fixed dividend distribution rights (which they may not in view of other requirements established in Basel III-Capital), automatic absorption of losses will take place in most instances. Retained earnings reserves will decrease automatically if a bank makes losses and, if the retained earnings reserves are fully extinguished in view of the losses made, the claims of the shareholders to distribution of the same are cancelled automatically. If shareholders have contributed share premium, in most instances share premium reserves will be treated in a similar way as the retained earnings reserves in case a bank makes losses. In other words, the requirements described in Basel III-Capital merely form a reiteration of certain common company law concepts applicable to banks organized in the legal form of a company.

Perhaps certain parts of the CET 1 requirements concerning loss absorbing capacity of these capital instruments play a useful role in determining the position of holders of CET1 qualifying capital instruments among each other. Needless to note, in certain company law regimes, the laws permit creation of different classes of shares with different rights and obligations of shareholders attached to each separate class. In such case the CET1 requirement cited here above confirms that shareholders representing the different classes of shares must deal with the loss absorption on a *pari passu* basis and in proportion to their holding. In other words, Basel III-Capital suggests that in case a bank makes losses, shareholders should share the burden in an equal way, without such burden sharing becoming an impediment (towards the bank) for the full loss absorption.

As regards the AT1 requirements for loss absorption, the metaphoric nature of 'loss absorption' is an expression of a principle that must apply to the holder of AT1 capital instruments, being that their rights are exposed to reduction if certain contingencies with a bank occur. It is this, perhaps greatest, innovation of Basel III-Capital that is closely connected to the 'bail in-mechanisms' introduced in Europe in connection with the recovery and resolution mechanisms for distressed banks, and the manner of regulating this 'contingent capital' mechanism justifies a separate and elaborate discussion in this contribution. This discussion follows in paragraph 7.

6.7. Alignment (preferred) distributions

For all three compartments of regulatory capital, criteria apply as regards the (restrictions regarding) distribution of dividends or (interest) coupon to the holders of the capital instruments or providers of loans. In general, the principles of alignment of distributions to holders of regulatory capital instruments intend to enable the bank to postpone or to irrevocably cancel interim distributions to its investors, if circumstances require that the bank's regulatory capital base must be strengthened in order to make the bank more resilient. No provisions of statutory or contractual law may give irrevocable rights to shareholders or creditors to interim distributions of dividends, interests or other comparable claims. Interim distributions of dividends, interests or comparable claims must be subject to the full discretion of the banks' management. In their turn supervisory authorities may, in certain circumstances, intervene

when dividend distributions are scheduled by banks' management and if it is considered imprudent that the bank makes such distributions affecting the levels of high quality regulatory capital. It is particularly the latter element, supervisory intervention as regards distributions to shareholders and other investors in regulatory capital, that plays an important role in the new regulations introduced with Basel III-Capital as implemented in the CRR.

As is the case for many other parts of Basel III-Capital, the principles applicable on the subject matter of (interim) distributions are described in a more compact and clearer fashion than is the case for the CRR text. The difference in language is related to the fact that Basel III-Capital shapes a set of standards generally, that must be processed by the lawmakers in the various jurisdictions transposing Basel III-Capital. The "legal language" in a directly applicable law (in Europe this is the case for the CRR) tends to describe matters in a more elaborate way and using expressions that are closely connected to company law and other bodies of law regulating the relations between entities and persons subject to such laws.

Distribution of dividends, interest or comparable claims to shareholders, bondholders or other creditors funding the bank with regulatory capital follows different rules when it concerns CET1, AT1 or Tier 2 instruments. With the application of the rules, a staggered distribution scheme applies for all three compartments of the regulatory capital base, where distributions to the highest quality part of regulatory capital (CET1) are to be made only if there is absolute certainty that the bank's capital is at sufficient levels, where distributions to Tier 2 capital instrument holders or lenders may be made more often and in less severe qualifying circumstances. By application of the different rules applicable to the three regulatory capital compartments, an own scheme of ranking of obligations for (interim) distributions is introduced that is in addition to the principles of layered subordination of claims as regards principal sums contributed by investors to the regulatory capital base of a bank.

In order to explain the differences between the three capital compartments of bank regulatory capital, the requirements as set out in Basel III-Capital are displayed entirely in the below table.

	Criterion	CET1	AT1	Tier2
I	Distributions are paid out of distributable items (retained earnings included).	Applies	Applies	Does not apply
II	The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).	Applies	Does not apply	Does not apply
III	There are no circumstances under which the distributions are obligatory. Non payment is therefore not an event of default. ⁵⁴ Cancellation of discretionary payments must not be an event of default. ⁵⁵	Applies	Applies	Does not apply
IV	Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.	Applies	Does not apply	Does not apply

⁵⁴ This is the language covered in the CET1 requirements. Basel III-Capital, paragraph 53, criterion 7 op.cit., page 14.

⁵⁵ This is the language covered in the AT1 requirements. Basel III-Capital, paragraph 55, criterion 7 op.cit., page 16 under the heading "Dividend/coupon discretion".

	Criterion	CET1	AT1	Tier2
V	Banks must have full access to cancelled payments to meet obligations as they fall due.	Does not apply	Applies	Does not apply
VI	The bank must have full discretion at all times to cancel distributions/payments.	Does not apply	Applies	Applies ⁵⁶
VII	The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation's credit standing.	Does not apply	Applies	Applies

For the sake of clarity, it is noted that the language contained in the above table is taken in its entirety from the Basel III-Capital text. The CRR provisions of articles 28, 52 and 63 contain more or less similar language to address the subject matter of dividend and interest payments by banks.

From the different criteria as set out in the table, it can be derived that some criteria seem to address same and overlapping requirements, albeit that they are phrased in a different way. For instance requirement III for CET1 addresses the same requirement as criterion VI for AT1 and Tier 2 instruments and loans, being that a bank's management may exercise full discretion as to the payment of dividend or interest to the holders of the capital instruments or the lenders providing loans qualifying as bank regulatory capital. The language of the first sentence of III is different ("no circumstances under which the distributions are obligatory") from the language used in VI ("full discretion at all times to cancel distributions/payments") but has in my view the same meaning.

Investors may not force a bank to make payments of dividend or interest on outstanding capital instruments or loans that are comprised in the three compartments of the regulatory capital. One could argue whether the additional language used for CET1 and AT1 to emphasize that non-payment of dividend or interest may never result in an "event of default" under the terms and conditions applicable to CET1 or AT1 instruments (see: criterion II) should also have been comprised in the description of the requirements of Tier 2 instruments. This language is missing in the criteria for Tier 2 instruments and must be construed from the use of the language in criterion VI that the bank must have full discretion to cancel distributions/payments. If a bank has full discretion, then this means in my view, that the delay or full cancellation of a scheduled interest payment on Tier 2 instruments may not end in a claim from investors or lenders making available Tier 2 funds to the bank, that the terms and conditions of the instruments or loans are breached. We emphasize again that should investors be able to successfully uphold that the bank would be defaulting under the conditions of the capital instrument, the instrument risks not to qualify as recognized regulatory capital. This consequence follows from, among others, article 30 CRR for CET1 capital instruments.

A more fundamental comment can be made as regards the application of the various criteria for the three different compartments of regulatory capital emphasizing the "internal ranking" in layers of subordination. In fact the distinction of obligations towards investors in regulatory capital instruments and loans is perhaps clearest between CET1 and AT1 on the one hand and Tier 2 on the other hand. The criteria for CET1 and AT1 capital instruments are drafted more or less in a similar way and confirm, as has

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In my view this follows from the requirement "The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation" as set out in requirement 6 of the criteria for inclusion in Tier 2 capital, Basel III-Capital, op. cit, page 18. The language used to address this mechanism for CET1 and At1 capital instruments is not reiterated for Tier 2 instruments, however. But effectively, if an holder of a Tier 2 capital instrument or a lender cannot accelerate coupon payments other than in circumstances of liquidation (and insolvency as is added to this in CRR), this makes an interest payment fully discretionary.

been noted earlier in this chapter, that AT1 instruments are to be considered hybrid instruments in many respects. They are usually placed in the markets in the form of debt instruments (bonds or similar instruments), but from the perspective of the legal rights and obligations that must be established between the bank and investors, are very akin to equity capital instruments.

For instance, payments of interest on AT1 instruments may only be made from the “distributable items” (see criterion I), which is very much a company law concept addressing and qualifying the distribution of earnings of a company to its shareholders. Earnings (being the profits of a company in a certain year) may only be distributed from the “free reserves” of a company. Free reserves are primarily⁵⁷ established from the earnings of a company in any given year and which are not applied to make distributions to shareholders, to set off negative income of a company or to the establishment of mandatory reserves (“statutory reserves”) resulting in non-distributable items on the balance sheet. By confirming that interest payments on AT1 instruments may only be made from “distributable items”, this means that interest coupon payments of AT1 instruments are, factually, profit dependent payments. A bank making losses in a certain year will have, from the perspective of this criterion, significant constraints following from mandatory banking law, to make interest payments on AT1 instruments. Such payments shall only be permitted, if the bank concerned has maintained sufficient retained earnings buffers from profits withheld (retained earnings) in the previous years. Profits of previous years not so distributed, and provided that the bank has sufficient (absolute) levels of regulatory capital, could serve to make interest payments on AT1 capital instruments in a year where a bank has made losses.

The most significant distinction between CET1 and AT1 capital instruments follows from criterion II. This criterion emphasizes that CET1 instruments may never be established in the form of “fixed income” instruments, in other words (dividend) distributions to CET1 capital instrument holders must always be variable and fully dependent on the earnings of the bank. By using the generic language in criterion II of “is not in any way tied or linked to the amount paid in at issuance”, it is, basically, confirmed that terms and conditions governing CET1 instruments may not contain a fixed percentage or fixed amount of distribution of dividend or interest payable to the holders of these instruments. This requirement does not apply to AT1 capital instruments and these instruments may therefore be shaped in the form of fixed income debt capital instruments, with fixed percentage or fixed amounts of distributable interest to the holders of these instruments, provided that the other criteria for distributions are complied with.

The most significant effect for the holders of CET1 capital instruments compared to AT1 capital instruments follows from criterion IV which effectively determines that payments of dividends to holders of CET1 capital instruments are subordinated to payments of dividends or interest “on more senior capital instruments”. Because this requirement does not apply to the AT1 capital instruments, it follows that AT1 capital instruments are “more senior” than CET1 capital instruments. This establishes the layered subordination between CET1 and AT1 capital instruments and factually results in a distinction of rights and obligations of holders of the two different types of capital instruments. This is furthermore confirmed by the language that “there are no preferential distributions” to holders of CET1 capital instruments. The

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In company law, share premium reserves are usually also referred to as “free reserves”. Distribution of share premium reserves to shareholders, effectively resulting of redemption of capital, may, however follow different rules than other “free reserves” of a company. In many jurisdictions share premium reserves are regulated in a similar way as paid in (nominal) capital. For the sake of completeness, I refer to this particular topic, but will not elaborate in the further paragraphs of this chapter.

meaning of “preferential distributions” has been further explained in the CRR provisions as follows. The provision of article 28, paragraph (h) (i) CRR determines:

“there is no preferential distribution treatment regarding the order of distribution payments, including in relation to other Common Equity Tier 1 instruments, and the terms governing the instruments do not provide preferential rights to payment of distributions⁵⁸”

In the language of the European transposition of Basel III-Capital, there is a further clarification as regards the language used in Basel III-Capital that “there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital”, which is difficult to read and to be interpreted. The CRR language emphasizes, that banks may not issue shares or other (comparable) equity capital instruments that would grant to the holders of such instruments rights to preferred (dividend) distributions in relation to other holders of CET1 capital instruments. The sanction on issue of these preferred equity shares, is that they may not be comprised in the CET1 regulatory capital compartment.⁵⁹ They may, however, be eligible for inclusion in other compartments of the bank’s regulatory capital, being the AT1 or Tier 2 compartment. Preferred shares may therefore, as has been the case in the regime applicable before introduction of Basel III-Capital, qualify as AT1 or Tier 2 instruments. In view of the applicability of criterion V, so-called “cumulative preferred shares” may not qualify as AT1 instruments, as the delayed or cancelled distribution of interest/dividend must be fully available to the bank and may, therefore, not be saved to the benefit of the holders of cumulative preferred shares for future distributions. This requirement does not apply to Tier 2 instruments. From this it follows that cumulative preferred shares may under certain circumstances qualify as Tier 2 regulatory capital instruments.

