AT1 Quarterly: legacy instruments, infection risk and usability of capital buffers

The capital positions of major European AT1 issuers have continued to strengthen despite the Covid crisis, underpinning comfortable buffers to MDA thresholds. Restrictions on paying equity dividends have helped but so have manageable levels of credit losses – so far. Key questions that have arisen include how usable capital buffers are if banks need to dip into them and at what price. And whether this period has created an opportunity to rethink the role and use of buffers. And as the first grandfathering period for non-compliant capital securities comes to an end, we also look for further clarity on the state of capital positions.

Legacy instruments and infection risk

We view positively guidance from supervisors encouraging banks to address outstanding legacy instruments that do not fully meet requirements to qualify as regulatory capital. This brings further clarity to the capital positions of banks and removes an unnecessary layer of complexity for investors. Consequently, we are likely to see further redemptions of outstanding legacy instruments.

The EU's Capital Requirements Regulation (CRR) incorporated grandfathering provisions to give banks sufficient time to meet new required levels and definitions of own funds. Recognition of non-compliant capital instruments has been phasing out since January 2014, with the transition period ending on 31 December 2021. For 2020, up to 20% of these instruments may qualify as own funds while in 2021, no more than 10% may qualify.

There are further refinements to the definitions of own funds in CRR II. More specifically, these aim to ensure that capital instruments issued by entities in third countries can be written down or converted into CET1 capital and that set-off or netting arrangements do not undermine their capacity to absorb losses. Another set of grandfathering provisions came into place, therefore, for non-compliant securities issued before 27 June 2019. The transition period extends until 28 June 2025.

As the first grandfathering provisions come to an end, the European Banking Authority (EBA) and the UK's Prudential Regulation Authority (PRA) have both raised concerns about outstanding legacy instruments and infection risk i.e. the possibility that legacy instruments affect the CRR eligibility of other regulatory instruments, disqualifying them as own funds or eligible liabilities. At the end of the transition period, legacy instruments may be cascaded down to a lower tier of capital or as eligible liabilities. For example, a grandfathered AT1 instrument may become a Tier 2 instrument or become eligible for MREL/TLAC purposes.

Flexibility regarding distributions and subordination criteria drive risk

Clauses in legacy instruments limiting the flexibility of distributions or subordination criteria may cause infection risk. The EBA points specifically to the case of Tier 2 instruments with reverse stoppers – distributions on these instruments must be cancelled if distributions are not made on AT1 or CET1 instruments. Reverse stoppers pose an infection risk to higher capital tiers as they create restrictions on issuers when they decide to cancel distributions on higher capital tiers. In this case, the flexibility to make payments on AT1 and CET1 instruments would be limited.

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Regarding subordination, CRR clearly specifies the ranking of CET1, AT1 and Tier 2 instruments. For example, AT1 securities must be subordinated to Tier 2 securities. Therefore, treating a legacy Tier 1 security as Tier 2 creates infection risk for the AT1 stack. The EBA has underscored that instruments must meet not only all eligibility criteria to be reclassified in a lower tier but also in the context of ranking rules for all other tiers.

Most likely solution is to redeem securities

To address infection risk, the EBA envisages the following solutions: (i) call, redeem, repurchase or buy the security back, (ii) amend the terms and conditions of the security, or (iii) retain on balance sheet as a non-regulatory instrument i.e. non-qualifying own funds and TLAC/MREL-eligible instruments. The third option is seen as the "last resort option" as it does not fully address the risk of infection.

Another solution: transposing Article 48(7) of BRRD

At the same time, the EBA acknowledges that transposing Article 48(7) of the Bank Recovery and Resolution Directive (BRRD II) may address these concerns (28 December 2020 deadline). National legislation could be introduced whereby ranking in insolvency is automatically amended based on a security's regulatory category. Some countries, including Germany and Spain, are following this approach. The EBA, however, notes that there is uncertainty about how this will be implemented in each member state.

Meanwhile, the UK PRA has asked banks to submit an action plan to address infection risks by 31 March 2021. Banks are expected to avoid complex features and capital structures that may complicate prudential assessment and may also undermine the loss-absorbing features of capital instruments. Referring to its policy on MREL, the UK PRA also states that the challenges to resolvability posed by having non-CET1 own funds instruments that do not meet MREL criteria may influence their assessment of a firm's resolvability.

