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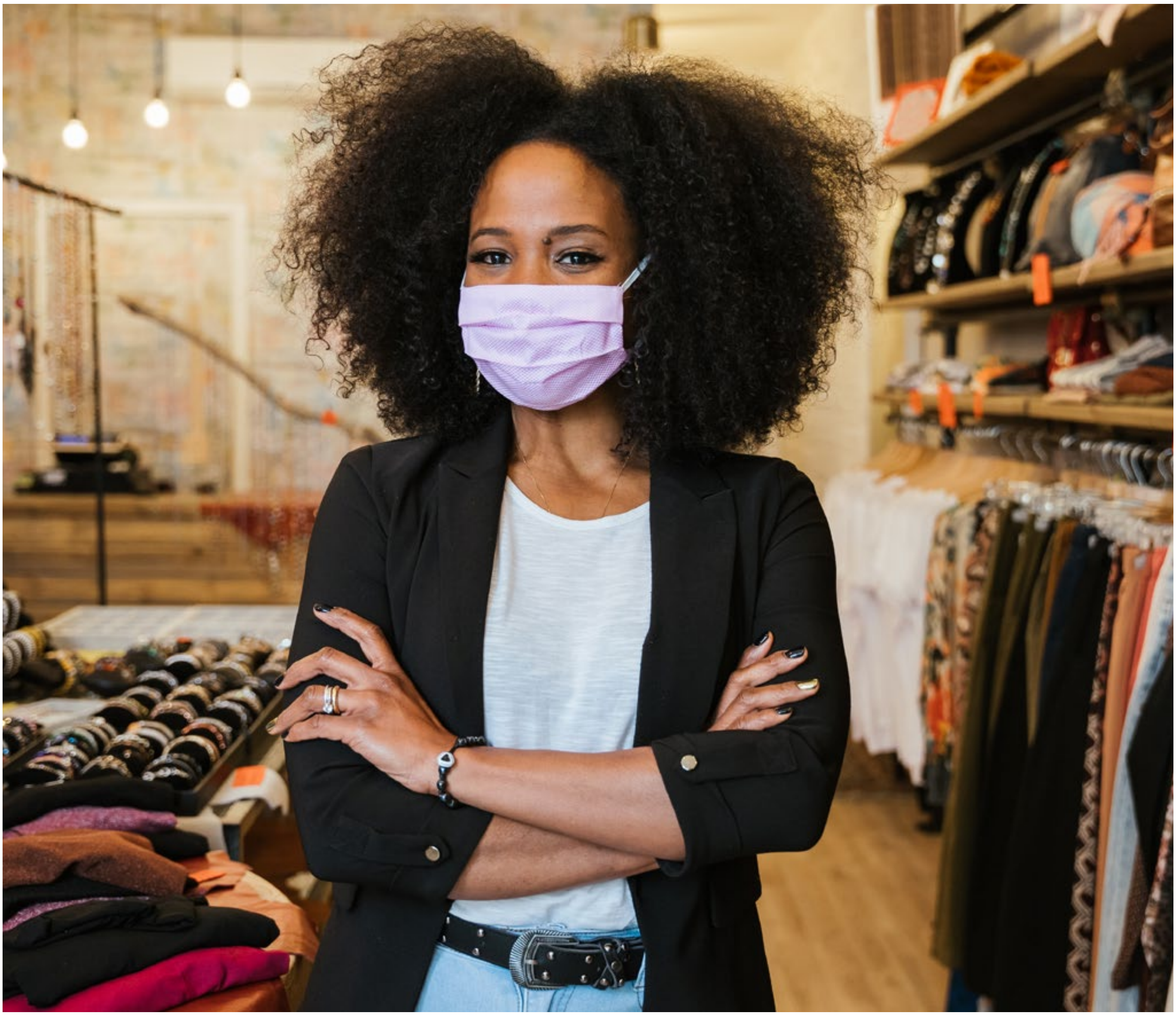
Introducing a New Hybrid Recapitalisation Instrument for Smaller EU Corporates

Navigating EU and Member State Accounting, Tax, Insolvency and State Aid Frameworks

November 2021



Association for Financial Markets in Europe
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Foreword

The effects of the COVID-19 pandemic continue to pose challenges to businesses across Europe. While many large and listed companies have been able to access funding through the capital markets in attractive terms, many smaller and unlisted companies have relied on government support programmes and bank lending. As economic conditions gradually improve, it is vital that smaller unlisted companies and midcaps with the potential to drive economic growth have access to ample fresh capital to invest in innovation and their future growth. Alternative types and sources of funding will be required to meet this challenge.

In our paper, 'Recapitalising EU businesses post COVID-19', released earlier this year, it was estimated that with the gradual reduction of state support measures, Europe could be facing a funding gap of €450-600bn in equity and hybrid capital to prevent business defaults. Yet, while the report successfully identified the nature of the funding challenge facing Europe, the next step is for market participants and policy makers is to work together and devise pragmatic solutions at the EU and the national levels.

To this end, AFME believes a hybrid equity-accounted structured product with common pan-European features would be an ideal solution. It would allow for a greater number of SMEs to gain access to funding without relinquishing control of their organisation – one of the chief concerns of SMEs identified in our earlier report. However, the varying national environments and legal frameworks in the EU means that the implementation of such a solution needs to be tailored to the national contexts in member states.

To help provide an all-inclusive solution, this report presents the following analysis:

- An overview of the key hybrid instrument attributes required to achieve the desired equity accounting, tax treatment and insolvency treatment taking Germany, France, Italy, Spain the Netherlands as sample Member States.

- A summary of state aid considerations that are likely to be taken into account in assessing proposed equity-accounted hybrid instruments for the purposes of compliance with EU state aid requirements.

- A generic sample term sheet outlining the proposed instrument features, and which can be used as a reference for discussion with officials, investors and mid-cap/SME corporate issuers.

The proposals presented in this report have been developed taking into consideration the objective of the Capital Markets Union to promote market-based financing solutions designed according to the needs of SMEs and mid-cap companies. We hope policy makers and key stakeholders find this report helpful in bringing the idea of a new hybrid instrument for SMEs to reality and that officials, corporates and investors can continue to work together to design solutions adjusted to the needs of companies seeking investment capital in the phase of economic recovery.

I would like to thank PwC and Linklaters for their assistance in the development of this publication, as well as AFME members who contributed extensively to the preparation of this analysis.

Adam Farkas
Chief Executive
Association for Financial Markets in Europe

Introducing a New Hybrid Recapitalisation Instrument for Smaller EU Corporates

Navigating EU and Member State Accounting, Tax, Insolvency and State Aid Frameworks

Executive summary

Background

In January 2021, AFME, with the support of PwC, published "Recapitalising EU businesses post COVID-19: How equity and hybrid markets instruments can drive recovery". In the report, AFME warned that Europe needs to bridge a gap of €450-600bn in equity needed to prevent widespread business defaults and job losses as COVID-19 state support measures are gradually reduced. As the Commission recently noted in a study[1], many of these state support measures have already begun to unwind in the summer of 2021.

The report included results of interviews with a number of SMEs and small mid-cap corporates who, due to their size, do not have access to the public equity, hybrid and debt markets as larger corporates. In particular, the findings reveal that many mid-size and SME corporates do not wish to give up control of their business but are willing to pay a premium not to dilute their voting rights, as well as are willing to distribute a share of profits to investors. Hybrid subordinated debt instruments are ideally suited to address these needs. The report included a number of recommendations to EU27 and member state officials, the first of which is:

"Proposing a new EU-wide hybrid instrument designed specifically for the corporate sector. This could be in the form of a new preferred shared instrument, which is state-aid compliant, to build scale and liquidity, and which ideally could be developed to comply with social investment objectives to attract maximum investor interest."

As noted below, some EU member states – including France, Spain and the Netherlands – have recently launched national schemes and instruments to support company recapitalisation. AFME very much supports these initiatives at the national level. However, we continue to see significant value in the development of an EU-wide recapitalisation instrument framework with features and incentive mechanisms that could be rolled out across various member states. A common European instrument model could benefit from the visibility, liquidity and scale of the single market and generate broad appeal amongst institutional investors, such as pension funds and insurers, that are seeking debt and hybrid-type risk profiles but with better returns, while catering to the needs of smaller companies. With sufficient EU-wide scale, a successful framework has the potential to develop into a well-defined asset class, which would encourage investment and European integration in alignment with the CMU objectives. As noted in our earlier report, the creation of the Additional Tier 1 (AT1) framework for banks is a helpful precedent demonstrating that specific European recapitalisation instruments can be created which meet the combined requirements of issuers and investors and combine a set of core harmonised features.