The various criteria for distributions of dividend, interest and comparable payments to holders of CET1, AT1 and Tier 2 capital instruments and loans emphasize, in summary, that there is a layered subordination of obligations between the three different capital instruments. Tier 2 capital instruments constitute, as regards interim payments by banks, the most senior creditor position, whereas the holders of CET1 possess the most junior claim. Among the holders of CET1 capital instruments, no differences in ranking of claims may be made, they share, *pari passu*, in the income distributed by the bank to its shareholders (and other holders of CET1 instruments). There is much more to say about the regulations concerning the interim distributions by banks as regulated in Basel III-Capital. The level of detail of the regulations on this subject matter is one of the innovative elements of the revisions to the Basel capital accords. They form a response to the difficulties in the financial markets, occurring at the occasion of the financial crisis, particularly as regards the discretion of banks’ management to distribute profits in times, where retaining such profits would be the more sensible approach to address the stress in the financial markets. Bank’s management faced during the financial crisis considerable pressure from investors to continue distributing profits, in a time where it was considered more prudent not to do so.

⁵⁸ Article 28, paragraph 5, (c) CRR determines that the European Banking Authority shall develop regulatory technical standards to specify the meaning of “preferential distributions”. These regulatory technical standards should have been submitted to the European Commission by 28 July 2013. As far as I am aware, such regulatory technical standards have not been developed (yet). Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013 with regard to regulatory technical standards for Own Funds requirements for institutions, (OJEU L. 78 of 14 March 2014, p. 8-26), does not address this subject matter.

⁵⁹ See: article 30 CRR.

One final note must be made with respect to distributions of dividend and interest on issued regulatory capital instruments. Within the CRR and Capital Requirements Directive IV (“CRD IV”)⁶⁰ framework, banks are subject to strict capital conservation requirements. These capital conservation requirements introduce, among others, the authority of the competent authority concerned, to impose on banks not meeting certain capital adequacy levels, to refrain from making distributions to holders of regulatory capital instruments. In addition to the full discretion that the management of the bank must be able to exercise, also influence from regulatory authorities may result in the cancellation of scheduled dividend or interest payments. See for a further outline of the relevant requirements: Section III (Capital conservation measures) of the CRD IV Directive, particularly articles 141 *et seq.* CRD IV Directive.

6.8. No intra-group support

The quality of bank’s regulatory capital may be diluted, if the obligations of the bank towards the investors in such capital are made subject to support by entities affiliated with the bank. If an obligation of the bank towards its shareholders or creditors is supported by means of a guarantee or any other form of contractual support, the bank’s primary obligations are qualified to the extent other (affiliated) entities would provide support. More precisely the possibilities for a bank not to meet its obligations under the circumstances as set forth in the regulatory capital requirements, could be mitigated in case another entity would be required to step in to fulfil the obligations of the bank if, for whichever reason, the bank is obligated to delay or to cancel the fulfilment of such obligations.

For all three types of regulatory capital instruments and loans, CET1, AT1 and Tier 2, restrictions apply as to the providing of intra-group support in respect of the obligations of the bank under the capital instruments or loans issued or borrowed by the bank. The common language used in both Basel III-Capital and the CRR is as follows:

“the instruments are neither secured nor subject to a guarantee that enhances the seniority of the claim”⁶¹

This requirement firstly confirms that a bank may not provide itself any guarantee or security interest over its assets to holders of regulatory capital instruments or loans. This is confirming the obvious position as regards all the other requirements made applicable to the regulatory capital instruments and loans. A guarantee, pledge, hypothecation or and other form of security provided by the bank would immediately result in an alteration of principles of subordination, permitted delay or cancellation of primary (payment) obligations of the banks and would affect the position of the bank considerably towards the creditors benefiting from such security interests.

The other part of the cited requirement applicable to all regulatory capital instruments is related to the prohibition of (intra)group support in the form of guarantees or security interests. The Basel III-Capital and CRR provisions determine the scope of affiliated parties that may not be providing such guarantees or security interests. In Basel III-Capital the expression used is only referring to the generic concept of “related entity”, in the CRR provisions an extensive list of entities affiliated to the bank is established,

⁶⁰ Directive 2013/36/EU of the European Parliament and the Council 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, Pb.EU L. 176 of 27 June 2013, p. 338-436.

⁶¹ See: Basel III-Capital, paragraph 53, criterion 12 for CET1 *op.cit.*, page 15, Basel III-Capital, paragraph 55, criterion 3 for AT1 *op.cit.*, page 14, Basel III-Capital, paragraph 58, criterion 3 for Tier 2 *op.cit.*, page 18, article 28, paragraph 1 (l) CRR for CET1, article 52, paragraph 1 (e) CRR for AT1 and article 63 (e) CRR for Tier 2.

providing the most extensive scope of affiliation with the bank of entities that are not permitted to grant guarantees or security interests. Among the long list of affiliated companies and entities, the CRR addresses that guarantees or security interest may neither be provided by subsidiaries of the bank, nor by its parent company.

6.9. No acceleration of repayments

A bank that can be forced by its shareholders or creditors under applicable terms and conditions, to accelerate repayments of principal invested by such shareholders or creditors (or to apply other methods of redemption or cancellation of capital or debt) would be under permanent risk of deterioration of its capital buffers and, therefore, would be less resilient against economic downturn or losses incurred as a result of internal revaluation of risks incurred. It is exactly this dilemma that played such an important role during the financial crisis. Many banks agreed to certain repayment, redemption or cancellation mechanisms becoming applicable when problems in the general economy or with the bank emerged.

Perhaps one of the strongest foundations of the new regime applicable in respect of the regulation of bank’s regulatory capital concerns the criteria applicable for accelerated repayments, redemptions or other cancellation of equity or debt made available by investors to banks. The relevant criteria apply, with variations, for all three compartments of bank regulatory capital, CET1, AT1 and Tier 2. Acceleration in this context, means that repayments, redemptions or other cancellation of principal is made prior to the maturity of the relevant capital instrument or debt obligation. This subject matter is, therefore, firstly qualified to the extent the terms and conditions of the instruments concerned may contain a defined maturity. For CET1 and AT1 capital instruments, we have discussed in earlier parts of this chapter that no pre-defined or pre-agreed maturity clauses may be comprised in the terms and conditions, the instruments are to be issued with a perpetual term. For Tier 2 instruments this is different.

Nevertheless, the criteria for all three compartments of bank regulatory capital, address acceleration of repayments in certain circumstances. The regime applicable for the three compartments is described in Basel III-Capital as follows:

	CET1	AT1	Tier 2
Criteria	(3) Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).	(4) Is perpetual, ie there is no maturity date and there are no step-ups or other incentives to redeem; and (6) Any repayment of principal (eg through repurchase or redemption) must be with prior supervisory approval and banks should not assume or create market expectations that supervisory approval will be given	(4) Maturity: a. minimum original maturity of at least five years b. recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis c. there are no step-ups or other incentives to redeem; and (6) The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

As noted in earlier paragraphs of this chapter, the possibilities for banks to exercise calls in respect of AT1 and Tier 2 capital instruments or loans to accelerate the repayment of capital instruments is made subject to a strict regime. This regime effectively aims at maintaining the levels of AT1 and Tier 2 capital by requiring that the bank issues capital instruments of same or better quality simultaneously with the cancellation of the instruments being called. For this particular subject matter, reference is made to earlier comments in this chapter.

As regards the subject matter of acceleration of repayments, the following specific comments may be made. As appears from the above cited standards of Basel III-Capital, only in the criteria for Tier 2 instruments an explicit reference is made to the acceleration of (future) scheduled repayments of principal and coupon from the bank to the holder of capital instruments or lenders of Tier 2 loans. This criterion refers to the (customary) provisions in terms and conditions for bonds or loans, where under certain pre-defined events, a creditor may exercise its contractual discretionary right to require from his debtor to repay principal (and any accrued interest not being paid). Such events are often referred to as “events of default” as they define all those events, where a debtor owing monies to his creditor is in breach of its obligations towards the creditor, either as regards payments to be made under the terms and conditions or other obligations (for instance an obligation to provide the creditor with information). For Tier 2 capital instruments or loans, such “events of default” are narrowed down to the events of “bankruptcy” and “liquidation”⁶². This means that any other provision in the terms and conditions of a Tier 2 capital instrument or loan that requires the bank to repay principal or interest prior to the expiration of the term, other than in the event of a liquidation or bankruptcy proceeding, is not enforceable towards the bank. For instance, a delay occurring in the payment of interest, may not result in the early termination of the agreements concerned and may not result in acceleration of the payment obligations of the bank.

The question arises, whether the absence of similar language in the criteria for CET1 and AT1 instruments as regards the restrictions for accelerated payments, means that such accelerated payment obligations would be permissible in the relationship between banks and investors in CET1 and AT1 instruments. Obviously that is not the case, but this must be derived from implied (analogous) application of this criterion due to the language used in the other criteria cited here above in the table addressing this point.

For CET1 capital instruments the language referred to “principal is perpetual and never repaid outside of liquidation” confirms that the terms and conditions of CET1 capital instruments may not contain early termination provisions resulting into acceleration of payments, whether this is based on a discretion exercised by shareholder/creditor or by the bank or whether this is based on the occurrence of (objective) events that would trigger the application of acceleration of obligations.

For AT1 capital instruments, the implied nature of this requirement is even more difficult to be construed. It is the use of the expression “there is no maturity date” and similar expressions that results into the conclusion that acceleration of payments of principal or interest is not permitted, except in the event of a liquidation of the bank or in the event there is prior supervisory approval. In this respect, the language used in the CRR is somewhat clearer. The provision of article 63 (j) CRR determines:

⁶² The provision of article 63(l) CRR contains the following language: “the provisions governing the instruments or subordinated loans, as applicable, do not give the holder the right to accelerate the future scheduled payment of interest or principal, other than in the insolvency or liquidation of the institution”.

“the provisions governing the instruments do not indicate explicitly or implicitly that the instruments would or might be called, redeemed or repurchased and the institution does not otherwise provide such an indication, except in the following cases:

(i) the liquidation of the institution;

(ii) discretionary repurchases of the instruments or other discretionary means of reducing the amount of Additional Tier 1 capital, where the institution has received the prior permission of the competent authority in accordance with Article 77.”

