Linklaters

August 2011

CRD IV: the European response to Basel III and the impact on tier 1 and tier 2 bank capital

1. Introduction

On 20 July 2011, the European Commission (the "**EC**") published its much-anticipated proposals to implement in Europe the international standards on bank capital recommended by the Basel Committee on Banking Supervision (the "**Basel Committee**"), commonly known as Basel III. The EC's proposals comprise a draft regulation (in three parts: regulation I, regulation II and regulation III) and a draft directive (together, "**CRD IV**"). In putting forward these CRD IV proposals, the EC observed that "banks have been at the centre of the financial crisis" and that "lessons have been drawn from this and mistakes of the past should not repeat themselves".

This paper analyses some of the CRD IV proposals relating to the nature of bank capital instruments and in particular focuses on:

> certain notable differences between the prudential capital requirements in Basel III and those in the CRD IV proposals; and

> the potential impact of the CRD IV proposals on tier 1 and tier 2 issuance structures and the emergence of a new breed of subordinated principal loss absorption instruments (including "contingent capital" or "CoCos") which will become eligible for inclusion in a bank's "additional tier 1" ("**AT1**") capital resources (which can comprise up to 25% of a bank's overall minimum tier 1 capital requirement), tier 2 capital resources (which can comprise up to 25% of a bank's overall minimum total capital requirement) and, for some banks, national "finishes" imposed on them by national regulators (the scope for which is discussed further below).

According to the EC, CRD IV will apply to more than 8000 banks, amounting to 53% of global bank assets, and is estimated to lead to an extra €460 billion of new capital having to be raised by 2019.

For additional information on other aspects of CRD IV, see our Prudential Regulation Tracker.

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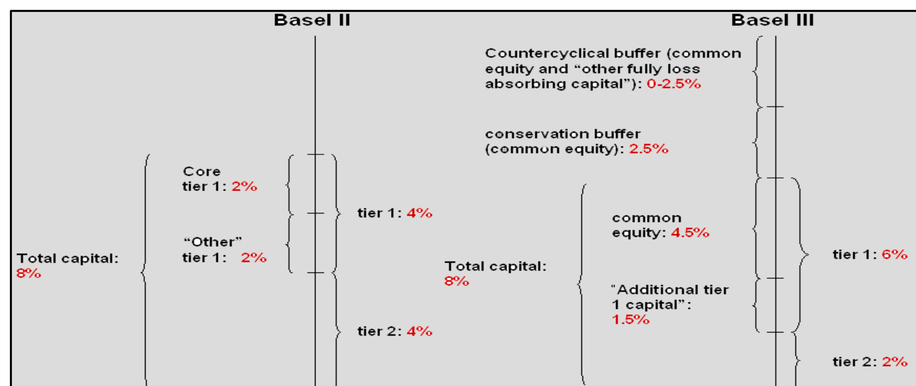
2. Background

> As part of the overall response of regulators to the global financial crisis, on 16 December 2010 the Basel Committee published "Basel III: A global regulatory framework for more resilient banks and banking systems" which contained the Basel Committee's guidelines relating to the quality, definition and quantum of bank capital and the capital conservation and countercyclical buffers. The guidelines relating to the definitions of AT1 and tier 2 capital substantially replicated the Basel Committee's draft proposals issued on 17 December 2009 entitled "Strengthening the resilience of the banking sector". Please click here to see our Regulatory Capital Client News Briefing on the December 2009 paper.

> In addition, on 13 January 2011 the Basel Committee published "Minimum requirements to ensure loss absorbency at the point of non-viability" which contained a requirement that AT1 and tier 2 capital instruments of "internationally active" banks should, in the absence of any applicable effective statutory resolution regime, include loss absorption mechanisms which are triggered at the point of the relevant issuer's "non-viability". This release and the 16 December 2010 release are together referred to herein as "**Basel III**".

