CLIFFORD

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Briefing note

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Issuance of hybrid debt instruments and so-called contingent convertible bonds (CoCo)

Apart from the issuance of securities treated purely as debt instruments (e.g. bonds) or equity instruments (e.g. shares), it is also possible to issue so-called "hybrid instruments". They are securities that make it possible to combine the benefits of debt and equity. CoCo (Contingent Convertibles), i.e. bonds subject to automatic conversion into equity, are a special type of such instrument. The issuance of hybrid instruments offers numerous benefits to issuers which are not provided by standard debt/equity instruments. At the same time, provided they fulfil the relevant criteria, hybrid instruments may be considered equity instruments for accounting purposes. Because of this they increase the equity ratio of their issuer without affecting the level of the issuer's debt.

What are hybrid instruments?

Hybrid instruments are securities which, by being given specific parameters, possess elements of both debt securities as well as those characteristic of equity. Usually bonds (or other debt securities) that have specific elements bringing them closer to equity instruments are considered hybrid instruments. Hybrid instruments are a tool that is particularly attractive for banks and other financial institutions which are obliged to maintain specified levels of equity pursuant to the regulations of the CRD IV[1] package or Solvency II[2].

The main features of hybrid instruments are:

- no maturity date or a very distant maturity date (several dozen years);
- subordination with respect to other obligations;
- making the payment (and/or rate) of interest dependent on the income achieved by the issuer or the possibility of suspending its payment in specific circumstances such as, for example, the occurrence of a loss or a deterioration of indicators, whereas the biggest benefits may be achieved through instruments with respect to which the issuer may suspend payment of interest at any time;

as well as, in specific circumstances relating to the financial condition of the issuer:

- the right to exchange or compulsory conversion of the instrument into the issuer's share capital; or
- the right to participate, in the event of the issuer's liquidation or bankruptcy, in the division of the assets of the entity that remain after the satisfaction of all obligations, on a par with other shareholders.

By virtue of some of the above-mentioned features hybrid instruments constitute a relatively safe source of additional capital for the issuer for investments or refinancing. This is because as subordinated instruments they do not collide with the interests of the existing creditors and they do not deteriorate the financial indicators (quite the opposite, they improve them). In turn, in the case of financial difficulties (losses, threat of bankruptcy), they make it possible to suspend payments or even to write-off part of the liabilities or convert them into share capital. At the same time, due to among other things a higher interest rate as compared to other instruments available on the market, they are regarded by investors as an attractive investment. Therefore, they can serve as a means of obtaining additional financing in a weak economic climate. According to publicly available information certain issues of hybrid instruments abroad involved the reduction of subscriptions by almost 80%.

Among hybrid instruments issued in the territories of European Union Member States one may mention those issued by financial institutions and those issued by other companies. An example of those issued by financial institutions is an issue by Credit Suisse Group AG in 2011 – the issue of Tier I perpetual bonds with a nominal value of USD 3,500,000,000 and CHF 2,500,000,000, respectively, with an interest rate of 9.5% and 9%, respectively, with an interest rate reset after 5 years and 30-year Tier II bonds (issued by an SPV and guaranteed by Credit Suisse Group AG) with a nominal value of USD 2,000,000,000, with an initial interest rate of 7.875%, with an interest rate reset after 5 years. Both of these types of bonds are subject to automatic conversion into shares in the case of a decrease in the Tier I equity of the Credit Suisse group below 7%. Those issued by other companies, such as power companies, include for example Veolia Environment S.A. in

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[1] Composed of the following legislative acts (and the secondary legislation thereto):
- Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRR);
- Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV).

[2] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

2013 – issue of hybrid perpetual bonds with a total value of EUR 1,000,000,000 and USD 400,000,000 and an interest rate between 4.5% and 4.875%.

Types of hybrid instruments

Hybrid instruments may be divided into the following types:

- non-voting preference shares with priority in the payment of dividends;
- particular kinds of subordinated debt;

both of which are not debt securities and are not the subject of this briefing;

- bonds convertible into shares (with a right to purchase shares for a specific price or to their gratuitous subscription) or bonds with a priority right (that give the holder, in the case of an issue of shares by the issuer, the right to the purchase or subscribe them with priority over others, including before existing shareholders with a pre-emptive right);
- bonds subject to automatic conversion into equity (so-called CoCo, i.e. "Contingent Convertibles", which in the case of a trigger, e.g. when the issuer's capital ratio falls below a certain level, may be subject to automatic conversion into shares, which means that the debt is actually absorbed by non- refundable equity);
- bonds with a principal writedown or interest deferral or suspension mechanism – dependent on the issuer's decision or on the occurrence of specific circumstances (e.g. a trigger);
- instruments used by insurance companies in accordance with the Solvency II regulations; or
- bail-in bonds, issued by banks that constitute Additional Tier I or Tier II capital in accordance with the CRR.

