

European Banking Authority Opinion on Legacy instruments

On the 21st of October the EBA released its long-awaited opinion on Legacy instruments which had been delayed by Covid 19.

Many investors and analysts were a bit puzzled by this opinion and did not really know what to expect.

- Would the Covid crisis lead the EBA to reaccept Legacy bonds in the capital stack?
- Would it change the new rules adopted in the Banking Package?
- Would the EBA incentivize banks not to call Legacy bonds in order to preserve capital in difficult times?

The EBA expressed a very clear opinion that Legacy bonds must be taken out, and rather sooner than later. In the words of the EBA *“for instruments with an issuer’s call option in the short to medium term, the EBA reasonably anticipates that institutions will use this possibility as a first option”*.

Globally, this opinion is very supportive of the Legacy asset class. You can find more details in the quick read below.

1 Why did the regulatory take such a hard stance?

There are two main reasons, in our view:

- **The first one** is obviously that banks have seen this coming: the Basel agreement organizing the grandfathering of Legacy bonds was released more than ten years ago! Again, quoting the EBA: *“it is the EBA’s assumption that the elimination of such legacy instruments from institutions’ balance sheets has been an important element reflected in their capital planning since 2014.”*
- **The second one** is highly technical, one could even say obscure, but also crucially important. **One major goal of regulatory reforms since 2008 has been to organize a smooth management of banking crises. This includes the resolution framework designed to settle a bank’s failure in a few days without triggering a systemic crisis.** This has been a success (even such high-profile failures as Banco Popular had no systemic impact) but raised legal questions due to the complex insolvency hierarchy of capital instruments which are bailed in. **To put it simply, authorities want to be able to treat creditors according to the “regulatory ranking” of the bonds they own (AT1, Tier 2, etc.) and not according to their “legal ranking”, which is usually defined in the prospectus.** Normally these two could coincide, but the end of the Basel 3 grandfathering period is messing up the entire system: bonds that were issued as (regulatory) Tier 1 bonds could lose their (regulatory) Tier 1 status to become e.g. Tier 2, but their (legal) Tier subordination status, defined in the prospectus, will not change. This is **what the EBA calls “infection risk”, i.e. the legal and regulatory rankings could be completely mixed up. This would threaten the eligibility of existing, normally fully eligible, capital instruments.**

Depending on the instruments, the EBA considers three options to manage that infection risk:

- **Option 1:** redemption of the bonds when a call date is available or bond buyback,
- **Option 2:** modification of the terms and conditions of the bonds (which requires bondholder’s approval) and,
- **Option 3:** in exceptional cases, when options 1 and 2 are not available (i.e. when there is no call option and a bond buyback has left some bonds outstanding), keeping the bonds but without using them as capital or MREL

The generally philosophy of the EBA’s opinion is clear, but, as always with Legacy bonds, the devil is in the details and some caveats apply.

We see three main issues:

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- In a document published on the 21st of October, **the UK announced that the EBA’s opinions will not be binding anymore as of the end of the transition period.** However, the PRA has expressed similar (but subtly different) views on this topic.
- **Some bonds could remain in a regulatory category that does not hinder the adequation of the regulatory and legal rankings.** For such bonds, the redemption will depend on other factors – such as compatibility with the new criteria set up in CRR2. **One key issue for such bonds will be the new grandfathering period applicable until 2025.**
- **In the context of BRRD2 transposition, some countries have been discussing the possibility of a blanket law which would align regulatory and legal rankings** – this is done on a country by country basis, as bankruptcy law is not harmonized at the European level. However, we are not sure this would effectively undermine the EBA’s opinion on legacy bonds. Indeed:
 - The EBA explicitly points out that *“regardless of how Article 48(7) of the BRRD is transposed in national law, it cannot be ruled out that [...] some ranking issues relating to legacy instruments [...] may still remain”*
 - Modifications of the insolvency rankings of existing bonds is likely to raise significant constitutional and property rights issues and member states could chose to align regulatory and legal rankings only for future bonds.
 - Some countries have explicitly stated that will not follow this route (the deadline for BRRD2 transposition is December 2020.)

