What to do with profits when banks are undercapitalized: Maximum Distributable Amount, CoCo bonds and volatile markets

This note gives an overview of the recent discussions relating to the clarification of the methodology for calculating the Maximum distributable Amount in banking supervision and the volatility on the market for banks contingent convertible bonds ("CoCo bonds").

What is the Maximum Distributable Amount?

Member States shall prohibit any institution that meets the combined buffer requirement from making a distribution of its profit in connection with Common Equity Tier 1 ("CET1") capital to an extent that would decrease its CET1 capital to a level where the combined buffer requirement is no longer met (Article 141(1) of the Capital Requirement Directive (CRD IV)). The purpose of such limitation is to ensure that the distribution of profits does not jeopardise the capital position of the credit institution.

In addition, Article 141 CRD IV provides that institutions which fail to meet their combined buffer requirement must calculate, according to a pre-defined regulatory formula, the maximum amount they are allowed to pay in the form of dividends (on CET1 instruments), discretionary coupons (on Additional Tier 1 ("AT1") instruments) or through the creation of new obligations to pay bonuses and pensions rights. This amount is called the Maximum Distributable Amount ("MDA").

The MDA is calculated as the amount of interim or year-end profits not yet incorporated in CET1 capital, multiplied by a factor ranging from 0 to 0.6 depending on the size of the CET1 shortfall.

1 The combined buffer requirement consists of the sum of the higher of the systematically important institution buffers (G-SII/O-SII) and the Systemic Risk Buffer (SRB), the countercyclical buffer and the capital conservation buffer. Banks must comply with those requirements in addition to pillar I (minimum requirements which apply at all times) and pillar II (bank specific) requirements (See figure 1).
against the combined buffer. Therefore an institution which does not report interim or year-end profits, and which does not comply with the combined buffer, is not allowed to distribute dividends, to pay coupons on AT1 instruments, nor to pay discretionary bonuses.

On 16 December 2015 the European Banking Authority (EBA) issued an opinion on the methodology for calculating the MDA. It provides that to calculate the amount of CET1 shortfall, the supervisor shall consider, in addition to the combined buffer, the overall capital requirements including the pillar I requirements and the pillar II requirements. Until then it was unclear whether the pillar II requirements would be considered for the MDA calculation. The EBA therefore invited the Commission to review the wording of Article 141 accordingly, and to review the prohibition on the distribution of profits in all circumstances where, in a given year, no profits are made and the combined buffer is not met.

On 19 February 2016 the ECB published the SREP methodology booklet, which confirms the EBA opinion that pillar II requirements shall be fully taken into account both for the trigger and the calculation of the MDA (See figure 1).

**Commission note clarifying aspects of Pillar 2 capital requirements**

It was reported in the press (Bloomberg, Handelsblatt, Reuters) that the Commission proposed, in a note to the Commission Expert Group on Banking, Payments and Insurance, to clarify the interactions between Pillar II requirements, Pillar II capital guidance and automatic restrictions on earning distribution. The European Parliament, in its 2015 annual report on the Banking Union, had called for such a clarification, emphasizing the need to guarantee a level playing field in the EU and to clarify the aim of the MDA mechanism (see box below).

**Box 1: European Parliament 2015 Annual report on the Banking Union (Point 26)**

[The European parliament] considers the calculation of Maximum Distributable Amount (MDA) for each individual bank in line with Article 141(6) of the Capital Requirements Directive (CRD) to be an important tool for achieving capital restoration, as an alternative to shrinking balance sheets; underlines that the legislation’s lack of clarity on the hierarchy between pillar two and capital buffers in relation to the MDA threshold and to other sanctioning measures does not prevent the SSM from using a margin of flexibility in order to avoid solutions which are too rigid and might negatively affect the AT1 bond market and the level playing field with other jurisdictions; calls for a legal clarification of the MDA mechanism and of the function of pillar two, which is to address ‘bank-specific risk’, in order to guarantee a level playing field in the EU and to provide more clarity on the aim of the mechanism; considers that the review of those provisions should aim to incorporate them into the regulation;

In that note, the Commission takes the same view on the stacking order as defined by the EBA and endorsed by the ECB, and confirms that an institution doesn't comply with the combined buffer if Pillar I and Pillar II requirements are not met.