Usability of capital buffers

No need yet to use buffers

Regulators have been encouraging banks to use capital buffers to support the economy. Banks have not done so – in part, because there has been no need to. The demand so far for loans has been largely met by government-supported lending programmes and earnings have been sufficient to absorb credit costs. However, uncertainty remains about whether this will remain the case as further lockdowns are imposed and payment holidays and moratoriums come to an end.

Banks may also be concerned that breaching the combined buffer will result in restrictions that could last well beyond the current dividend ban as it may take a long time to replenish buffers in a low-return environment. As well, cancelling AT1 coupons because of a buffer breach is likely to be perceived poorly by debt market participants.

How practically useable are buffers

Consequently, there are ongoing questions about whether banks will need to or should breach MDA thresholds and what the regulatory stance will be. To improve the useability of the combined buffer, the UK PRA recently proposed removing the restriction precluding banks from making distributions when doing so would cause their CET1 capital levels to fall into the combined buffer[1]. As well, there is a proposal to amend the definition of the MDA to include profits which have already been recognised as CET1 capital over the last four calendar quarters.

This is one way to address the issue, but it raises a broader question about the role of capital buffers. Heading into the pandemic, few national authorities in Europe had set a countercyclical buffer rate above zero. This has been largely justified by relatively muted credit growth seen in many countries. As the consequences of the pandemic began to materialise, regulators that could, quickly reduced this buffer. Notably, the Netherlands

[1] Consultation Paper, CP17/20. Capital Requirements Directive V (CRD V): Further implementation, October 2020.

also temporarily reduced the systemic risk buffer for the three large Dutch banks. The Netherlands along with the Nordic countries are among the few using the systemic risk buffer; Nordic regulators, however, did not reduce them.

Benefits of countercyclical buffer rates above zero

Reducing the countercyclical buffer was a helpful response in the face of widespread economic disruption. However, it was not available for all due to the non-existent level of the buffer in many cases. Again, the UK provides an interesting example. Having previously decided that the countercyclical buffer rate should be around 1% in a standard risk environment, the UK PRA currently believes that the appropriate level should be around 2%[2].

One could also ask whether the capital conservation buffer needs to be fixed at 2.5%. Could the buffer be split, say, 1% countercyclical and 1.5% capital conservation? In the current environment, where there is some hesitancy to increase capital requirements, this may be a way to achieve a countercyclical buffer rate above zero. This would provide regulators with more flexibility to adjust requirements as needed and allow banks to continue supporting the economy.

Rebalancing structural and cyclical elements of capital stack

Both the Basel Committee on Banking Supervision and the Financial Stability Board have flagged the usability and structure of capital buffers as an area for further work. Within the ECB, there are calls for a review of the buffer framework considering the experience during the Covid-19 pandemic[3]. To enhance the ability of authorities to act countercyclically, there is a desire to rebalance the structural and cyclical elements of the capital stack. Of the existing macroprudential buffers, only the countercyclical buffer is meant to be released in a downturn while others like the systemic risk buffer and O-SII buffer are more structural in nature. There is also growing recognition that a positive countercyclical buffer rate in normal times would provide regulators with more flexibility in a stressed environment.