While the pandemic has had an economic impact across Europe, we acknowledge that there are diverse national contexts as regards corporate funding needs. In some members states there is likely to be no major perceived access to finance gap for midcaps and smaller companies or no need to go beyond existing support measures. However, we believe that those members states would also benefit from the existence of a pan-European framework that can serve to promote cross-border investment, financial integration through the private sector and a more homogenous recovery across member states. A successful EU framework could also become appealing to issuers in those members states.

Ideally, the instrument we propose would include EU-wide financial support through an instrument such as the European Investment Fund's Pan-European Guarantee Fund, which is targeted toward COVID-19 support for SMEs and mid-caps. However, the size of this fund is only €25 bn. The only other source of EU-wide support for SMEs is the InvestEU fund component of the NextGenerationEU project, which has been allocated €9.4 bn of pan-European funding dedicated to SMEs. Although both of these programmes can be levered to some extent, on a combined basis these will not provide sufficient equity funding for COVID-19 impacted corporates.

It should be noted that in recent months, the French government has launched a €20 bn government-supported non-voting subordinated debt programme for French SMEs and mid-caps, utilising French-specific obligations subordonnées (Subordinated Bonds) and "Prêts Participatifs" (Participating Loans) structures. Although this programme was not designed to achieve equity accounting treatment for the corporate issuers, it is a very welcome development and worth reviewing by official sector readers who are exploring ways of supporting SMEs and mid-caps in individual EU countries. The Spanish government has also implemented a €1 bn Fund for the Recapitalisation of Covid-Affected Firms, targeted toward small businesses (there is a separate €10bn fund for strategic companies, a €7 bn fund to assist with payments as well as a €3bn

1 https://ec.europa.eu/info/system/files/com-2021-500_en.pdf

fund for the restructuring of guaranteed loans). The Dutch government has launched a €400mm SME subordinated loan support programme as well. There may also be additional types of programmes available in these and other EU countries but which are not referenced here.

Purpose of the Report and Key Conclusions

From the conclusions of the first report, it is clear that there are and probably always will be insufficient institutional buyers of hybrid subordinated debt instruments issued by small corporates. Individual issues are simply too small to be cost-effective for most investors, who will need to do extensive credit and business plan research for a relatively small reward in absolute earnings terms. As a result of this market context, some type of public sector support will be required to form a large pool of instruments from a variety of issuers and industries. This pool can then be enhanced, to make it "investable". The form of public support could be a financial guarantee, or alternatively a deeply subordinated cash investment in a pool. It is important to note that the enhancement will not necessarily be to "AAA" or even to an investment grade rating but rather a level which attracts sufficient interest from investors, at a return/price that works for the corporate issuers.

Ideally, the right instrument for the EU market would be a single equity-accounted hybrid debt instrument which includes public-sector financial support in some form, which would comply with EU state-aid requirements. If this is not politically possible, AFME recommends that individual member states use forms of equity-accounted debt instruments that can comply with required national and international accounting, tax, insolvency and possibly credit ratings agency requirements, as well as EU state aid requirements.

Selected national EU schemes to support company recapitalisation

France

€20bn

Government-supported non-voting subordinated debt programme for **SMEs and mid-caps**, utilising "Prêts Participatifs" and "Obligations Subordonnées"structures

Spain

€1bn

Fund for the Recapitalisation of Covid-Affected Firms, targeted toward **small businesses**

€10bn

Separate fund for strategic companies

Netherlands

€400m

SME subordinated **loan support** programme

As a follow-up to the January report, AFME has asked PwC to prepare highlights of key attributes required in order to achieve the desired equity accounting, tax treatment, and insolvency treatment, for Germany, France, Italy, Spain and the Netherlands. Other EU member state officials can hopefully use these examples to develop structures which work in their own countries. We have also asked Linklaters to help provide input on key EU state aid issues, as well as draft a sample high-level term sheet which describes the key points to be addressed in developing national structures. It should be noted that this term sheet is intended to be used only for initial discussion purposes in each country between the official sector, SMEs and mid-cap issuers, and hybrid investors, so that further details can then be researched. In particular, Linklaters cautions that although the EU has put in place, likely until mid-2022, temporary additional state aid measures that allow member states to tackle the difficulties corporates are currently encountering state aid requirements are complex and very pool-specific. Neither AFME, Linklaters nor PwC has had any discussions with EU state aid officials on this sample term sheet, since we of course did not have a specific pool of corporate instruments to present to the EU for review. That would be a step to be taken by individual member state governments, who would need to seek the approval of potential schemes from a state aid perspective.

Before going into key structure conclusions, members would like to highlight:

- Although some of the impact of Covid in the EU is beginning to recede, Covid is likely to have a longterm impact on the health of many EU corporates. The conclusions of this report are therefore likely to be relevant for many years, and

- Beyond the immediate conclusions of this report, we need banks as capital markets experts and lenders to continue to work with the public sector, corporates and investors to mobilise alternative forms of hybrid capital, to build a lasting ecosystem in various countries, industry sectors, and investors.

On a specific product basis, in addition to the work of PwC and Linklaters, AFME members active in the hybrid debt and equity markets for larger corporates provided significant expertise to shape a workable product for mid-caps and SMEs. Key conclusions are:

a. **Key Issuer Objectives:** AFME members believe that small corporates will generally care most about equity accounting treatment under national GAAP (and IFRS, if relevant), tax deductibility and the all-in cost of issuance (including financial guarantee costs). Although in this report PwC presents the "equity treatment" from the largest credit agencies on corporate debt issuance (which can be very important for rated corporates), for small corporates this is a relatively low priority. Similarly, while insolvency considerations are presented in this report, insolvency treatment is dictated by the memorandum. A small corporate will need to ensure that the debt is subordinated below the rights of all its other creditors, in the event of an insolvency. Failure to construct the debt like this would likely impact the corporate's ability to raise debt from traditional sources and to transact on normal terms with trade creditors.

b. **Recommended Core Structure:** Broadly, a deeply subordinated debt instrument with no maturity date is likely to be accounted for as equity under IFRS and in many but not in all EU member states, under national GAAP. Step-ups and call options can be permitted. To achieve a cost-effective instrument for the issuer, the instrument must be considered to be debt for tax purposes, to achieve tax deductibility. Another important point for the issuer and investors alike is that the periodic interest paid on the subordinated debt instrument must not be subject to any tax withholding or deduction at source so that the pool receives the interest income on a gross basis. This precludes use of equity instruments such as preferred shares, which were suggested in the January report.

c. **Public Sector Enhancement:** To make a pool of subordinate corporate debt sufficiently interesting from an investor's standpoint, the subordinated corporate debt will need to be pooled. Some type of credit enhancement will be required and will be sized on a pool-specific basis.

d. **State Aid Process and Considerations:** The EU has published guidelines on its website as to the approximate cost per year that must be charged on financial structures that receive support from a member state in order not to distort the market. The cost will increase progressivity as the duration increases. For equity structures, these guidelines range from at least 1-year IBOR + 225-250bps for the first year, to 800-950bps/year for the 8th year and after. These approximate costs are referenced in this document.

e. **All-in Cost to Issuers, and Return for Investors:** It is impossible to accurately forecast an all-in cost to small corporate issuers without a specific pool that can be discussed with EU state aid officials. And it is impossible to forecast a suitable net return to investors without this same data, as well as speaking to investors to get their views. We have included a very, very approximate all-in cost estimate to corporates of c5-10% to start the discussion. The actual cost to issuers is highly dependent on the overall size of the programme and the credit profile of industry sectors participating. It is likely that the cost of this programme will be less than the cost of "traditional" equity with voting rights.

As a recommended next step, AFME members recommend that EU as well as individual member state level officials meet with a group of SMEs and mid-cap corporates (or their associations), hybrid investors (or their associations) and a small group of AFME members to develop detailed structures that could work best to assist small corporates impacted by COVID-19.

AFME would like to again thank PwC and Linklaters for their assistance in development of this publication. PwC has provided assistance on the "Summary of Accounting, Tax, Insolvency and Credit Ratings Agency Considerations (PwC), and Linklaters has provided assistance on the "Summary of State Aid Considerations" and "Illustrative Private Subordinated Bond (PSB) Transaction Term Sheet" sections. Readers should please note that for simplicity reasons the PSB term sheet only describes the core terms of the instruments issued by mid-cap and SME borrowers. One or several special purpose vehicles (SPVs) will need to be set up in the overall transaction structure, in order to pool the individual subordinated loans to the corporate borrowers. These vehicles will issue notes to the end-investors, and due to pooling and credit enhancement effects, the terms that investors will receive will probably be slightly different than the cash flows paid by individual mid-caps and SMEs to the SPV.

Summary of Accounting, Tax, Insolvency and Credit Ratings Agency Considerations

PwC Summary of Accounting, Tax, Insolvency and Credit Ratings Agency Considerations

On 19 January 2021, AFME and PwC published the report "Recapitalising EU businesses post COVID-19: How equity and hybrid markets instruments can drive recovery"[2]. The report made eight recommendations for supporting the financing of European corporates in the post COVID-19 economic recovery.