> The proposed new CRD IV will replace the former capital requirements directives (2006/48/EC and 2006/49/EC). The EC asserts that "a single market needs a single rule book" and, as such, the majority of the proposals relating to capital are contained in the draft "maximum harmonisation" regulation. As a result, they will, when implemented, have direct effect in member states without the need for national transposition. This is designed to limit divergence between the approaches taken by individual member states. That said, the proposals for the new capital conservation and countercyclical buffers are set out in the draft directive and will need to be transposed by member states "in a way suitable to their own environment". For further discussion of the consequences of this, see paragraph 3.1 below.

The graphic below summarises the impact of the Basel III proposals on capital requirements.



3. Key differences between Basel III and CRD IV

According to the EC in its CRD IV FAQs, CRD IV "respects the balance and level of ambition of Basel III". Although the Basel III guidelines have been substantially replicated in CRD IV, by necessity CRD IV contains additional detailed drafting in places and there are a number of areas where there are provisions which either differ from the equivalent Basel III rules (for example, by being "super equivalent") or which are not contained at all in Basel III and which are CRD IV-specific. Set out below is a summary of some of the notable areas where CRD IV has developed from Basel III and which are likely to be of interest to issuers and their advisers.

3.1 Minimum (and maximum?) quantum requirements

Paragraph 50 of Basel III provides for banks to hold common equity tier 1 capital ("**CET1**") of "at least" 4.5% of a bank's risk-weighted assets, tier 1 capital of "at least" 6% and total capital of "at least" 8%. This leaves open the potential for individual regulators to require capital ratios above these minima.

By contrast, Article 87 of the draft CRD IV regulation mandates these minimum capital requirements on all EU banks and does not permit national competent authorities to impose higher minimum capital requirements, albeit they will have some limited other powers to require additional capital, including in the context of the countercyclical buffer and under their "Pillar 2" powers - see further below.

The EC's proposed approach is to prescribe "maximum harmonisation" minimum capital requirements which will have direct effect right across the EU, and which may not be "gold-plated" by individual member states. This is one of the most politically contentious aspects of the proposals. The EC contends that the use of national discretions and options under the current capital requirements directives, and the ability of member states under those directives to impose stricter rules, has led to a high level of divergence between European countries which distorts competition and the proper functioning of the European internal market. To address these concerns, the EC is seeking to create a "single rule book" in Europe. By contrast, a number of EU countries and bodies such as the IMF have expressed opposition to this "maximum harmonisation" approach, arguing that it interferes with national regulators' discretion and does not take proper account of material national variations in things like the relative size of the banking sector, levels of national debt or the exposure of tax payers in a particular country. See for example the open letter sent to the EU internal market commissioner and signed by finance ministers of various EU member states. This issue is particularly pertinent in those member states which are considering introducing minimum capital requirements above the Basel III minima. For example, in the UK, the Independent Commission on Banking is considering recommending that large retail banking operations should have a minimum CET1 ratio at all times of 10% of risk-weighted assets. A CET1 ratio of 10% would exceed the aggregate of the EC's proposed CET1 minimum (4.5%), its proposed capital conservation buffer (2.5%) and, where relevant, the Basel Committee's proposed surcharge for global systemically important banks (which is expected to impose an additional 2.5% CET1 buffer capital requirement on the most systemically important banks but less for others - see section 4 below).

While the EC is proposing removing any national discretion to increase the minimum capital requirements in the draft CRD IV regulation, it is acknowledged in the draft directive that member states will retain some limited powers to require their banks to hold more capital. National competent authorities would continue to have "pillar 2" powers to undertake supervisory reviews of specified governance arrangements, risk processes, internal control mechanisms and strategies of a particular bank. If the competent authority determines that the imposition of other supervisory measures on the bank would not be enough to "ensure a sound management and coverage of its risks", it can impose an additional specific own funds requirement on the relevant bank. The draft CRD IV directive does not prescribe the form of such additional own funds, which could therefore be in a variety of forms, including CoCos.

