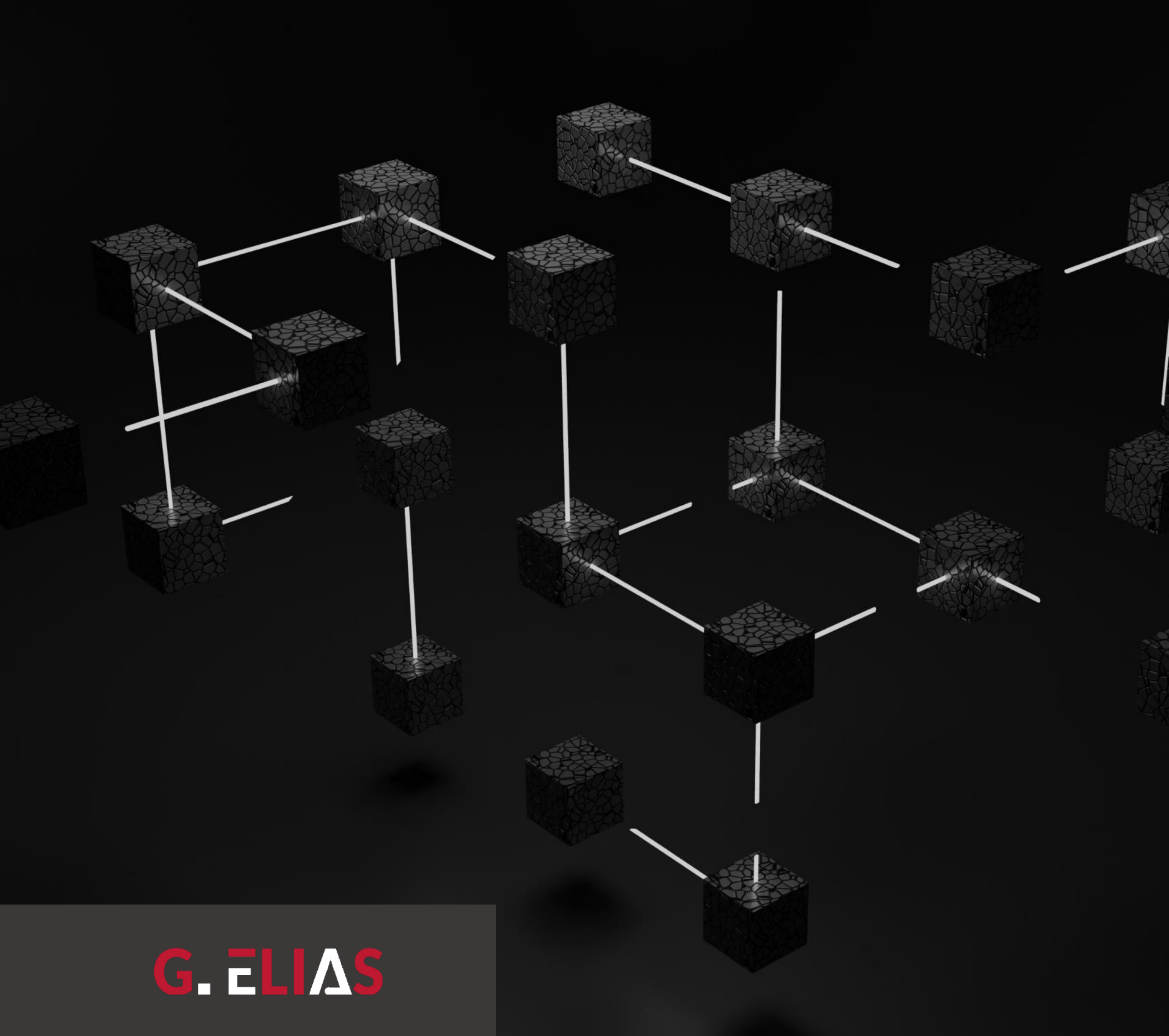

Understanding AT1 Instruments

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Introduction

The financial crisis of 2007-2008 revealed that the quality and quantity of the capital base of banks around the world maintained in accordance with the Basel II framework were insufficient to absorb shocks from economic and financial stress.[1] It became evident from that crisis that loan losses and write-downs (which are necessary to absorb shocks) came solely out of common equity capital including retained earnings. In response, the Basel Committee on Banking Supervision (BCBS) in December 2010, developed and issued the Basel III reforms with principles and requirements aimed at ensuring that banks hold high quality Tier 1 and Tier 2 capital explicitly able to fully absorb losses and write-downs before any intervention from the government is triggered, thereby increasing the ability of banking system to internally absorb shocks during crises.