Again, it must be derived from the implication of this provision that there cannot be any terms and conditions applicable in respect of AT1 capital instruments, that a bank is obliged to repay principal or interest at the occurrence of an “event of default”.

7. The contingent capital mechanism

7.1. The BCBS proposal for loss absorbency at the point of non-viability of banks

As noted previously in paragraph 6.6, one of the main innovative elements of the regulations introduced with Basel III-Capital concerns the requirement to include contingent capital mechanisms in the terms and conditions of regulatory capital instruments. Such mechanisms expose the holder of regulatory capital instruments, upon the occurrence of certain triggers, to either (i) a compulsory write down of principal or (ii) a compulsory exchange of the principal for equity instruments of the bank. The obligations of the holders of the capital instrument to accept a write down or conversion to equity follows from the contractual provisions as agreed upon, as such contractual provisions are backed up by a strong statutory regime based on the provisions of the CRR.

The primary source of the obligations is therefore the contractual (and corporate law) relationship that, if need be, is supplemented or replaced by statutory provisions of the CRR as secondary source of such obligations. With this solution, the European legislator has clearly implemented for ‘ordinary’ contingent capital, the recommendations made in literature for the shaping of the legal basis of so-called ‘bail in instruments’.⁶³ As we will discuss in paragraph 8, bail in mechanisms as they may be applied in the context of a bank resolution proceeding require an equal ‘hybrid’ foundation in both statutory provisions as in contractual provisions. In the case of bail in instruments the obligations of the shareholders and creditors are primarily based on statutory provisions, but, in accordance with the intentions of the European legislator, they must be backed up by contractual arrangements as secondary source as well.

The fundamental ideas concerning this mechanism forcing holders of regulatory capital instruments to absorb losses by means of a permanent reduction of their claims towards the bank has been proposed by the BCBS in August 2010. The BCBS noted in this respect:

“The development of the proposal in this paper is driven by a desire to guarantee the gone-concern loss absorbency of all regulatory capital instruments (including cases when there is public sector support). This should also help in reducing a source of moral hazard, seen by some as an underlying cause of the current financial crisis and a potential cause of future crises. In the absence of a presumption of public sector intervention, subordinated forms of funding should impose significant incremental costs on shareholders of firms that pursue increased rewards by assuming additional risk. This incremental cost is a direct consequence of the limited upside of subordinated forms of funding combined with their potential to receive little or nothing

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See particularly the in-depth analysis delivered by Chris Bates and Simon Gleeson in ‘Legal aspects of bank bail-ins’, Law and Financial Markets Review, July 2011, p. 264-275.

in insolvency. However, this deterrent mechanism, which should lean against excessive risk taking, is broken if the holders of subordinated funding see their downside as limited due to an expectation of a public sector bailout. The proposal in this paper should help revive this mechanism. Furthermore, by making the private sector the first source of new common equity to revive a bank that has become non-viable, this proposal should reduce the number of circumstances in which public sector rescues are deemed to be necessary.”⁶⁴

It is in this proposal of the BCBS that the concept of “gone concern” of banks has been first used to describe a situation where banks are not necessarily being made subject to an insolvency or compulsory liquidation proceeding, but where investors in regulatory capital instruments are nevertheless required to participate in loss absorbency. Gone concern is defined by the BCBS as either (i) a situation where the bank is made subject to such insolvency or liquidation proceedings or (ii) a situation where it is decided to rescue the bank by means of support by a public sector bail out. The contingent capital mechanism aims at introducing a trigger for the latter situation, effectively moving the applicability of subordination principles at an earlier point in time than the enactment of an insolvency or liquidation proceeding. This mechanism serves two objectives: (i) moral hazard risk should reduce⁶⁵ and (ii) public bail out should become less necessary because the private sector participates in the absorption of losses.⁶⁶

It is important to understand that the BCBS proposal targeted one of the circumstances in which contingent capital instruments may be used, being that holders of subordinated debt positions in a bank that is being rescued through state aid, should be forced to participate in sharing the burden of this rescue operation. The motivation of the BCBS is therefore focusing on the need to introduce a mechanism where at an early point of time and prior to the enactment of an insolvency or compulsory liquidation proceeding, holders of regulatory capital instruments are subject to the application of the subordination principles. The application of these principles require them to accept a reduction of their rights to repayment of the principal amount made available to the bank even when the bank is not made subject to insolvency or liquidation proceedings. The BCBS also acknowledged in the August 2010 proposals that contingent capital mechanisms may be used for other purposes, for instance a method of recapitalizing a bank in a going concern situation.

The obvious difference between the use of the instrument of contingent capital to resolve the issues as highlighted by the BCBS in the cited paragraph of the August 2010 proposal here above and the use of the instrument for recapitalization efforts of a bank lies in the definition of the trigger that causes the

⁶⁴ BCBS, Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability, August 2010, p. 4, www.bis.org. See on this recommendation from the BCBS furthermore: Stefan Avdjiev, Aanaatstasia Kartasheva and Bilyana Bogdanova, ‘Cocos: primer’, BIS Quarterly Review, September 2013, www.bis.org.

⁶⁵ In a Frequently Asked Question Annex to the BCBS proposal of August 2010, the BCBS responds to the question “Could the proposal reinforce moral hazard in relation to senior debt?”, with the following answer: “The proposal set out in this document aims to solve one very specific problem, which is that there is no internationally consistent mechanism by which all capital instruments at all internationally active banks can be made to suffer a loss in the event that a failed or failing institution is rescued through a public sector capital injection. Parallel efforts are ongoing to ensure that all banks that fail are capable of being effectively resolved and losses allocated to both senior and subordinated instruments. The proposal in this document should not be viewed as an alternative to effective resolution schemes, but rather a complement.”

⁶⁶ See for further background: IMF Staff Discussion Note, Ceyla Pazarbasioglu, Jianping Zhou, Vanessa Le Leslé and Michael Moore, Contingent Capital: Economic Rationale and Design Features, 25 January 2011, International Monetary Fund, SDN/11/01; Paul Glasserman and Behzad Nouri, ‘Contingent Capital With A Capital-Ratio Trigger’, August 2010, ssrn.com/abstract=1669686; Mark J. Flannery, ‘Contingent Capital Instruments for Large Financial Institutions: A Review of the Literature’, Annual Review of Financial Economics 2014; Edward Simpson Prescott, ‘Contingent Capital: The Trigger Problem’, Economic Quarterly-Volume 98, Number 1-First Quarter 2012, pages 33-50; Gregg Rozansky, ‘The loss Absorbency Requirement and “Contingent Capital” under Basel II’, The Harvard Law Forum on Corporate Governance and Financial regulation, 24 April 2011; Goldman Sachs Global Markets Institute, ‘Contingent capital Possibilities, problems and opportunities’, March 2011.

contingent capital mechanism to become effective. Contingent capital instruments applied to draw the holders of regulatory capital instruments in the burden sharing mechanisms at the occasion of a public bail out will have another definition of the “trigger” than contingent capital mechanisms used for a recapitalization. In the former situation the trigger will be aligned to the time that the bank is being rescued through public sector monies or nationalization, in the latter situation the trigger will not necessarily be based on the intervention by the public sector.

The BCBS formulated the triggers in the August 2010 proposal to cover for the use of contingent capital in cases where there was state aid offered to a failing bank. The trigger as proposed by the BCBS was defined as follows:

“The trigger event is the earlier of: (1) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority; and (2) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority.”⁶⁷

The difficulty of understanding the BCBS proposal is, that it has placed its proposals for application of the contingent capital mechanisms within the context of state aid operations being enacted, but as regards the implementation of the proposals in concrete language for the standards to be included in the Basel capital accords, it introduces also other circumstances where this contingent capital mechanism may be applied. The definition of “trigger” in the August 2010 proposal is broader than the event that state aid operations are enacted.

In all, it is also confusing that the BCBS is addressing the subject matter in a working document with the title “proposal to ensure the loss absorbency or regulatory capital at the point of non-viability”, whereas the trigger is clearly defined to become relevant before that the point of non-viability has been reached. It is fair to say that prior to the point of non-viability, one should speak of the bank’s operations being going concern and not gone concern and, all by all, the August 2010 proposal of the BCBS has contributed to the significant complexity that can be noted as regards this subject matter. This complexity is about the following.

The Basel III-Capital standard of 2010 adopted a few months later in December 2010, required for AT1 instruments to contain a contingent capital mechanism. The exact language used for this mechanism is as follows:

“Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:

- a. Reduce the claim of the instrument in liquidation;
- b. Reduce the amount re-paid when a call is exercised; and
- c. Partially or fully reduce coupon/dividend payments on the instrument.”⁶⁸

⁶⁷ BCBS, August 2010, op cit, p. 5.

⁶⁸ Basel III-Capital, paragraph 55, criterion 11 for AT1 op.cit., page 17.

As may be noted from this language, the BCBS has avoided in its final proposal to address the circumstances where the contingent capital mechanism should become applicable. The “trigger event” has not been defined at all. The final language of the Basel III-Capital text does leave the subject matter of defining the trigger event to the legislators of the jurisdictions that transpose the Basel III-Capital standards into their regulations. However, shortly thereafter, a further decision of the BCBS was published on 13 January 2011⁶⁹, suggesting that additional requirements are imposed in order to address that “all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss”. Such additional requirements supplement the Basel III-Capital provisions on the subject matter. The core language of this additional standard is as follows:

“The terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by an internationally active bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event unless:

(a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss;

(b) a peer group review confirms that the jurisdiction conforms with clause (a); and

(c) it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that such instruments are subject to loss under clause (a) in this paragraph.”

What is new and adds to the Basel III-Capital standards published a number of months before this further proposal, is the emphasis on the applicability of this standard to both ‘non-common’ Tier 1⁷⁰ and Tier 2 instruments. This proposal therefore broadens the scope of applicability of the Basel III-Capital proposals for AT1 capital instruments as discussed here above, to Tier 2 capital instruments as well. It should be noted, however, that the focus in this proposal is on the contingent capital mechanisms becoming applicable at the occasion of a bail out (a rescue operation by a government) and does not focus on recapitalization of banks generally outside the circumstances of a distressed situation with a bank requiring government intervention.

7.2. The position in Europe as regards the use of contingent capital mechanisms

The regulation of contingent capital rules is one of the complex subject matters of the CRR. The initial proposals for CRR submitted by the European Commission in July 2011⁷¹ have been unclear about the scope of applicability of the contingent capital mechanisms. In Europe the relevant regulations on contingent capital mechanisms are to be found in the CRR qualitative requirements for AT1 capital instruments only. In the proposal text the following text can be found in recital (27):

⁶⁹ BCBS, ‘Minimum requirements to ensure loss absorbency at the point of non-viability’, Press Release 11 January 2011, Ref no: 03/2011, www.bis.org.

⁷⁰ The BCBS means with non-common Tier 1, all capital instrument not qualifying as Common Equity Tier 1 instruments.

⁷¹ Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms, Brussels 20 July 2011, COM (2011) 452 final.

“In line with the decision of the BCBS, as endorsed by the GHOS⁷² on 10 January 2011, all Additional Tier 1 and Tier 2 instruments of an institution should be fully and permanently written down or converted fully into Common Equity Tier 1 capital at the point of non-viability of the institution.”

