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Could it Happen in the EU? An Analysis of Loss Distribution between Shareholders and AT1 Bondholders under EU Law

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ABSTRACT

In March 2023, the Swiss bank Credit Suisse's so-called Additional Tier 1 (AT1) bonds were written down to facilitate the bank being taken over by UBS, its national rival. Ensuing discussion and market reactions went well beyond Swiss borders, as the write-down was completed without Credit Suisse's shareholders first being wiped out, thereby deviating from the principle that shareholders bear losses ahead of all other investors. This article asks whether such an outcome is possible under EU law. A comprehensive analysis demonstrates how this question is governed by the combined operation of contractual clauses and the resolution authority's statutory powers. Combining applicable EU law with empirical analysis of contractual terms employed by EU banks issuing AT1 bonds and their capital requirements, the article argues that an outcome akin to that of the Credit Suisse write-down is unlikely for EU banks. Building on this analysis, it is shown what reform is needed if EU policymakers consider it desirable to have AT1 bonds absorb losses outside of cases requiring intervention by the resolution authority.

KEYWORDS: Additional Tier 1 capital, bank crisis management, bank insolvency law, capital requirements regulation

1. INTRODUCTION

European and US banks experienced turbulence during the spring of 2023. Amongst others, the Swiss bank Credit Suisse fell victim of rapid withdrawals of funds from short-term creditors. Fearful of a disorderly failure, the Swiss government orchestrated a 'shotgun merger' with its national rival UBS. To sweeten the pill for UBS, the Swiss resolution authority instructed Credit Suisse to make use of contractual rights under its Additional Tier 1 (AT1) bonds to permanently write down these instruments, thereby reducing the obligations taken on by UBS as part of the merger. As the bondholders did not receive shares in return—this was not a requirement per the terms of the bonds—these events left them empty-handed.

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The write-down caused outrage among investors in the AT1 instruments.[1] The reason was that shareholders were not first diluted: they did in fact receive UBS shares as consideration for the merger, notwithstanding AT1 bondholders being left with zero. AT1 bondholders argued that this breached the priority ranking in a winding up, where shareholders would have ranked behind AT1 bondholders, thus only receiving distributions insofar as AT1 holders (and senior creditors) had received full payment of their claims. Simply put, shareholders would have been required to take losses ahead of AT1 bondholders had the bank instead been wound up. If the Swiss government's intervention had been required to adhere to these principles, it would have been impermissible to let existing shareholders retain an equity interest unless AT1 bondholders retained their full claims or received equity interests of a value equal to their principal amount.[2]

The Swiss authorities' actions caused the European Banking Authority, the European Central Bank, and the Single Resolution Board to issue a joint statement underlining their commitment to follow the priority framework in resolution, which, among other things, requires shareholders to take losses ahead of AT1 holders.[3] In essence, these authorities are saying that crisis measures will not involve treating AT1 holders as they were treated in the Credit Suisse case.

This article discusses the extent to which the claims of holders of AT1 bonds issued by a bank established in the EU—and thus subject to EU law capital requirements regulation and its bank resolution regime—can be written down notwithstanding that losses are not first imposed on the bank's shareholders by way of a cancellation or dilution of their shareholdings.[4] In other words, the article discusses whether the abovementioned EU agencies gave an accurate description of current EU law in their response to the Swiss actions. The article shows how this question is governed by the combined operation of contractual clauses required to qualify instruments as AT1 capital under the Capital Requirements Regulation (CRR) and the resolution authority's statutory powers under national legislation transposing the Bank Recovery and Resolution Directive (BRRD) (see section II). It is argued that there could be cases where AT1 instruments are to be written down without first diluting shareholders, while in other cases the order of write-downs must follow the priority ranking applicable in a winding up (section III), meaning that there could be two legal bases providing for different principles for loss distribution between shareholders and AT1 holders. Combining applicable EU law with empirical analysis of contractual terms employed by EU banks issuing AT1 bonds and their capital requirements, section III goes on to argue that an outcome akin to that of the Credit Suisse write-down is unlikely for EU banks. Section IV discusses policy implications of these findings. Section V concludes.

2. BACKGROUND

2.1. AT1 capital: Definition and functions

2.1.1. Classification

Banks established in the EU are required to satisfy capital requirements. Such requirements, set out in the Capital Requirements Regulation (CRR)[5] and administrative decisions, oblige

[1] N Asgari and others, 'Credit Suisse bondholders in uproar over $17bn debt wipeout' *Financial Times* (London, 20 March 2023) <www.ft.com/content/07888bca-2ddf-466f-9508-044ac68bb03d accessed 19 February 2024.

[2] J Paz Valbuena and H Eidenmüller, 'Bailout Blues: The Write-Down of the AT1 Bonds in the Credit Suisse Bailout' (2023) 24 European Business Organization Law Review 409, 410.

[3] Single Resolution Board, European Banking Authority and European Central Bank, 'SRB, EBA and ECB Banking Supervision statement on the announcement on 19 March 2023 by Swiss authorities' (20 March 2023) <www.eba.europa.eu/srb-eba-and-ecb-banking-supervision-statement-announcement-19-march-2023-swiss-authorities accessed 19 February 2024.

[4] The scope of this article is restricted to cases where the issuing bank is a private or public limited liability company and thus has issued shares.

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1.

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banks to ensure that their ratio of capital to some measure of their assets (which may be risk-weighted) exceeds a certain percentage. Common Equity Tier 1 (CET1) capital—which in very simplified terms comprises share capital and retained earnings—qualify for all types of capital requirements.

However, instruments other than shares can also generate capital eligible items for satisfying some, but not all, capital requirements. Additional Tier 1 (AT1) instruments are instruments that satisfy the requirements for counting as AT1 capital.[6] When AT1 instruments are included in the numerator of a capital ratio, the instruments contribute towards meeting the capital requirement in question. Tier 2 instruments are a third source of regulatory capital. These instruments are essentially long-term debt obligations that rank ahead of AT1 instruments but are subordinated to all other debts.[7] AT1 capital can be conceived of as being of a higher quality than Tier 2 capital, as there are capital requirements in respect of which AT1 capital count alongside CET1 capital while Tier 2 capital is ineligible.

To illustrate: CRR article 92(1)(a) requires banks to ensure that the ratio of CET1 capital to their total risk exposure amount (TREA)—a risk-weighted measure of their assets—exceeds 4.5 per cent. This is a requirement that banks can only meet with CET1 capital. Article 92(1)(b) requires banks to ensure that the sum of CET1 and AT1 capital exceeds 6 per cent of TREA. Accordingly, this requirement can be met with both CET1 and AT1 capital, but not Tier 2 capital. Finally, article 92(1)(c) requires that the sum of CET1, AT1, and Tier 2 capital exceeds 8 per cent of TREA. For this requirement, all three types of capital are thus eligible.

CRR's minimum capital requirements seek to ensure that banks have the loss-bearing capacity sufficient to withstand certain losses without becoming balance-sheet insolvent—that is, their assets being insufficient to cover their liabilities. It is apparent that requiring banks to maintain a certain amount of capital contributes to this end: balance-sheet insolvency implies negative equity. Requiring banks to ensure that their equity exceeds the amount that banks would have in the absence of regulation reduces the risk of their equity becoming negative and thus balance-sheet insolvent.

AT1 instruments are sometimes referred to as hybrid capital. This is because such instruments have some features typically associated with debt instruments, while other features are akin to those of shares. For instance, AT1 instruments will typically contain a schedule for the payment of interests on the principal amount on specified dates, but the issuer has discretion as to whether it wishes to make such payments.[8] The fact that AT1 instruments count towards satisfying some capital requirements likely reflects a trade-off between ensuring that banks have sufficient loss-bearing capacity and keeping down their financing costs.[9] The idea is that if the terms of AT1 instruments render them sufficiently share-like, it is then permissible for bank capital regulation to treat them on par with CET1 capital.