Bearing in mind that the BCBS has scheduled the full implementation deadline of the Basel III framework for 2028, the Central Bank of Nigeria ("**CBN**") through a circular issued on September 2, 2021 and titled "Basel III Implementation by Deposit Money Banks In Nigeria" kickstarted the implementation of the Basel III accord (the "**Framework**")[2] in Nigeria. The implementation of the Framework is, for the time being, running parallel with the current Basel II requirements. Thus, Deposit Money Banks in Nigeria ("**DMBs**") are required to render monthly returns for each of the Basel III and Basel II requirements. Nonetheless, banks in Nigeria have been eager to and are taking steps to shore-up their capital bases with the quality and quantity of capital that satisfies the requirements under the Framework.

One of the ways this has been done is through the issuance of Additional Tier 1 financial instruments ("**AT1 Instruments**"). Notably so, Access Bank in October 2021 became the first Nigerian bank to issue AT1 Eurobonds in line with the CBN Basel III guidelines: the Guidelines on Regulatory Capital, the Guidelines on Leverage Ratio, Guidelines on Liquidity Coverage Ratio, the Guidelines on Liquidity Monitoring Tools, Guidelines on Large Exposures, and Guidelines on Liquidity Risk Management and Internal Liquidity Adequacy Assessment Process (the "**Guidelines**").

In this article, we discuss the nature and peculiarities of AT1 Instruments under the Guidelines, possible challenges of such financial instruments, as well as its attractiveness (or otherwise) to investors.

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[1] Basel III: A global regulatory framework for more resilient banks and banking systems (December 2011, rev. June 2011), Bank for International Settlements.

[2] The CBN officially released the guidelines and reporting templates for the Basel III implementation by Deposit Money Banks in Nigeria (DMBs) via its circular dated September 2, 2021 amongst which includes the Guidelines on Regulatory Capital (GRC), Guidelines on Leverage Ratio (LeR), Guidelines on Liquidity Coverage Ratio (LCR) Guidelines on Liquidity Monitoring Tools (LMT), Guidelines on Large Exposures (LEX), Guidelines on Liquidity Risk Management and Internal Liquidity Adequacy Assessment Process (ILAAP).

What are AT1 Instruments?

Under the Framework and Guidelines, regulatory capital now consists of Tier 1 and Tier 2 capital, the components, and terms of which must be able to absorb losses and write-downs.[3] Tier 3 capital subsisting under the Basel II framework has now been discarded under Basel III – because Tier 3 capital are only able to support market risks.

AT1 Instruments are simply those types of financial instruments subject to terms and conditions which qualify them as admissible into the Tier 1 capital base of the issuing bank. Expectedly, these instruments are very similar to common equity being deeply subordinated, fully discretionary on payment of dividends/coupon payments which may not be cumulative, with no maturity dates and no incentives to redeem. Although AT1 Instruments typically take the form of bonds or other debt instruments, it could take any form or be structured differently, provided that all of the conditions for admission into the Tier 1 capital base of the bank are satisfied. Premiums from the issuance of AT1 Instruments also form part of AT1 capital.

Under the Guidelines, Tier 1 capital base of each bank in Nigeria must be at least 7.5%[4] or 11.25%[5] of risk-weighted assets of the bank at all times, out of which 7.0% and 10.5% must be common equity tier 1 capital ("**CET1**" or "**CET1 Capital**"). To shore-up Tier 1 capital with additional AT1 capital, banks issue AT1 capital instruments like bonds or notes, and utilize the proceeds of the issuance to fund projects and general banking business. It is not inconceivable that types of AT1 instruments or financing contracts may evolve beyond what is popular today, taking various other forms – so long as, of course, the conditions for admission into the bank's capital base as Tier 1 capital are satisfied.