Member states will also have some flexibility to set higher capital requirements for secured real estate lending and to adjust the level of its countercyclical buffer (see paragraph 3.7 below) to its economic situation. Finally, the EC proposals permit member states to shorten the period during which they phase in CRD IV should they wish to introduce the full 1 January 2019 capital requirements ahead of time.

Limited scope for member state discretion

The CRD IV proposals prescribe a maximum harmonisation approach to regulatory capital minima: CET1 - 4.5%; tier 1 - 6%; and total capital - 8%. The limited scope for national regulators to require increased levels of capital are:

- Imposing pillar 2 requirements following a supervisory review process (CRD IV directive Articles 92 to 100)
- Imposing higher capital requirements for secured real estate lending (CRD IV regulation Article 119)
- Adjusting the level of the countercyclical buffer (CRD IV directive Article 126)
- Accelerating implementation of CRD IV in full (CRD IV regulation Article 464(6))

Although Michel Barnier, the Internal Market Commissioner, has been reported as saying that CRD IV will be implemented sufficiently flexibly to enable those EU countries which have indicated a wish to impose higher minimum capital requirements on the banks which they regulate than the minima provided for in the CRD IV regulation to do so, it would seem at odds with the principle of the countercyclical buffer (which is to moderate credit supply at different points in the economic cycle) to use it as one of the means to require a permanent extra layer of capital over the CRD IV minima.

3.2 Common equity tier 1 capital requirements

Basel III recognises "common shares" which comply with a list of substantive criteria as being the only type of capital instrument eligible for inclusion in the CET1 resources of a bank which is in the form of a joint stock company.

By contrast, CRD IV recognises any “capital instrument” (including, for example, potentially a “silent partnership” interest) which satisfies a list of various substantive criteria set out in Article 26 of the CRD IV regulation as CET1. The list of criteria matches in all material respect the equivalent list in Basel III.

Article 24(4) of the CRD IV regulation tasks the European Banking Authority (the “**EBA**”) (formerly CEBS) with responsibility for establishing, maintaining and publishing a list of the forms of capital instrument in each member state which qualify as CET1 capital.

Articles 25 to 27 of the CRD IV regulation provide significantly more detail on the required characteristics of CET 1 instruments for mutuals and cooperative entities than does Basel III, including potential derogations from the requirements in Articles 26.1(g) (repayment of principal otherwise than in the liquidation of the entity), (h)(iii) (stated cap on periodic distributions), (h)(iv) (distributions linked to face amount) and (k) (stated cap on any liquidation distribution).

See also paragraph 3.8 below on the grandfathering of existing CET1 instruments.

3.3 AT1 capital: loss absorption at a pre-specified trigger point

Item 11 of the AT1 capital criteria set out in paragraph 55 of Basel III (the “**Basel AT1 Criteria**”) requires only those AT1 instruments which are “classified as liabilities for accounting purposes” to contain “principal loss absorption” through either conversion to common shares or a principal write-down mechanism, in either case to be triggered at a “pre-specified trigger point” (the meaning of which is left undefined). Once the trigger is activated, the conversion or write-down becomes mandatory.

Item 11 of the Basel AT1 Criteria, along with the requirement for point of non-viability loss absorption (see below), is at the heart of the new breed of subordinated principal loss absorption instruments, including those which contingently mandatorily convert into equity (such as the February 2011 issue by Credit Suisse of US$2bn 7.875% buffer capital notes) and those which contain contingent mandatory principal write-down features (such as the January 2011 issue by Rabobank of US$2bn 8.375% perpetual non-cumulative capital securities). Both variants are often described as “CoCos” and, in the case of the contingent convertible notes, require the careful fusion of regulatory capital technology and convertible bond technology into one instrument.