Globally, this opinion is very supportive of the Legacy asset class. Banks will face a very high hurdle to justify not calling a bond after the end of the grandfathering period, even if the call is very expensive. However, we believe this will only happen gradually, **as banks need time to digest the content of this very technical opinion and the market will probably adopt a “show me the money” attitude – i.e. only giving full credit to the opinion when legacy calls become routine practice. Until then, we believe investment opportunities will remain.**

2 A reminder of risks specific to subordinated debt

Credit risk

Since the introduction of the Bank Recovery and Resolution Directive (BRRD), the risk of a bank being resolved is the greatest risk for a long-term investment in subordinated debt. In the event of resolution, default or deterioration of the credit quality of the issuers (for example, if their rating is downgraded by credit rating agencies), the bonds in which the fund is invested will decline in value resulting in a lower net asset value.

Coupon

It is possible that the coupon will not be paid (apart from any resolution scenarios).

Subordinated debt entitles holders to receive coupon payments at a specified frequency. In some cases, the issuer may cancel coupon payment(s). The non-payment of a coupon is irrevocable, at the discretion of the issuer or by bond (in cases related to rules restricting coupon payments based on regulatory capital levels).

Extension

It is possible that a bond issuer will fail to redeem a bond when expected. The initially promised maturity date may be extended. As a result, investors might recoup their capital at a later time than initially scheduled.

Interest rate risk

Investors are exposed to interest rate risk, meaning when market interest rates rise, the prices of bonds fall, thus lowering the fund’s net asset value. For an overview of the risks associated with investing in the Axiom funds, consult the “Risk Profile” section of the respective prospectuses.

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Glossary

1. **AT1 and RT1** - Additional Tier 1 and Restricted Tier 1 bonds are a new deeply subordinated debt format eligible for regulatory capital requirements/purposes under Basel 3 and Solvency 2. The instruments are designed to absorb losses in two ways: the first is via partial or complete suspension of coupon payment at the discretion of the issuer and the second is via either a (full or partial/temporary or permanent) principal write down or a (full or partial) conversion of the nominal amount into equity of the institution. The latter is triggered by a so-called quantitative capital trigger event with a predetermined regulatory capital ratio.
2. **Banking package** - In 2013, the regulatory framework on capital requirements and the eligibility of debt instruments drafted by the Basel Committee was supplemented by a Capital Requirements Directive (CRD4) and Capital Requirements Regulation (CRR) adopted by the European Parliament and Council. This legislation instituted a transition period between Basel II and Basel III and the gradual disqualification of legacy instruments. **On 16 April 2019, a new set of rules was adopted - the “banking package” (CRR2, CRD5, BRRD2)** - which defines and extends the scope of this legal framework. We wrote a note on that topic available on request at contact@axiom-ai.com.
3. **Calls** - capacity for the issuer to redeem a bond before maturity, usually – but not always – at par. Calls can either have a specific date or be triggered by regulatory, credit or tax events
4. **Grandfathering period** – this is the transition period after which old securities will no longer qualify as regulatory capital by 2022 for banks and by 2026 for issuance companies.
5. **Legacy bonds** - refers to hybrid debt that was eligible as regulatory capital under Basel 1 or Basel 2 and that is not eligible under Basel 3.
6. **Basel 1, 2, 3** - Under Basel 3, Common Equity Tier 1 is the strongest form of regulatory capital, comprising mainly share capital and retained earnings with some deductions as compared to accounting capital (such as deferred tax assets). The CET1 ratio is the ratio of CET1 capital to risk weighted assets.
7. **MREL** - MREL (Minimum Requirement for own funds and Eligible Liabilities) : A minimum requirement of own funds and securities eligible for capital under the BRRD directive.
8. **CRR2** - the Capital Requirement Regulation is a legal transposition of Basel 3 in the EU. As a regulation, it is immediately applicable.

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