It is against this background one must understand CRR articles 52ff, which contain several requirements that instruments must satisfy to count as AT1 capital. These requirements reflect the Basel Committee on Banking Supervision's requirements for eligibility criteria for regulatory capital.[10]

6 See CRR articles 52ff.
7 See CRR article 63.
8 CRR article 52(1)(l)(iii).
9 M Lamandini and D Ramos Muñoz, 'The definition of Common Equity Tier 1 Capital and of Contingent Capital' in BPM Joosen, M Lamandini and TH Tröger (eds), *Capital and Liquidity Requirements for European Banks* (Oxford University Press 2022) para 2.31.
10 Basel Committee on Banking Supervision, 'CAP10: Definition of eligible capital' (effective as of 15 December 2019) paras 10.09–10.12.

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2.1.2. Priority in insolvency

One requirement concerns priority in insolvency. CRR article 52(1)(d) states that to count as AT1 capital, instruments must 'rank below Tier 2 instruments in the event of the insolvency of the institution'. What this means is that the instruments shall rank below all debts (other than other AT1 instruments) if the bank becomes subject to insolvent winding up. The link between this requirement and the objective of rendering AT1 instruments 'share-like' is that shareholders rank behind creditors in a winding up. By requiring that AT1 instruments must rank behind all (other) debts (but ahead of shareholders) in a winding up to qualify as AT1 capital, CRR requires the instruments to have the priority in a winding up most akin to that of shares.

2.1.3. Write-down and conversion

CRR article 52(1)(n) contains a second requirement of interest for present purposes. This provision states that in order for an instrument to count as AT1 capital,

> the provisions governing the instruments [must] 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

In other words, the contractual terms must provide that upon a 'trigger event' occurring, one of three things shall happen to the principal amount then outstanding: a permanent write-down, a temporary write-down, or a conversion to CET1 instruments (shares or the like). The link between this requirement and the objective of rendering AT1 instruments share-like is that reducing the principal amount increases CET1 capital. A reduction of principal also reduces payments under the instruments, thereby conserving capital in the bank.

When contracting over AT1 instruments, the issuing bank and investors may choose between (i) a mechanism where principal is written down without holders receiving anything in return and (ii) a mechanism where principal converts to shares issued by the bank. In this article, the clauses falling within category (i) and (ii) will be referred to as *pure write-down clauses* and *conversion clauses*, respectively.

Within the category pure write-down clauses, a further distinction can be made between instruments providing for permanent and temporary write-down. The difference is as follows: an instrument with a temporary write-down feature contains a clause giving the issuer the option to reinstate—that is, write up—the principal amount of the instruments should the issues triggering the write-down be remedied. In accordance with EU law requirements,[11] the terms do not place any obligation on the issuing bank to write up the instruments. In other words, there is nothing preventing the issuing bank—or, for that matter, another bank assuming its assets and liabilities in a merger—from indefinitely leaving the principal amount of all written down instruments at zero. The inclusion of a mechanism for writing up previously written down instruments could create an expectation among AT1 investors that the issuer will make use of this possibility when permitted by applicable regulation and market forces. However, where the write-down takes place in connection with a wider recapitalization of the bank or its business—for example an offering of new shares or the bank being acquired by a competitor—the interests of the new shareholders or acquirer may dictate that the instruments are never subsequently written up. The result could thus be that a 'temporary' write-down is de facto permanent.

The choice between a pure write-down clause and a conversion clause has potential implications for loss distribution among shareholders and AT1 holders. A conversion involves AT1

[11] Commission Delegated Regulation (EU) No 241/2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for Own Funds requirements for institutions [2014] OJ L74/8 article 21(2)(c).

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holders receiving new shares issued by the bank. As the aggregate number of shares increases when a conversion is completed, this dilutes the positions of existing shareholders. Conversely, a pure write-down does not have this effect. If a pure write-down mechanism is triggered, causing AT1 holders to suffer a write-down without shareholders first having seen the rights attaching to their shares eliminated or reduced, the priority hierarchy is different than in a winding up where, as discussed, shareholders by definition have inferior priority to AT1 holders.

Regardless of the choice between a pure write-down clause and a conversion clause, the terms need to define what counts as a trigger event activating the clause chosen. CRR article 54 states that, at the least, the bank's CET1 capital ratio—which, as discussed, is roughly speaking the ratio of CET1 capital to risk-weighted assets—falling below 5.125 per cent shall be a trigger event, thus leading to AT1 instruments being written down or converted (as applicable). As is made clear by a delegated regulation adopted by the Commission,[12] the CET1 capital ratio falling below the 5.125 per cent threshold leads to an irrevocable obligation for the issuing bank to write down or convert the instrument to shares.

This article will refer to clauses triggering write-down following the CET1 capital ratio falling below 5.125 per cent or a higher percentage as *mechanical triggers*. It appears that the threshold for most mechanical triggers is either 5.125 per cent or 7 per cent. Banks and investors are free to include additional triggers in the terms of the instrument. This is explicitly made clear by CRR article 54(1)(b).

To sum up, AT1 instruments may have different trigger events and the consequences of a trigger event occurring—write-down or conversion—will also differ between instruments.

2.1.4. Credit Suisse's AT1 instruments

The AT1 instruments written down in connection with UBS' takeover of Credit Suisse were of a type with a pure write-down clause. The instruments contained two trigger events. The first were mechanical triggers like what is required under EU law. These were not invoked, as it would have required Credit Suisse's CET1 capital having fallen below the trigger level. There was nothing to suggest this had occurred. In fact, a few days prior to the write-down the Swiss authorities had issued a press release stating that the bank complied with its capital requirements.[13]

The second trigger event in the Credit Suisse AT1 instruments was the occurrence of a viability event. This meant that the terms gave Credit Suisse the power to write down the bonds upon it being determined that a write-down was necessary to ensure the bank's viability. Among other things, this condition would be met were Credit Suisse to receive an 'irrevocable commitment of extraordinary support from the public sector'.[14] The Swiss authorities have argued that the write-down was permissible because of this contractual clause.[15] To sum up, the outcome for Credit Suisse's AT1 bondholders appears to be a result of (i) the bonds containing a pure write-down clause and (ii) the bank's non-viability being a circumstance capable of activating this clause.

It is important to note that an instrument qualifying as AT1 capital under EU law is not conditional upon its terms providing that a viability event shall activate the write-down or conversion clause (as applicable). An AT1 instrument issued by an EU bank could therefore contain only mechanical triggers, thus not generating *a contractual basis* for writing down the instruments due to qualitative assessments of the bank's non-viability. This would set the terms

12 Commission Delegated Regulation (EU) No 241/2014 article 22(1).

13 FINMA, 'Press release: FINMA and the SNB issue statement on market uncertainty' (15 March 2023) <www.finma.ch/en/news/2023/03/20230315-mm-statement/ accessed 19 February 2024.

14 Paz Valbuena and Eidenmüller (n 2) 413.

15 FINMA, 'Press release: FINMA provides information about the basis for writing down AT1 capital instruments' (23 March 2023) <www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/8news/medienmitteilungen/2023/03/20230323-mm-at1-kapitalinstrumente.pdf accessed 19 February 2024.

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apart from Credit Suisse's AT1 instruments and is, as will be discussed below, of importance for applicable requirements with respect to loss distribution between AT1 holders and shareholders. For ascertaining the possibility of holders of AT1 instruments issued by EU banks suffering a similar fate to Credit Suisse's AT1 holders, it is therefore of importance to have information on market practice in the EU.