CRD IV (Article 49.1(n) and Article 51) makes certain amendments and clarifications to item 11 of the Basel AT1 Criteria. First, it dispenses with the distinction between liability-accounted and equity-accounted instruments: all AT1 capital must contain a principal loss absorption feature. Secondly, CRD IV interprets “pre-specified trigger point” as the common equity tier 1 capital ratio of the bank falling below either 5.125% or any higher level specified in the terms and conditions of the AT1 instrument. Responsibility for producing draft technical standards by 1 January 2013 with respect to, *inter alia*, the “nature of the write-down” and “the procedures and timing for.. determining that a trigger event has occurred [and] writing down the principal amount.. or converting it to a [CET1] instrument” is devolved to the EBA, so further details on the operation of the loss absorption feature – and, until then, some continued uncertainty – can be expected.

3.4 AT1 and tier 2 capital: loss absorption at the point of non-viability

As discussed above under *Background*, the 13 January 2011 Basel Committee release, "Minimum requirements to ensure loss absorbency at the point of non-viability", contains a requirement for both AT1 and tier 2 capital instruments issued by "internationally active banks" to include a loss absorption mechanism (again meaning conversion into common equity or principal write-down) which is triggered at the relevant issuer's point of "non-viability" ("**PONV**"). The requirement to include PONV loss absorption provisions in the terms and conditions of AT1 and tier 2 capital instruments is disapplied if the governing jurisdiction of the relevant bank has a statutory resolution regime in place which achieves a similar outcome.

The position under CRD IV with respect to PONV loss absorption is less clear than under even Basel III. Recital 27 to the draft CRD IV regulation refers to AT1 and tier 2 instruments having to include PONV loss absorption but, surprisingly, it is not mentioned again in the body of the regulation itself or in the CRD IV directive. The absence of a fully fleshed out PONV loss absorption provision in CRD IV has prompted speculation that the EC will include PONV loss absorption through its proposals to create a European bank resolution regime instead, thereby removing the need for detailed contractual PONV mechanisms to be included in AT1 and tier 2 instruments themselves. However, the EC's January 2011 consultation document, "Consultation on technical details of a possible EU Framework for bank recovery and resolution", its latest major public pronouncement on a bank resolution regime, is largely silent on the specific issue of PONV loss absorption, although it did reserve the EC's position with respect to "debt write down tools" as a resolution mechanism and referred instead to similar work being done by other institutions – the Financial Stability Board ("**FSB**") on bail-in for global systemically important financial institutions and the Basel Committee on non-viability conversion for AT1 and tier 2 instruments. When the EC's proposals for bank resolution are published (now expected this autumn), we should be better able to deduce the likely direction of travel on the PONV loss absorption requirement in Europe.

If it is indeed the EC's aim to coordinate its work in this area with that of the FSB and have in place peer-reviewed resolution regimes (which include a Basel III-compliant PONV provision) in all 27 EU member states by 1 January 2013, it will be a significant accomplishment. If for any reason this aim is not achieved, the current version of CRD IV does not currently provide for any contractual alternative PONV loss absorption mechanism.

3.5 AT1 and tier 2 capital: temporary or permanent write-down? Full or partial write-down?

Basel III is largely silent as to whether an instrument which has had its principal amount written-down following the triggering of either the "pre-specified trigger" or the PONV trigger can be written-up again following a reversal of its capital deficiency.

Similarly, Article 49(1)(n) of the CRD IV regulation, which deals with "pre-specified triggers" in AT1 instruments, simply refers to an ATI instrument having to be written-down on the occurrence of the trigger event. The text is silent as to whether a subsequent write-up is permitted or not.

Instead, the EC has delegated to the EBA the responsibility for formulating technical standards to "specify.. the nature of the write down of the principal

amount". It is not clear whether the remit given to the EBA extends to a consideration of whether the write-down can be temporary and not permanent, which is an important factor in the tax and accounting analyses of these instruments in some jurisdictions. Although CEBS, the predecessor to the EBA, explicitly approved of temporary write-downs for hybrid tier 1 instruments in the context of “CRD II”, this is a contentious issue among different regulators. The EBA has until 1 January 2013 to submit such draft technical standards to the EC.