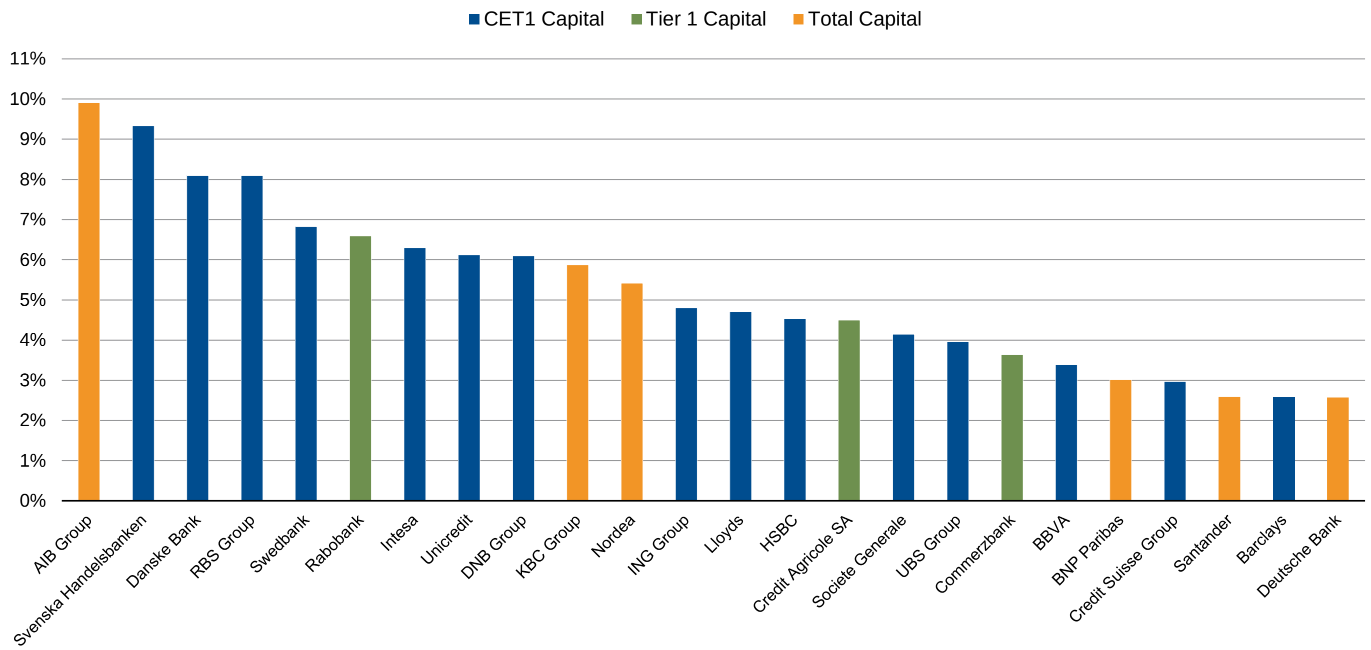
[2] Bank of England, Financial Stability Report, December 2019.
[3] https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202010_1~01c4f1a5f4.en.html#toc4

Appendix I: Headroom to MDA-relevant requirements

Due to various measures meant to support the lending capacity of banks, capital requirements have been eased since the start of the year. Most relevant for AT1 investors, countercyclical and systemic risk buffers have been reduced or eliminated. For ECB-supervised banks, Pillar 2 requirements can now also be met with a mix of CET1 and capital instruments. While this does not reduce total capital requirements, it may increase the buffer to the CET1 MDA-threshold.

At the same time, capital positions are being supported by amendments made to CRR in June in response to the Covid-19 pandemic. These include IFRS 9 transition relief, infrastructure and SME RWA supporting factors, and the exclusion of exceptional levels of market volatility from the market-risk VAR model capital multiplier. In 2021, there will also be some benefit from the treatment of some software as capital although we do not expect this to be significant.

Below we compare reported capital positions as of 30 September 2020 against MDA-relevant requirements. The narrowest buffer to relevant requirements is shown – this may be in relation to CET1, Tier 1 or total capital.