2.1.5. Market practice for EU issuers

To the best of my knowledge, there are no published studies breaking down how EU banks issuing AT1 instruments have used the option of including trigger events in addition to CET1 capital ratio falling under 5.125 per cent or a higher threshold.[16] To get a better picture of market practice regarding this choice, I collected information on the trigger events in 55 AT1 instruments issued by EU banks.[17] The instruments were identified as follows. First, a subset of 36 banks were randomly selected among entities that were (i) subject to the direct supervision of the European Central Bank (ECB) and (ii) had a non-zero pillar 2 requirement for 2023.[18] The reason why banks were drawn from this population, which comprises 105 entities, is that I assume that AT1 instruments are mainly issued by larger banks, as such banks have better access to relevant capital markets. As the ECB is in charge of the direct supervision of the largest entities in the Banking Union, which comprises Member States whose currency is the euro or who otherwise participate in the Banking Union,[19] a list of entities subject to the ECB's direct supervision will comprise most of the largest banks in the EU.

Having drawn the 36 banks, I sought to identify whether they had outstanding AT1 instruments. To this end, I utilized the fact that EU banks are required to disclose on their websites information regarding the bank's amount of different forms of regulatory capital (such as CET1 capital and Tier 1 capital).[20] If a bank in its most recent disclosures reported an amount of Tier 1 capital (that is, the sum of CET1 and AT1 capital) exceeding its reported CET1 capital, I took this as implying the existence of AT1 instruments. Among the banks examined, 20 had Tier 1 capital in excess of CET1 capital.

For the banks reporting Tier 1 capital in excess of CET1 capital, I consulted the investor relations (or equivalent) sections of their webpages and, where relevant, the webpages of regulated markets. For 80 per cent of the banks concerned (n = 16), I was able to download the terms of AT1 instruments (or a summary thereof). I then examined whether the clauses of these instruments governing write down or conversion to shares contained trigger events other than mechanical triggers. In cases where I was unable to locate the terms of the AT1 instruments, I consulted the issuing banks' most recent disclosures regarding the main features of their AT1 instruments.[21] The approaches to reporting on circumstances triggering write-down or conversion do not seem to be entirely consistent, and I therefore only included AT1 instruments in the sample where the reporting unambiguously made clear that the terms either

16 See, however, S Avdjiev and others, 'CoCo Issuance and Bank Fragility' (2020) 138 Journal of Financial Economics 593, which provides data on the terms of so-called contingent convertible capital securities, which covers some types of Additional Tier 1 instruments.

17 The information was collected from publicly available sources during August 2023 by the author.

18 I used the list published by the ECB for the purposes of disclosing the pillar 2 requirements of banks under its direct supervision, available at <www.bankingsupervision.europa.eu/banking/srep/html/p2r.en.html (as last updated on 8 February 2023, accessed 29 August 2023). In some instances, the requirement is imposed on a holding company controlling a bank. I collectively refer to banks and such holding companies as banks.

19 Regulation (EU) No 468/2014 of the European Central Bank establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141/1, article 6(4).

20 CRR article 447(1)(a), cf articles 433a ff.

21 Banks that are not considered 'small and non-complex institutions' are pursuant to CRR required to disclose such information on an annual basis, see CRR article 437(b), cf articles 433a–433c.

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included or did not include a contractual right to write down or convert the instruments for reasons other than the CET1 ratio falling below a quantitative threshold.

The result is a sample consisting of 55 AT1 instruments issued by 19 banks.[22] The sample contains both instruments with write-down mechanisms and instruments with a conversion mechanism. Among the instruments examined, 53 contained only a mechanical trigger. Only two instruments (both issued by the same bank) contained a clause whereby viability-linked events would trigger a write-down or conversion. This also means that only one of the 19 issuers had outstanding instruments with a viability event trigger. This suggests that contractual clauses giving the issuer a power to write down or convert the instruments upon the occurrence of viability events are not widespread in outstanding AT1 instruments issued by banks under direct ECB supervision. As the ECB supervises most of the largest EU banks, the findings also suggest that EU banks issuing AT1 instruments rarely employ contractual terms empowering the bank to write down the instruments following viability events.

The sample contains two AT1 instruments issued after the write-down of Credit Suisse's AT1 instruments. Both instruments contain only a mechanical trigger. Comparing this—albeit very small—subsample with the trend among other instruments in the sample does therefore not indicate the Credit Suisse episode having triggered a change in EU market practice with regard to the use of the option of including viability triggers in the terms of the instruments.

The sample includes instruments issued by three of the eight EU banks on the Financial Stability Board's 2022 list of Global Systemically Important Banks (G-SIBs), which also included Credit Suisse.[23] The issuers in question are Credit Agricole, ING, and UniCredit. None of their terms contained triggers beyond a mechanical trigger. Accordingly, there is no difference between the terms of instruments in the sample issued by the G-SIBs and the general trend in the sample.

To summarize, the examination of the AT1 instruments included in the sample gives reason to believe that it is not a widespread practice for EU issuers to include trigger events beyond mechanical triggers—for example, viability events—in the terms of their AT1 instruments. This sets market practice in the EU apart from the terms of Credit Suisse's AT1 bonds, which provided for a write-down upon the occurrence of a viability event. This is an important finding. It means that the circumstances invoked by the Swiss authorities as justifying a write-down under the terms of Credit Suisse's instruments would not by themselves have been capable of justifying a write-down by operation *of the contractual terms* typically employed by EU banks issuing AT1 instruments. A write-down following events that Credit Suisse's bond terms defined as viability events would therefore for most EU AT1 instruments have had to be based on a statute rather than contract.[24] This article will therefore turn to the statutory powers of resolution authorities to write down AT1 instruments under national legislation transposing

[22] The issuers are Aareal Bank AG (DE), Banco Bilbao Vizcaya Argentaria, SA (ES), Banco BPM SpA (IT), Banco de Sabadell SA (ES), Bank of Cyprus Holdings Public Limited Company (CY), BPER Banca SpA (IT), Crédit Agricole SA (FR), Deutsche Pfandbriefbank AG (DE), Hellenic Bank Public Company Ltd (CY), ING Groep NV (NL), La Banque Postale (FR), Münchener Hypothekenbank eG (DE), Nordea Bank Abp (FI), Norddeutsche Landesbank—Girozentrale (DE), Nova Ljubljanska banka dd (SI), UBS Europe SE (DE), Unicaja Banco SA (ES), UniCredit SpA (IT), and Volksbank Wien AG (AT).

[23] Financial Stability Board, '2022 List of Global Systemically Important Banks (G-SIBs)' (21 November 2022) <https://www.fsb.org/wp-content/uploads/P211122.pdf accessed 19 February 2024.

[24] Many AT1 instruments also include provisions stating that instrument holders by acquiring the instruments recognize and agree to be bound by the statutory powers of the resolution authority. The motivation for including such provisions in the terms is likely to ensure that the exercise of the statutory powers will be recognized in non-EU/EEA jurisdictions. Generally, instrument holders agreeing to be bound by the statutory powers does not operate to expand the powers of applicable resolution authorities beyond the powers they have as a matter of the national laws transposing BRRD. Notwithstanding such provisions, resolution authorities thus have to observe requirements in the statutory framework with regard to priority.

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the Bank Recovery and Resolution Directive (BRRD)[25] in national law and the requirements concerning loss distribution between shareholders and AT1 holders.

2.2. BRRD: Resolution, write-down powers, and priority

BRRD requires Member States to adopt statutory provisions allowing for the resolution of failing banks. A public body is to be appointed as the resolution authority. The resolution authority has the power to restructure banks deemed to be failing or likely to fail by applying *resolution tools*. Within the European Banking Union, the Single Resolution Mechanism Regulation (SRMR) supranationalizes decision-making as regards the powers set out in national provisions transposing BRRD. Roughly speaking, the Single Resolution Board, which is an EU agency, makes decisions concerning the use of such powers—sometimes subject to the endorsement of the Commission and the Council—that national resolution authorities thereafter implement by using powers under national law.[26]

One resolution tool is the power to 'bail in' debt.[27] A bail-in involves debt being written down or converted into shares without needing to obtain the consent of the affected creditors and, where relevant, shareholders. As a bail-in reduces the debts of the bank, its equity increases. This, in turn, improves its CET1 capital ratio.