The suggestion is, therefore, that the rules on contingent capital mechanisms must apply to both AT1 capital instruments as well as to Tier 2 capital instruments. However, in the final language containing the requirements for Tier 2 capital instruments or loans, the relevant contingent capital mechanism had not been taken over. Furthermore, the language written to implement the contingent capital mechanism in the proposed article 49 CRR left it open to the European Banking Authority (“EBA”) to define a number of the technical requirements for the contingent capital feature of the AT1 capital instruments, to be proposed in the form of a so-called regulatory technical standard⁷³.

In article 51 CRR, however, the Commission Proposal of 2011 already contained specific language as to the description of the “trigger” that would require the AT1 capital instruments to be either converted into CET1 capital or to be written off. The trigger is defined as the dropping of the CET1 ratio of the bank concerned to certain levels, and does not define the trigger event to apply (only) in the event of a government intervention (bail out) occurring. The trigger as defined in the CRR is, as will be discussed below, not as much related to create loss absorption mechanisms “gone concern” but rather the CRR-trigger for contingent capital instrument is (exclusively) based on a “going concern” situation and aims at a forced recapitalization of the bank.⁷⁴

In de CRR proposal the European Commission therefore stepped away from the main objective as had been formulated by the BCBS in January 2011 imposing requirements on banks (and their investors) for contingent capital mechanisms. Where the BCBS motivated this rather drastic change in the regime for qualitative requirements for regulatory capital instruments referring to the need to avoid public money being spent on rescue operations for banks, the CRR-text of the provisions regulating the contingent capital mechanism (being article 49, paragraph 1 (n) and article 51 CRR of the Commission proposal) in fact made no reference to that motive again. The Commission proposal itself did only make a rather brief reference in the recital as cited here above to that original motive of introducing contingent capital mechanisms attached to regulatory capital instruments. As will be discussed below, the bail in instruments requiring a similar debt write down or conversion to equity as contemplated by the new regulations for bank recovery and resolution based on a discretionary decision of the resolution authorities opting for the ‘bail in tool’, is being justified by the overriding motive of prevention of the use of public money for the rescue of banks.

The difficulty with this proposal text of July 2011 was, that it was unclear in which additional circumstances contingent capital mechanisms should play a role. In other words, in which part of the European body of law would the contingent capital mechanism be introduced in the circumstances of a rescue operation for a bank (involving the need for public bail out and (therefore) burden sharing by the private sector). Furthermore, where the recital text of (27) suggests that the contingent capital mechanism should apply

⁷² “GHOS” is the Group of Central Bank Governors and Heads of Supervision which is the governing body of the BCBS and is comprised of central bank governors and (non-central bank) heads of supervision from member countries.

⁷³ See paragraph two of article 49 CRR of the Commission Proposal text of July 2011.

⁷⁴ See Basel Committee on Banking Supervision critical notes on this subject matter in the consistency assessment, op cit, page 26.

to both AT1 instruments as well as Tier 2 instruments, in the language of the CRR provisions the subject matter was only regulated in the requirements for AT1 instruments.⁷⁵

In the final negotiated text of the CRR as it is now in force, the background of the various circumstances where contingent capital mechanisms must play a role is explained in a much clearer fashion. In recital (45) of the CRR the following explanatory text can be found:

“In line with the decision of the BCBS, as endorsed by the GHOS on 10 January 2011, all additional Tier 1 and Tier 2 instruments of an institution should be capable of being fully and permanently written down or converted fully into Common Equity Tier 1 capital at the point of non-viability of the institution. Necessary legislation to ensure that own funds instruments are subject to the additional loss absorption mechanism should be incorporated into Union law as part of the requirements in relation to the recovery and resolution of institutions. If by 31 December 2015, Union law governing the requirement that capital instruments should be capable of being fully and permanently written down to zero or converted into Common Equity Tier 1 instruments in the event that an institution is no longer considered viable has not been adopted, the Commission should review and report on whether such a provision should be included in this Regulation and, in light of that review, submit appropriate legislative proposals.”

It is with this further explanation that the European legislator has outlined the full background, circumstances and motives for the application of contingent capital mechanisms. The first set of circumstances that may require the holder of AT1 capital instruments to accept, once the trigger event is occurring, that part of the whole of the principal of the loan made to the bank is either converted into CET1 or written off is regulated in articles 52 and 54 CRR and as to be further explained below, means that the contingent capital mechanism is effectively only playing a role in *going concern* situations and in situations that need not necessarily be beyond the point of non-viability of the bank’s business.

The second set of circumstances where contingent capital mechanisms play a role, is in circumstances where the recovery or resolution of the bank is being organized through application of the mandatory law mechanisms for problem banks. It is this second set of circumstances that has been set forth in the Bank Recovery and Resolution Directive⁷⁶ which will be discussed in more detail hereinafter.

Europe has, therefore, introduced the contingent capital mechanism for two different situations:

- (i) a situation where a bank whose operations are *going concern* forces its AT1 capital investors to cooperate with a recapitalization (this will be explained in more detail in paragraph 7.3); and
- (ii) a situation where the contingent capital mechanism is applied to force subordinated and common creditors to cooperate with a write down or conversion of their receivables on the bank. This mechanism may apply whether the bank’s business is *gone concern* (that is beyond the point of viability) or *going concern* (that is a situation where the whole or part of the

⁷⁵ Whilst the *mandatory* CRR requirements focus therefore on AT1 capital instruments only, this does not mean that market participants are restricted in a choice to (voluntarily) apply same mechanisms for Tier 2 instruments. In fact in the capital markets some issues of Tier 2 contingent capital instruments are made by large financial institutions. Particularly Swiss institutions have taken the initiative to place structured Tier 2 capital instruments containing contingent capital features. See: Credit Suisse Tier 2 low trigger contingent capital instruments issue in July 2013. For background information: Reuters 29 July 2013, www.reuters.com/assets.

⁷⁶ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, PbEU L. 173 of 12 June 2014, p. 190-346.

bank's business will be recovered, transferred to another bank or otherwise rescued) or a mixture of these circumstances (this will be explained in more detail in paragraph 8).

7.3. The contingent capital mechanism regulated in articles 52 and 54 CRR

7.3.1. Introduction

The contingent capital requirement is one of the 17 (qualitative) requirements for AT1 capital instruments. The broad concepts underpinning these requirements have been explained at length in paragraph 6 of this chapter. The contingent capital requirement is therefore in addition to the requirements on permanency, loss absorption, no delay in committed contributions, alignment of (preferred) distributions, no intra-group support and no acceleration of repayments. The specific requirement for contingent capital mechanisms is set forth in article 51, paragraph 1 (n) CRR that determines the following:

“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 Common Equity Tier 1 instruments”

It should be noted that none of the phrases of this provision refers to the actual status in which a bank must be, before the contingent capital mechanism becomes effective. The text of this provision is neutral as regards the status, it does not, in other words, refer to problematic situations with a bank requiring extraordinary measures justifying the cancellation of rights of creditors of the bank. The simple reference to the “trigger event” requires an in-depth analysis of what is meant with this term. Also reference is made to permanent or temporary write down or conversion of the AT1 capital instruments.

This means, that it is the intention of the legislator, that AT1 capital instruments written down, or subject to a conversion in CET1 must be eligible to be reinstated back in the form of AT1 capital instruments once the circumstances with bank so justify. This is a clear indication that the contingent capital mechanism, is not only intended to permanently resolve situations with a problematic bank. The mechanism should allow that creditors are forced to move up the ranks of a less subordinated position, improving the terms and conditions that apply to those creditors at a certain point of time. By nature this means in my view, that the contingent capital mechanism as laid out in these CRR provisions aim to address a situation where a bank is conducting its operations *going concern*.⁷⁷

Further rules about the various elements of this contingent capital mechanism are laid out in the lengthy provision of article 54 CRR.

7.3.2. The trigger event of article 54 CRR

Perhaps the most important provision regulating the scope of application of the contingent capital mechanism under CRR, concerns the definition of the “trigger event” in article 54, paragraph 1 (a) and (b)

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See also the explanations given in the Impact Study conducted by the European Commission in support of the CRR proposals, where it is noted as follows: “In their responses to the consultation on the eligibility of instruments for CET1 capital, several public authorities and many industry respondents stated that greater onus should be placed on the substance of a capital instrument, e.g. its ability to absorb losses effectively, than on its legal form. As regards eligibility of Additional Tier 1 capital instruments, there was a significant support among public authority respondents for all such instruments to be required to have a principal write-down or conversion feature with an objective trigger, in line with the approach taken in CRD II, in order to ensure that such instruments absorb losses effectively and help an institution to remain as a going concern.”, Commission Staff Working Paper; Impact Assessment accompanying the document Regulation of the European Parliament and the Council on prudential requirements for the credit institutions and investment firms, 20 July 2011, SEC(2011) 949 final.

CRR. The trigger event is defined as the factual situation when the CET1 capital ratio referred to in point (a) of article 92, paragraph 1 CRR falls below either (i) 5.125% or (ii) a higher level set at the discretion of the bank and as set forth in the (contractual) terms and conditions of the capital instruments issued.

The first comment to be made is the definition of the level of CET1 capital set at the minimum of 5.125% whereby there is a reference to the generic quantitative capital requirements provision of article 92 CRR. In that CRR provision the minimum level of CET1 capital has been set, as discussed in paragraph 5 of this chapter, at 4.5% and not at 5.125%. How to explain this discrepancy? There is no true clarity about this particular topic to be found in the background materials of CRR. In my view the way the provision of article 54, paragraph 1 (a) CRR is drafted confuses the matter. Rather the language that the legislator should have used in this provision, is making a reference to the provisions detailing the (qualitative) requirements for CET1 capital instruments, especially the provisions of article 28 CRR. So the provision of article 54, paragraph 1 (a) should read, in my view, to refer to "CET1 capital within the meaning of article 28 CRR falls below 5.125%".

Such a reading of this provision makes sense in view of the fact that with the introduction of the CRR, banks will be required to maintain significant higher levels of CET1 capital than as regulated in article 92 CRR. Such higher levels of CET1 stem from the requirements of the additional capital buffers, such as the capital conservation buffer regulated in articles 128 and further of the CRD IV directive. A capital conservation buffer (which ultimately will be 2.5% in addition to the capital requirements for ordinary exposures) must be maintained in the form of CET1 capital instruments. Effectively, all European banks will eventually be required to maintain at least 7% of CET1 capital, being the 4.5% CET1 as defined in article 92 CRR for ordinary exposures in the banking book or in the trade portfolio and 2.5% to maintain the minimum level of the capital conservation buffer. This is separate from any other requirements following from other capital buffers, which also need to be maintained in the form of CET1 capital.

It is, in my view, not without coincidence that the percentage of 5.125 for the trigger event of the contingent capital mechanism is chosen. This percentage interest is equal to the minimum CET1 capital requirement of 4.5% and the first tranche of the capital conservation buffer of 0.625% to be reached in the course of 2016 and the 5.125% level represents therefore the minimum scenario of regulatory capital to be reached within a relatively short period of time. The reasoning of the European Commission may have been (although there is no clear reference in public sources for this view), that banks that would face difficulties to meet the CET1 level of 4.5% accumulated with the first tranche of 0.635% of the capital conservation buffer, would be helped by the contingent capital trigger that would proportionally, if there is a conversion mechanism in place in respect of the AT1 instruments issued by that bank, result in a permanent or temporarily increased CET1 capital compartment.