One recommendation involved developing a common EU-level state-aid-exempt recapitalisation instrument, such as a preferred share instrument, with (reasonably) standardised legal, accounting, tax bases, and economic terms, for use across Member States.

This section contains a review by PwC of the accounting, tax, insolvency and rating agency considerations for creating such an instrument.

PwC (referred to as "we" in this section) have considered both:

- classic subordinated debt hybrid; and
- equity preference share hybrid

PwC have identified both the general treatment from each product lens as well as capturing any important differences across selected EU member states (Germany, France, Italy, Spain, Netherlands).

2 https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_COVID-19Recapitalisation2020%20(1).pdf

Accounting treatment

In the table below we set out the accounting treatment for hybrid financial instruments. We start with IFRS treatment as local GAAP accounting treatment in most EU member states is aligned with this. While not uniformly the case, an equity instrument for IFRS purposes will in many jurisdictions also be equity under local GAAP. We then note some differences between IFRS and local GAAP accounting treatment for Germany, France, Italy, Spain and the Netherlands.

Key considerations	
IFRS	**Definition of a liability:** A financial liability is any liability that is a contractual obligation to deliver cash (or another financial asset) to another entity, or a contract that will or might be settled in the entity's own equity instruments and is: • a non-derivative for which the entity is or might be obliged to deliver a variable number of the entity's own equity instruments; or • a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. (IAS 32.11). **Equity** Equity instruments are defined as a residual interest in an entity's assets after deducting all of its liabilities. The classification of a financial instrument in equity or in liabilities is based on the substance of the contractual agreement rather than its legal form. (IAS 32). In compound financial instruments (e.g. convertible bonds) the liability component must be separated from the equity component. **Equity instruments with debt like features** As noted above, any instrument whereby the issuer has a contractual obligation to pay cash to the holder will be a financial liability. In our experience, there are some commonly applied mechanisms that investors may consider to provide additional security while retaining equity treatment for accounting purposes, typically in respect of preference shares: 1. The use of 'dividend' pusher features, i.e. ordinary dividends cannot be paid until dividends are paid on the preferred instrument (or even until the preferred instrument is redeemed). 2. The use of 'step-up' features, i.e. the coupon on a preferred instrument has a substantial step up after a specified period to effectively dilute the ordinary shareholder if it isn't redeemed by the issuer. These mechanisms provide economic compulsion but not a contractual obligation and so provide additional protection to a holder without compromising the accounting treatment.
Additional EU member state / EU-wide considerations	In many countries, local GAAP is aligned with IFRS in this area. While this is not uniformly the case, an equity instrument for IFRS purposes will in many jurisdictions also be equity under local GAAP.
Key Germany differences to IFRS	For the classification of financial instruments as equity under German GAAP, the following three criteria must be fulfilled simultaneously: (i) subordination; (ii) profit-related compensation and loss participation up to the principal amount; and (iii) long-term lending (only applicable for corporations, not for commercial partnerships)[3]
Key France differences to IFRS	In French GAAP, the notion of equity derives from legal requirements. [Code de Commerce R123-190 and R123-191 and PCG art.934-1]. There is a specific line item labelled "other equity" between liabilities and equity, under which certain financial instruments are classified (bonds redeemable in shares, participating loans etc [Code de Commerce R123-190/2 and PCG art 934-1] [4]

3 https://accounting-app.pwcplus.de/article/215204/?download=215480&file=similarities_and_differences_ifrs_german_gaap.pdf

4 https://assets.kpmg/content/dam/kpmg/fr/pdf/2019/09/fr-global-assurance-ifrs-compared-french-gaap-overview_sept19.pdf

Accounting treatment

Key considerations	
Key Italy differences to IFRS	Under ITA GAAP the notion of equity instrument is a residual definition: "an equity instrument is the difference between assets and liabilities in the balance sheet". No guidance exists to distinguish between financial liabilities and equity instruments as in IAS 32 and the classification is mainly driven by legal requirements (Civil Code art.2424). The standard OIC 28 - patrimonio netto, describes the recognition and classification of equity items distinguishing between earnings, reserves and capital reserves also based on distributability. [5]
Key Netherlands differences to IFRS	Under Dutch GAAP (D-GAAP) the accounting treatment of equity in the entity financial statements differs from the consolidated financial statements. Under IFRS there is no distinction between the accounting treatment in the consolidated and entity financial statements. [6] In entity only accounts the company can either follow the legal form of the contract or follow the same guidance as D-GAAP consolidated or follow the classification as used in the entities consolidated accounts (IFRS). In the consolidated accounts the accounting treatment is similar to IFRS with the only difference that instruments on which payments are only due when profits are made can be presented as equity or debt. For this to apply, payments should only be dependent on future profits and no further obligation should be present in the instrument.
Key Spain differences to IFRS	No differences to IFRS. Spain GAAP follows IFRS.

5 https://www.pwc.com/it/it/publications/assets/docs/oic-2019.pdf

6 https://www.pwc.nl/nl/assets/documents/pwc-similarities-and-differences.pdf

Tax treatment

There are few tax regimes which specifically define the tax treatment of hybrid capital instruments. One which does is the UK. Hybrid capital rules initially applied to regulatory capital securities issued by banks and insurers, but then widened to all sectors through the 2019 Finance Act. This Act defines the scope of hybrid capital taxation rules, the taxation of hybrid capital instruments and anti-avoidance rules. Although the UK is no longer a European Union state, since the UK has a specific hybrid Act as well as pre-Brexit it is a jurisdiction in which a significant share of EU hybrid capital instruments have been arranged for issuance by EU issuers and purchase by EU and non-EU investors, As such, we consider the UK to be a suitable reference point for tax treatment of instruments of this type.in the table below we use the UK as a helpful and familiar reference point to set out anticipated tax treatment of hybrid capital instruments in detail. We then note specific rules across EU member states which could lead to a different tax treatment.

	Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
Anticipated classification for tax purposes in the hands of the issuer **For ease of reference, UK treatment is assumed as a baseline, and five EU countries are then compared**	The instrument would be treated as a normal commercial loan to the extent it qualifies as a "hybrid capital instrument" ("HCI"). A loan relationship qualifies as a HCI if: 1. It makes provision under which the debtor is entitled to defer or cancel a payment of interest under the loan relationship; 2. It has no other significant equity features; and 3. The debtor has made an (irrevocable) election in respect of the loan relationship. In relation to the second requirement, features that would preclude an instrument from qualifying are any of the following: • voting rights in the debtor; • the right to exert dominant influence over the debtor; • provision for altering the debt amount outside a write down or a conversion event in "qualifying cases" (i.e. where provision is made for the debt to be altered or converted if the debtor is experiencing solvency or liquidity problems, or where such provision is required to comply with regulatory or other legal requirements); and • provision for the creditor to receive anything other than interest or debt repayment outside a conversion event in "qualifying cases". In addition, the instrument must not be part of any arrangement which has obtaining a tax advantage as a main purpose. The treatment set out below is based on the instrument meeting the HCI conditions.	If the instrument does not give rise to a 'money debt' (which requires a debt as a matter of law), the instrument should be treated as issued share capital for UK corporation tax purposes.
Issuer tax deductibility of coupons, including timing of deductions (e.g. following accounts or cash paid basis) and any consequences of payment in kind	The coupons should be deductible as they are recognised in the income statement. The payment in kind should not impact this treatment as the deductibility follows the accruals recognised in the accounts. The deductibility of the coupon for the issuer may be subject to other UK tax rules that restrict interest deductions (e.g. Corporate Interest Restrictions). This will be on a case by case basis.	Coupons would be considered to be dividends. Dividends payable should be treated as non-deductible distributions. This treatment should not be impacted due to dividends being subject to payment in kind.
Treatment of foreign exchange	Any foreign exchange movements recognised in the income statement of the UK issuer (for example, where the issuer is GBP functional for statutory reporting and tax purposes, but the HCI is denominated in another currency) should be brought into account for tax purposes.	Any foreign exchange differences recognised for accounting purposes by the issuer on retranslation of the instruments should not be taxable.

	Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
Withholding tax	As a general rule, a company making a payment of UK source yearly interest withholds tax at 20% from that payment. There are various exemptions from UK withholding tax which could potentially apply, including (but not limited to): • payments of interest by UK resident companies if the beneficial owner of the interest (i.e. the holder) is also a UK resident company; • payments of interest on a quoted Eurobond; • payments of interest paid to or by a UK bank. To the extent PIK notes (also known as funding bonds) are issued in respect of the payment in kind, such notes should also be recognised as payments of interest for tax purposes and therefore should also be subject to withholding.	Assuming the holder has shareholder rights, then any dividends paid should not be treated as interest. Thus, it should be treated as a distribution for UK tax purposes. UK WHT tax is not levied on dividends.
Stamp duty	Transfers of HCI are exempt from stamp duty.	An issuance should not be seen as a 'transfer' for the purposes of UK stamp, and so should fall outside the scope of a 0.5% charge to stamp duty and SDRT on issuance. However, there are rules that can technically apply a 1.5% stamp tax charge where securities are issued into a clearance service or to a depositary bank as part of a depositary receipt programme. In any event, following certain tax case law (*HSBC Holdings PLC and Vidacos Nominee Ltd (C569/07)*; and *HSBC Holdings PLC and the Bank of New York Mellon Corporation (TC2009/16584)*), we would not expect HMRC to seek to collect this charge. In respect of subsequent transfers of the instrument, either stamp duty or SDRT may give rise to a 0.5% charge on documents that have legal effect of transferring the beneficial ownership of the instrument.
Anticipated classification for tax purposes in the hands of holder	As is the case for the issuer, the instrument would be treated as a normal commercial loan to the extent it qualifies as an HCI.	If the HCI conditions are not met, the instrument would be treated as issued equity for UK corporation tax purposes. There are a number of exemptions available that would result in coupon income (i.e. dividends) not being taxable in the hands of the holder (including dividends from 'controlled' companies, dividends made in respect of portfolio holdings etc.).
Could related / connected party tests (or other) result in undesirable control or other grouping consequences?	There are a number of provisions which should be considered (please see below).	The same provisions as listed for an HCI should be considered for an equity instrument. With respect to the connected party provision, even if the parties were connected, then the treatment of the dividends as described would not differ.

	Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
If so, what are the relevant thresholds that should be considered?	**Connected party rules:** Parties are 'connected' where one party 'controls' the other, or both parties are controlled by the same person. Control is considered where the holder has the power to secure the affairs of the issuer (e.g. by holding more than 50% of the share capital of the issuer, or by virtue of the possession of more than 50% of the voting power), or as a result of other powers conferred by documentation regulating the issuer. In any event, if the holder and issuer were connected, the coupons arising would still be deductible in the issuer and taxable in the holder, but such amounts would be determined under an "amortised cost basis of accounting" (notwithstanding the actual accounting applied for statutory reporting purposes). **Change in ownership:** Broadly, a change of ownership would occur where more than half of the ordinary share capital is acquired. These rules can act to restrict the use of trading and/or non-trading losses where certain conditions are met. **Capital gains degrouping charges:** In high level terms, a degrouping charge can arise to bring into tax a previous intragroup transfer that was carried out on a tax neutral basis, where the transferee leaves the group within 6 years from the transfer. A degrouping event could be caused if the holder obtains more than 75% of the ordinary share capital of the issuer or the holder is entitled to more than 50% of the issuer's profits.	As per the Classic Subordinated Debt Hybrid.
VAT	The issue of such an HCI would be outside the scope of UK VAT. Any UK VAT incurred on costs associated with the issue of the HCI would be recoverable as overhead expenditure in accordance with the issuer's UK VAT recovery profile/rate.	The issue of such an equity instrument would be outside the scope of UK VAT. Any UK VAT incurred on costs associated with the equity issue would be recoverable as overhead expenditure in accordance with the issuer's UK VAT recovery profile/rate.
Additional EU member state / EU-wide considerations - Anticipated classification for tax purposes in the hands of the issuer	With the exception of the UK (as set out above) and Spain, there are no specific regimes that apply to instruments of this nature. The conditions which drive the classification of the instrument differs between jurisdictions (as set out below). Generally, the factors that are more indicative of an equity classification of an instrument of this type include: • The legal features of the instrument • Ability to influence the issuer, and having links to the profits; • Longer instrument term (length varies per jurisdiction); and • Subordination. High level differences in the tax treatment across the EU jurisdictions for a debt instrument and an equity instrument compared to the treatment of the UK (set out above) have been highlighted below.	

Additional EU member state / EU-wide considerations	Conditions determining the classification of the instrument for tax purposes	Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
Germany differences to UK treatment	Debt instruments and equity instruments are typically distinguished applying the following criteria: • Duration of the granting of capital (the longer the instrument the more likely it will be classified as equity, generally 28 years or more) • Link to profits of the issuer • Subordination • Participation in built-in gains • Possibility to take influence on the issuer	With respect to the treatment of foreign exchange, liabilities should be capitalised for German GAAP and for tax purposes at acquisition cost. To the extent the currency conversion of a liability results in a lower liability, it continues to be recognised at historical cost. In the case of a higher liability, however, an adjustment may only be made for tax purposes in the event of a probable permanent increase in value. Where the issuer is a German bank, coupon payments to a German tax resident should be subject to 26.375% WHT. A WHT on coupon payments to a non-resident holder should only come into account if the instrument in addition to the subordination element is structured as profit participating, or contains influence rights, a conversion right or a participation in the liquidation proceeds. No stamp duty regime exists in Germany.	26.375% German WHT applicable for dividend payments. Dividend income will generally be subject to tax at the level of a German and non-German holder of the instrument. No stamp duty regime exists in Germany.
France differences to UK treatment	Assessed on a case-by-case basis (based on the legal features of the instrument in light of expected shareholder's risk taking and returns). Whether the instrument is not redeemable, or its redemption is under the sole control of the issuer, or is effected by the issuance and allotment of another equity instrument; and whether the remuneration is not due and therefore does not have to be recognised as a liability in the balance sheet, in case of absence or insufficiency of profit are key criteria. The qualification of the instrument under French local GAAP is essential to assess the nature of the instrument for French tax purposes.	Specific rules may apply for the issuer's tax deductibility of coupons where a premium has been paid or received. As a general rule, French source interest paid outside of France is exempt from withholding tax (excluding payments made to non-cooperative tax jurisdictions).	Dividend payments are subject to tax at a 26.5% rate (in 2021, 25% as from 2022) if paid to a non-resident company (which may be reduced based on French (e.g. CIV) or EU law and DTT, or increased if paid in non-cooperative tax jurisdictions). Transfers of shares are subject to stamp duty (0.1% in case of shares and not parts sociales) or to French FTT (0.3% for certain listed French companies only).

Additional EU member state / EU-wide considerations	Conditions determining the classification of the instrument for tax purposes	Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
Italy differences to UK treatment	Treatment depends on whether securities granting the holder a participation in the results of the issuer (or group company).	WHT at 26% (or lower treaty rate) may apply; most bonds fall under a domestic provision effectively exempting most foreign recipients. Payment in Kind treatment is not a common concept in Italy, and there is no case law or administrative practice in this regard.	WHT at 26% (or lower treaty rate); 11% for EU / EEA pension funds, 0% for EU / EEA investment funds UCITS / AIFMD, 1.2% for EU companies subject to tax, zero under the parent / subsidiary directive. A 95% dividend exemption applies to the extent the remuneration is totally non-deductible in the hands of the issuer. Shares issued by Italian companies and derivatives having those shares as underlying are subject to Italian FTT.
Netherlands differences to UK treatment	There is no specific regime for Netherlands, however, the basic rule is that tax follows the classification from a Dutch law perspective (i.e. where an instrument qualifies as debt under Dutch law, the instrument would also be classified as debt for tax purposes). Generally, an instrument qualifies as debt for Dutch law purposes where there is a repayment obligation. However, there are some complex exceptions which also need to be considered, including: • Whether or not the interest is profit dependent; • Whether or not the instrument is subordinated; • Whether or not the term of loan is more than 50 years.	No interest WHT applies, except in relation to low tax or blacklisted jurisdictions. In these exceptional cases, WHT is applicable at 25%. No stamp duty regime exists in the Netherlands.	Foreign exchange movements may be taxable year on year. However, this can be exempt where the participation exemption applies (generally where equity holding is more than 5%). Dividends may be subject to WHT at a standard rate of 15%. No stamp duty regime exists in the Netherlands. Dividend income is taxable in the hands of the holder, unless the participation exemption applies. (minimum 5% equity). The participation exemption may also apply to equity instruments other than shares, however, there are further requirements that will need to be met which should be considered further.