Other resolution tools are powers to transfer assets and liabilities to another bank or a public bridge bank.[28] These powers could, for instance, be used to transfer assets and insured deposits to another entity while leaving other debts behind in the resolved bank (which is then to be wound up). The idea is that the transferee shall carry on the bank's business.

Resolution is not the only framework for handling failing banks. In fact, resolution is to be used only when necessary to safeguard financial stability and other public interests.[29] In other cases, failing banks are to be wound down under what BRRD terms 'normal insolvency proceedings'.[30] This is the proceeding for winding up insolvent banks under the national law of the failing bank's home state.[31] BRRD and SRMR accordingly envisage a two-track system for handling failing banks.[32] Member States are free to apply general insolvency proceedings or a sector-specific framework for winding up failing banks. While details and objectives differ, an insolvent winding up of a bank essentially involves selling its assets and distributing the proceeds among its creditors.[33] Available funds are first distributed among the creditors with the highest priority, then, insofar as funds remain, to those with the second-highest priority, and so on. Shareholders only receive distributions if funds remain after all creditors have been paid in full.

As discussed in section II.1, it follows from CRR article 52(1)(d) that a feature defining AT1 instruments is their ranking 'below Tier 2 instruments in the event of the insolvency of the institution'. The words 'in the event of the insolvency of the institution' must be understood

[25] Regulation (EU) No 806/2014 of the European Parliament and of the Council establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ L225/1. Directive 2014/59/EU of the European Parliament and of the Council 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 [2014] OJ L173/90.

[26] See, for example, D Busch, 'Governance of the European Banking Union's Single Resolution Mechanism' (2017) 28 European Business Law Review 447.

[27] BRRD article 43/SRMR article 27.

[28] BRRD articles 38 and 40/SRMR articles 24 and 25.

[29] BRRD article 32(1)(c), cf article 32(5)/SRMR article 18(1)(c), cf article 18(5).

[30] BRRD article 32b.

[31] BRRD article 2(1)(47).

[32] SS Ellingsæter, *Creditor Priority in European Bank Insolvency Law: Financial Stability and the Hierarchy of Claims* (Hart Publishing 2023) ch 3.

[33] See, generally, JH Binder and others, 'The choice between judicial and administrative sanctioned procedures to manage liquidation of banks: A transatlantic perspective' (2019) 14 Capital Markets Law Journal 178; Ellingsæter (n 33) 87–89.

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as a reference to priority in 'normal insolvency proceedings', that is, whatever proceeding the bank's home state uses for winding up banks whose failure does not warrant resolution. Thus, AT1 instruments only receive distributions in a winding up if all (other) creditors have been paid in full. The AT1 instruments will however rank ahead of CET1 instruments (ordinary shares), as CET1 instruments by definition rank last in a winding up.[34] This means that AT1 instruments have superior priority to shareholders in a winding up pursuant to 'normal insolvency proceedings'.

BRRD gives the resolution authority powers to write down AT1 and Tier 2 instruments. The Directive terms these powers the 'write down and conversion powers'.[35] BRRD treats these as conceptually distinct from the bail-in power and the transfer powers discussed above, which BRRD terms 'resolution tools'.[36] The Directive thus conceptualizes the powers to write down AT1 instruments and Tier 2 instruments as something distinct from interfering with claims ranking higher in the hierarchy in an insolvent winding up of the bank.

The write-down and conversion powers must be exercised whenever a bank is resolved. However, it is also possible to exercise write-down and conversion powers outside of resolution. The idea is that these powers could be used to avoid the need for resolution. The powers could perform such a function if writing down AT1 instruments and other regulatory capital results in a sufficient recapitalization of the bank; it is then not necessary to invoke the resolution tools to write down debts with superior priority.

BRRD article 59 sets out the conditions for the exercise of the write-down and conversion powers. When these conditions are met, resolution authorities not only have the *option* to write down or convert AT1 instruments: they will also be required to do so. This follows from article 59(3), which provides that Member States '*shall require* that resolution authorities exercise the write down or conversion power ... when one or more of the following circumstances apply ...' (emphasis added).[37]

BRRD article 60 provides requirements for how the resolution authority is to exercise the write-down and conversion power when the circumstances in article 59(3) are present. Of particular interest is article 60(1), which begins as follows:

> When complying with the requirement laid down in Article 59, resolution authorities shall exercise the write down or conversion power *in accordance with the priority of claims under normal insolvency proceedings* ... (emphasis added)[38]

BRRD article 60(1)(a) goes on to operationalize this general requirement with respect to shares and other CET1 items.[39] They are to absorb losses through the resolution authority taking 'one or both of the actions specified in Article 47(1)'. The actions to which article 47(1) refers are first, the cancellation or forced transfer of existing shares and, second, conversion of debt into shares.[40] All these actions interfere with the rights of existing shareholders, either by depriving them of their shares (cancellation or forced transfer), or reducing their relative influence and share of total dividend payments (conversion of debt diluting existing shareholders).

[34] CRR article 28(1)(j).
[35] BRRD article 2(1)(66). See also SRMR article 3(1)(44)
[36] BRRD article 2(1)(19). See also SRMR article 3(1)(9).
[37] See also the corresponding provision in SRMR article 21(1).
[38] See also the corresponding provision in SRMR article 21(10).
[39] See also the corresponding provision in SRMR, article 21(10)(a).
[40] Cf SRMR article 17(1). For detailed analysis, see JH Binder, 'Art. 17 SRMR' in JH Binder and others (eds), *Brussels Commentary on the European Banking Union* (Nomos, CH Beck and Hart Publishing 2022) paras 9–19. See also M Schillig, *Resolution and Insolvency of Banks and Financial Institutions* (Oxford University Press 2016) paras 11.25–11.26.

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Holding BRRD articles 59(3) and 60(1) together, the following is obtained. If one of the circumstances in article 59(3) is present, the resolution authority must exercise the write-down power. When using this power—whether independently of resolution or not—the resolution authority must observe the priority in 'normal insolvency proceedings', that is, whatever proceedings the home state employs for winding up banks. As shareholders rank behind AT1 instruments in such proceedings, it follows that it is not possible for the resolution authority to write down AT1 instruments without interfering with the rights of shareholders in the manner described in article 47(1). This conclusion is of great importance: in terms of loss distribution between shareholders and AT1 holders, the statutory powers require an outcome different from that resulting from the pure write-down clauses discussed in section II.1.

Having described how the resolution authority must exercise its statutory write-down and conversion powers with respect to priority, this article turns to the question of under what conditions such powers are triggered. The exact answer depends upon whether the bank is part of a group of companies and whether the instruments have been issued within that group. For the sake of simplicity, in this article the analysis will be restricted to cases where a bank entity itself has issued the AT1 instruments and is not in a holding company structure.

There are then two sets of circumstances that could trigger the write-down and conversion powers. In addition, there is also a general requirement of necessity: the write-down or conversion must be a last resort.

The initial step is to consider the circumstances potentially triggering the statutory powers. The first is that the bank is 'failing or likely to fail'.[41] As discussed later, this is a defined term. The second is that the bank needs 'extraordinary public support' to survive.[42] There is some overlap between the two grounds, because the need for extraordinary public support could also qualify a bank as failing or likely to fail.[43] To simplify things, the need for public support will be dealt with separately.

This leaves three circumstances that render a bank being deemed 'failing or likely to fail'.[44] First, that the bank 'will, in the near future, be unable to pay its debts or other liabilities as they fall due'. This means that a bank experiencing a run that will eventually deplete its liquid assets will be deemed failing or likely to fail. Second, 'the assets of the institution will, in the near future, be less than its liabilities'. Third, the bank having breached regulatory requirements to an extent that would justify the withdrawal of a bank's licence. As will be discussed in section III, this would for instance be the case where the bank has insufficient own funds to meet the minimum capital requirements and any so-called pillar 2 requirement.