Another comment to be made in respect of the trigger event, concerns the language contained in the second limb of paragraph 1(a) describing the trigger mechanism. The second limb discusses the possibility that the bank issuing AT1 capital instruments would formulate in the terms and conditions a higher trigger event, by determining that if CET1 drops below of a higher level than 5.125%, then the conversion or write down mechanism applies to the AT1 instruments. Such higher trigger event would then result in a quicker recapitalization of the bank, even if the level of CET1 is relatively high. There has been quite some activity on the capital markets that shows that such high trigger contingent capital instrument in the form of AT1 capital instruments are likely to be used by banks in the future. Some examples of contingent capital instruments issued concerned an issue of Tier 2 capital instruments with a high trigger of 7% CET1. The

first issue of such instruments have been made already in 2010⁷⁸ and since then further similar issues of high trigger Tier 2 notes have been made. Most of the issues of AT1 capital instruments in Europe made thus far, contain the CRR trigger of 5.125% albeit that the first high trigger issues of AT1 instruments are being placed in the markets as well.⁷⁹

7.3.3. Conversion to CET1 Capital Instruments

As noted here above, the contingent capital mechanism requires the issued AT1 capital instruments either to convert into CET1 capital instruments, or to contain a write down mechanism. The conversion mechanism requires the conversion into CET1 capital instruments, in fact this will in most of the circumstances mean that debt instruments issued by the bank will convert into shares issued by the bank. Such shares must meet all the requirements of CET1 capital instruments. Therefore the issue of CET1 capital instruments upon conversion of the AT1 capital instrument must be in the same form and under the same conditions as other CET1 capital instruments outstanding prior to the conversion.

Because of the requirement that the CET1 instruments issued upon conversion to the holders of the AT1 instruments must meet all the criteria of article 28 CRR, this effectively means that the CET1 issued upon conversion will need to be aligned in a number of respects with the CET1 instruments outstanding prior to conversion. For instance the CET1 capital instruments issued upon conversion must be perpetual (article 28, paragraph 1 (e) CRR), they may not be subject to reduction or repayment except in case of liquidation of the bank or upon obtaining approval of the regulatory authorities (article 28, paragraph 1(f) CRR) and there is no term that the holders of the CET1 instruments upon conversion are entitled to preferential distributions (including in relation to other CET1 instruments) or other fixed claims for distribution of dividend (or comparable distributions) unless these distributions are made to other holders of CET1 instruments as well (article 28, paragraph 1, (h) CRR).

In brief, the holders of AT1 capital instruments that are notified by the bank that a trigger event occurred and that are required to accept conversion of their debt instruments to equity of the bank, will upon such conversion have a claim on the bank that ranks, *pari passu*, with all the other holders of CET1 capital instruments whether this claim concerns principal or dividend or other distributions by the bank.

⁷⁸ See: Rabobank of the Netherlands issue of contingent convertible capital instruments at a very early stage of development of the laws requiring banks to issue contingent capital instruments with a trigger referring to the drop in the regulatory capital ratio. This was the first issue of a “high trigger” contingent capital instrument that targeted to improve the Tier 1 capital of the bank whereas Lloyds Banking Group in the UK was among the first institutions to issue in late 2009 a low trigger contingent capital instrument. See for a further debate: Coffee, op cit. p. 45 et seq. See furthermore for high trigger Tier 2 contingent capital instruments: Credit Suisse Tier 2 Buffer Capital Notes, www.credit-suisse.com/investors. See for another issue of these notes: RPT-Fitch Rates Credit Suisse AG’s Tier 2 Low-trigger Contingent Capital Instruments ‘BBB+(EXP)’, Reuters 29 July 2013, www.reuters.com/assets. As may be observed, there is some semantic difference in the naming of the trigger. Some of the published materials refer to a “low trigger” in the sense that there is a low threshold to step over before the trigger is occurring (a high capital requirement as trigger, results into a faster occurrence of the write down or conversion mechanism becoming applicable). Others refer to “high trigger” to refer to high numbers of CET1 capital being the trigger definition. I concur with the latter way of describing these triggers, which is also consistent with the language used in article 54, paragraph 1(a) second limb CRR.

⁷⁹ See for a “low trigger issue” the 1.75 billion euro and 1,25 billion US Dollar issue made by Deutsche Bank AG in May 2014 (€1,750,000,000 Undated Non-cumulative Fixed to Reset Rate Additional Tier 1 Notes of 2014 and U.S.\$1,250,000,000 Undated Non-cumulative Fixed to Reset Rate Additional Tier 1 Notes of 2014), prospectus dated 26 May 2014, www.db.com/ir/en and for a “high trigger issue” the Barclays issue of €1,076,730,000 6.50% Fixed Rate Resetting Perpetual Subordinated Contingent Convertible Securities (Callable 2019 and Every Five Years Thereafter), prospectus dated 17 June 2014, www.barclays.com/content/dam/barclayspublic/InvestorRelations.

7.3.4. Write down mechanisms of article 54 CRR

Write down mechanisms incorporated in the terms and conditions of AT1 instruments will result in a permanent, irrevocable extinguishing of the claims to principal and interest coupon on the debt instruments once the trigger event occurred. With this drastic measure, the capitalization of a bank improves, as the proportion of subordinated debt decreases and (therefore) the proportion of CET1 capital increases. The write down mechanism therefore equally contributes to a recapitalization of the bank in a similar way as the conversion of AT1 capital instruments to CET1 capital instruments.⁸⁰

Clearly, for existing investors in CET1 capital instruments issued by the bank, a write down mechanism is the favorable structure for to be issued AT1 capital instruments. The write down mechanism ensures that dilution effects for the existing holders of CET1 capital is reduced or even wholly prevented. For these reasons, the issue of AT1 capital instruments with a write down mechanism may not be the preferred structure from the perspective of a bank, as it may be expected that pricing of the AT1 instruments containing a write down mechanism, will be less favorable than AT1 capital instruments containing conversion mechanisms.⁸¹

Article 54, paragraph 1 (d) CRR contains a list of the requirements to be met in respect of the write down mechanism. It clarify, amongst others, that the subordinated claim to principal exercisable by the creditor in the event of an insolvency or liquidation of the bank, must be reduced entirely. Effectively this means that the holders of AT1 capital instruments subject to a write down after the trigger event occurred, will lose all of their claims, even after the bank is declared subject to insolvency or subject to liquidation.

One of the further requirements for the write down mechanism is set forth in article 54, paragraph 4 CRR. This provision determines that the write down should result in a full restoration of the CET1 ratio of the institution to 5.125%. Again this percentage of the ratio refers in all likelihood to the combination of minimum CET1 capital as required in article 92 CRR and the first tranche of the capital conservation buffer of 0.625%. If the restoration of the CET1 ratio may be achieved with a write down of a lower amount of principal of the AT1 capital instruments subject to such write down, then a partial write down may be effected too.

7.3.5. Other requirements

Other requirements concerning the contingent capital mechanism attempt to ensure that no impediments exist or are raised upon the application of the conversion or write down mechanism. Such impediments must be taken away upon issue of the AT1 capital instruments. In many respects this means that a bank issuing AT1 capital instruments must properly consider the applicable company law provisions

⁸⁰ In US literature one could see an almost 'natural' aversion against the principles of write down of debt. The very first contingent capital instrument that contained such a feature, Rabobank's issue in 2010 of contingent convertible bonds with a high (7%) trigger faced quiet some critics although the issue was oversubscribed many times and the yield to be paid to investors was relatively favorable for Rabobank. Commentators argued that Rabobank was able to place these instruments successfully because of its (then) existing AAA-rating and the fact that it was (therefore) unlikely that Rabobank would face difficulties triggering the contingent capital mechanism. See for a further analysis of this issue and references to the comments in the markets: Coffee, *op cit*, p. 45-47. In the commentaries delivered on this particular issue, little attention has been paid to the fact that Rabobank is a cooperative bank who at the time of the first issue of its contingent convertible debt could not place instruments that would convert into equity listed on a stock exchange. Many European banks (some of them are rather large and classified as systemically important institutions) are organized in the form of a cooperative and will, by nature, only be able to issue contingent capital instruments with debt write off features.

⁸¹ See for instance the comments in the press after the second issue of contingent capital bonds with a write down mechanism by Barclays Bank: "Appetite for the deal was likely to have been tempered by the fact Barclays has indicated it could do other cocs, possibly including an equity conversion version that might appeal to a broader group of investors", *Financial Times*, 4 April 2014, www.ft.com.

to ensure that there is no obstacle on the way to application of the contingent capital mechanism. See for further detail the provisions of article 54, paragraphs 5, 6 and 7 CRR.

8. Bail in mechanisms after adoption resolution or recovery mechanisms BRRD

8.1. Introduction

In this paragraph we will briefly comment on the bail in mechanisms set forth in the BRRD. A discussion of these mechanisms in the context of the ordinary capital requirements for banks pursuant to the CRR, makes sense, as it clarifies some of the underlying concepts of the BRRD mechanism in a better way. However, we are not discussing all the features of the bail in mechanism in the whole context of the BRRD, for which other chapters in this book provide a better and more comprehensive discussion. For instance we will only briefly touch upon the concept of banks being “beyond the point of non-viability” as being an important trigger for the bail in mechanisms to be put in motion. But for a thorough discussion about the instance and circumstances where bank recovery and resolution mechanism come into force, reference is made to other chapters.

The background of contingent capital instruments has been explained in detail in this chapter. The most important motive for introduction of the “bail in” mechanisms for banks that are facing difficulties to continue operations (going concern) has been highlighted already a number of times in earlier paragraphs of this chapter. It has been one of the important motives of the BCBS to introduce the contingent capital mechanism in a time where it became clear that very significant rescue operations for banks were needed in order to avoid further development of turmoil in the financial markets. At the occasion of the rescue operations being put in place, it became evident that bank regulatory capital requirements fell short of obligating investors in bank’s capital to join in the burden sharing when difficulties with banks arose.

The motives set out in many studies and reports on the subject matter which have been cited in a number of cases here above are reiterated to a great extent in the background recitals of the BRRD. In recital (67):

“An effective resolution regime should minimise the costs of the resolution of a failing institution borne by the taxpayers. It should ensure that systemic institutions can be resolved without jeopardising financial stability. The bail-in tool achieves that objective by ensuring that shareholders and creditors of the failing institution suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the institution. The bail-in tool will therefore give shareholders and creditors of institutions a stronger incentive to monitor the health of an institution during normal circumstances and meets the Financial Stability Board recommendation that statutory debt-write down and conversion powers be included in a framework for resolution, as an additional option in conjunction with other resolution tools.”