As discussed in paragraph 3.4 above, recital 27 to the CRD IV regulation refers to a requirement that AT1 and tier 2 instruments contain write-down (or conversion into equity) triggered at PONV. It goes on to state that upon the PONV, the instrument must be “fully and permanently written down or converted”.

Finally, in the context of “pre-specified trigger” loss absorption in AT1 instruments, it should be noted that Article 51(c)(iii) of the CRD IV regulation, by acknowledging that reduced distributions can continue after any write-down, points to a partial write-down (and the maintenance of some economic value in the instrument) being permissible rather than imposing a mandatory full write-down.

3.6 AT1 capital: dividend stoppers

Item 7(d) of the Basel AT1 Criteria expressly permits, on any cancellation of a coupon under an AT1 instrument, the activation of a “dividend stopper”, which would prohibit the payment by the issuer of a dividend on its ordinary shares for a certain period of time.

By contrast, Article 50(b) of the CRD IV regulation expressly forbids the inclusion in the terms of an AT1 instrument of any dividend stopper feature, on the basis that such a feature could hinder recapitalisation. In the absence of stoppers (as well as pushers and ‘alternative coupon satisfaction mechanisms’), it remains to be seen how investors respond to, or seek pricing compensation for, the notion that dividend payments could continue to be made to holders of an issuer’s junior capital while payments are being cancelled on its AT1 instruments.

Under Article 49.2(d) of the CRD IV regulation, the EBA has also been mandated to develop draft regulatory standards by 1 January 2013 which specify any other features of AT1 instruments which could hinder recapitalisations and which will be prohibited.

3.7 Capital buffers

Part III of the December 2010 Basel III release sets out the requirements for a capital conservation buffer and Part IV sets out the requirements for a countercyclical buffer. The purpose of the capital conservation buffer is to avoid a situation in which public funds have to be injected into banks, whereas the countercyclical buffer is intended to have the very different purpose of moderating the supply of credit by banks to the economy at different points in the economic cycle. Both capital buffers are additional to the minimum capital requirements described in section 3.1 above. Unlike the capital conservation buffer which has to be comprised of common equity, Basel III left open the possibility that in the future the countercyclical buffer could be comprised of not only common equity but also "other fully loss absorbing capital" such as, perhaps, CoCos. CoCos may have some advantages for banks in a world where equity financing is more limited than in

the pre-crisis years and where there are increased pressures on return on equity targets.

Nonetheless, Article 124 of the draft CRD IV directive provides that the countercyclical buffer should be comprised of only common equity. No explanation is given by the EC for this departure from Basel III.

The principal features of the proposals in CRD IV for capital buffers are set out in the box below.

Capital Buffers

> CRD IV directive Article 123 – provides for maintenance of a capital conservation buffer of 2.5% comprised of common equity.

> CRD IV directive Article 124 – supplements the capital conservation buffer with a bank-specific countercyclical capital buffer ("**CCB**") comprised of common equity.

> Failure to meet both buffers in full will trigger capital conservation measures (restrictions on distributions on common equity and AT1 securities, bonuses and discretionary pension benefits) and the obligation to submit a capital conservation plan within five days.

> Each member state sets the relevant national CCB buffer rate quarterly. The European Systemic Risk Board may give guidance to national designated authorities on setting its national CCB rate in light of, for example, long-term credit/GDP ratio trends, but each member state may take account of "any other variables that its designated authority considers relevant" in setting its CCB rate. The CCB rate should normally be between 0 and 2.5%, but such "other variables" may justify a member state increasing its CCB rate above 2.5%.

> Where a member state has set its national CCB rate in excess of 2.5%, other member states may, but are not obliged to, recognise such rate in determining the bank-specific CCB requirement of the banks which they regulate.

> Bank-specific CCBs should consist of the weighted-average of the national CCB rates that apply in the jurisdictions where the relevant credit exposures are located.