<table>
<tr><th>Additional EU member state / EU-wide considerations</th><th>Conditions determining the classification of the instrument for tax purposes</th><th>Classic Subordinated Debt Hybrid</th><th>Equity Preference Share Hybrid</th></tr>
<tr><td>Spain differences to UK treatment</td><td>Instruments regulated according to Law 10/2014 and fulfilling requirements stated in that Law will be treated as debt. Requirements include:

Preferred shares considered as additional Tier 1 capital for the purposes of Regulation (EU) 575/2013, provided that they comply with the conditions set out in Chapter 3 of Title I of Part Two or in Chapter 2 of Title I of Part Ten of that Regulation and that the following requirements are met:
Be issued by a Spanish credit institution or by a public limited company resident in Spain or in a European Union territory, which does not have the status of a tax haven, the voting rights of which correspond directly or indirectly to a Spanish credit institution and whose exclusive activity or object is the issuance of preferred shares.
In the case of issues carried out by a subsidiary company of those provided in the preceding point, the resources obtained must be permanently invested in the parent credit institution of the issuing subsidiary, so that they are directly related to the risks and financial situation of the parent credit institution and of its consolidable group or subgroup to which it belongs.
Not to grant their holders political rights, except in the exceptional cases established in the respective issue conditions.
Not to grant pre-emptive subscription rights with respect to future new issues.
Be listed on regulated markets, multilateral trading systems or other organized markets.
The public offering must have a tranche aimed exclusively at professional clients of at least 50 per cent.
Debt instruments issued by credit institutions complying with specific regulatory requirements:
Be issued by a Spanish credit institution or by a public limited company resident in Spain or in a European Union territory, which does not have the status of a tax haven, the voting rights of which correspond directly or indirectly to a Spanish credit institution and whose exclusive activity or object is the issuance of preferred shares.
In the case of issues carried out by a subsidiary company of those provided in the preceding point, the resources obtained must be permanently invested in the parent credit institution of the issuing subsidiary, so that they are directly related to the risks and financial situation of the parent credit institution and of its consolidable group or subgroup to which it belongs.
Not to grant their holders political rights, except in the exceptional cases established in the respective issue conditions.
Not to grant pre-emptive subscription rights with respect to future new issues.</td><td>WHT at 19%, although some exemptions apply, particularly for non-resident investors and where the investor is a Spanish entity. With respect to individual investors that are Spanish tax resident, WHT will apply to coupon payments, although some exemptions may apply in relation to income on disposal.</td><td>Transactions derived from the issuance of preferred shares will be exempt from Transfer Tax, Stamp Duty and VAT.</td></tr>
</table>

Insolvency treatment

In the table below we set out the insolvency treatment of hybrid capital instruments. We start with the generalised principles used across the EU, but insolvency regimes can be very different across EU member states. Indeed, the Capital Markets Union action plan from the European Commission has maintained a long-term aim to harmonise these rules. We then present some of the major differences across Germany, France, Italy, Spain and the Netherlands.

Key considerations	
Overview	As a general principle, most insolvency regimes across Europe stipulate that "creditors with insolvency claims have an equal right to be paid in proportion to and in accordance with the ranking of their claims. They are entitled to a distribution only if higher ranking insolvency claims can be satisfied to their full amount admitted."[7] **EU Restructuring Directive:** In 2019, the EU introduced a Restructuring Directive which aims to take a preventative approach to insolvency by allowing early opportunity for restructuring, inspired by Chapter 11 of the US Bankruptcy Code.[8] The key relevant changes include: • **Obligation to treat affected parties in separate class segments:** At the very minimum, classes should be divided between secured and unsecured creditors. While Member States can still determine class rights, voting rights, the legal framework for any contested claims and what level constitutes a majority, the Directive stipulates that the majority shall not exceed 75% debt.[9] Member States should also be able to exempt debtors that are small and medium enterprises (SMEs) from this obligation on account of their relatively simple capital structure. • **Cross-class cram-down mechanism:** If the restructuring plan is not approved by a class, it may still be approved by the Member State court using the Best Interest Test (to ensure that no dissident creditor is worse off under a restructuring plan than they would be in the case of liquidation) and which may choose between an absolute priority rule (APR) or a non-compulsory relative priority rule (RPR) to determine the pay out. The RPR does not require that senior classes are paid in full before junior classes: they just need to be treated "more favourably". Note that the APR can makes it difficult to award value to the equity of SMEs (the "problem of the relevant shareholders"), so from the perspective of the EU, the RPR could alleviate this challenge.[10 11 12] Member States must implement the Restructuring Directive into national law by 17 July 2021, subject to a one-year extension. Germany, France, Spain and the Netherlands have published draft or final legislation already. Italy has requested a one-year extension. Spain will likely need to distinguish more classes of affected creditors (beyond just secured and unsecured).

7 International Insolvency Institute. "PRINCIPLES OF EUROPEAN INSOLVENCY LAW-1445 wds".

8 Becker, B. (2019). 'The EU's insolvency reform: Right direction, not enough, and important issues left unaddressed', 27 June 2019.

9 Thorn, M. and Zaman, M.(2019). 'And, more keeping up with the Joneses: The new EU restructuring directive and reforms in the United Kingdom', October 2019

10 Thorn, M. and Zaman, M.(2019). 'And, more keeping up with the Joneses: The new EU restructuring directive and reforms in the United Kingdom', October 2019.

11 Russo, E. (2021). 'The EU Directive on Restructuring and Insolvency and the Strengthening of the Creditor's Role in the Course of Restructuring Procedures', 15 April 2021.

12 Ballerini, G. (2020). 'The priorities dilemma in the EU preventive restructuring directive: Absolute or relative priority rule?', International Insolvency Review 2021, Vol. 30: pp. 7–33.

Insolvency treatment

	Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
What level of subordination is required to achieve equity treatment?	A classic subordinated debt hybrid instrument will rank in insolvency after all other creditors, including intra-group creditors.	Equity preference shares will rank in insolvency after all creditors, including subordinated debt. Preferred equity normally ranks above ordinary equity in the event of insolvency and that will be reflected in the memorandum and articles of association.
How is the instrument treated in case of corporate insolvency?	This will largely be guided by the terms of the document setting out the subordinated debt. However, there may be terms which limit the subordinated debt holder's rights: • There may be an intercreditor type agreement, for example prohibiting the holder of the subordinated debt from issuing insolvency proceedings against the company. • There may also be provisions providing that interest on the debt above subordinated debt is paid before subordinated debt. In the above, the instrument will rank in an insolvency waterfall after all the costs and expenses and after all other creditors, but above equity.	Equity preference shares in insolvency will be paid after all creditors, including subordinated debt holders.

Additional EU member state considerations	
Key Germany differences	The German insolvency regime is generally not seen to be creditor or debtor friendly. Rather it falls somewhere in between, as it sets out to maximise creditor return but also has long timelines to receive claims and has severe sanctions to managing directors if a debtor does not file for insolvency in time.[13] Subordinated creditors typically fall behind unsecured creditors but before shareholders in the creditor ranking.[14] Within subordinated creditors, claims subordinated by statutes (e.g. shareholder loans) are satisfied and then claims subordinated by agreement (e.g. full subordinated securities) are satisfied.[15]
Key France differences	The French insolvency regime is generally seen to be debtor friendly, as it focuses on preservation of business and employment through restructuring options.[16] "The value distribution follows a predetermined rank order but the exact recoveries are rather unpredictable ex ante due to the high number of context-sensitive privileges (employees', public creditors, etc.)." Unsecured claims rank last in the creditor ranking.[17]
Key Italy differences	The Italian insolvency regime is generally seen to be debtor friendly; the duration of judicial proceedings allows the debtor to delay the timing of payments.[18] However, recent rules have made the process more efficient and quicker, making it tougher for debtors to delay payments (e.g. *Codice della Crisi d'impresa e dell'Insolvenza* or the Insolvency and Company Crisis Code to come into force on 1 September 2021).[19] All unsecured creditors (including subordinated creditors) rank behind secured creditors and last in the creditor ranking. However, the composition "plan must provide payment to unsecured creditors of at least 20% of their credit"[20]

13 ICLG, "Germany: Restructuring & Insolvency Laws & Regulations 2021", 2021.

14 Mayer Brown (2017). "German Insolvency Law - an overview.". 2017.

15 ICLG, "Germany: Restructuring & Insolvency Laws & Regulations 2021", 2021.

16 Mondaq, "France: Restructuring & Insolvency Comparative Guide", 22 February 2021.

17 Legal 500, "France - Restructuring & Insolvency", 2021.

18 ICLG, "Italy: Restructuring and Insolvency Laws and Regulations 2021", 2021.

19 Gianni-Origoni-Grippo-Cappelli Partners, "The New Italian Crisis and Insolvency Code: Focus on Early Warning", 2021.

20 ICLG, "Italy: Restructuring and Insolvency Laws and Regulations 2021", 2021.

Additional EU member state considerations	
Key Netherlands differences	The Dutch insolvency regime is generally not seen to be creditor or debtor friendly. It was previously creditor-friendly due to limited reorganisation options, but with the EU Directive taking effect this year, Dutch law now gives more restructuring options to debtors.[21] Contractually agreed subordination clauses as part of intercreditor arrangements are common in the Netherlands. However, the wording of these clauses is important in determining whether it will have an effect inside bankruptcy (statutory subordination), outside bankruptcy (non-statutory subordination), or both.[22] • **Non-statutory subordination** "has effect only outside bankruptcy and comes in many varieties (e.g. relate to the ability to claim on certain obligations or to the right to claim itself, ensure that a claim of the subordinated creditor only becomes due if the claims of certain senior creditors have been paid, restrict the recourse rights of the subordinated creditor to certain assets of the debtor)."[23] • **Statutory subordination** would result in the creditor ranking behind all or certain other creditors of the debtor, as agreed in the documentation.[24] Ordinary claims typically rank behind preferential claims and last in the creditor ranking. They must be submitted for verification and, if verified, will receive a pro rata share of the remainder after the estate claims, secured claims and preferential claims are paid.[25]
Key Spain differences	The Spanish insolvency regime is generally seen to be creditor friendly in terms of legal rights (e.g. secured creditors are virtually "immune to the effects of bankruptcy proceedings"). However, it is worth noting that the most common outcome is wind down, which ultimately may lead to scarce proceeds available to creditors.[26] Subordinated claims rank behind ordinary claims and last in the creditor ranking. These claims will not be paid until the ordinary claims are settled in full.[27] If the proceeds available are not sufficient to pay all credits qualified with the same grade, they will be paid in proportion.[28]