The language used in the BRRD is sharper in its nature, where it is suggested that shareholders and creditors should “suffer appropriate losses”. This deviates from the background motives as set out in the BCBS documents from which we cited here above and it also deviates from the CRR language used to address this subject matter. In the BRRD the bail in mechanism is placed in the context of penalization of creditors and shareholders, rather than a burden sharing mechanism that was the original concept of the international authorities advocating the contingent capital mechanism. The BRRD language also overestimates the influence that shareholders and creditors may have in monitoring the financial health of banks in going concern situations. As explained here above, investors in regulatory capital have little

influence on the course of affairs of banks and must accept rather strict reduction of rights exercisable towards the bank when purchasing regulatory capital instruments.⁸²

8.2. Bail in going concern and gone concern

The BRRD provides for numerous scenarios that may apply to a bank that is facing difficulties to continue its operations. The bail in mechanism requiring shareholders and creditors to cooperate with a reduction of their rights may also be applied in numerous circumstances. Where the original concepts of the contingent capital mechanism had been, that such mechanisms should in principle be applied when the “point of non-viability” of a bank was reached and the bank’s business must be considered gone concern, numerous references in the BRRD for application of the bail in mechanisms in a partial or whole ‘going concern’ situation can be found too. The BRRD bail in mechanism can therefore play a role in going concern as well as in gone concern situations. In recital (68) of the BRRD this is expressed as follows:

“In order to ensure that resolution authorities have the necessary flexibility to allocate losses to creditors in a range of circumstances, it is appropriate that those authorities be able to apply the bail-in tool both where the objective is to resolve the failing institution as a going concern if there is a realistic prospect that the institution’s viability may be restored, and where systemically important services are transferred to a bridge institution and the residual part of the institution ceases to operate and is wound up.”

From this recital it clearly appears that the BRRD bail in mechanisms may be applied in a wider range of circumstances than the original concepts as developed by the BCBS intended to achieve. The principal mechanism as laid out by the BCBS is to force shareholders and creditors of a bank that is made subject to a rescue operation requiring tax payer monies to be made available for the capitalization of the bank, to participate in the loss absorption to the fullest extent with this one attempts to avoid that shareholders or creditors of a rescued bank would be in the position that their claims on the bank would revive after the rescue operation would be performed and the bank would successfully return to become a viable business.

The BRRD has made the circumstance where the bail in mechanism may be applied much broader and, therefore, deviates from the internationally agreed upon background and motives for contingent capital mechanism applicable to banks. The purposes of the bail in tool are set forth in article 43, paragraph 2 of the BRRD as follows:

“Member States shall ensure that resolution authorities may apply the bail-in tool to meet the resolution objectives specified in Article 31, in accordance with the resolution principles specified in Article 34 for any of the following purposes:

- (a) to recapitalise an institution or an entity referred to in point (b), (c) or (d) of Article 1(1) of this Directive that meets the conditions for resolution to the extent sufficient to restore its ability to comply with the conditions for authorisation (to the extent that those conditions apply to the entity) and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU,

⁸² Coffee, op cit, pp. 33-37 however, does emphasize that contingent capital may have effects on disciplining shareholders from exercising undue pressure on bank’s management to take undesirable risk. One of the comments he makes on p. 35 is: “This potential wealth transfer [after conversion holders of debt take a significant position as holder of equity capital and dilute existing (common) shareholders, add. author], is intended to deter the equity from approaching the trigger points at which conversion would occur — and thus disincentivize them from increasing risk and leverage”.

where the entity is authorised under those Directives, and to sustain sufficient market confidence in the institution or entity;

- (b) to convert to equity or reduce the principal amount of claims or debt instruments that are transferred:
 - (i) to a bridge institution with a view to providing capital for that bridge institution; or
 - (ii) under the sale of business tool or the asset separation tool.”

The resolution objectives of article 31 BRRD are not necessarily restricted to the avoidance of development of systemic risk in the financial markets, but may also relate to other objectives. The avoidance of system risk is, as noted here above, one of the main (if not the exclusive) driver for the introduction of the bail in mechanisms as suggested by the BCBS in August 2010. For instance the resolution objectives under the BRRD may also relate to the protection of rights of depositors having claims on the bank, with the exception of depositors not protected by the deposit guarantee scheme of Directive 2014/49/EU⁸³ or investors protected by the investor compensation scheme of Directive 97/9/EC⁸⁴. Another resolution objective is to ‘ensure the continuity of critical functions’. This may be relevant for banks that are not systemically important, but whose insolvency may nevertheless cause significant issues in the markets or in the provision of services to customers. One could for instance think of a bank that plays an important role in the payments system in a certain member state of the EU.⁸⁵

8.3. Bail in principles of article 34 BRRD

The application of the bail in principles set out in article 34 BRRD are important for the mechanisms to be applied in the bail in operation. Five of the principles concerned are relevant in this respect. These are listed below by citing the provision of article 34, paragraph 1 BRRD in an abbreviated way:

“Member States shall ensure that, when applying the resolution tools and exercising the resolution powers, resolution authorities take all appropriate measures to ensure that the resolution action is taken in accordance with the following principles:

- (a) the shareholders of the institution under resolution bear first losses;
- (b) creditors of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings, save as expressly provided otherwise in this Directive;
- (f) except where otherwise provided in this Directive, creditors of the same class are treated in an equitable manner;
- (g) no creditor shall incur greater losses than would have been incurred if the institution or entity referred to in point (b), (c) or (d) of Article 1(1) had been wound up under normal insolvency proceedings in accordance with the safeguards in Articles 73 to 75;
- (h) covered deposits are fully protected”

There is a close connection, as far as the position of providers of regulatory capital is concerned, with the provisions of the CRR as regards the subordinated treatment of claims held by investors in CET1, AT1 and

⁸³ Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, Pb.EU L. 173 of 12 June 2014, p. 149-178.

⁸⁴ Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes, OJEC L. 84 of 26 March 1997, p. 22-31.

⁸⁵ See: the definition of ‘critical functions’ in article 2(35) of the BRRD: “means activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross-border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations”.

Tier 2 capital instruments. As we have noted in previous paragraphs, the subordination mechanism of those regulatory capital instruments all require that the terms and conditions provide for a full cancellation of claims of the holders of capital instruments, both as relates principal and dividend, interest or comparable claims, in case of an insolvency or liquidation procedure. There is no doubt, that in this respect the resolution principles of the BRRD as set out in article 34, paragraph 1 will be met in those cases where a bank issued CET1, AT1 or Tier 2 capital instruments. For the fulfilment of the principles of the BRRD it is also unlikely that the national laws of the member states of the EU must be revised or supplemented with language to implement the provision of article 34, paragraph 1 BRRD, as the CRR provisions already are directly applicable and have binding vertical and horizontal effect.

As we will note in paragraph 8.5, the position of other creditors than the regulatory capital financiers must be addressed separately in the national laws of the EU member states. For subordinated creditors holding claims pursuant to capital instruments or loans not meeting the CRR requirements for AT1 or Tier 2 capital instruments and for other ordinary creditors, the principles of article 34, paragraph 1 BRRD are not likely to form already part of the national laws of the member states and therefore specific provisions of national law must be introduced.

8.4. Contractual triggers versus statutory triggers

Perhaps one of the most complex issues concerning contingent capital concerns the question whether or not conversion or write off mechanisms are enforced by contractual or by statutory obligations. In other words, what is the basis for the fact that creditors must accept at a certain point of time that their claim vis-à-vis the bank is reduced, cancelled or extinguished entirely once the contingent capital mechanisms are put in motion? As we have highlighted in a number of instances in this contribution, one could take the view that there is a double basis for such mechanisms, it is both a contractual mechanism and a statutory mechanism.

The clearest analysis of this issue has been delivered by Bates and Gleeson in 2011 where they define this issue in the context of bail-in instruments as follows:

“It might be possible in some jurisdictions – including possibly the UK – to create a bail-in regime entirely by private contract by including the relevant provisions in debt instruments issued by the entity and in the constitution of that entity. However, this would give rise to some interesting legal conundrums, since the issuer would be seeking to create debts on terms allowing the debtor, at its discretion, to eliminate all or part of the debt and to replace that debt with new shares. Even if this were possible, it seems unlikely that it would be acceptable to those creditors or the entity’s shareholders that such a regime could be operated by the board of the relevant company entirely in its discretion, and even more unlikely that, in the context of the modern law on directors liability, any board of directors would in practice be prepared to exercise such a discretion. Thus even if the regime were based entirely on private law, it seems likely that the contractual provisions would need to be structured so that the initiation of the bail-in is triggered by an external act of an appropriate regulator or other public body and to ensure that any discretion about the extent of any necessary writedown or any compensatory issue of equity is also exercised by the authorities rather than the board. This would almost certainly create procedural and technical difficulties for public authorities, who in many cases would perceive unacceptable risks to acting pursuant to private rights rather than public obligations.

An alternative approach would be to provide for bail-in by legislation. Bail-in backed by legislation has a number of appealing aspects – in many jurisdictions legislation will be necessary to deal with company law issues, and legislative backing would clearly underpin market confidence in the robustness of a bail-in. However legislation is an imperfect solution for all but the smallest banks, since for the majority of banks a significant portion of

their senior debt is likely to be governed by laws other than that of their place of incorporation – for example most large continental European banks are likely to have bonds governed by English or New York law.”⁸⁶

It is based on these thoughts that I have reiterated in this contribution that both for contingent capital instruments under the ordinary regime for regulatory capital — particularly the provisions applicable to AT1 capital instruments — as well as for bail in instruments applied to creditors (no matter which status these creditors have, whether they are contributors to the regulatory capital or if they are common creditors), for the contingent capital or bail in mechanisms to be legally enforceable and effective, an ‘hybrid’ application of both contractual provisions and statutory provisions is necessary.⁸⁷

As for bail in mechanisms applicable once a resolution process is being initiated, one could not refer to the application and effectiveness of statutory provisions only for the determination in which way the rights of bank’s creditors are reduced, cancelled or extinguished entirely. In my view there must be a basis in the relevant contractual terms and conditions too. This particular ‘hybrid’ construction of contractual and statutory law has been acknowledged by the European legislator as well, but only for certain cases.

In article 55 (Contractual recognition of bail-in), paragraph 1 BRRD, the following provision is given:

“Member States shall require institutions [...] to include a contractual term by which the creditor or party to the agreement creating the liability recognizes that liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or amount outstanding due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority [...].”

The relevant requirement is particularly relevant for all those instances that banks enter into contracts with external financiers of “eligible liabilities” where the contractual terms and conditions are governed by the “law of a third country”. For instance a German bank issues debt instruments in the US capital markets (e.g. a US Dollar denominated medium term bond) where the terms and conditions are (as is customary) governed by the laws of New York. For such a debt instrument, the German bank shall be required to include in the contractual terms and conditions provisions to support the potential application of bail in mechanisms effected by the resolution authority responsible and authorized for the resolution of the German bank. The European legislator has recognized that in such cases, one cannot rely (only) on the binding effect of the laws in the European Union for investors in other jurisdictions. The obligations of investors must be enforced by imposing specific contractual provisions in such instance.

At least for this example of an international financing arrangement involving an European bank seeking financing in the international capital markets, the European legislator is not confident that the mere application of statutory provisions applicable pursuant to the transposition of the BRRD in the laws of the Member State where the bank is established, suffices to enforce the bail in mechanism towards the external creditors. In my view this issue is also relevant for other situations where there is no connection to a jurisdiction outside the European Union. This is particularly caused by the fact that the European legislator has (unfortunately) chosen to use the instrument of a European directive for the implementation of the recovery and resolution schemes in the Members States of the European Union.

⁸⁶ Bates and Gleeson, op cit, p. 269-270.