As mentioned, in addition to a bank being 'failing or likely to fail', the write-down power may also be used if a bank requires what BRRD terms extraordinary public financial support—roughly speaking, state aid 'to preserve or restore [its] viability, liquidity or solvency'.[45]

Finally, a bank being either failing or likely to fail, or in need of extraordinary public support, is by itself insufficient for activating the resolution authority's write-down and conversion power: this also requires the absence of a 'reasonable prospect that any action, including alternative private sector measures or supervisory action (including early intervention measures)' other than the resolution authority's exercising its write-down or conversion powers preventing the

[41] BRRD article 59(3)(b) read together with article 59(4)(a)/SRMR article 21(1)(b) read together with article 21(3)(a).

[42] An exception applies where the 'extraordinary public support' is granted in the circumstances referred to in BRRD article 32(4)(d)(iii)/SRMR article 18(4)(d)(iii), that is, so-called precautionary recapitalizations intended to replenish capital shortfalls identified through stress tests and similar exercises.

[43] See BRRD article 32(4)(d)/SRMR article 18(4)(d).

[44] BRRD article 32(4), cf article 59(5)/SRMR article 18(4), cf article 21(4). For detailed analysis of SRMR article 18(4), see E Tornese, 'Art. 18 SRMR' in JH Binder and others (eds), *Brussels Commentary on the European Banking Union* (Nomos, CH Beck and Hart Publishing 2022) paras 48–78.

[45] BRRD article 2(1)(28)/SRMR article 3(1)(29).

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bank's failure.[46] In other words, the powers cannot be used if there are other means for removing the circumstances rendering the bank 'failing or likely to fail'.

3. THE RELATIONSHIP BETWEEN THE CONTRACTUAL AND STATUTORY WRITE-DOWN POWERS

3.1. The issue

Section II showed that the contractual terms of an AT1 instrument may contain provisions empowering the issuing bank to write down the principal amount without first diluting shareholders. Such powers are usually triggered by a mechanical trigger—the bank's CET1 capital ratio falling below a quantitative threshold, which must be 5.125 per cent or higher. Section II also reported the results of an examination of contractual terms employed by a sample of EU AT1 issuers. These results suggest that it is not a widespread practice among EU issuers to include other write-down or conversion triggers than mechanical triggers in the terms of their AT1 instruments.

Section II also demonstrated that resolution authorities in certain circumstances will have both a power and an obligation to make use of statutory powers to write down or convert AT1 and other regulatory capital instruments. When so doing, the authority is required to observe the hierarchy applicable in 'normal insolvency proceedings', which would involve diluting shareholders before writing down the claims under the AT1 instruments. This requirement applies regardless of whether the terms provide for a pure write-down mechanism or conversion into shares. In other words, when the BRRD powers are exercised, AT1 instruments cannot be written down unless shareholders are diluted.

The above has an important implication: there are circumstances in which two legal bases for writing down AT1 instruments could exist in parallel. First, a contractual basis flowing from the terms of the instruments (as required by CRR article 52(1)(n)). Second, a statutory basis flowing from national legislation transposing BRRD article 59ff. The two bases could differ as to whether a write-down of AT1 instruments is conditional upon the bank's existing shareholders being diluted or deprived of their shares. As discussed in section II, the use of the contractual basis will not necessarily require adherence to the priority hierarchy in a winding up as many AT1 instruments contain a pure write-down mechanism. Such clauses purport to empower the bank to write down the instruments without holders receiving shares in exchange and thereby diluting existing shareholdings. Conversely, BRRD's write-down and conversion powers require at least the dilution of existing shareholders. Everything else being equal,[47] shareholder interests will therefore be best served by the use of the contractual power while AT1 holders will hope for the use of the statutory powers.

This raises two core questions discussed in the following sections. First, what happens if the conditions for exercising the write-down power under the terms of the AT1 instrument and the statutory write-down power, respectively, are both satisfied? Second, could there be circumstances where the conditions for writing down AT1 instruments pursuant to their terms are not met, but the conditions under BRRD article 59 are?

3.2. What takes precedence?

Neither BRRD nor CRR contain provisions governing the relationship between contractual write-down powers in AT1 instruments and the statutory write down and conversion powers. While this issue has been raised—for example, two authors describe the relationship between

[46] BRRD article 59(4)(b)/SRMR article 21(3)(b).

[47] One other aspect that could be of importance for whether AT1 holders prefer the use of contractual or statutory powers is the prospect of a write-down based on the contractual power being followed by a reinstatement of the amount written down. As discussed in section II.1.c, what in theory need only be a temporary write-down may often in reality be permanent.

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these powers as giving rise to 'blind spots'[48]—to my knowledge, the present literature does not contain detailed analysis on whether one power takes precedence over the other. This article therefore turns to analyse this question.

The first point to be considered is whether the circumstances potentially triggering the statutory powers—for example, the bank being deemed failing or likely to fail—would preclude a bank from relying on contractual terms purportedly giving the bank the power to write down the instruments without holders receiving shares in return. If the terms of the AT1 instruments provide for a clause to this effect, freedom of contract suggests that there is nothing to prevent the bank from doing so. The question is, then, whether there are arguments capable of justifying a different conclusion. This would require the finding that EU law operates to invalidate a contractual clause giving the bank a power to write down the instruments. It is worth noting that there are examples of EU primary and secondary law striking down contractual clauses on account of breaching public policy. One example is the Treaty on the Functioning of the European Union (TFEU) article 101(2), which renders automatically void agreements breaching the prohibition of that article's first paragraph against practices restricting competition.[49] There are also examples of the European Court of Justice declaring national provisions governing the private law relationship between financial service providers and their clients as incompatible with EU directives on account of such provisions rendering ineffective client rights guaranteed under such directives.[50] It is therefore not inconceivable that upholding a contract as valid *could* be incompatible with EU law requirements insofar as the contract interferes with the public authorities satisfying their obligations under EU law, in this case, the obligation under BRRD articles 59ff to use statutory write-down and conversion powers in line with priority applicable in a winding up.

However, it seems unlikely that a pure write-down clause will be deemed to conflict with EU law. Such clauses present a case very different from the examples just mentioned. In the case of TFEU article 101(2), an EU law provision explicitly renders certain contractual clauses void. There are no such provisions prohibiting pure write-down clauses. And it is not merely that no EU law provisions provide that a pure write-down clause shall not be effective insofar as it overlaps with the resolution authority's write-down and conversion powers. To the contrary, EU legal acts positively indicate that this should be possible: as discussed in section II, CRR explicitly contemplates that AT1 instruments could include a write-down mechanism giving the issuer the power to write down the principal amount without instrument holders receiving shares in return. This circumstance provides a forceful argument against the proposition that EU law requires contractual write-down clauses to be ineffective when the conditions for the resolution authority's statutory write-down and conversion powers are satisfied.

It can therefore be concluded that a contractual write-down power triggered by the CET1 capital ratio falling below a threshold defined in the terms of the AT1 instrument may be exercised notwithstanding the conditions for a write-down and conversion pursuant to the statutory power being met.

Now consider the opposite case: could the bank's contractual power to write down AT1 instruments preclude the resolution authority from writing down the instruments under statutory powers? As discussed in section II, a bank either being failing or likely to fail or otherwise in need of extraordinary public support to be viable is a necessary but insufficient condition for

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48 Lamandini and Ramos Muñoz (n 9) para 2.34. See also A Cahn and P Kenadjian, 'Contingent Convertible Securities: From Theory to CRD IV' (2014) Institute for Law and Finance Working Paper Series No 143 <www.ilf-frankfurt.de/fileadmin/_migrated/content_uploads/ILF_WP_143.pdf accessed 19 February 2024; A Witte, 'Art. 21 SRMR' in JH Binder and others (eds), *Brussels Commentary on the European Banking Union* (Nomos, CH Beck and Hart Publishing 2022) para 5.