21 ICLG, "Netherlands: Restructuring & Insolvency Laws & Regulation 2021", 2021.

22 De Brauw Blackstone Westbroek, "In review: credit support and subordination in Netherlands", 2020.

23 De Brauw Blackstone Westbroek, "In review: credit support and subordination in Netherlands", 2020.

24 De Brauw Blackstone Westbroek, "In review: credit support and subordination in Netherlands", 2020.

25 ICLG, "Netherlands: Restructuring & Insolvency Laws & Regulation 2021", 2021.

26 ICLG, "Spain: Restructuring and Insolvency Laws and Regulations", 2021.

27 Baker McKenzie, "Global Restructuring & Insolvency Guide - Spain", 2017.

28 ICLG, "Spain: Restructuring and Insolvency Laws and Regulations", 2021.

Credit ratings agency treatment

In the table below we set out the credit rating treatment of hybrid capital instruments, for three of the main credit rating agencies: Fitch, S&P and Moody's. While there are variations across ratings provider, their approach is largely consistent across EU member states, so (unlike for the accounting, tax and insolvency above) we do not set out any EU member state differences.

Rating agency	Options	Criteria for equity treatment	Additional considerations	
			Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
Fitch[29]	**100% equity / 0% debt** **50% equity / 50% debt** **0% equity / 100% debt**	Deeply subordinated to all senior creditors, only senior to common equity, both before/ upon bankruptcy Inability to trigger events of default or only limited events of default. Coupon deferral at issuer's discretion / effective maturity of 5+ years or conversion to equity. Lack any material covenants or change of control clauses. Remain within the issuer's long-term capital structure. Has sufficiently strong replacement language, although need not be in the form of a legally binding covenant (Fitch applies judgment here). Does not lead to punitive consequences of deferral, call or conversion.	A call date will not be deemed an effective maturity date unless it is accompanied with a coupon step-up greater than 1%. Optional convertibles (whether the option is with the issuer, instrument holder, or both), will be treated as debt in all cases.	Rather than events of default, non-payment will often result in investors' ability to block payment of common distributions or dividends and/or to appoint directors. Fitch considers these consequences sufficiently benign to be acceptable for equity recognition.

29 Fitch Ratings, 'Corporate Hybrids Treatment and Notching Criteria', 12 November 2020.

Rating agency	Options	Criteria for equity treatment	Additional considerations	
			Classic Subordinated Debt Hybrid	Equity Preference Share Hybrid
S&P[30]	**100% equity / 0% debt (high equity content)** **50% equity / 50% debt (intermediate equity content)** **0% equity / 100% debt (no equity credit)**	**General** Conversion price floor at least same as share price at time of issue. Nominal value of hybrid instruments achieving intermediate or high equity credit (excl. mandatory convertibles) is a maximum of 15% of corporate issuer's capitalisation. **High equity credit** Converts into ordinary equity over the short-term (0-3 years). Issuer commitment to allowing conversion. **Intermediate equity credit** Residual time until effective maturity (10-20+ years). Subordinated in liquidation to all senior debt obligations. Not callable within 5 years of issue date (unless external event). Able to absorb losses or conserve cash for 5+ years without triggering default/wind-up of issuer and in stress scenarios before point of non viability or bankruptcy. Terms/features do not discourage/materially delay deferral and shareholder approval is not required to activate a deferral (coupons can be cumulative or noncumulative). **No equity credit** Lack of issuer intent to hold hybrid for sufficiently long period. Effective maturity accelerated in the event of a rating deterioration. All hybrid amounts in excess of 15% of capitalization.	Mismatched mandatory convertibles (debt remains outstanding after the associated equity issuance) also eligible for high equity content if criteria for equity treatment met and the issuer will use the proceeds of the equity issuance to repay debt.	N/A

30 S&P Global Ratings, 'Hybrid Capital: Methodology and Assumptions', 1 July 2019.

Credit ratings agency treatment

<table>
<tr><th rowspan="2">Rating agency</th><th rowspan="2">Options</th><th rowspan="2">Criteria for equity treatment</th><th colspan="2">Additional considerations</th></tr>
<tr><th>Classic Subordinated Debt Hybrid</th><th>Equity Preference Share Hybrid</th></tr>
<tr><td>Moody's[31]</td><td>Investment Grade (IG) issuers:
100% equity / 0% debt
75% equity / 25% debt
50% equity / 50% debt
25% equity / 75% debt
0% equity / 100% debt

Speculative Grade (SG) issuers:
100% equity / 0% debt
0% equity / 100% debt</td><td>IG: Non-convertibles
Long in maturity (30+ year initial maturity, 60 years 'perpetual')
Have strong triggers of mandatory coupon suspension (e.g. no dividend pushers of 6+ months, no ACSMs)
No strong incentives to call (i.e. no step-ups prior to 10 years after issuance of the security or step-ups greater than 100 bps over the life of the hybrid)
Exception: maximum step-ups of 500 bps in a change-of-control event, as long as all senior creditors are similarly protected in the event that the hybrid can be called
Applies cap of Hybrid Equity Credit/ Adjusted Equity ≤ 30% to all IG hybrids except for common equity
IG: Convertibles:
Perpetual preferred host security with a noncumulative coupon skip mechanism typically receives more equity credit.
SG:
Only preferred stock and other equity that have no debt claim in bankruptcy and cannot accelerate due to non payment or trigger a broader issuer-wide default are given equity credit - All debt treated as 100% debt.
Shareholder loans may also be treated as 100% equity.</td><td>If it doesn't meet the 3 preferred security criteria, then classified as subordinated debt.</td><td>Preferred securities must meet following 3 criteria, else subordinated debt:
1. Very deeply subordinated securities, generally the most junior instrument above common equity;
2. Cannot default or cross-default other than at maturity, if the hybrid is dated;
3. Have limited ability to influence the outcome of a bankruptcy proceeding or a restructuring outside bankruptcy.</td></tr>
</table>

31 Moody's Investor Service, 'Hybrid Equity Credit, 10 September 2018.

Linklaters Summary of Recapitalisation – Key State aid considerations[32]

European Commission Process
State aid issue only arises if State funds are involved • A recapitalisation at 'market economy conditions' is not State aid, but unlikely in COVID-19 context
State aid must be notified for prior approval from the EU Commission (EC)
Review process requires time and close cooperation / negotiation with the EC • Recent recapitalisation measures have required 3-5 months • The EC generally aims to ensure equal treatment and follows previous decisions
Thorough examination to ensure aid is proportionate and kept to the minimum necessary. Close assessment of instruments, to ensure e.g. temporary nature and adequate remuneration for taxpayers' risk

Temporary COVID-19 rules
EC's 'Temporary Framework' (TF) runs until end of 2021 (extension to June 2022 likely) • Measures (schemes or individual measures) to help companies weather the effects of the pandemic • Initially limited to liquidity tools (loans / guarantees), extension to equity / hybrid measures resulted in stricter conditions
More favourable and generally quicker than "normal" State aid rules, but still entails stringent conditions
Much media focus on individual recapitalisations of airlines – *Air France, Lufthansa, SAS* – but also numerous schemes • German "umbrella" schemes under which federal and regional authorities can invest through debt and equity instruments • Also Denmark, Hungary, Italy, Latvia, Lithuania, Poland, Spain
Several cases include hybrid instrument treated as equity under IFRS, e.g. non-convertible, perpetual with non-mandatory payments of coupons at the discretion of the beneficiary

32 This overview focuses on aid provided as a direct State participation in subordinated debt instruments which is treated as equity for accounting or rating purposes. It is noted that a State guarantee for a portfolio of subordinated debt instruments held via an SPV in a securitised structure is not contemplated in the EC's TF. The EC would therefore likely require ad hoc conditions, drawing on the guidance covered in this presentation as well as the guidance provided for aid in the form of guarantees on loans.

Stringent conditions imposed under the Temporary Framework

Is aid necessary, appropriate and proportionate?