⁸⁷ See also: Bates and Gleeson, op cit, p. 270 where they have based their reasoning also on the complexity of the laws governing the relevant contractual relationship between the banks and investors in the (capital) instruments or the lenders of (subordinated) debt borrowed by banks. For internationally operating banks it shall be necessary that any contractual obligation of a creditor to accept bail in or contingent capital mechanisms must be backed up by statutory law provisions in the jurisdiction where the relevant bank is established.

Directives do not have direct horizontal effect and it will therefore be dependent as to how national laws of the Member States may contain sufficiently 'mandatory effect' to set aside contractual terms and conditions once a bail in mechanism would apply to the creditors concerned having lent monies to the bank.

In line with this reasoning, it is my view that for regulatory capital instruments structured and issued in conformity with the CRR provisions for CET1, AT1 and Tier 2 capital instruments and (subordinated) loans, less doubt will exist as to the effectiveness of the bail in mechanism. This is caused by the fact that contractual obligations governing the relationship between shareholders and creditors on the one hand and the bank on the other hand, are backed up by the direct horizontal effect of the statutory CRR provisions. Even if the contractual terms and conditions would be ambiguous or multi-interpretable, the CRR provisions will ultimately determine the consequences of the bail in mechanism applied to the bank. In my view, there is also to a certain extent redundancy in the BRRD provisions that attempt to reconfirm the principles of contingent capital as set out in the CRR, certainly if it concerns AT1 instruments.

As explained in previous paragraphs, none of the requirements for Tier 2 instruments impose to include in the terms and conditions a contingent capital mechanism, requiring the holders of Tier 2 debt to accept either conversion of the debt into equity or to accept write down of the principal and coupon. Nonetheless, the recent activity in the capital markets has demonstrated that a large number of European institutions commenced to introduce Tier 2 capital instruments containing contingent capital features. Some of those Tier 2 instruments convert to equity at the reaching of low triggers, others even convert when relatively high triggers are reached (the dropping of the Tier 1 ratio below 7%).

Interestingly, institutions opting for such contractual enforcement of contingent capital features are not basing their funding policies on mandatory requirements following from the CRR. Rather, the introduction of the contingent capital contractual mechanism is based on voluntary choices. Institutions that introduce these contractual mechanisms with "high triggers" even take a more aggressive stance as regards the revision of the common principles of ranking of obligations of the bank towards its shareholders and creditors. Rights and obligations of holders of CET1 and AT1 capital instruments of these institutions are determined by the CRR provisions and contractual back up of these mandatory rules. Holders of Tier 2 capital instruments with high trigger contingent capital features even effect a greater dilution of the rights of holders of the CET1 and AT1 capital instruments beyond the mandatory qualitative capital requirements.

In my view, institutions following these strategies wish to anticipate on the introduction of the bail in regime of BRRD. By taking the lead in reshaping the regulatory capital base of the institution voluntarily introducing regulatory capital instruments beyond mandatory qualitative capital requirements, they attempt to avoid the detrimental effects of application of the resolution tool of bail in. These strategies may well be a response of the market to the perceived undesirable effect of introducing uncertainties for the common creditors of the bank as a result of their potential participation in bail in as imposed by the authorities once the BRRD provisions come into effect. The uncertainty is about the lack of a mandatory rule (at least as far as the provisions of the BRRD is concerned) to revise or amend the contractual terms and conditions of financing instruments qualifying as ordinary debt issued by banks to address the potential impact of bail in as imposed by the resolution authorities for those creditors.

In such circumstances it is easier for a bank to place new Tier 2 instruments in the markets containing clear contractually enforceable provisions as regards the contingent capital mechanism, than to repaper

existing contractual relations with ordinary creditors. Such repapering exercise would not be backed by mandatory law provisions. Such repapering would, therefore, need the consent of the creditors concerned. Absent a mandatory law provision enforcing such consent to be provided (or replacing it), banks would be either too dependent on the cooperation of the creditors. Banks could also take the risk of relying on interpretations as regards the effectiveness of the provisions of the national laws implementing BRRD giving the resolution authorities the (superior to contractual rights) authority to extinguish the rights of common creditors once the bail in comes into force. Such reliance on the effectiveness of statutory law will be, at least, qualified to the extent complexities arise in international transactions involving multiple jurisdictions and international private law complexities not covered by article 55 BRRD.⁸⁸ In other words, article 55 BRRD is flawed to the extent that it only imposes obligations on banks to consider implementing contractual bail in mechanisms for debt obligations where there is a relation with a third country creditor.

8.5. Bail in mechanisms for regulatory capital providers under the BRRD

When referring in the previous paragraph to the fact that for the application of the principles of article 34(1) BRRD as regards the bail in mechanism, there is no need to introduce provisions in the national laws of the EU member states, this does not mean that the application of the bail in mechanisms of the BRRD as regards regulatory capital instruments will follow automatically from the CRR provisions. This is, obviously, not the case. Rather, the various rights and obligations attached to regulatory capital instruments as provided for in the CRR are likely to form the foundation of bail in mechanisms carried out under the BRRD, but CRR rules concerning the reduction or limitation of claims of holders of CET1, AT1 or Tier 2 instruments are complimentary to the BRRD regime and does not substitute the BRRD regime.

The concurrent principles of CRR and BRRD makes it also very complex to analyze what the exact consequences are for holders of the CET1, AT1 and Tier 2 capital instruments in a situation where a resolution mechanism is applied towards a bank and where the resolution authority decides to apply the bail in tool as set forth in article 37, paragraph 3 (d) BRRD. This is certainly the case if the bail in mechanism is applied after some of the 'bail in features' of the ordinary CRR provisions already have been put in motion in the past. For instance, a situation may occur where a bank has notified the holders of the AT1 or Tier 2 capital instrument holders, that a trigger event has occurred and that the principal sum of the capital instruments needs to be converted into CET1 capital. Such trigger mechanism may be applied, as we have observed here above in circumstances where a bank is still properly capitalized and meets all the requirements to maintain sufficient levels of own funds under the provisions of the CRR. A subsequent application of the BRRD bail in mechanism may effectively result in a subsequent and additional reduction of claims of the holders of the CET1 capital instruments they obtained after the contingent capital mechanism has been applied pursuant to the CRR rules when a bank was still way before the 'point of non-viability'. Such subsequent application of bail in mechanisms, effectively results into a 'double dip' situation for bank regulatory capital providers. The BRRD bail in rules do not provide for protection of the position of the holders of CET1 instruments that they obtained after the application of the contingent capital mechanism prior to the application of the bank resolution regime under the BRRD.

It is noteworthy that in practice, some of the issuers of contingent debt capital instruments have introduced 'dual triggers', where the bank debt converts to equity based on either the (i) passing of the regulatory threshold for minimum capital or (ii) a decision of the relevant resolution authorities. With

⁸⁸ See Bates and Gleeson that seem to support this conclusion, *op cit*, p. 270.

such a contractually agreed upon 'dual trigger', the investors in such contingent capital instruments are clearly agreeing on the possibility that a double dip mechanism may be applied. Either their claims convert to capital in a going concern situation with the bank in case certain capital ratios are no longer met. Or the conversion takes place gone concern, when the resolution authorities have taken over the management of the bank⁸⁹ or where such resolution authorities wish to avoid the reaching of the 'point of non-viability'.

In article 45 BRRD (Application of the minimum requirement) it is determined that the member states of the EU must provide the resolution authorities the power to determine the "minimum requirement for own funds and eligible liabilities" that should be met by banks. This minimum requirement shall be "calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution (this means, amongst others a bank, *add. author.*)" With "own funds" reference is made to the Tier 1 and Tier 2 capital of the bank.⁹⁰ With "eligible liabilities" reference is made to the liabilities that may be in scope of the bail in mechanism (other than the "own funds" that are automatically in scope) pursuant to article 44, paragraph 1 BRRD. Eligible liabilities are, in brief, unsecured, non-preferred medium-term liabilities⁹¹ of banks, always with the exception of the part of the deposits covered by the deposit guarantee schemes applicable to the bank concerned.

The "resolution authorities" may determine the minimum requirement of own funds and eligible liabilities in order to make potentially applied bail in mechanisms upon a resolution proceeding being applied in the future effective. The reasoning is that once a bail in mechanism is applied, there should be sufficient room for conversion or write down of liabilities that either (i) a bank may be reinstated to act in compliance with the requirements for authorization or (ii) sufficient capitalization is available for a bridge institution or an acquiring bank pursuant to the application of the sale of business tool or asset separation tool. See the provision of article 43, paragraph 2 (a) and (b) BRRD for a description of this objective.

From the perspective of own funds requirements, this provision of the BRRD is a potential source of conflicts between views of the resolution authorities and the ordinary competent authorities that supervise banks for a number of reasons. Quantitative levels of regulatory capital are determined by the provisions of the CRR for ordinary risk exposures (see paragraph 5 for a brief comment on these requirements) and in respect of the additional capital buffers (that is the capital conservation buffer, countercyclical buffer and systemic risk and systemically important institution buffers) by means of the national law provisions implementing the CRD IV Directive. The regulations of the BRRD determining the powers of the resolution authorities in the member states provided for a separation of functions, in principle, of the resolution authorities on the one hand and the ordinary competent authorities on the other hand. See the provisions of article 3 BRRD for further detail in this respect.

⁸⁹ Such dual triggers in issued contingent capital particularly (and as far as I could investigate exclusively) are agreed upon in terms and conditions of Swiss Banks issuing contingent capital instruments. See for a further background of this: Deutsche Bank Research, 'Contingent Convertibles', 23 May 2011 in which it is stated: "Under the new Swiss capital regulations [...] CoCos were placed in the market in a comparable way for the first time, as opposed to previous issues of bonds similar in nature to CoCos. The CoCos featured a 30-year maturity, a coupon of 7.875% and a trigger deemed to have been met if the core capital ratio drops below 7%. Conversion may also be made if the national supervisory authority is of the opinion that the bank would reach the point of non-viability without such a swap."

⁹⁰ The definition of "own funds" in article 2, paragraph 1 (38) BRRD refers to the definition of "own funds" within the meaning of article 4(1)(118) of the CRR.

⁹¹ The liabilities should have a maturity of no less than 12 months, see article 45, paragraph 2 BRRD.

It is not clear whether the resolution authorities, applying the provision of article 45 BRRD as regards the minimum level of “own funds” may take different views about the levels than the national competent authorities on the basis of the CRR and CRD IV Directive provisions. In other words, how must banks deal with potentially conflicting views by the two different competent authorities if the views on the levels of own funds are conflicting? And furthermore, where the CRR and CRD IV Directive provisions on capital adequacy for banks are already a significant driver to force banks to increase levels of own funds, is the BRRD regime interfering with this process of recapitalization of banks that is the effective result of the Basel III-Capital standards? For instance, if a resolution authority determines that a bank must maintain the liabilities that may be subject to bail in mechanisms pursuant to the BRRD in the form of a certain percentage of “own funds” pursuant to the application of article 45, paragraph 6 BRRD that deviates from the ordinary CRR and CRD IV Directive levels, how will this conflict be resolved?

This is one of the examples where the introduction of the BRRD raises concerns as to whether or not the European lawmakers have sufficiently thought of the combined application of CRR and BRRD, certainly if one looks at the original motives of the new capital requirements for banks upon adoption of the Basel III-Capital standards.