49 See also Case C-126/97 *Eco Swiss China Time Ltd v Benetton International NV* [1999] ECR I-3055, paras 36–37.

50 Case C-209/12 *Walter Endress v Allianz Lebensversicherungs AG* EU:C:2013:864.

empowering the resolution authority's use of write-down or conversion powers. In addition, there must *not* be 'reasonable prospect that any action, including alternative private sector measures or supervisory action (including early intervention measures)' other than said powers preventing the failure.[51]

This second condition—necessity—gives rise to an interesting question: how is one to assess whether using statutory write-down and conversion powers is necessary when there is also a contractual basis for writing down the bank's AT1 instruments? To illustrate the issue at hand, suppose the following scenario. A bank issues AT1 instruments permitting it to write down the principal amount of the instruments upon the CET1 capital ratio falling below a given percentage. Subsequent developments lead to circumstances where the bank's capital ratio has fallen below this threshold (thus triggering the contractual write-down power) and the bank qualifying as 'failing or likely to fail' under BRRD (thus satisfying the first condition for the exercise of the statutory write-down and conversion powers). Suppose further that a write-down of the AT1 instruments will cause the bank to no longer be 'failing or likely to fail'.

In these circumstances there would, strictly speaking, be a 'reasonable prospect' of an 'action'—the exercise of the contractual write-down power—preventing the bank's failure.[52] The consequence would be the second condition for write-down and conversion powers under BRRD not being met, thereby ruling out the resolution authority's use of statutory powers (and the requirement to follow the hierarchy in a winding up).

Is this a sensible interpretation of BRRD? It seems so. If the Directive operates in this manner, a bank and AT1 investors could agree upon the AT1 capital serving as the last line of defence of the bank's shareholders. The AT1 holders would effectively provide a form of insurance enabling issuing banks to raise CET1 capital levels in challenging times,[53] which could also preclude shareholders being diluted by the resolution authority exercising the write-down and conversion powers. There is admittedly something of an anomaly to uphold such a bargain outside of cases where the resolution authority exercises its statutory powers while refusing to do the same when such powers are invoked—recall that BRRD article 60 requires that shares then have priority behind AT1 instruments and does not distinguish between instruments containing pure write-down clauses and conversion clauses. However, CRR clearly contemplates the possibility of a pure write-down occurring outside of the resolution authority's powers if the CET1 capital ratio falls below the threshold set out in the terms of the instruments.

This leads us to conclude that the bank's contractual power to write down AT1 instruments could potentially preclude the resolution authority writing down the instruments under statutory powers.

3.3. Is it possible that the conditions for a contractual write-down power could be met while the conditions for the statutory power are not?

3.3.1. The issue

Having established that a mechanical trigger set out in AT1 instruments in certain circumstances could preclude the exercise of the resolution authority's statutory write-down and conversion powers, the next question concerns the practical significance of this conclusion. The contractual write-down power will be of no significance where it is triggered *after* the resolution authority

[51] BRRD article 59(4)(b)/SRMR article 21(3)(b).

[52] This also appears to be the view of Lamandini and Ramos Muñoz, see Lamandini and Ramos Muñoz (n 9) para 2.34. In practice, the determination of whether an 'action' has a 'reasonable prospect' of preventing failure will depend on the methodology employed by the resolution authority, see TH Tröger, 'Too Complex to Work: A Critical Assessment of the Bail-in Tool under the European Bank Recovery and Resolution Regime' (2018) 4 Journal of Financial Regulation 35, 51–52.

[53] P Bolton, W Jiang and A Kartasheva, 'The Credit Suisse CoCo Wipeout: Facts, misperceptions, and lessons for financial regulation' (2023) 35 Journal of Applied Corporate Finance 66, 73.

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has exercised its statutory power. The article therefore turns to consider in what circumstances the contractual write-down power could be triggered before or in parallel with the statutory power.

As discussed in section II, market practice for EU issuances of AT1 instruments is for the terms to include only mechanical triggers as circumstances triggering a write-down or conversion. The discussion in this article will therefore be restricted to cases where the terms only contain mechanical triggers. This means that the triggering of a contractual write-down power will be preceded by a decrease in the bank's CET1 capital ratio, which often will be the result of losses suffered by the bank.

The determination that a bank is 'failing or likely to fail' may result from a bank having suffered losses. However, such a determination may also result from a bank having liquidity-related problems.[54] It is therefore helpful to distinguish between two scenarios. The first is where a reduction in the CET1 capital ratio indirectly causes the bank to be deemed failing or likely to fail without the ratio (yet) having fallen below the threshold triggering a write-down pursuant to the terms of the AT1 instruments (section III.3.b). The second is liquidity issues causing such a determination even though the capital ratio remains above the threshold in the AT1 terms (section III.3.c).

3.3.2. Mechanical triggers and losses

The question considered in this subsection is straightforward: to what extent is it possible that a bank's losses could cause it to be deemed failing or likely to fail even though its CET1 capital ratio has not (yet) fallen below the threshold triggering a write-down under the terms of the AT1 instruments?

Consider the case where the threshold for the contractual write-down power is 5.125 per cent—the minimum trigger level required for recognition as AT1 capital. This threshold exceeds the absolute minimum requirement for the CET1 capital ratio, which is 4.5 per cent.[55] However, banks tend to be subject to capital requirements exceeding this level. One important reason is the prevalence of so-called pillar 2 requirements, which apply on top of CRR's minimum requirement. Pillar 2 requirements are determined for individual banks by their supervisor on a case-by-case basis.[56] Pursuant to the Capital Requirements Directive IV (CRD IV) article 104a,[57] the bank's supervisor has the power (and may also be under an obligation) to impose pillar 2 requirements for risks that CRR's minimum requirement either underestimates or does not cover at all. While bank supervisors already prior to the global financial crisis had the power to impose pillar 2 requirements, their prevalent use appears to be a post-crisis phenomenon.[58]

A bank's inability to meet both CRR's minimum and the pillar 2 add-on constitutes a ground for the supervisor revoking a bank's licence.[59] This could, in turn, constitute a ground for the determination that the bank is failing or likely to fail, potentially triggering the resolution authority's statutory power to convert AT1 instruments and in the process diluting shareholders.

There is in other words a possibility that a bank's losses could activate the resolution authority's statutory powers although the CET1 capital ratio remains above 5.125 per cent. The likelihood of this occurring depends on how much CET1 capital a bank needs to satisfy

[54] Admittedly, a liquidity problem quickly results in a solvency problem, as a pressing need for liquidity could cause a bank to sell illiquid assets at steep discounts, thereby decreasing the bank's net asset value.

[55] CRR article 92.

[56] See CRD IV article 104a.

[57] Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338.

[58] Ellingsæter (n 33) 34–35.

[59] CRD IV article 18(d).

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its pillar 2 requirement. For this reason, it is of interest to consider the pillar 2 requirements that issuers of AT1 instruments are typically required to observe. A good idea of this can be gained by examining the pillar 2 requirements the ECB determines for the banks under its direct supervision—that is, the largest banks established in Member States whose currency is the euro or who otherwise participate in the Banking Union.[60]

In 2023, the average and median amount of CET1 capital required to meet the ECB's pillar 2 requirements were 1.26 per cent and 1.20 per cent of TREA, respectively.[61] Accordingly, to be able to meet CRR's minimum requirement and the ECB's median pillar 2 requirement with regards to CET1 capital, a bank's CET1 capital must at least equal 5.70 per cent (4.50 per cent + 1.20 per cent) of TREA. A bank whose pillar 2 requirement is equal to or higher than the median ECB requirement could therefore potentially be deemed failing or likely to fail prior to crossing the 5.125 per cent threshold. As the CET1 capital ratio would then still be too high to activate the contractual write-down power, a write-down would not be an alternative measure for avoiding failure, and the necessity condition discussed in section III.2 would not preclude the use of the statutory powers.