> In line with Basel III, the buffer capital requirements in the CRD IV proposals are phased in from 1 January 2016 to 1 January 2019.

3.8 Grandfathering

The CRD IV position with respect to grandfathering is broadly consistent with Basel III, with some notable exceptions. As with Basel III, CRD IV provides for a regime which allows member states to recognise grandfathered securities on a tapered basis until up to 31 December 2021.

However, whereas Basel III's grandfathering regime was limited to instruments issued prior to 12 September 2010, CRD IV moves this cut-off date to 20 July 2011, the date of adoption of the CRD IV proposals by the EC.

Article 463(3) of the CRD IV regulation grandfathers as CET1 those instruments which today qualify as core tier one capital under national rules implementing the current capital requirements directive and which do not satisfy the new CRD IV requirements for CET1. In contrast, Basel III excludes entirely from CET1 resources any instrument issued by a joint stock company which is not an ordinary share, with effect from 1 January 2013.

Article 463(4) of the CRD IV regulation grandfathers as AT1 those instruments which today qualify, or are grandfathered, as innovative tier 1 capital under Article 57(ca) of the current capital requirements directive.

Article 463(5) of the CRD IV regulation grandfathers as tier 2 those instruments which today qualify as upper or lower tier 2 instruments under Articles 57(f) – (h) of the current capital requirements directive.

Articles 467 and 468 of the CRD IV regulation apply additional grandfathering filters in respect of AT1 and tier 2 instruments which fall within Articles 463(4) and (5) but which contain call options with incentives to redeem. The basic rule is that such instruments will only be fully included in the grandfathering regime from 1 January 2013 if: (i) the call option and incentive to redeem could only have been exercised *prior to 20 July 2011*, but (ii) the call option was not exercised and (iii) the instruments do not adhere to the new AT1 or, as the case may be, tier 2 requirements under CRD IV. Where the situation is the same except that the call option and incentive to redeem can only be exercised *on or after 1 January 2013*, grandfathering treatment will only be given in respect of such instruments from 1 January 2013 to the date the call option is able to be exercised, whereupon the instrument will be fully derecognised. No grandfathering at all is given, and recognition withdrawn from 1 January 2013, if the option could have been exercised between 20 July 2011 and 1 January 2013. However, if "from the date of the effective maturity of the instrument" (i.e. the call date) the instrument complies with the AT1 or, as the case may be, tier 2 requirements under CRD IV (which, as discussed in paragraph 3.4, will likely require a PONV loss absorption resolution regime to be in place), it will qualify and not have to rely on grandfathering if the call option is not exercised.

4. Additional capital requirements and resolution regimes for "global systemically important banks"

In addition to Basel III and CRD IV, proposals are beginning to emerge on the additional capital banks deemed to be of global systemic importance ("**GSIBs**") will be required to hold and on possible resolution regimes for such institutions.

Two papers have been released, one issued by the Basel Committee, entitled "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement", and the other by the Financial Stability Board, entitled "Consultative Document: Effective Resolution of Systemically Important Financial Institutions".

The Basel Committee is recommending that GSIBs be required to hold CET1 of up to a maximum of 3.5% of risk weighted assets depending on various factors including an institution's size, interconnectedness and complexity

(although the current expectation is that this GSIB buffer will impose an additional 2.5% CET1 capital requirement on the most systemically important banks and less for others, with the 3.5% “bucket” currently remaining empty). This is in addition to the requirements under Basel III/CRD IV described above. Adding together the minimum capital requirements, the capital conservation buffer, the countercyclical buffer and, if implemented in the form being proposed, the GSIB buffer, certain banks could be required to have common equity resources of up to 12% of risk weighted assets[1].