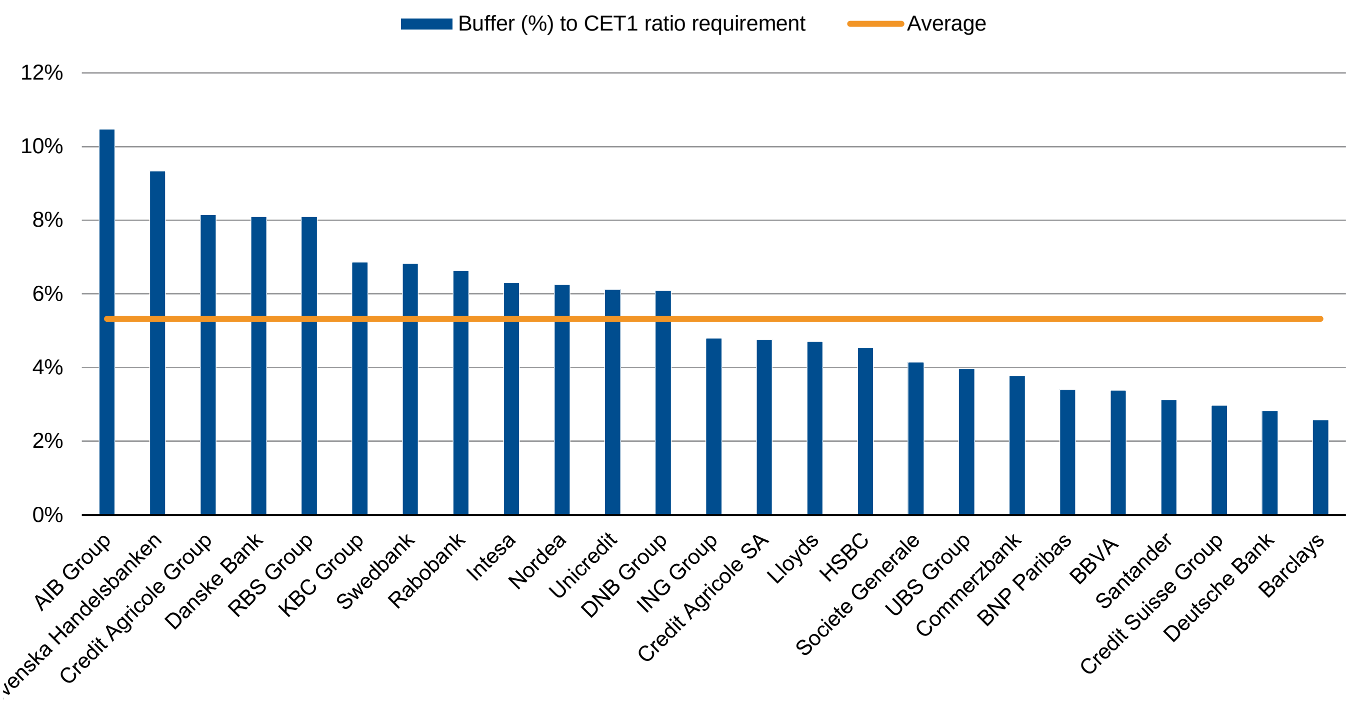
Note: (1) Capital figures for AIB and Rabobank as of 30 June 2020.
Source: Banks, Scope Ratings estimates.

Appendix II: Headroom to MDA-relevant CET1 requirements

		2Q 2020			3Q 2020				
	Basis	Req CET1	CET1 ratio	Buffer	Req CET1	CET1 ratio	Buffer	Currency	Buffer (bn)
AIB Group	Transitional	9.7%	20.2%	10.5%	9.7%	20.2%	10.5%	EUR	5.3
Barclays	Transitional	11.2%	13.5%	2.3%	11.3%	13.9%	2.6%	GBP	8.0
BBVA	Transitional	8.6%	11.6%	3.0%	8.6%	12.0%	3.4%	EUR	11.6
BNP Paribas	Transitional	9.2%	12.4%	3.1%	9.2%	12.6%	3.4%	EUR	23.3
Commerzbank	Transitional	9.7%	13.4%	3.7%	9.7%	13.5%	3.8%	EUR	6.9
Credit Agricole Group	Transitional	8.8%	16.1%	7.3%	8.8%	17.0%	8.1%	EUR	45.6
Credit Agricole SA	Transitional	7.8%	12.0%	4.1%	7.8%	12.6%	4.8%	EUR	16.1
Credit Suisse Group	Fully loaded	10.0%	12.5%	2.5%	10.0%	13.0%	3.0%	CHF	8.5
Danske Bank	Transitional	10.1%	17.6%	7.5%	10.1%	18.2%	8.1%	DKK	62.1
Deutsche Bank	Transitional	10.4%	13.3%	2.8%	10.4%	13.3%	2.8%	EUR	9.2
DNB Group	Fully loaded	12.8%	18.2%	5.4%	12.8%	18.9%	6.1%	NOK	59.7
HSBC	Transitional	10.9%	14.9%	4.0%	10.9%	15.4%	4.5%	USD	40.0
ING Group	Transitional	10.5%	15.0%	4.5%	10.5%	15.3%	4.8%	EUR	15.0
Intesa	Transitional	8.4%	14.6%	6.2%	8.4%	14.7%	6.3%	EUR	21.6
KBC Group	Transitional	9.7%	16.6%	6.9%	9.7%	16.6%	6.9%	EUR	6.9
Lloyds	Transitional	9.3%	13.4%	4.1%	9.3%	14.0%	4.7%	GBP	12.1
Nordea	Transitional	10.2%	15.8%	5.6%	10.2%	16.4%	6.3%	EUR	9.4
Rabobank	Transitional	10.0%	16.6%	6.6%	10.0%	16.6%	6.6%	EUR	13.6
RBS Group	Transitional	8.9%	16.3%	7.4%	9.1%	17.2%	8.1%	GBP	14.1
Santander	Transitional	8.9%	11.8%	3.0%	8.9%	12.0%	3.1%	EUR	17.3
Societe Generale	Transitional	9.1%	12.5%	3.4%	9.1%	13.2%	4.1%	EUR	14.6
Svenska Handelsbanken	Fully loaded	10.1%	18.7%	8.6%	10.1%	19.4%	9.3%	SEK	65.1
Swedbank	Fully loaded	10.0%	16.4%	6.4%	10.0%	16.8%	6.8%	SEK	47.2
UBS Group	Fully loaded	10.0%	13.3%	3.3%	10.0%	14.0%	4.0%	USD	11.2
Unicredit	Transitional	9.0%	14.5%	5.5%	9.0%	15.2%	6.1%	EUR	20.6

