CLIFFORD

CHANCE

ISSUANCE OF ADDITIONAL TIER 1 (AT1) INSTRUMENTS POSSIBLE UNDER POLISH LAW

Poland has created Additional Tier 1 ("**AT1**") instruments within the meaning of the Capital Requirements Regulation No 575/2013 (the "**CRR**") by the Act of 14 April 2023 (the "**Amendment Act**") which amends, among others, the Act of 15 January 2015 on Bonds (the "**Bonds Act**") and the Banking Law of 29 August 1997 (the "**Polish Banking Law"**).

As from 1 October 2023 (which is the date on which the Amendment Act will come into force) it will be possible to issue contingent convertible bonds (so called *obligacje kapitałowe*) and to incur subordinated loans (*pożyczki podporządkowane*) that can be qualified as AT1 instruments which are governed by Polish law. To be treated as Additional Tier 1 capital under the CRR the relevant instruments will need to obtain permission from the Polish Financial Supervision Authority (*Komisja Nadzoru Finansowego*, the "**KNF**").

Key issues

- Poland has created two AT1 instruments: contingent convertible bonds (obligacje kapitałowe) and subordinated loans (pożyczki podporządkowane).
- Issuance of new AT1 instruments will allow banks to increase their T1 capital ratio as defined by CRR.
- Payment of distributions (e.g. interest) on new instruments will depend solely on the issuing institution's decision.
- Upon the occurrence of a triggering event, the instruments will be subject to conversion into shares or written-off with the aim of allowing the issuing institution to recapitalize.

CAPITAL ADEQUACY REQUIREMENTS

The CRR relates to capital adequacy requirements – in other words, the obligations of certain institutions (banks, among others) (the "**Institutions**") to maintain their own funds at appropriate levels that will ensure the stability of the financial sector. The CRR divides the instruments corresponding to the Institutions' assets into different categories. Apart from AT1 instruments under CRR we can distinguish (among others):

- Common Equity Tier 1 ("**CET1**") instruments (e.g. shares meeting CRR requirements); and
- Tier 2 ("**T2**") instruments (e.g. bonds meeting CRR requirements for T2 instruments and not qualified as AT1 instruments).

As a rule, Institutions should have, among others, a 6 per cent. or higher Tier 1 ("**T1**") capital ratio. The capital ratio is calculated by expressing the given capital of the institution (e.g. CET1 capital) as a percentage of the total risk exposure amount determined in accordance with CRR provisions. When calculating the T1 capital ratio, the amount of funds of the Institution under CET1 and AT1 capital is relevant. This means that issuing AT1 instruments

allows Institutions to raise their T1 capital level (as well as the level of their total capital ratio, which according to the CRR should be at least 8 per cent.).

WHAT ARE AT1 INSTRUMENTS?

The AT1 instruments are hybrid instruments introduced to help the Institutions fulfill their CRR requirements. When the Institution is in a good financial condition, AT1 instruments operate in the same way as standard debt instruments (e.g. the investor receives interest on the AT1 bonds). However, if the mechanism is triggered, AT1 instruments serve as a means to recapitalize the Institution, either by:

- conversion of the AT1 instrument to the CET1 instrument; or
- full or partial write-off.

Therefore, AT1 instruments are "something between" CET1 and T2 instruments. The main differential points are:

- unlike the CET1 instruments, the AT1 instruments do not need to be equity instruments (like shares or stocks) but can be (specific) debt instruments (usually bonds); and
- unlike the T2 instruments, the AT1 instruments upon the occurrence of a trigger event must be written off on a permanent or temporary basis[1] or converted to CET1 instruments (e.g., some AT1 bonds upon the occurrence of a trigger event will be converted to shares of the issuer).

Besides the above, the instrument can qualify as AT1 instrument if specific requirements set out in the CRR are met. According to Article 127 of the Polish Banking Law to qualify a given instrument as an AT1 instrument it is necessary to obtain approval from the KNF.

POLISH CONTINGENT CONVERTIBLE BONDS (POLSKIE *OBLIGACJE KAPITAŁOWE*)

GENERAL COMMENTS

According to the Amendment Act, Polish contingent convertible bonds (*obligacje kapitałowe*, "**CoCos**") may be issued by Polish banks[2], brokerage houses, Polish insurance companies and Polish reinsurance companies. The provisions of the Amendment Act to a large extent reflect the CRR provisions.