Terms and Conditions for Admission of a Financial Instrument as AT1 Capital

Although a DMB may intend to issue qualifying AT1 Instruments, not every such instrument issued will be admitted as AT1 capital. The terms and conditions of such instrument must satisfy the strict regulatory requirements set out in the CBN Guidelines on Regulatory Capital. Some of the key qualifying criteria are as follows:

A. *Perpetual With No Incentives to Redeem*

Typically, debt instruments or loans have specified tenors and therefore have maturity dates on which the instrument is redeemed, i.e., the principal loan amount plus accrued and unpaid interests/coupons are paid to the investor/subscriber. AT1 admissible instruments, on the contrary, are "tenor-less" – they have no maturity date. This means that there is *no obligation* on the issuing bank to repay investors the principal amount invested in purchasing the instrument at any time. In addition, there must be no term or condition of issue that incentivize or encourage the issuing bank to redeem the instrument. Thus, holders of AT1 Instruments may be unable to recover their principal investments except via a secondary sale,

[3] CBN Guidelines on Regulatory Capital dated September 21, 2021, Paragraph 3.1.
[4] For national/regional banks.
[5] For international banks and domestically systemic important banks.

although, the holders will for as long as the notes are outstanding and the issuing bank is viable and profitable, continue to receive dividends/interests on the instruments perpetually.

B. *Neither the Issuing Bank nor a Related Entity May Invest in or Guarantee the Instrument*

To qualify as AT1 capital instrument, neither the issuing bank nor a related entity may provide any credit enhancement feature. Such credit enhancement feature may contemplate payments to investors out of the banks CET1 capital, retained earnings, or even loan. Thus, the prohibition of credit enhancements by the bank or an affiliate is prudent considering that the purpose of the AT1 capital is not merely to raise capital – but to raise capital in addition to, not out of, CET1 Capital or retained earnings, and to ensure that the capital raised can absorb shocks without affecting the institution or requiring an additional capital raise. For the same reason, the issuing bank, or an entity it controls or exercises significant influence over may not purchase such instruments.

C. *Payments of Principal and Interests on the Instruments are Not Guaranteed*

As a corollary to the condition that the instruments are perpetual, any repayment of principal through repurchase or redemption requires the prior approval of the CBN – which is not and must not appear to be assured. Moreover, the issuing bank must retain its discretion to cancel any interest/dividend payments to AT1 Instrument investors in order to enable it meet other obligations of the bank. Unlike usual conditions of debt instruments, such cancellation of interests/dividends would not constitute an event of default. This is important because the key purpose of the AT1 capital is to absorb shocks; creating shocks or liability events as would typically be the case where such cancellation constitutes an event of default, would defeat the purpose of the capital structure. Dividends/interests cancelled cannot be recovered, as dividends/ interests are not cumulative. If unpaid dividends or interests were to be accumulative, such instruments then contributes to the liabilities of the bank, which runs contrary to the requirement that "*the instrument cannot contribute to liabilities exceeding assets for the purpose of insolvency testing*."[6]

D. *Convertible and Loss-Absorbing Upon the Occurrence of a Non-Viability Event*

The terms and conditions of the instrument must be explicit on the fact that if a non-viability event, as determined by the CBN, occurs with respect to the issuer, the principal value of the instrument may either be converted to common equity or written down. The instrument may be written down up to the full principal value of the instrument – depending on the amount required to return the issuing bank's CET1 level ratio to the required level. A write down is permanent: it reduces the claim on the instrument in liquidation and the amount repayable if a call is exercised. Additionally, the write down on the principal has consequential effects on the amounts of dividends/interests payable post write-down. If the principal amount is fully written down, no interest/dividend will be payable. Compensation for write-downs may only be in the form of common stock of the issuing bank or its parent company.

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[6] Supra 3, Para 36 (k).

The Yes Bank Crisis

*On March 14, 2020, the investors of the Additional Tier 1 Bonds issued by Yes Bank Limited ("**YB**") ("**YB AT1 Bonds**") were met with a huge shock as the YB AT1 Bonds worth Rs8,415 crore (equivalent of US$1,085,155) were completely written down. YB was deemed non-viable due to incurred loss and breach of the Royal Bank of India's (the "**RBI**") mandated Common Equity Ratio.[1] The aggrieved investors filed a petition in court against YB, RBI and Securities and Exchange Board of India, amongst others, on the ground that the AT1 Bonds were sold to the investors without adequate disclosures on the nature of the instrument. However, the YB and its legal advisers maintained that the YB AT1 Bonds were issued in compliance with the Basel III rules and the write down was in accordance with these rules – which were public information. The risk of write-downs highlights the need for professional legal and financial advice before investing in AT1 Instruments*.