Suppose instead that the threshold for the mechanical trigger in the AT1 terms is higher than CRR's minimum requirement. Naturally, there is then a lower likelihood of losses causing the bank to become unable to meet the pillar 2 requirement without also having triggered the write-down clause under the terms. Insofar as banks have included a threshold in the terms exceeding CRR's minimum requirement, this is often set at 7 per cent of TREA. For the median bank under direct ECB supervision, its capital ratio falling under a 7 per cent threshold would occur well before the bank's CET1 capital becomes insufficient for satisfying its pillar 2 requirement.

3.3.3. Mechanical triggers and liquidity issues

It was shown above that setting the threshold for a contractual write-down power at 7 per cent of TREA would often lead to the contractual power being triggered before the bank has insufficient CET1 capital for satisfying pillar 2 requirements which, together with CRR's minimum requirement (often referred to as pillar 1), establishes the minimum amount of CET1 capital a bank must have to be permitted to continue to operate.

However, one cannot rule out the possibility of a bank being deemed failing or likely to fail even if its CET1 capital exceeds 7 per cent. As the events preceding the Credit Suisse takeover illustrate, there is a risk of a bank becoming subject to a run and encountering liquidity problems even though it is in full compliance with its capital requirements. More generally, it is also worthwhile to have regard to the fact that a bank's CET1 capital ratio is partly computed with reference to the accounting values of the loans on its books, which do not automatically change from day to day.[62]

The experience with the EU's resolution framework provides evidence of banks being deemed failing or likely to fail without their CET1 capital ratios first having been significantly reduced. For banks subject to resolution under the Single Resolution Mechanism, the ECB is, as a main rule, responsible for making decisions regarding whether banks are 'failing or likely to fail'.[63] The ECB has so far in six cases made determinations that a supervised entity (and, in two

[60] Regulation (EU) No 468/2014 of the European Central Bank establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [2014] OJ L141/1, article 6(4).

[61] Source: <www.bankingsupervision.europa.eu/banking/srep/html/p2r.en.html (as last updated on 8 February 2023, accessed 29 August 2023) and author's own calculations. Observations for banks that did not have a pillar 2 requirement are omitted.

[62] CRR articles 111(1) and 166(1).

[63] SRMR article 18(1).

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of these cases, also certain subsidiaries) qualified as such. Half of these determinations resulted from liquidity issues.[64]

It is noteworthy that while CET1 capital equal to 7 per cent of TREA exceeds the amount of such capital banks need to satisfy the pillar 1 and pillar 2 requirements, banks currently tend to maintain CET1 capital ratios significantly above this threshold. There are three reasons for this. First, banks are subject to *capital buffer requirements*. Unlike what is the case for pillar 1 and 2 requirements, a bank may breach buffer requirements without being at risk of being deemed failing or likely to fail. The consequences of such breaches are instead restrictions on making distributions to shareholders or granting bonuses to senior management.[65] To avoid such restrictions, banks will seek to have CET1 capital sufficient to satisfy buffer requirements.

A bank's aggregate capital buffer requirement depends on several factors. Of importance for present purposes is that all EU banks are required to maintain a capital conservation buffer of CET1 capital equal to 2.5 per cent of TREA. To satisfy pillar 1, pillar 2, and capital conservation buffer requirements, the median bank under ECB supervision therefore needs CET1 capital at least equal to 8.20 per cent of TREA.

Banks could also be subject to additional capital buffer requirements. National authorities are to determine a sector-wide countercyclical capital buffer rate, which, as a main rule, is to be in set in the interval from zero to 2.5 per cent.[66] Roughly speaking, each bank must maintain a buffer equivalent to the product of the buffer rate multiplied by its TREA. The EU capital requirements framework also requires national authorities to impose additional capital buffer requirements on banks identified as global systemically important institutions (G-SIIs) or other systemically important institutions (O-SIIs).[67] G-SIIs are, as a main rule, to be subject to a requirement in the range from 1 per cent to 3 per cent of TREA, while the main rule for O-SIIs is a requirement from zero to 3 per cent of TREA. Finally, Member States can impose additional buffer requirements on the entirety or a subset of its financial sector to cover macroprudential or systemic risks not covered by CRR or the other buffer requirements.[68]

Second, banks may maintain capital to satisfy the supervisor's *pillar 2 guidance*, that is, the bank supervisor's expectations for how much capital the bank should have in excess of its capital requirements.[69] Third, the bank may maintain a so-called 'management buffer' which is an additional amount of capital for ensuring that the bank's capital does not fall short of what is needed to satisfy capital requirements and the supervisor's expectations.

The result is that larger banks normally have CET1 capital ratios well above 10 per cent.[70] This contrasts with what was the situation prior to the global financial crisis, when it was perfectly normal for banks to have a CET1 capital ratio in the low single digits. One implication of this 'new normal' is that a bank's CET1 capital ratio falling below 7 per cent will be preceded by this ratio having fallen substantially from its normal level (and, absent system-wide losses, that of its competitors).

It is possible that a bank in the descent towards the 7 per cent threshold could become 'failing or likely to fail' before reaching the threshold. This is because news of significant decreases in the CET1 capital ratio—say, from 11 per cent to 8 per cent—implies that the bank has suffered

[64] These are the determinations concerning Banco Popular Español (dated 6 June 2017), ABLV Bank AS, and ABLV Bank Luxembourg SA (both dated 23 February 2018), and Sberbank Europe AG, Sberbank dd and Sberbank banka dd (all dated 27 February 2022).

[65] CRD IV article 141.

[66] CRD IV article 136.

[67] CRD IV article 131.

[68] CRD IV article 133.

[69] CRD IV article 104b.

[70] European Banking Authority, '2021 EU-wide Stress Test: Results' (30 July 2021), 21 (Figure 6) <www.eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/EU-wide%20Stress%20Testing/2021/ST%20results/1017864/2021-EU-wide-stress-test-Results.pdf accessed 19 February 2024.

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material losses. Depositors and other short-term creditors could interpret such news as a signal of more deeply rooted issues at the bank: in their minds, the losses could be the proverbial tip of the iceberg. Their response could, in turn, be to withdraw deposits and other short-term funding, in the extreme causing the bank to run out of liquidity. As discussed in section II, 'a determination that the institution will, in the near future, be unable to pay its debts or other liabilities as they fall due' is a circumstance qualifying the bank as 'failing or likely to fail'.[71] This would, in turn, empower the resolution authority to write down AT1 instruments pursuant to the statutory powers, a power which, as discussed, must be exercised in accordance with the priority hierarchy in a winding up.

To summarize, it is conceivable that losses could cause liquidity problems threatening a bank's continued operations, and thereby triggering a determination that the bank is failing or likely to fail, at a stage where the bank's CET1 capital ratio still exceeds a 7 per cent threshold. BRRD article 59 would then require the resolution authority to use its statutory write-down and conversion powers, which pursuant to article 60(1) must be exercised in a manner that first dilutes shareholders.[72]

4. POLICY IMPLICATIONS

4.1. Enhancing or restricting contractual freedom

This article has shown that there are limits to the possibilities for contracting over the priority of AT1 instruments vis-à-vis shareholders. Banks and AT1 investors are free to determine whether a reduction of principal pursuant to a contractual clause will take the form of a pure write-down or, conversely, will take place by way of a conversion giving AT1 holders shares in the bank and diluting existing shareholders. However, as AT1 instruments have priority ahead of CET1 instruments in a winding up, it follows from BRRD article 60(1) that the resolution authority cannot use its statutory powers to write down AT1 instruments without first imposing losses on CET1 instruments (that is, shares).[73] This applies regardless of what type of write-down mechanism an AT1 instrument contains, thus reducing the ability of issuing banks and investors to contract over priority in cases where the statutory powers are invoked.