State to demonstrate that beneficiaries:

- Will go out of business or face serious difficulties without the aid
- Are unable to find financing on markets at affordable terms
- Will not be helped beyond capital structure predating COVID-19

Support to one company over €250m likely to require separate notification

Is it in 'common interest' to provide aid?

State to demonstrate that aid will avoid 'social hardship' or 'market failure' due to loss of employment / innovative company / systemically important company or disruption to important service

Ensures that the State is properly remunerated and includes incentives for the State's exit?

To ensure beneficiaries look for alternative capital when market permit, the remuneration shall be "sufficiently high" and increase over time. Often source for substantial discussions with the EC

Risk level determines margins, but for equity / hybrid minimum 1-year IBOR plus:

Year	1	2,3	4,5	6,7	8 etc.
SME	225 bps	325 bps	450 bps	600 bps	800 bps
Large	250 bps	350 bps	500 bps	700 bps	950 bps

By contrast, minimum premiums for State guarantees / loans are substantially lower: 1-year IBOR plus:

Year	1	2,3	4-6
SME	25 bps	50 bps	100 bps
Large	50 bps	100 bps	200 bps

Further mechanism to encourage early end to State support required. E.g.:

- Compounded interest on unpaid (deferred) coupons
- Coupons to accrue to initial nominal amount
- Governance obligations will apply until aid is repaid

If no exit, aid will eventually be treated under "normal" stricter rules

Governance obligations include:

- Complete ban on bonusses and limits on management remuneration
- Ban on dividend payments, non-mandatory coupon payments and buy back shares (other than from the State)
- Ban on acquisitions over 10% as long as 75% of aid is not redeemed
- Ban on "aggressive commercial expansion"

Alignment at times challenge between:

- TF and IFRS (and opinions diverge)
- TF and national rules

Experience shows EC can be flexible

Linklaters Illustrative Transaction Term Sheet

Initial remarks:

1. The below is a generic term sheet for the issuance by an unrated unregulated corporate issuer of an unrated, undated callable subordinated bond ("Private Subordinated Bond" or "**PSB**"). The PSB will provide for the ability to absorb losses along the traditional dimensions of subordinated capital instruments:

   (a) On a going concern basis, the PSB gives the corporate issuer the ability to suspend coupon payments at its discretion on a cumulative basis.

   (b) On a gone concern basis, the PSB provides the holder of the bond a subordinated claim, thereby protecting senior creditors upon a voluntary or involuntary winding up of the issuer.

   (c) The PSB will be legally available for an undated period of time and be redeemed only at the discretion of the issuer.[33]

   (d) The PSB does not give the holder of the bond any shareholder rights such as voting rights, rights to dividends or participation in the liquidation proceeds.

   In the past auditors confirmed to issuers of similar instruments that such instruments could be accounted for as IFRS equity.

2. Before a PSB can be issued to an SME in any particular member state, in addition to accounting aspects, local mandatory **corporate law** and **insolvency law** aspects as well as local **tax law** aspects (that will need to be covered by binding rulings and/or tax opinions) will need to be considered.

   On the investor side, in the case of an investor other than a bank, **regulatory law** aspects may need to be considered, such as bank licensing requirements (i.e., to avoid this constituting licensable credit business) or fund regulations.

   State aid issues need to be looked at in respect of a government entity direct or funded participation, including the State guarantee benefitting (directly or indirectly) the issuer and/or the investors. To react to the COVID-19 crisis, the European Commission has put in place a Temporary Framework that allows for state support in certain situations at more favourable terms than under the normal state aid rules.[34]

33 NB: A State guarantee for a portfolio of subordinated debt instruments held via an SPV in a securitised structure is not contemplated in the Commission's Temporary Framework. The guidance covers aid in the form of guarantees on loans and direct State participation in subordinated debt instruments which is treated as equity for accounting [or rating] purposes. The Commission would therefore likely require ad hoc conditions, drawing on both these sets of rules.

In relation to duration, guarantees on debt are generally limited to maximum six years but e.g. a lower guarantee coverage could offset a longer duration

34 Depending on the final structure of the PSB, prior approval by the Commission (upon notification by the Member State concerned) under the Temporary Framework is subject to stringent conditions. Requirements for the proposed securitised structure TBD.

3. The below is drafted for an investment by way of a private placement initially to a bank for purposes of creating a PSB portfolio. The bank would retain a portion of the risk under the PSB portfolio (say [10]% of each component of the PSB) and would sell (or, maybe, otherwise transfer the risk under) the remainder (say [90]% of each component of the PSB) to an issuance vehicle (of a nature yet to be determined, "**SPV**"). The SPV would fund the purchase price therefor by issuing public notes (the "**Public Notes**") to third-party investors in the market. The up to first [40]%[35] of any losses in the portion of the PSB portfolio transferred to the SPV would be guaranteed by government guarantee ("**Guarantee**") for which the SPV would pay, from a portion of the interest income it receives from its PSB portfolio, to the government entity an appropriate guarantee fee that is compatible with state aid rules.

4. In addition to the legal documentation for the PSB, further documentation with additional parties will be required, such as the following:

   (a) Intercreditor arrangements (e.g. a stand-still) need to be put in place between the SME and its major creditor(s) to avoid that the major creditor(s) attach to the issuance proceeds of the PSB.

   (b) All steps and documentation required to establish the SPV.

   (c) All arrangements necessary for the issuance of the Public Notes, such as the termsheet, prospectus, full terms and conditions and ancillary documentation for the Public Notes.

   (d) All arrangements necessary for the Guarantee, such as the termsheet and full terms of the Guarantee.

5. We have not looked into any other forms of subordinated, equity-like instruments that we have seen being used in the past. In Germany, for example, we have seen, as part of broader measures covering multiple companies, such as German support schemes covering both equity instruments and hybrid capital instruments (convertible bonds and so-called "silent participations"), instruments being issued directly to the (tax exempt) German federal government. Until some years ago, we also frequently saw transactions in which participation rights (so-called "*Genussrechte*") were issued by SMEs to (tax resident) German domestic investors. The tax treatment of these instruments varies depending on the precise terms thereof, and the German (withholding) tax regime tends to make them unattractive to non-domestic investors.

   Other EU27 jurisdictions may use other forms of instruments that may need to be looked into. Given that the corporate, insolvency, regulatory and tax law regimes differ significantly from member state to member state, it may be difficult to come up with a one-size-fits-all solution.

35 NB: The Commission has not provided for limitations in relation to direct participation in subordinated debt instruments which is treated as equity for accounting [or rating] purposes. In relation to State guarantees on debt, a State guarantee may not exceed 35% of the loan principal, where losses are first attributed to the State and only then to the credit institutions.

[Issuer]

€ [•] Undated Private Subordinated Bonds (PSB)

INDICATIVE TERMSHEET

Issuer:	[Issuer] (Ticker: [•] / Country: [•])
Issuer's Legal Entity Identifier:	[•]
Securities offered:	EUR-denominated Private Undated Subordinated Bonds ("**PSB**")
Purchaser:	[Bank] [ultimate investors will buy Public Notes issued by the SPV as described in Clause 3 of the Initial Remarks on page 1 of this document]
All-in cost until the First Reset Date:	[c 5-10]%, depending on the size of programme and industry sector profile[36]
Documentation of the PSB:	Private placement documentation (including full terms and conditions, a bond purchase agreement, a global certificate and an agency agreement)
Further documentation required:	Intercreditor arrangements (stand-still) to be put in place between the Issuer and its major creditor(s) Further documentation as described in Clause 4 of the Initial Remarks on page 2 of this document
Aggregate Principal Amount of the PSB:	EUR [•] [Minimum issue size of the PSB of not less than EUR [1]m] [the total size of the programme as described in Clause 3 of the Initial Remarks will be > EUR [1]bn]
Use of Proceeds:	[General corporate purposes][37]
Rating of the Issuer:	[Unrated][38]
Rating of the Bonds:	Unrated

36 Not considering the step-up(s) that will be required if the instrument is deemed State aid.

37 NB: Under the Temporary Framework, a State guarantees on debt shall relate to investment and/or working capital loans. As noted above, a State guarantee for a portfolio of subordinated instruments held via an SPV in a securitised structure is not contemplated in the Commission's Temporary Framework and the Commission would likely require ad hoc conditions, drawing on the Guidance on State aid in the form of guarantees on loans and direct State participation in subordinated debt instruments which is treated as equity for accounting [or rating] purposes.