E. *Deeply Subordinated*

AT1 Instruments must rank below the issuing bank's obligations to depositors, general creditors, and subordinated debt of the bank (e.g., repayment obligations on Tier 2 capital instruments). Moreso, there can be no special arrangement to enhance the seniority of the notes.

F. *Fully Paid-Up*

Finally, one of the key requirements of AT1 admissible instruments is that the capital instrument must be issued and cash, fully paid in from day one.

Should AT1 Instruments be Taxed as Debt or Equity?

Considering the main purpose of AT1 capital (loss-absorption) and the conditions necessary to ensure that such capital achieves its purpose as discussed above, AT1 Instruments may best be described as hybrid instruments or even just *sui generis*. Being distinguished from CET1 capital, AT1 Instruments are much like common equity securities with no voting rights. Nonetheless in insolvency, an issuing bank's obligations to investors on AT1 Instruments ranks above its repayment obligations to common shareholders.

However, where write-downs of AT1 Instruments are not compensated with issuance of equity instruments to the investors, such investors will in insolvency, be worse off than common shareholders who may recover all their equity investments. For this reason, where a viability event occurs, conversion of AT1 Instruments to common equity should be preferable to write-downs.

In connection with the uncertainty as to the form/nature of AT1 Instruments, one of the most frequently asked questions is the tax treatment of income on such instruments. Unlike other jurisdictions, *e.g.,* the European Union where AT1 Instruments are treated as debt instruments,[7] the Nigerian tax authorities are yet to publish any such directive on the tax treatment of AT1 Instruments. This is understandable, considering that Basel III implementation is yet in its nascent stages in Nigeria.

On tax treatment possibilities, however, AT1 capital instruments may be treated either as debt or equity. Where treated as debt, (i) interests payable will generally be subject to withholding tax at 7.5% or 10% depending on whether the holder of the instrument is located in Nigeria or in a country with which Nigeria has signed a double tax treaty, and (ii) capital gains on disposal of the instrument will be subject to capital gains tax at the rate of 10%, subject to any applicable exemption. Similarly, where such instruments are treated as equity, (i) dividends will (subject to any applicable exemption e.g., franked investment income exemption) will be subject to withholding tax at 7.5% or 10% depending on whether the holder of the instrument is located in Nigeria or in a country with which Nigeria has signed a double tax treaty, and (ii) capital gains tax payable on disposal of the instrument will be 10%, subject to any applicable exemption.[8]

As at the date of this article, tax treatment as debt mirrors tax treatment as equity. However, prior to Finance Act, 2021, no capital gains tax was payable on gains accruing from the disposal of shares.[9]

Additionally, pursuant to the expiration of the Companies Income Tax (Exemption of Bonds and Short-Term Government Securities) Order, 2011, ("CIT Order"), and the VAT (Exemption of Proceeds of Disposal of Government and Corporate Securities) Order 2011, ("VAT Order"), interest paid on corporate bonds are no longer exempted from taxes ordinarily imposed under the Companies Income Tax Act. However, since the exemptions under the Personal Income Tax (Amendment) Act 2011 are not time bound, the interest payments on corporate bonds to individuals remain exempt from personal income tax.

Summary

By the implementation of the Basel III Framework in Nigeria, DMBs will have a unique way to shore-up their capital base with enough capital to cushion the effects of financial crisis. Although AT1 Instruments are highly regulated and largely untested in Nigeria, it is expected that the issuance of AT1 Instruments by Nigerian banks will be on the increase and will promote stability in the financial and real sectors.

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[7] Section 845C Taxes Consolidation Act 1997 ('TCA 1997') was introduced by the Finance Act 2015 to confirm that an AT1 Instrument should be treated as a debt instrument-See Page 6, Tax and Duty Manual "Treatment of Additional Tier 1 Capital, Part 36-00-18" dated April 2020 < https://www.revenue.ie/en/tax-professionals/tdm/income-tax-capital-gains-tax-corporation-tax/part-36/36-00-18.pdf> assessed on March 2, 2022.

[8] Finance Act 2021 amending Section 30 of the Capital Gains Tax Act 1967

[9] Section 30 CGT Act Cap C1 LFN 2004.

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