GSK | UPDATE

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# Hierarchy of Banks' Liabilities

## ADDITIONAL TIER 1 INSTRUMENTS' PRINCIPAL WRITE-DOWN UNDER LUXEMBOURG AND EU LEGISLATION

### Executive Summary

- The Credit Suisse Write-Down of AT1 instruments has taken market participants by surprise, but it seems to be the result of the exercise of discretionary powers by the Swiss regulator rather than the establishment of a new market standard.
- Given the current regulatory framework under Luxembourg and EU law, it seems unlikely that AT1 instruments issued by Luxembourg based institutions are written down before CET1 instruments had already absorbed all the losses they could.
- Investors should take a closer look beforehand at the contractual terms of the AT1 instruments they intend to subscribe.

The ability of regulators to write-down to zero the principal of AT1 instruments (as defined below) on a going-concern basis is an important component of the Basel framework aiming to strengthen the loss absorption capacity of credit institutions. Credit Suisse's buy-out and the write-down of AT1 instruments amounting to CHF 16 billion mandated by the Swiss Financial Market Supervisory Authority (**FINMA**), when at the same time common equity shareholders were not wiped out (the "**Credit Suisse Write-Down**"), has, on the one hand, taken capital market participants by surprise and, on the other hand, provides an opportunity to approach the nature of such regulator's ability from a different perspective. It seems that the Credit Suisse Write-Down was not made in the context of a resolution procedure but it was rather the result of the exercise of the discretionary power of FINMA, which decided that Credit Suisse was non-viable or approaching the point of non-viability (**PONV**) (this action is conceptually a PONV Write-Down, as defined below, even though it is not governed by the same legal rules). A concern that naturally arises relates to the reversal of the fundamental corporate finance and legal rules concerning the hierarchy of creditors in capital market transactions. The EU constitutes a significant AT1 debt market globally.

Thus, naturally, what concerns a large portion of the market at the moment (which comprises also retail investors), is whether such write-down to zero of the principal of AT1 instruments could be effected in the EU and whether it would result in the reversal of the ranking between shareholders and debt investors. The present analysis will attempt to provide an answer to such question by presenting the applicable legal rules in the EU and more specifically in Luxembourg.

### I. The nature of Additional Tier 1 Capital and the legal basis for their write-down under Luxembourg and EU law

Basel III introduced an explicit going-concern framework by clarifying that Tier 1 capital must be able to fully absorb losses. As a general rule, Tier 1 capital comprises Common Equity Tier 1 capital (**CET1**), such as shares, it being the highest quality of regulatory capital as it absorbs losses immediately when they occur and Additional Tier 1 capital (**AT1**), which also provides loss absorption on a going-concern basis, although AT1 instruments do not meet all the criteria for CET1. One manner that AT1 instruments can absorb losses is the write-down of their principal. There are three legal foundations under EU and Luxembourg law which would allow such write-down.

According to articles 52(1)(n) and 54 of Regulation (EU) No 575/2013 on prudential requirements for credit institutions, as amended (the "**CRR**"), among others, an instrument can be qualified as AT1 if its issuer has the capacity to write down its principal (or convert it into equity) (the "**CRR Write-Down**"). Such write-down is exercised when a trigger event occurs, which is connected with the CET1 ratio of the issuing credit institution. In that sense, the CRR Write-Down seems to be an innate characteristic of AT1 instruments governed by Luxembourg or, in general, EU law.

At the same time, AT1 instruments are subject to bail-in, in accordance with the provisions of Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms, as amended (the "**BRRD**") and, for credit institutions established in Luxembourg, of the Luxembourg law of 18 December 2015, on the failure of credit institutions and certain investment firms, as amended (the "**Luxembourg BRRD Law**"). Under the requirements set down in the BRRD and the Luxembourg BRRD Law the resolution authority, in case of Luxembourg the *Commission de Surveillance du Secteur Financier* (**CSSF**), has the capacity to write down the principle of the AT1 instrument (or convert the AT1 instrument into equity) (the "**Bail-in Write-Down**"). Such write-down constitutes a resolution action of the resolution authority.

In accordance with article 59 of the BRRD and 57 of the Luxembourg BRRD Law, if the relevant resolution authority designates a bank as non-viable, or as approaching the PONV, it can write down the principle of the AT1 (or convert the AT1 instrument into equity) even without commencing a resolution plan (the "**PONV Write-Down**"). This type of Write-Down is different from the Bail-in Write-Down in the sense that, *inter alia*, the PONV Write-Down does not constitute a resolution action. For the purposes of the application of the mandatory write-down (and conversion power), the point of non-viability under BRRD and the Luxembourg BRRD Law is the point at which (i) the relevant resolution authority determines that the relevant entity meets the conditions for resolution (but no resolution action has yet been taken) or (ii) the relevant authority or authorities, as the case may be, determine(s) that the relevant entity or its group will no longer be viable unless the relevant capital instruments are written down or converted into ordinary shares or (iii) extraordinary public financial support is required by the relevant entity other than, where the entity is an institution, for the purposes of remedying a serious disturbance in the economy of an EEA Member State and to preserve financial stability.