However, the note also further elaborates on the nature of Pillar 2 capital requirements, which are basically those additional capital requirements that are imposed by the bank supervisor to address the specific risk profile of each institution. The Commission notes proposes to clarify the difference between capital requirements, which must be met at all times, and capital guidance, which would

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2 “Note for the Commission Expert Group on Banking, Payments and Insurance, clarifying aspects of Pillar 2 capital requirements, Pillar 2 capital guidance and automatic restrictions on earnings distribution in the context of the CRR/CRD review”.
be transformed into a capital requirement if a bank "consistently fail to comply" with the capital guidance. According to the Commission, capital guidance should address hypothetical situations such as potential capital shortfalls under a stress test. Currently, pillar II requirements do not necessarily exclude situations where the bank would report a capital shortfall under the adverse scenario of a stress test. The Commission argues that such hypothetical situation should be excluded from Pillar II requirements (but taken into account in the Pillar II capital guidance), unless the capital planning of the institution proves to be consistently inadequate.

The recommended interpretation of the Commission resembles the guideline of the UK Prudential Regulation Authority (PRA), which provides for a Pillar II buffer which comes on top of the combined buffer (see figure 2). This buffer addresses situations where the PRA expects that the combined buffer will be insufficient to ensure an institution meets its capital requirements under stress.

The Commission note therefore seems to address concerns that different approaches in determining Pillar II requirements could undermine the level playing field in the financial sector, and clearly points out that Pillar 2 capital requirements should on the one hand be subject to public disclosure, and on the other hand only be imposed via a reasoned appealable administrative act.

**Figure 2: PRA approach to capital requirements**

By clarifying that adverse scenarios should not be taken into account in Pillar II requirements, the Commission introduces more flexibility for the supervisor, since the breach of the Pillar II capital guidance will not lead to automatic restrictions on earning distribution. It therefore mitigates the concern that restrictions on earning distribution would apply as soon as a bank reports a capital shortfall under an adverse scenario of a stress test. In Bloomberg's view "[T]he commission is considering changing the way some of those levels are defined to increase banks’ flexibility about making the payouts, a move that amounts to a softening of standards."

**Why MDA matters?**

The respective stances of the EBA, ECB and the Commission have a direct impact on the expected remuneration of AT1 instruments. Indeed, the probability that banks meet the MDA trigger point directly depends on where the threshold is set. Figure 3 below shows that a number of banks report capital positions just over the combined buffers (including Pillar I and Pillar II requirements).
This is one reason, together with concerns over the global economy and recent resolution actions taken throughout the European Union, why contingent convertible bonds ("CoCo bonds", the majority of which qualify as AT1 instruments) have suffered sharp falls in prices since the start of 2016, with the main index dropping 10% before partially recovering.

CoCo bonds are bonds which can be converted or written-down in case one of more trigger events occurs. In addition, to qualify as AT1 capital, any coupon payment is discretionary, and the MDA provision in CRD IV prevents the bank from paying coupons in case capital requirements are breached. In simple terms: CoCo bonds hence carry both a “conversion risk” and a “coupon risk”. While the bonds behave like regular bonds in good times, in falling markets they are volatile and bondholders are exposed to maximum losses. These kind of ”bail-in bonds” have been very successful since 2009 since they helped banks restore their capital positions at a low price. One financial analyst reported in the Financial Times that the cost of CoCo bonds is about half the return demanded by equity shareholders (while interest payments are tax-deductible).

However, in a low interest rate environment, at a time when investors were looking for yields, the coupons paid on CoCo bonds were still very attractive, fuelling suspicion that prices insufficiently factored-in the risk of conversion or the risk of coupon cancellation. Such bonds attracted much demand in 2014 and 2015 (See figure 3), but in early 2016 they were hardly hit by heightened doubts on the global growth and the clarification of their regulatory treatment.

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3 Thomas Hale, Martin Arnold and Laura Noonan, Financial Times, 23 February 2016, “Bank coco market faces uphill struggle”.
4 Alberto Gallo, Financial Times, 7 May 2014, “Regulators must act on coco bond risks”.
6 See footnote 2.
Recent data suggest CoCo issues have faltered in 2016 while last year they were still expected to rise, given that banks have to meet rising capital requirements. The readjustment of CoCo prices in the market means investors better take into account the risk that the bank may be forced to cancel coupons in the future. Therefore the risk assessment of those bonds by private investors seems better aligned with the provisions attached to their regulatory status.

Source: Financial Times

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Monica Bianchi, Moody's Investor Service, 26 May 2015, “CoCo issuance to rise as banks seek to meet capital requirements”