For example, like all AT1 instruments, CoCos are perpetual. This means that:

- a bondholder may receive interest for an indefinite period of time; and
- bonds are not subject to redemption upon the bondholders' request (i.e. bondholders cannot seek payment of the nominal value of the bonds until bankruptcy of the issuer is declared or its liquidation commences).

Despite the perpetuity of bonds, if so specified in the terms and conditions, an issuer will be entitled to write off or defer interest in full or in part. Such actions will not constitute a breach of the issuer's undertakings under the terms and conditions, and they reflect the provisions of the CRR that for classification as an AT1 instrument, it is necessary that interest is payable from distributable

[1] Which means that their nominal value will be reduced in full or in part permanently or for some time.
[2] Foreign banks cannot issue such bonds under Polish law.

items and that an issuer has full discretion regarding the decision to write off interest.

The terms and conditions must also specify a trigger event. The trigger event occurs when the CET1 capital ratio of the Institution falls below 5,125 per cent. or a level higher than 5,125 per cent., if such higher threshold is specified in the terms and conditions. The Institution may specify in the terms and conditions one or more trigger events in addition to the capital ratio event.

It is also necessary to determine the consequence of the trigger event – it can be either the conversion of the bonds into shares or full or partial write-off (which can be temporary or permanent). The terms and conditions can also specify the rules for increasing the nominal value of CoCos after the write-off but their value cannot be increased above their nominal value at the issue date.

In certain circumstances provided in the CRR the institution may redeem CoCos. The redemption of CoCos is possible 5 years after the issue of bonds and after obtaining the permission of the KNF[3]. The KNF should grant such permission if:

- the CoCos redeemed are replaced by other AT1 instruments (e.g., newly issued CoCos) or CET1 instruments on the terms specified in the CRR; or
- the Institution has demonstrated to the satisfaction of the KNF that after the redemption, its own funds and eligible liabilities will exceed levels required by the provisions of, among others, the CRR by the margin that the KNF deems necessary.

SPECIFIC POLISH LAW ISSUES

Some provisions relating to CoCos are specific to Polish law. Firstly, they can be offered only to professional clients (as defined in the Act of 29 July 2005 on Trading in Financial Instruments, the "**Trading in Financial Instruments Act**"). Also, the nominal value of one CoCo must be at least PLN 400,000 (or the equivalent of this amount in another currency).[4]

According to general rules applicable to all debt instruments issued under Polish law, CoCos should be issued in dematerialized form and recorded in a securities depository maintained by KDPW S.A. (i.e. Polish central securities depository). However, the Amendment Act provides an exception permitting CoCos to be issued in documentary form if there is an intention to register them in the central securities depository of other Member State.

Another specific issue is the conversion of CoCos into CET1 instruments. Under Polish law CoCos can be converted into shares in a joint-stock company (*akcje*). Shares obtained for CoCos cannot be privileged (i.e. have enhanced voting or dividend rights).

The conversion cannot take place in the case of CoCos issued by cooperative banks, state banks and brokerage houses operating as Polish limited liability companies. In such cases, the occurrence of a trigger event may only result in a write-off.

[3] Exceptions apply related to changes in the regulatory or tax classification of CoCos. Under the conditions set out in Article 78(4) of CRR, it is possible to redeem CoCos before the expiration of the 5-year period.
[4] It is already the case with respect to the subordinated and senior non preferred bonds issued under Polish law.

To successfully issue convertible CoCos it is necessary for a general meeting of shareholders to adopt four resolutions:

- a resolution containing an authorization for the management board of the issuer to adopt a resolution to issue shares upon the occurrence of the trigger event specified in the terms and conditions (such resolution constitutes an amendment to the articles of association of an issuer, thus it needs to be adopted by a majority of 3/4 of votes unless the articles of association establish a higher majority for its amendment and it needs to be submitted to the National Court Register);
- a resolution relating to the issuance of CoCos (requiring a majority of 3/4 of votes);
- a resolution on an increase of issuer's share capital by conversion of CoCos into shares (requiring a majority of 3/4 of votes); and
- a resolution on exclusion of pre-emption rights regarding shares to be issued in exchange for CoCos (requiring a majority of 4/5 of votes)[5].