Having considered the legal basis on which a write-down of AT1 instruments could be effectuated and based on the publicly known facts on the Credit Suisse Write-Down, it seems that FINMA acted in the context of a concept similar to both the PONV Write-Down and the CRR Write-Down, as it is implemented in the Swiss national legal framework. Essentially, the contractual documentation of the AT1 instruments designated a PONV as a trigger event which would lead to a write-down. Initial commentators of the FINMA decision have stressed that such provision is not in line with market practice for AT1 instruments and it is usually not found in the documentation of AT1 instruments governed by the laws of EU member states, including Luxembourg law. At the same time, it can be argued that the requirements for a Bail-in Write-Down were not met in the case of the Credit Suisse Write-Down, given that the write-down decision was not taken in a resolution action. In view of that, the investigation of whether a reversal of the creditor hierarchy could happen under Luxembourg or EU laws will be made in the context of a PONV Write-Down.

## II. PONV Write-Down and hierarchy of creditors in Luxembourg and the EU

The Credit Suisse Write-Down seems to deviate from typical creditor hierarchy rules but this outcome was possible given the nature of the Swiss contractual terms of the AT1 instrument and the applicable regulatory framework. An automatic and permanent write-down of the AT1 principal to zero was triggered when the regulator for Credit Suisse Group (**CSG**) determined that a viability event had occurred. The AT1 documentation includes a definition of a viability event:

"*Customary measures to improve CSG's capital adequacy being at the time inadequate or unfeasible, CSG has received an irrevocable commitment of extraordinary support from the public sector (beyond customary transactions and arrangements in the ordinary course)* *that has, or imminently will have, the effect of improving CSG's capital adequacy and without which, in the determination of the regulator, CSG would have become insolvent, bankrupt, unable to pay a material part of its debts as they fall due, or unable to carry on its business*."

It is unlikely that a PONV Write-Down effectuated in Luxembourg or in the EU in general would have the same or a similar effect. On 20 March 2023, the Single Resolution Board, the European Banking Authority and the European Central Bank reminded investors that they expect common equity instruments to be the first to absorb losses in case of resolution or insolvency; only after these have been depleted would the EU require AT1 instruments to be written down. This position is also reflected in the BRRD and the Luxembourg BRRD Law.

Article 48 of the BRRD and 49 of the Luxembourg BBRD Law provides that resolution authorities exercise the write down and conversion powers in the following order: CET1 items; then AT1 instruments; then T2 instruments; then other subordinated debt that is not AT1 or T2 instruments in accordance with the hierarchy of claims in normal insolvency law; then the rest of eligible liabilities in accordance with the hierarchy of claims in normal insolvency law. This rule is confirmed in article 60 of the BRRD and 58 of the Luxembourg BRRD Law, which regulates specifically PONV Write-Downs. Under those provisions the relevant competent resolution authority shall exercise the write-down (or conversion) power in accordance with the priority of claims under normal insolvency proceedings. It shall reduce the Common Equity Tier 1 first in proportion to the losses and to the extent of their capacity and should also cancel the existing shares or other instruments of ownership or transfer them to bailed-in/affected creditors. Only after such actions have been made, the principal amount of Additional Tier 1 instruments is written down (or converted into Common Equity Tier 1 instruments or both). Subsequently, Tier 2 instruments can absorb losses as well.

In view of the above, the non-viability of a credit institution located in Luxembourg or in the EU, should not lead to the write-down of its AT1 instruments, unless CET1 instruments had already absorbed all the losses they could. The conclusion is the same when considering the effects of a Bail-in Write-Down. On the other hand, a CRR Write-Down could indeed lead to the write-down to zero of AT1 instruments when at the same time the CET1 instruments are not affected. In essence, this is the rationale behind the CRR Write-Down; it should lead to the write-down of AT1 instruments so that the CET1 ratio of the institution can be rebuilt. Nevertheless, as indicated above, AT1 instruments typically link the trigger events for a CRR Write-Down with the CET1 ratio of the issuing credit institution; it would be unusual to simply designate a PONV as trigger event.

## III. Conclusion

The architecture of the EU and the Luxembourg legal framework on writing down the principal of AT1 instrument is structured in a manner, which should not allow a resolution authority to reverse the standard creditor hierarchy while exercising a PONV Write-Down. The provisions of the BRRD and of the Luxembourg BRRD Law oblige the resolution authorities to follow the "*hierarchy of claims in normal insolvency law*". In that context, it would be rather unlikely for an EU resolution authority to completely write-down (under a PONV Write-Down) AT1 instruments without having the CET1 instruments already absorbed losses.

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