Notes: (1) Capital figures for AIB and Rabobank as of 30 June 2020.
(2) For Handelsbanken, Swedbank, DNB and Danske, Pillar 2 requirements are excluded from MDA relevant CET1 requirements.
Source: Banks, Scope Ratings calculations.

Headroom to MDA-relevant CET1 requirements



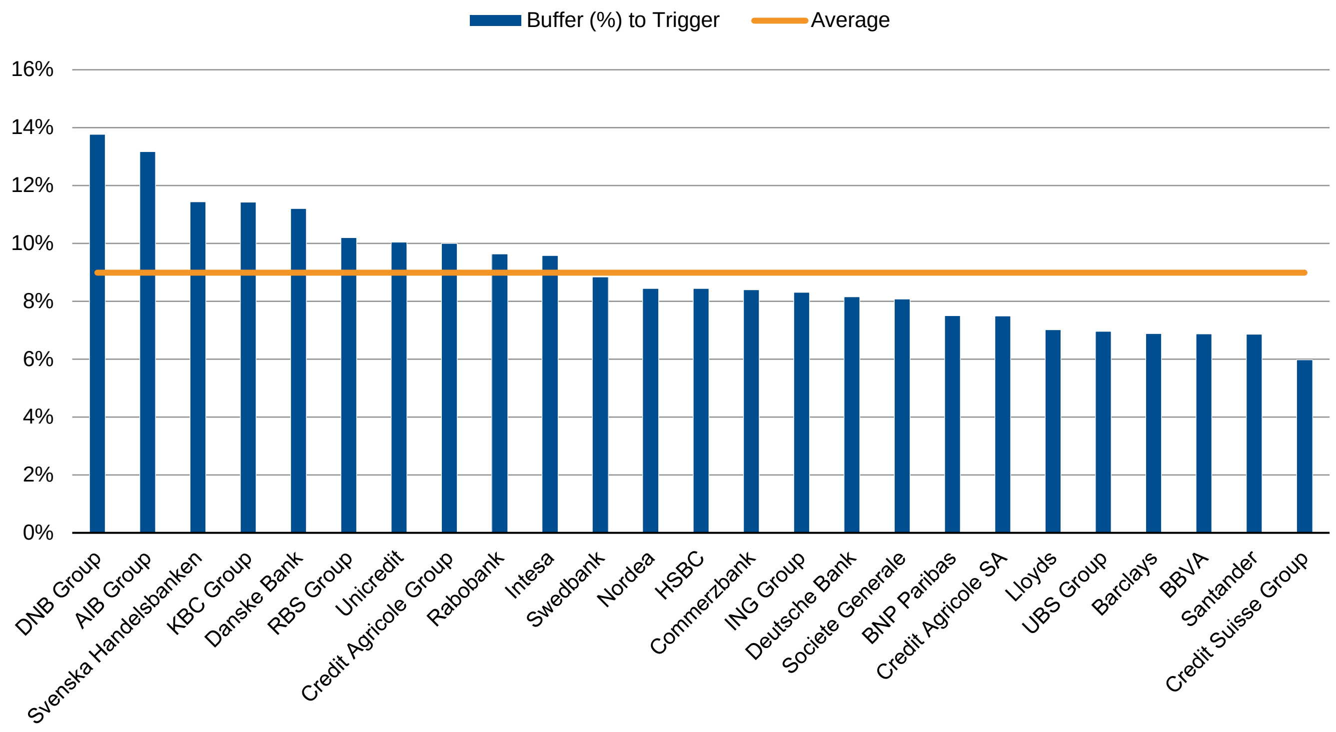
Source: Banks, Scope Ratings calculations.