At the same time, it must be borne in mind that it is possible classify hybrid instruments in a number of ways. For example the criteria for deeming a given instrument a hybrid for accounting purposes are different to the ones based on CRR, or those applied by rating agencies. When classifying a given hybrid instrument, it should be taken into consideration that not every security of this type will satisfy all of these elements. For example, a given hybrid bond may be deemed an equity instrument for the purposes of the applicable accounting standards, but at the same time it may give only a partial (e.g. 50%) *equity credit* assigned pursuant to the relevant methodology by a rating agency. Depending on the issuer's expectations, it is possible to shape the terms of issue and the remaining documentation for hybrid securities accordingly, so that they meet the defined criteria.

Benefits of issuing hybrid instruments

Hybrid instruments (including CoCos) are a useful tool for financing which satisfies the expectations of both issuers and investors. Securities of this type enjoy unflagging popularity in Western Europe and worldwide, and, due to the adoption of the Act on Bonds of 15 January 2015, the issuance thereof may also be possible under Polish law.

Examples of the benefits stemming from the issuance of hybrid instruments include:

- In certain cases (or as a result of a unilateral decision of the issuer), hybrid instruments make it possible to decrease the amount of interest paid to the bondholders or even to defer their payment. This gives the issuer more flexibility if the financial results are worse than expected.
- As a result of the recognition for accounting purposes of a given hybrid instrument as an equity instrument (after the relevant requirements are fulfilled), it is possible to improve parameters which are based on balance sheet amounts

disclosed in the issuer's books. These include, among other things, the net accounting value of the issuer or the financial leverage ratio[3].

- The rating assigned by rating agencies makes it possible to conduct an issue of hybrid instruments with a cost often lower than the cost of equity, which may potentially allow a company to make a beneficial repurchase of its own shares without increasing the nominal debt.
- By issuing hybrid instrument banks (as well as other institutions obliged to do so) can increase their equity base without issuing shares that would lead to a dilution of their shareholding and to a decrease of the market value of these assets.
- Due to thier subordinated nature and the mechanism of conversion into equity, the issuance of hybrid instruments as a rule should not worsen the position of already existing creditors. Therefore, this is a way of obtaining additional funds without violating the conditions resulting from existing debt (e.g. a credit facility) that the issuer already has.
- As a result of the conditional conversion of part of the issuer's debt into equity in the case of a significant deterioration of the issuer's solvency, it is possible to avoid bankruptcy which the issuer would otherwise be forced to announce. This is also intended to make it possible for bank-issuers, in the case of a significant deterioration of their solvency, to find a way out of such a situation without relying on public aid.
- If the relevant conditions are fulfilled, an additional benefit for the issuer of hybrid instruments may be the recognition of the interest paid to the holders of these instruments as revenue-generating costs, which makes it possible to decrease the taxation base (the so-called "tax shield") – but see the section entitled "Material tax issues" below.

Typical parameters of market issues of hybrid instruments

Entities operating on the market can freely shape their obligations in the hybrid instruments issued (provided that this is compliant with the provisions of law of the given EU Member State). The provisions of the terms of issue that are the most characteristic of hybrid instruments include (among other things):

- Subordination – depending on the instrument, this may vary from ordinary subordination through a junior instrument to an instrument with priority only over shares and preference shares.
- Maturity (maturity date) – this is usually very distant (over 50-60 years, although there are also shorter-term instruments) or an instrument of this type may be issued as perpetual (i.e. without a specified maturity date).
- Conversion or principal writedown – in most cases both solutions are interchangeable, but there are also instruments that combine them. Conversion consists of a change of a hybrid instrument into an equity instrument with a lower priority than the base hybrid instrument (these usually are shares). Whereas, a decrease in denomination is tantamount to a pro rata redemption of part or all of the hybrid instruments as part of a given series – for no consideration. The benefit of this is that, as opposed to a conversion, there will not be any dissolution of the issuer's shareholders. These mechanisms lead to the absorption of the issuer's losses. They can be optional or compulsory.
- The interest rate, and the possibility of its reset, including step-up. Usually, a change of the interest rate as part of the provisions of the terms of issue includes a cyclical change (increase) in given periods of time (e.g. 5-year periods). In some issues there are also other clauses, e.g. regarding a fix-to-float change of the interest rate or vice versa.
- Forcing/deferral of payments, i.e. the so-called pusher/stopper clause. This relates to the terms and conditions of the disbursement or suspension of payments in specific cases, in particular in combination with events under selected equity instruments (e.g. the payment of a dividend on shares). For example, payment may be combined with a dividend, which means that in the case of payment of the latter the issuer cannot suspend payment under the hybrid instrument, and if such a stipulation is made, the issuer will also be obliged to make previously suspended payments – indefinitely

[3] Understood as a ratio of assets to own funds. The larger the leverage ratio, the bigger the share of outside capital (debt). Hybrid instruments make it possible to increase the asset base without additional debt, which may be attractive especially to issuers who wish to decrease their debt/equity ratio.

or for a specified period of time, e.g. six months (the look-back clause). Whereas suspension means the reversal of the above-mentioned mechanism.