In addition, one additional resolution of the general meeting of shareholders on exclusion of preemption rights regarding CoCos (requiring majority of 4/5 of votes) is worth adopting as they are securities convertible into shares and therefore are subject to shareholders' preemption rights under Polish law.

Since to qualify CoCos as AT1 instruments it is necessary to obtain the approval of the KNF, the Bonds Act allows CoCos to be redeemed not only when the CRR allows to do so, but also in the event of refusal by KNF to grant such approval. The issuer may redeem CoCos in that case if the terms and conditions include information about the possibility of such redemption.

SUBORDINATED LOANS (POŻYCZKI PODPORZĄDKOWANE)

Subordinated loans qualifying as AT1 instruments are other instruments which may play an important role in the process of increasing bank's T1 capital level, as for shareholders it is much easier to conclude such loan agreements than to subscribe for a new series of shares or bonds.

Subordinated loans (*pożyczki podporządkowane*) are in many ways similar to CoCos. "Banking"[6] subordinated loans can be concluded only between a bank as borrower and a professional client (as defined in the Trading in Financial Instruments Act) as lender. The principal amount of the loan should be no less than PLN 400,000 or the equivalent of this amount in another currency. The loan agreement is concluded for an indefinite period of time, and the lender cannot seek repayment until bankruptcy of the borrower is declared or its liquidation commences.

The interest may be paid for an indefinite period, and this obligation cannot be terminated unlike other indefinite obligations under Polish law. As in the case of CoCos, the borrower may write off interest in whole or in part (if its management board so decides), and that won't constitute a breach of the borrowers' contractual obligations.

[5] Provisions regarding such exclusion should also be included in the resolution regarding the issuance of CoCos.
[6] Similar regulations allowing to incur subordinated loans have been introduced by the Amendment Act for brokerage houses, small brokerage houses, polish insurance companies and polish reinsurance companies.

The trigger event must be specified in the same way as in the case of CoCos. It is also necessary to determine the consequence of the trigger event – in the case of subordinated loans it can be only a full or partial write-off (temporary or permanent). The terms of the loan agreement can also specify the rules for increasing the value of the loan principal after the write-off, but it cannot be increased above the principal value from the day of the conclusion of the agreement.

Despite the perpetuity of the subordinated loan, the bank may repay it if it decides to and if it fulfills conditions stipulated in the CRR. Repayment is possible 5 years after the conclusion of the agreement and after obtaining the permission of the KNF[7]. The conditions of such permission are analogous to the conditions for redemption of CoCos.

As in the case of CoCos, to qualify subordinated loans as AT1 instruments it is necessary to obtain the approval of the KNF. Therefore, the Polish Banking Law also allows the loan to be repaid in the event of refusal by KNF to grant approval. The borrower may repay the loan in that case if the agreement includes information about the possibility of such repayment.

AT1 INSTRUMENTS AND BANK'S INSOLVENCY

According to the new Article 11(4a) the Bankruptcy Law of 28 February 2003 ("**Bankruptcy Law**") liabilities rising from instruments issued for the purpose of their classification into own funds[8] as AT1 instruments and T2 instruments, as well as subordinated loans concluded for the purpose of their classification into own funds as AT1 instruments, are not taken into account in determining whether the debtor is insolvent (within the meaning of Article 11(2) of the Bankruptcy Law). For that purpose, the liabilities of bond issuers and borrowers are treated as non-existing.

Similarly, those liabilities are not taken into account in determining whether a Bank is insolvent in accordance with Article 426 of the Bankruptcy Law.

If AT1 liabilities still exist at the bankruptcy proceedings (*postępowanie upadłościowe*) stage (i.e. if they have not been fully written off), they are satisfied after all other liabilities except shares, in category 9. If CoCos were converted into shares, then investors' claims will rank in category 10 (CET1 instruments).

AT1 instruments may also be written down or converted into CET1 instruments by the Bank Guarantee Fund ("**BFG**") on the terms provided for in the Directive (EU) 2017/2399 amending Directive 2014/59/EU of 15 May 2014 (the "**BRRD**") and the Act of 10 June 2016 on the Bank Guarantee Fund, Deposit Guarantee Scheme and Resolution (the "**BFG Act**") implementing it.