38 Implied issuer rating [B+] or better ([pre-] [post-] Covid 19) [TBD]

Status / Ranking of the Bonds:	Direct, unsecured and subordinated obligations of the Issuer ranking [(i) subordinated to all unsubordinated and subordinated obligations of the Issuer which do not fall under (ii) or (iii); (ii) *pari passu* amongst themselves and *pari passu* with all other unsecured obligations of the Issuer ranking subordinated to all unsubordinated and subordinated obligations of the Issuer (including any Parity Security), except for any subordinated obligations required to be preferred by mandatory provisions of law; and (iii) senior only to the rights and claims of holders of Junior Securities. "**Parity Security**" means any present or future security, registered security or other instrument which (i) is issued by the Issuer and ranks or is expressed to rank *pari passu* with the obligations of the Issuer under the Bonds, or (ii) is issued by a Subsidiary of the Issuer and guaranteed by the Issuer or for which the Issuer has otherwise assumed liability where the Issuer's obligations under the relevant guarantee or other assumption of liability rank *pari passu* with the Issuer's obligations under the Bonds. "**Junior Security**" means (i) the ordinary shares of the Issuer, (ii) any share of any other class of shares of the Issuer, (iii) any other present or future security, registered security or other instrument of the Issuer under which the Issuer's obligations rank or are expressed to rank *pari passu* with the instruments of the Issuer described under (i) and (ii), and (iv) any present or future security, registered security or other instrument which is issued by a Subsidiary of the Issuer and guaranteed by the Issuer or for which the Issuer has otherwise assumed liability where the Issuer's obligations under such guarantee or other assumption of liability rank or are expressed to rank *pari passu* with the instruments of the Issuer described under (i), (ii) and (iii). "**Subsidiary**" means an entity in which the Issuer holds directly or indirectly a majority interest and which is controlled by the Issuer within the meaning of IFRS.] [subordination clause TBC in light of local (in particular insolvency) law and regulatory requirements]
IFRS accounting:	Equity
Local GAAP accounting:	[•][39]
Tax treatment:	[Debt] [TBC]
Pricing Date:	[•]
Settlement Date:	[•]
Specified Denomination:	EUR [100,000]
Maturity:	Perpetual
First Reset Date:	[•][40]

39 For example, German IFRS equity bonds tend to be treated as debt for German GAAP purposes (to allow for the instruments to be treated as debt for tax purposes) [TBD]

40 Expected to be year [8] [NB: Under the Temporary Framework, the duration of the guarantees on debt is generally limited to maximum six

Rate of Interest:	[Until the First Reset Date: the Fixed Interest Rate; Thereafter: every [•] years interest rate reset at Reference Rate + Initial Margin + Step-up Margin]
Fixed Interest Rate:	[•]% p.a., payable [quarterly] [[semi-] annually] in arrear on [•] [[[•], [•]] and [•]] in each year
Initial Margin:	[•] bps
Step-up Margin:	[500] bps[41]
Reset Reference Rate:	[•] year swap rate as displayed on the Reuters screen "ICESWAP2/EURFIXA" under the heading "EURIBOR BASIS" and the caption ["11:00 AM Frankfurt time"] on the second TARGET Business Day prior to the relevant Reset Date (subject to customary benchmark replacement language) [interest structure TBD]
Change of Control Event step-up:	+ [500] bps p.a. above applicable prevailing Rate of Interest "**Change of Control Event**" means [add appropriate definition considering the specifics of the relevant issuer].
Optional Redemption by the Issuer:	The Issuer may call and redeem the Bonds (in whole but not in part) with effect as of each Business Day during the period from and including the First Optional Redemption Date to and including the First Reset Date and on each [Interest Payment Date] thereafter at par plus any accrued and unpaid interest on the Bonds to but excluding the date of redemption and, for the avoidance of doubt, any Deferred Interest Payments payable.
Special Event Redemption Rights of the Issuer:	The Issuer may at any time call the Bonds (in whole but not in part) (a) at par upon a Gross-up Event, in case of minimal outstanding aggregate principal amount or a Change of Control Event; and (b) at [101% of] par prior to the First Optional Redemption Date (par thereafter) upon an Accounting Event, or a Tax Event, in each case plus any accrued and unpaid interest on the Bonds to but excluding the date of redemption and, for the avoidance of doubt, any Deferred Interest Payments payable.
[Make-whole Call:	[TBD]]
No right of the Bondholder(s) to require redemption:	The Bondholders will have no right to terminate or otherwise accelerate the redemption of the Bonds.

years but e.g. a lower guarantee coverage could offset a longer duration.]

41 If deemed State aid, the instrument will have to include a step-up mechanism increasing the remuneration of the State on an annual basis.

If a government entity would provide a State guarantee in respect of a subordinated debt instrument of an SME (qualifying as debt), the required minimum margin step-up, for years 1 to 6, would be 175bps - 200bps - 250bps.

If a government entity would directly invest in a subordinated debt instrument of an SME (qualifying as equity), the required minimum margin step-up, for year 1 to 8, would be 225bps - 325bps - 450bps - 600bps - 800bps.

The requirements for the securitised structure proposed here (involving a State guarantee to an SPV in respect of a portfolio subordinated debt instruments issued by numerous SME portfolio companies, with each such subordinated debt instrument qualifying as equity, must be discussed with the Commission, as there are no specific rules addressing such situation.

Interest Deferral:	Optional deferral (in whole [or / but not] in part) at the Issuer's discretion at any time. Interest not due and payable as a result of any Interest Deferral will constitute deferred interest payments ("**Deferred Interest Payments**"). [Deferred Interest Payments will not bear interest.][42]
Dividend Stopper upon Deferral until Settlement in full of Deferred Interest Payments:	[Yes, details TBD][43]
Constraints on Executive Remuneration upon Deferral until Settlement in full of Deferred Interest Payments:	[Yes, details TBD][44]
Optional Settlement of Deferred Interest Payments:	Deferred Interest Payments may be settled in whole [or / but not] in cash at any time at the Issuer's discretion.

42 N.B. that in certain jurisdictions such as Germany Deferred Interest Payments must not be compounding as a matter of mandatory civil law. Where permitted by applicable local law, the Commission may request that any Deferred Interest Payments shall itself bear interest.

43 N.B. If deemed State aid, the Commission may impose ban on dividend payments as well as non-mandatory coupon payments.

44 N.B. If deemed State aid, the Commission may request limits on executive remuneration, including bonuses or other variable or comparable remuneration elements.

Mandatory Settlement of Deferred Interest Payments:	Deferred Interest Payments must be settled (in whole but not in part) on the next Mandatory Settlement Date. "**Mandatory Settlement Date**" means the earliest of: (i) the date falling five Business Days after the date on which a Compulsory Settlement Event has occurred; (ii) the date on which the Issuer pays scheduled interest on the Bonds; (iii) the date on which the Issuer redeems the Bonds in accordance with these Terms and Conditions, or the date on which the Issuer or any Subsidiary repurchases or otherwise acquires (in each case directly or indirectly) Bonds; and (iv) the date on which an order is made for the liquidation of the Issuer, all subject to customary carve-outs. "**Compulsory Settlement Event**" means any of the following events, subject to customary carve-outs set out in the Terms and Conditions: (i) the ordinary general meeting of shareholders of the Issuer resolves on the payment of any dividend, other distribution or other payment on any share of any class of the Issuer; (ii) the Issuer or any Subsidiary makes a payment or pays any distribution in respect of any Parity Security (other than the Bonds and other than a payment which is made in the form of shares of any class of the Issuer); (iii) the Issuer or any Subsidiary redeems, repurchases or otherwise acquires (in each case directly or indirectly) any Parity Security; or (iv) the Issuer or any Subsidiary pays any distribution or makes any other payment in respect of any Junior Security (in each case other than a dividend, distribution or payment which is made in the form of shares of any class); or (v) the Issuer or any Subsidiary redeems, repurchases or otherwise acquires (in each case directly or indirectly) any Junior Security.
Day Count Fraction:	Actual/Actual (ICMA)
Business Days:	TARGET 2, Clearing System
Business Day Convention:	Following unadjusted
Governing Law:	[Local Law]
Offering format:	Reg S only, [Bearer Bonds]
[Clearing Systems:	[TBD]]
[ISIN / Common Code:	[•] / [•]]
Paying and Calculation Agent:	[•]

This term sheet does not purport to be complete and is taken from, and is qualified in its entirety by, the full terms and conditions of the Bonds ("Terms and Conditions"). Terms not defined herein are defined in the Terms and Conditions.

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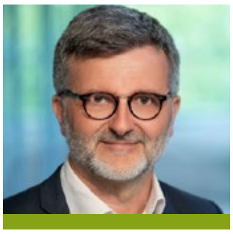

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/ About AFME

The Association for Financial Markets in Europe (AFME) is the voice of all Europe's wholesale financial markets, providing expertise across a broad range of regulatory and capital markets issues.

We represent the leading global and European banks and other significant capital market players.

We advocate for deep and integrated European capital markets which serve the needs of companies and investors, supporting economic growth and benefiting society.

We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, our technical knowledge and fact-based work.

Focus
on a wide range of market, business and prudential issues

Expertise
deep policy and technical skills

Strong relationships
with European and global policymakers

Breadth
broad global and European membership

Pan-European
organisation and perspective

Global reach
via the Global Financial Markets Association (GFMA)

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