Although it is clear that the Basel Committee is recommending that only CET1 capital be used to fulfil the GSIB buffer requirement, it remains to be seen whether the European banking industry will lobby European and international regulators to consider whether this GSIB buffer could also be satisfied by the type of subordinated principal loss absorption instruments, or CoCos, described elsewhere in this paper. One factor standing in the way of this appears to be the perception at the Basel Committee that CoCos are complex and may not trigger as intended, despite the existence of mature and deep markets in convertible bonds and bonds with principal write-down features and the fact that CoCo instruments are already approved for inclusion in AT1 and tier 2 capital resources under Basel III and CRD IV. Certain countries, notably Switzerland, have embraced such instruments for buffer capital purposes. And, according to its press release announcing that agreement had been reached on the GSIB buffer consultative document, the Basel Committee stated that it "will continue to review contingent capital, and support the use of contingent capital to meet higher national loss absorbency requirements than the global minimum, as high-trigger contingent capital could help absorb losses on a going concern basis." Market participants have until 26 August 2011 to provide comments to the Basel Committee on the GSIB buffer proposal.

In the second paper, the Financial Stability Board states its view that it is favourably inclined towards bail-in to enable the relevant national resolution authority to write-down or convert into equity unsecured claims "with a view to maintaining continuity of systemically vital functions". It considers both contractual bail-in and statutory bail-in as possible resolution tools available to national authorities in relation to GSIBs. Some commentators have noted that support by policy-makers for bail-in as a means of avoiding, or reducing the risk of, future sovereign bail-outs of banks by shifting the burden to private investors may mean that private senior unsecured bond investors – a key source of banks’ wholesale funding –become increasingly focused on the amount of a bank’s going-concern loss absorbing capital – such as CoCos – in order to reduce their exposure to bail-in risk.

Given the relatively early stage of development of these two initiatives, the EC has stated that it is “premature to include any requirements related to systemically important banks” in CRD IV.

5. Tax treatment of instruments

To see our multi-jurisdictional analysis of tax issues relating to new tier 1 structures, please see “Tax treatment of Tier 1 instruments following Basel III”.

In the United Kingdom, the budget announcement of 23 March 2011 stated that HMRC “will work with industry and representative bodies to explore the tax treatment of new capital instruments which banks may create as a result

[1] This assumes a countercyclical buffer of 2.5% and a GSIB buffer of 2.5%.

of the Basel III proposals on banks' capital requirements. Certain features of these instruments make the current tax treatment uncertain. The Government will be consulting on this measure." Market participants can follow developments on the website page HMRC have set up on Basel III.

6. Conclusion

The package of reforms ushered in by CRD IV marks the beginning of a new era in European bank capital. The reforms will be the subject of continued scrutiny and lobbying until they are finally approved by the Council of Ministers and the European Parliament. The current proposals still leave a number of important areas unclear. Responsibility for fleshing out the details has in some areas deliberately been devolved to the EBA, who are tasked with submitting binding technical standards with respect to, for example, the principal write-down feature by 1 January 2013 (see section 3.5). However, other matters do need to be agreed and/or clarified before the CRD IV proposals are adopted. In particular, clarity is needed around:

> loss absorption at PONV in AT1 and tier 2 capital instruments and what is intended to be dealt with by way of contract and what by way of statutory resolution regimes;

> some of the transitional and grandfathering provisions;

> whether or not principal write-downs in AT1 instruments can be restored upon resumption of health; and

> the manner in which any 'national finishes' are to be accommodated within a maximum harmonisation legislative framework.

Moreover, the role, if any, to be played by non-CET 1 instruments, such as CoCos, in the GSIB buffer, the CCB and 'national finishes' will need to be clarified during the continuing Basel Committee, EC and national consultation processes.

The outcome of some of these points has importance for the drafting, structuring and tax treatment of the new generation of loss-absorption instruments. The final structure of these instruments will also determine what shareholder and other corporate authorisations banks may need to obtain in order to be able to issue such instruments, particularly those which convert into equity. That there will be a new generation of more loss absorbing instruments is beyond doubt: both Basel III and CRD IV require AT1 and tier 2 instruments – which are substantial capital buckets – to have CoCo style loss-absorbing properties and the Basel Committee endorses the use of such instruments for 'national finishes'. It will be important that clarity on the points raised above is obtained at as early a stage as is possible if banks and their advisers are to have the opportunity to develop new CRD IV-compliant capital instruments which can be issued (or exchanged in liability management exercises for non-compliant, old-style instruments) in the period leading up to, and following, 1 January 2013.