8.6. BRRD Provisions fill the gap as regards contingent capital mechanisms for Tier 2 debt

As we have noted earlier in this contribution, one of the differences between the text of the Basel III and CRR concerns the regulation of the contingent capital mechanisms for Tier 2 debt instruments. As noted here above the original concepts promoted by the BCBS with respect to contingent capital instruments concerned all components of Tier 1 and Tier 2 debt; if a bank reached a point of non-viability, the debt instruments classifying as Tier1 and Tier 2 capital instruments must be converted to equity or wholly or partially been written off.

The text of CRR does not regulate the mandatory conversion of Tier 2 debt instruments or loans or the write off of principal of these debt instruments or loans if certain triggers are met. This is the reason why we refrained from including Tier 2 instruments in the description of the “loss absorption” characteristics of debt capital instruments as set forth in paragraphs 6.1 and 6.6.

The BRRD provisions bridge this gap between the CRR provisions and rules and the recommended consequences for the rights and obligations of holders of Tier 2 instruments or loans once a bank is reaching its point of not being viable. In this respect the provision of article 34(1) BRRD would be justified to be included in the national laws implementing the BRRD.

8.7. Bail in mechanisms for ordinary creditors under the BRRD

European politicians were keen to adopt a regime where the bail in mechanisms applicable in the case a bank is failing extends to ordinary creditors as well. With “ordinary creditors” is meant, all creditors that are not subject to the qualitative capital requirements provisions of the CRR as discussed in earlier paragraphs. This means that this may concern creditors with an ordinary claim on the bank that would rank *pari passu* with all other ordinary creditors, but it may also comprise subordinated creditors that exercise claims under a subordinated loan provided to the bank that is not eligible to be comprised in the Tier 1 or Tier 2 compartments of the regulatory capital of the bank.

For the definition of liabilities that may be within scope of the bail in mechanism, the BRRD provisions provide for a list of eligible liabilities in article 44 paragraph 2 BRRD. The list is drawn up as a negative list

of excluded liabilities that are outside the scope of applicability of the bail in mechanism applied if a resolution proceeding becomes applicable and the resolution authorities have decided to apply the bail in tool. In drawing up the list of liabilities excluded from the bail in mechanism, a number of choices have been made by the European law makers. The obvious exclusion concerns all depositors with a coverage under the deposit guarantee schemes applicable to banks in the European Union. Effectively this means that depositors will be protected against the bail in mechanism up to EUR 100,000 of the deposit made with the bank. Other obvious exclusions concern certain wage liabilities of banks towards employees of the bank and other comparable preferred claims that are customarily excluded in insolvency proceedings from the application of the principles of *concursum creditorum*.

The BRRD introduces a number of new principles applicable to bank's financing to regulate the subject matter of effective bail in mechanism. In this contribution, two of these innovative elements are discussed. Firstly it concerns the subject matter of quantitative requirements imposed on banks in respect of maintaining sufficient eligible liabilities that may be subject to bail in mechanisms. Secondly it concerns the qualitative requirements to be imposed on creditors that have an ordinary claim on a bank and that must be eligible for application of the bail in mechanism.

The quantitative requirements follow from the application of article 45, paragraph 1 BRRD that has been highlighted before when discussing the subject matter of effects of the bail in mechanism for the providers of Tier 1 and Tier 2 bank regulatory capital. The provision concerned determines the following:

“Member States shall ensure that institutions meet, at all times, a minimum requirement for own funds and eligible liabilities. The minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution.”

With “eligible liabilities” reference is made to the provision of article 44 paragraph 2 BRRD. These are the ordinary claims and subordinated claims of creditors that do not participate in the regulatory capital of the bank and that are not otherwise excluded from the bail in mechanism. Typically, this provision of the BRRD will have a significant influence on the manner in which banks will be capitalized in the future, as it will to a great extent determine, in my view, the costs of funds that banks may raise by means of savings from depositors not being protected by deposit guarantee schemes as well as by means of the issue of regulatory capital instruments and other debt instruments not qualifying as regulatory capital. Whilst depositors being covered by deposit guarantee schemes are protected against potential bail in mechanism to the extent of coverage (being EUR 100,000), any other depositors may face a threat that its claim may be comprised in the bail in mechanisms upon resolution of the bank. The pressures on the funding schemes by banks come from two sides. On the one hand, banks would like to encourage creditors to finance the bank with loans and deposits that may be excluded from potential bail in mechanisms in order to avoid the costs of funding to increase. On the other hand resolution authorities may impose on banks to have a significant tranche of eligible liabilities written in the books in order to make the bail in mechanism effective.

This detrimental effect of the BRRD is amplified by the second innovative element that I wish to highlight in this contribution. This concerns the qualitative requirements for “eligible liabilities” as set forth in article 45, paragraph 4 BRRD. In this provision the following list of requirements is set forth in order for liabilities to be eligible for bail in mechanisms:

“4. Eligible liabilities shall be included in the amount of own funds and eligible liabilities referred to in paragraph 1 only if they satisfy the following conditions:
(a) the instrument is issued and fully paid up;
(b) the liability is not owed to, secured by or guaranteed by the institution itself;
(c) the purchase of the instrument was not funded directly or indirectly by the institution;
(d) the liability has a remaining maturity of at least one year;
(e) the liability does not arise from a derivative;
(f) the liability does not arise from a deposit which benefits from preference in the national insolvency hierarchy in accordance with Article 108.”

The reference in this clause to “own funds” is a complete redundant and confusing one. All of the requirements listed in this provision are already regulated in the provisions of the CRR as discussed in earlier paragraphs. In this respect we take the view that for regulatory capital instruments, in so far as they have not already been subject to the contingent capital mechanisms prior to the entry into force of the resolution proceedings, the contractual and statutory backing of the obligations of the creditors holding such instruments rather follows from the original contract and the CRR provisions and not necessarily from the Member State law provisions implementing the BRRD. For other “eligible liabilities” this provision introduces a new concept of law that fundamentally deviates from the ordinary provisions of company law and contract law that usually govern the relationship between a bank and its (ordinary) creditors. These requirements effectively reduce the quality of the claim of the creditor on the bank and results into a shift of these claims to the compartment of high risk investments. Such loans or investments made by external financiers, will, consequently, be priced in accordance with this high risk profile and will, as noted here above, be resulting into high yielding debt obligations for the bank.

9. Conclusions

The long discussion of all the criteria of Basel III-Capital for the quality of CET1, AT1 and Tier 2 capital instruments and loans makes conclusions at the end of this chapter appropriate. As has been noted in a number of instances in this chapter, there are considerable differences in the exact language used in the Basel II-Capital standards and the provisions of the CRR. A careful weighting of all these differences, however, justifies the conclusion that in material respects the European lawmakers have attempted to follow the standards as formulated by the BCBS to a great extent. This means that European law should create as much as possible a level playing field for banks established or operating in Europe, as compared to the legislation adopting the Basel III-Capital standards for the quality of bank’s capital applicable elsewhere in the world, assuming adoption in conformity with the Basel III-Capital standards in those other jurisdictions.

However, there are differences to be noted. These particularly stem from the requirement of the European lawmakers to transpose the standards of Basel III-Capital into legal language that results in directly applicable and direct binding regulations to the institutions concerned as well as to the supervisory authorities and governments in the EU member states. Some of the concepts used in the CRR aim to place the provisions concerning the quality of bank capital in the framework of applicable company, contract and bankruptcy laws applicable in Europe. Sometimes the CRR rules refer to defined concepts in other bodies of European law, particularly the regimes applicable to public limited liability companies as set forth in the European company law directives.

Some of the criteria developed in Basel III-Capital reiterate principles that already applied prior to the adoption of Basel III. However, most of the criteria constitute the new body of standards applicable in this

respect providing much more detail in respect of the applicable restrictions and requirements as regards bank's regulatory capital. This approach of spelling out all the applicable criteria in this way, stems from the objective of the BCBS to create a clearer and less opaque regime as regards this important part of regulation of bank's businesses. The clarity provided, aims at managing expectations from market participants and investors' in bank regulatory capital in order to avoid constraints occurring in the future as regards the applicable regime in times of economic downturn or at the occurrence of a specific distressed situation with a bank.

Expectations needed to be managed, as politicians worldwide have reconsidered the paradigm of protection of investors' interests generally as concerns banks. This paradigm shift applies, as appears from the discussion in the above paragraphs, in all circumstances. It is not necessarily restricted to banks facing such status of financial distress that it compromises the continuity of going concern operations. It would be wrong to place the Basel III-Capital standards for bank's regulatory capital only in the context of banks facing severe difficulties. Rather, the new standards for the quality of bank's regulatory capital apply to all banks, whether they operate in prosperous circumstances or not. They aim at improving the resilience of banks generally and at a sector wide level. Basel III-Capital is addressed to internationally active (i.e: larger) banks. The CRR regulations have extended the Basel III-Capital requirements to all banks, whether internationally operating or not, whether small or big, whether operating a universal banking business with heterogeneity of business lines or banks operating a traditional homogenous lending business only.

In the political discussions that have been held in connection with the adoption of the BRRD, one could note observations that the bail in mechanism introduced intends to ensure that public (tax payer) monies would no longer be needed to rescue failing banks. Rather the 'private sector' should be fully absorbing the losses with such banks through the application of the bail in mechanisms. Bail outs of banks should be replaced with bail in processes. As noted here above, many politicians took the view that failures with banks should result in penalization of the private sector by imposing drastic measures. In these discussions it is often forgotten (or deliberately ignored) that Basel III-Capital and the implementation of these standards in the CRR already introduced far reaching limitations of the rights of the providers of regulatory capital financing to banks. In other words, the achievements of the BRRD introducing a bail in mechanism for these types of creditors are, in my view, rather concurrent with the already existing rules in the CRR for the qualitative requirements for CET1, AT1 and Tier 2 capital instruments and loans.

In my view the lawmakers in Europe have insufficiently addressed to potential competing and conflicting principles of CRR and BRRD with respect to capital requirements for banks. The provisions of the CRR and BRRD again result in a patchwork of provisions in Europe as regards capital requirements, where it has been the objective of the CRR to reduce the differences in the member states in the EU as much as possible. There are many examples in the provisions of the BRRD where these conflicts of laws and potential overlapping provisions can be observed. It would take too much space to address all of these BRRD provisions to the fullest extent. The example given in paragraph 8 (and my views are not limited to this example), demonstrates this issue in a clear way.

BRRD is also flawed as regards the subject matter of the effectiveness of the bail in mechanism that is not otherwise supported by clear contractual obligations of the common creditors concerned. As noted in this chapter, a hybrid application of both contractual rights and obligations and mandatory law provisions would be the most effective way in introducing enforceable bail in mechanisms that also encompass the

position of common creditors that are to be selected as being part of the sum of eligible liabilities that may be subject to bail in.

The developments in the capital markets as regards the price of the regulatory capital instruments compliant with the new Basel III-Capital requirements have demonstrated that banks pay a very significant price for the risks that creditors must take if they purchase capital instruments that meet the qualitative requirements for CET1, AT1 or Tier 2 capital. Pressures of resolution authorities to increase the levels of eligible liabilities, however, may result in the costs of funds for banks to increase with significant numbers too. In my view, the BRRD provisions in this respect result in somewhat circular consequences of the new laws introduced to address the resolution of banks that are facing difficulties to survive. Are these new BRRD rules not in fact igniting a structural defect for banks' financing possibilities at normal market prices for relatively risk-free financing?

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