ISSUANCE OF AT1 INSTRUMENTS BY POLISH ENTITIES UNDER FOREIGN LAW

The Amendment Act addresses only the issuance of AT1 instruments under Polish law. It is certainly worth considering the possibility of issuing AT1 instruments by Polish entities under foreign law.

[7] Exceptions apply related to changes in the regulatory or tax classification of subordinated loans. Under the conditions set out in Article 78(4) of CRR, it is possible to repay them before the expiration of the 5-year period.
[8] Which means the sum of T1 capital and T2 capital.

This issue is quite complex and crucial questions would include whether instruments issued under foreign law by a Polish entity will be able to be classified as AT1 instruments according to the Bankruptcy Law and what conditions relating to such instruments shall remain governed by Polish law.

Another question is whether it would be possible to convert such instruments issued under foreign law into shares upon the occurrence of the trigger event. For now, the answer seems to be negative due to provisions of the Polish Commercial Companies Code. However, the absence of a conversion option should not preclude the issuance of AT1 instruments by Polish entities under foreign law as in the light of the CRR requirements such instrument may only include a write-off option.

TAX TREATMENT

Currently, no special tax regime has been introduced regarding the taxation of contingent convertible bonds and subordinated loans that can be qualified as AT1 instruments, despite demands made in this regard during the legislative process. To be precise, the new legislation focuses entirely on regulatory issues, without providing for appropriate tax solutions to make the issuance of such instruments more desirable.

As regards tax deductibility, hybrid instruments, unlike ordinary equity instruments, should allow interest payments made to bondholders/lenders to be considered as a deductible expense, thereby reducing the tax base of the issuer/borrower. Nevertheless, it cannot be ruled out that, due to their hybrid nature, this cost will be questioned, especially from the perspective of the anti-hybrid mismatch regulation. A hybrid mismatch may arise in the case of e.g., hybrid financial instruments, which takes place when two jurisdictions treat a financial instrument differently for tax purposes. According to this regulation, a taxpayer is not entitled to deduct from its tax base any costs that are subject to double deduction or deduction without inclusion. This applies when deduction without inclusion and double deduction are made by affiliated entities and - in the case of deduction without inclusion - under a hybrid mismatch.

As regards withholding tax, payments made under AT1 instruments should be subject to the withholding tax regime applicable for debt instruments (interest). However, bearing in mind their hybrid nature, reclassification into equity instruments for withholding tax purposes cannot be completely ruled out.

IMPACT ON THE MARKET

The introduction of AT1 instruments into Polish law is another step in the right direction.

These instruments have been present on debt capital markets of other Member States for several years now and it is good to see that Poland is catching up.

The creation of new instruments will give institutions more flexibility in the process of fulfilling capital adequacy requirements by issuing debt instead of equity. It is also beneficial from the investors' perspective, because due to the increased risk associated with the issue of AT1 instruments, they will most likely offer a much higher rate of return than classic bonds or loans.

Investing in AT1 instruments certainly may involve more risk to investors, as the Credit Suisse case showed. Because the AT1 bonds write-down regarding Credit Suisse happened relatively recently, Polish AT1 instruments may not, at least initially, be as popular as some would hope. However, we expect that in the next few years they will start to play an increasingly important role in the Polish debt financing market.

CONTACTS

Grzegorz Namiotkiewicz
Partner

T +48 22 627 11 77
E grzegorz.namiotkiewicz @cliffordchance.com

Miłosz Gołąb
Partner

T +48 22 627 11 77
E milosz.golab @cliffordchance.com

Aleksandra Rudzińska
Counsel

T +48 22 627 11 77
E aleksandra.rudzinska @cliffordchance.com

Tomasz Szymura
Counsel

T +48 22 627 11 77
E tomasz.szymura @cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

© Clifford Chance 2023

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571

Registered office: 10 Upper Bank Street, London, E14 5JJ

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Delhi • Dubai • Düsseldorf • Frankfurt • Hong Kong • Houston • Istanbul • London • Luxembourg • Madrid • Milan • Munich • Newcastle • New York • Paris • Perth • Prague • Riyadh • Rome • São Paulo • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

AS&H Clifford Chance, a joint venture entered into by Clifford Chance LLP.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.