Where an AT1 instrument contains a pure write-down clause, shareholders and AT1 holders could have incentives to push for the use of contractual powers and statutory powers, respectively.[74] Powerful shareholders could seek to have resolution authorities hold off on using the statutory powers until the CET1 capital ratio falls below the threshold activating the mechanical trigger, thus empowering the bank to write down the AT1 instruments without holders receiving shares in return.[75] If the conditions for exercising the contractual and statutory powers are both satisfied at the same time, a situation could arise where AT1 holders seek to have the resolution authority exercise its statutory powers while shareholders lobby for the bank exercising the contractual power. Differences in priority could also give shareholders an incentive to raise legal challenges against the use of statutory powers, while such differences could cause AT1 holders to challenge the use of contractual powers. For similar reasons, there is a long-held view in the general insolvency law literature that priority should not differ outside and inside of insolvency

[71] BRRD article 32(4)(c)/SRMR article 18(4)(c).

[72] The corresponding provisions in SRMR are article 21(1) and (10).

[73] The corresponding provision in SRMR is article 21(10).

[74] If an AT1 instrument's terms contain a 'temporary' write-down feature as discussed at section II.1.c, AT1 holders may prefer a contractual write-down if they expect that the issuer will subsequently write up the instruments (which the issuer is never obligated to do). The interests of AT1 holders would then not conflict with those of the shareholders, as both would prefer the use of the contractual write-down powers over the statutory powers. However, as also discussed in that section, what needs only be a temporary write-down may often in reality be a permanent write-down. In such a case, AT1 holders would prefer the use of the statutory powers.

[75] Cf the point on bondholder incentives in Paz Valbuena and Eidenmüller (n 2) 415.

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proceedings.[76] The regulatory framework should therefore be reformed so that the hierarchy between shareholders and AT1 holders is the same regardless of whether instruments are written down by virtue of contractual or statutory powers.

There are two options for aligning priority outcomes following the use of contractual and statutory powers. The first option would be to ban pure write-down clauses, thus only permitting instruments that convert to CET1 instruments following a trigger event. The second option would be to amend BRRD (and SRMR) so as to provide that AT1 instruments with a pure write-down clause will rank behind shareholders if the bank is wound up and, consequently, if the statutory write-down and conversion powers are applied (whether in connection with resolution or otherwise).

What option that is desirable depends on several factors. One is whether permitting banks to issue AT1 instruments with priority below shareholders could have negative effects on the incentives of bank shareholders.[77] Whether this is the case is beyond the scope of this article. Another factor is whether an option of issuing AT1 instruments with such a priority could confuse market participants regarding how losses will be distributed among holders of different instruments in a winding up or resolution. Potential negative effects of uncertainty include investors mispricing AT1 instruments and paving the way for legal challenges against resolution actions involving writing down such instruments.[78] Moreover, legal uncertainty could make it more difficult for AT1 investors to correctly price the instruments. This would, in turn, reduce the influence of market discipline on the governance of the issuing bank.[79] To mitigate legal uncertainty, CRR could be amended to make the issuance of AT1 instruments having priority below shareholders conditional upon their terms explicitly referencing a new provision in CRR which would state that an instrument's terms referencing that provision will result in priority behind shareholders in an insolvent winding up of the issuer.

4.2. Reforming mechanical trigger requirements

This article has showed that EU law currently contemplates two legal bases for writing down or converting AT1 instruments. First, to qualify as AT1 instruments, the contractual terms must at least contain a mechanical trigger clause giving the issuing bank a power to write down or convert the instruments upon CET1 capital falling below 5.125 per cent. Second, following transposition of BRRD, national laws are to give resolution authorities the power to write down or convert AT1 instruments upon the issuing bank becoming 'failing or likely to fail' or otherwise in need of extraordinary public support to address liquidity or solvency issues.

Section III argued that developments in bank capital regulation mean that it will rarely be the case that the conditions for a contractual write-down power are met while the conditions for the statutory power are not. This diminishes the practical importance of contractual write-down clauses. Assuming a policy rationale for continuing to require that the contractual terms of AT1 instruments contain mechanical triggers[80]—thus facilitating a write-down before the issuer becomes 'failing or likely to fail'—this has policy implications: namely that trigger levels need to be adapted to the rest of capital requirements regulation. For instance, as discussed in section III, the introduction of capital buffer requirements and pillar 2 guidance means that the 'new normal' for larger EU banks is to maintain a CET1 capital ratio well above 10 per cent. If the goal is to have AT1 instruments absorb losses before a bank is deemed failing or likely to fail, the

[76] TH Jackson, *The Logic and Limits of Bankruptcy Law* (first published 1986, Beard Books 2001) 21.
[77] See the review of the literature in P Oster, 'Contingent Convertible bond literature review: making everything and nothing possible?' (2020) 21 Journal of Banking Regulation 343, 360–361.
[78] Paz Valbuena and Eidenmüller (n 2) 415.
[79] See generally Tröger (n 53).
[80] See, for example, the discussion in Tröger (n 53) 43.

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mechanical triggers should be set at a level that does not require a very large decrease from this new normal. To illustrate: if a normal CET1 capital ratio is, say, 12 per cent or more, the trigger should perhaps not be set at 5.125 per cent. A write-down would then require the CET1 capital ratio having decreased by almost seven percentage points from its peak level. It seems unlikely that such a decrease will occur without depositors and other short-term creditors running on the bank, thereby causing the determination that the bank is failing or likely to fail and requiring resolution authorities to intervene.

5. CONCLUSION

The fact that Credit Suisse's AT1 holders took losses ahead of its shareholders surprised market participants and commentators. The write-down caused debate, and its legality looks set to be litigated. This article set out to discuss the extent to which a similar outcome could occur for an EU bank's AT1 holders. Could their claims be written down notwithstanding that losses are not first imposed on the bank's shareholders? The article has argued that such an outcome is unlikely.

An important reason for this conclusion is that the terms employed in EU AT1 issuances differ from the terms of the Credit Suisse instruments with respect to the circumstances giving the issuer a contractual right to write down or convert the instruments. In the EU, the terms of AT1 instruments normally only provide for a contractual write-down power upon the bank's capital ratio falling below a quantitative threshold. By contrast, the terms of Credit Suisse's AT1 instruments also provided for a write-down following other circumstances linked to the bank's viability. It was this aspect of the terms that was relied on to justify the write-down of these instruments.

For AT1 instruments with terms conforming to EU market practice, an outcome where the instruments are written down while leaving shareholders untouched is only possible if the issuer's CET1 capital ratio falls below the quantitative threshold fixed in the contractual terms without the resolution authority first having made use of its statutory write-down and conversion powers. This is because the exercise of such statutory powers must be 'in accordance with the priority of claims under normal insolvency proceedings',[81] which requires imposing losses on shareholders before AT1 holders. This article has argued that developments in bank capital regulation mean that it will seldom be the case that the conditions for a contractual write-down power are met while the conditions for the statutory power are not.

Consequently, the practical importance of contractual write-down clauses—that is, their function as a legal base additional to statutory write-down and conversion powers—is limited for EU banks issuing instruments with terms conforming to EU market practice. The article does not take a position as to whether it is desirable to ensure that contractual clauses providing for the writing down of AT1 instruments are activated prior to a bank's problems having become so severe as to require the resolution authority's intervention. However, if this is a desirable policy, policymakers should reserve status as AT1 capital for instruments where the capital threshold activating the mechanical trigger is substantially higher than what is currently required.

Contrasting the findings of the article with the legal basis invoked by Swiss authorities for the write down of Credit Suisse's AT1 bonds, this article also highlights that while the Basel framework sets out common principles for regulatory capital, local implementation and practices may in some cases lead to significant differences between jurisdictions.

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[81] BRRD article 60(1)/SRMR article 21(10).