Appendix III: Headroom to write-down/conversion trigger

			1Q 2020		2Q 2020		3Q 2020	
	Basis	Trigger	CET1 ratio	Buffer	CET1 ratio	Buffer	CET1 ratio	Buffer
AIB Group	Transitional	7.00%	20.3%	13.3%	20.2%	13.2%	20.2%	13.2%
Barclays	Fully loaded	7.00%	12.7%	5.7%	13.5%	6.5%	13.9%	6.9%
BBVA	Transitional	5.125%	11.1%	6.0%	11.6%	6.5%	12.0%	6.9%
BNP Paribas	Transitional	5.125%	12.0%	6.8%	12.4%	7.2%	12.6%	7.5%
Commerzbank	Transitional	5.125%	13.2%	8.0%	13.4%	8.3%	13.5%	8.4%
Credit Agricole Group	Transitional	7.00%	15.5%	8.5%	16.1%	9.1%	17.0%	10.0%
Credit Agricole SA	Transitional	5.125%	11.3%	6.2%	12.0%	6.8%	12.6%	7.5%
Credit Suisse Group	Fully loaded	7.00%	12.1%	5.1%	12.5%	5.5%	13.0%	6.0%
Danske Bank	Transitional	7.00%	17.6%	10.6%	17.6%	10.6%	18.2%	11.2%
Deutsche Bank	Transitional	5.125%	12.8%	7.7%	13.3%	8.1%	13.3%	8.2%
DNB Group	Fully loaded	5.125%	17.7%	12.5%	18.2%	13.1%	18.9%	13.8%
HSBC	Fully loaded	7.00%	14.5%	7.5%	14.9%	7.9%	15.4%	8.4%
ING Group	Transitional	7.00%	14.0%	7.0%	15.0%	8.0%	15.3%	8.3%
Intesa	Transitional	5.125%	14.2%	9.1%	14.6%	9.5%	14.7%	9.6%
KBC Group	Transitional	5.125%	16.3%	11.2%	16.6%	11.5%	16.6%	11.4%
Lloyds	Fully loaded	7.00%	13.9%	6.9%	13.4%	6.4%	14.0%	7.0%
Nordea	Transitional	8.00%	16.0%	8.0%	15.8%	7.8%	16.4%	8.4%
Rabobank	Transitional	7.00%	16.3%	9.3%	16.6%	9.6%	16.6%	9.6%
RBS Group	Fully loaded	7.00%	16.5%	9.5%	16.3%	9.3%	17.2%	10.2%
Santander	Transitional	5.125%	11.6%	6.5%	11.8%	6.7%	12.0%	6.9%
Societe Generale	Transitional	5.125%	12.6%	7.5%	12.5%	7.4%	13.2%	8.1%
Svenska Handelsbanken	Fully loaded	8.00%	17.6%	9.6%	18.7%	10.7%	19.4%	11.4%
Swedbank	Fully loaded	8.00%	16.1%	8.1%	16.4%	8.4%	16.8%	8.8%
UBS Group	Fully loaded	7.00%	12.8%	5.8%	13.3%	6.3%	14.0%	7.0%
Unicredit	Transitional	5.125%	13.4%	8.3%	14.5%	9.4%	15.2%	10.0%

Notes: (1) For banks with securities containing different trigger levels, the highest is used.
(2) Capital figures for AIB and Rabobank as of 30 June 2020.
Source: Banks, Scope Ratings calculations.

Headroom to write-down / conversion trigger



Source: Banks, Scope Ratings.

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