10 August 2011

Linklaters leads the way in Regulatory Capital having advised on:

Post-crisis, post-Basel 3 new Tier 1 and Tier 2 "COCOs" in 2011:
Credit Suisse Group's private placement of US$6bn Tier 1 Buffer Capital Notes and the simultaneous offer of US$2bn Tier 2 Buffer Capital Notes

Rabobank Nederland's issue of US$2bn 8.375 per cent Perpetual Non-Cumulative Capital Securities

Key post-QIS5/draft Solvency II Insurance Sector deals in 2010 and 2011:
Allianz's issue of EUR500m convertible Notes with contingent mandatory conversion - the first "coco" issued by a European insurer

Aviva's £5,000,000,000 Euro Note Programme and its subsequent €450m tier 2 issue

Friends Provident's £500m tier 2 issue

AXA's €1.3bn Fixed to Floating Subordinated Notes due 2040

Hannover Re's €500m Subordinated Fixed to Floating Rate Callable Bonds due 2040

Old Mutual's 2010 update of its £3,500,000,000 Euro Note Programme and subsequent tier 2 issue

Legal & General's £2,000,000,000 Evio Note Programme

Establishment of Standard Life's MTN programme

Key 2008-2010 transactions:
Royal Bank of Scotland Group's £25.5bn issue to the UK government of new core tier 1 capital in the form of B shares, the largest bank recapitalisation to date

Lloyds Banking Group's £9bn tier 2 "enhanced capital notes" as part of its liability management exercise

Royal Bank of Scotland Group's buy back and exchange of £15.9bn of capital comprising 53 series of tier 1 preference shares and notes and upper tier 2 notes

Key deals in the mutuals sector:
Yorkshire Building Society's £100m 13.5% Contingent Convertible Tier 2 Capital Notes due 2025 (contingently convertible into Profit Participating Deferred Shares (PPDS)), 2010

The exchange of subordinated debt and loans by investors in West Bromwich Building Society for PPDS issued by the Society, 2009

Linklaters leads the way in Regulatory Capital Liability Management having advised:

Merrill Lynch International as dealer manager on ABN AMRO Bank's tender offer to the holders of the £750m perpetual subordinated upper tier 2 notes to tender any and all such notes for repurchase by ABN AMRO for cash.

Royal Bank of Scotland on its exchange offer to holders outside the United States of 13 series of upper tier two notes and one series of tier one notes to exchange such notes for newly issued senior notes.

Lloyds Banking Group on its exchange offer to the holders of 52 series of hybrid capital existing securities (held outside the United States) to offer to exchange such securities for either enhanced capital notes (ECNs) or the relevant exchange consideration amount, payable in ECNs and/or new shares.

Investec Bank on its exchange offer in relation to £200m 7.75% guaranteed subordinated step-up notes due 2016 and £350m 6.25% undated subordinated callable step-up notes, each issued by Investec Finance and guaranteed by Investec Bank.

Allied Irish Banks on its offer in June 2009 to exchange five series of subordinated securities for new subordinated securities.

Allied Irish Banks on its offer in January 2011 to purchase 11 series of subordinated dated securities.

Allied Irish Banks on its offer in May 2011 to purchase 18 series of subordinated securities (including tier 1 and upper and lower tier 2 securities).

Allied Irish Banks on its offer in March 2010 to exchange six series of subordinated securities for new subordinated securities.

Merrill Lynch International as dealer manager on Banco Santander's offer to purchase 11 series of subordinated securities for cash.

Old Mutual on its tender offer to the holders of its €750m fixed to floating rate callable option A dated tier 2 notes due 2017.

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