- Interest deferral, usually in respect of interest or other performances due to the instrument holders. This may occur in the following forms:
  - compulsory/optional –compulsory suspension is usually dependent on a specific trigger, whereas optional suspension of payments depends on the issuer's decision;
  - cumulative/non-cumulative – in this case the difference means a non-definitive (cumulative – deferral of payment) or definitive (cumulative – annulment of payment) suspension/deferral of payments. This can relate to a specific period of time or a term calculated from the moment of suspension until redemption.

Issuance of hybrid instruments under Polish law

Depending on the case, three basic criteria (irrespective of other conditions) apply for a given security to be classified as a hybrid instrument. These criteria include: the linking of the bondholders' income with share in the income of the issuer or a similar mechanism allowing the absorption of a loss (e.g. the possibility of suspending or deferring the payment of interest in the case of lower profits or lack thereof, or the right to evade payment based on a unilateral decision of the issuer), subordination with respect to other receivables and the lack of the possibility of submitting the given instrument for redemption. This last condition often means that equity instruments are issued as perpetual bonds or instruments with a very distant maturity date. Additionally, in the case of CoCo type instruments upon the occurrence of a trigger such instruments are automatically converted into shares.

One of the elements typical for hybrid instruments is the linking of payments under such instruments to certain parameters or financial indicators, in particular profits (so that they resemble a mechanism characteristic for a dividend paid out on shares, which are an equity instrument). Under Polish law such an effect may be achieved by issuing so-called "participation bonds" described in Art. 18 of the Act on Bonds. Participation bonds are debt securities that grant the bondholders the right to a share in the issuer's profits. This also involves certain requirements. The detailed rules governing such a share in the profits (including the amount thereof which may but does not necessarily need to be expressed as a percentage) should be stated in the terms and conditions of the issue of the participation bonds. An attempted disposal by the issuer of a share in the profits to bondholders, which is incompliant with the terms and conditions of the issue, is ineffective with respect to the bondholders. In addition, the right to a share in the issuer's profits must be being recorded in the business register of the National Court Register in which the issuer being a company is registered. A possible problem to be taken into account in the case of an issue of participation bonds may be a lack of willingness on the part of the tax authorities to classify the payments under such instruments as revenue-earning costs within the meaning of the applicable tax regulations.

Another issue is the possibility of specifying the liabilities under the bonds so that the payment of interest depends solely on the issuer. The regulations allow the issuer to shape freely, pursuant to the Act on Bonds, the conditions for payments under the bonds, the manner of making such payments, as well as other rights and obligations – each of these elements must be set out in the terms and conditions of the issue. In this case the tax risk is lower than that related to participation bonds.

The Act on Bonds also allows the issue of instruments which will be subordinated with respect to all other creditor claims in relation to the given issuer (so-called subordinated bonds). In practice, this means that in the case of the liquidation or bankruptcy of the issuer, the claims under subordinated bonds will rank last in the order of priority, following the satisfaction of all other claims – except for those the company's shareholders. At the same time, it will not be possible to establish security interests for such bonds (including security in rem, such as e.g. a mortgage or a registered pledge).

Another mechanism introduced by the new Act on Bonds is the issuance of perpetual bonds. These are debt securities which, unless provided for otherwise in the terms and conditions of the issue, will not be subject to redemption. It is worth noting that the provisions of the Civil Code governing the expiry of continuous obligations by termination do not apply to the liabilities under perpetual bonds. This means that it is not possible to terminate the liabilities resulting under the bonds, and that they can merely be redeemed if such redemption has been stipulated in the terms and conditions of issue of such bonds. This must be no sooner than after at least 5 years from the date of their issuance.

The Act does not include any prohibitions on combining the elements mentioned above (however, each such element is to included in the terms and conditions of issue). Therefore it is theoretically possible to conceive an issue of bonds that will combine the aspects of participation in profits, subordination and the lack of a maturity date. An appropriate combination should result in an instrument with features characteristic for hybrid instruments.

Issuance of convertible bonds, senior bonds or an embedded automatic conversion mechanism

A characteristic feature of a significant number of hybrid debt instruments (and all CoCo type instruments) is their convertibility into an equity instrument which will usually be a share or an equivalent thereof (hence also e.g. a subscription warrant). This may be achieved in one of the two ways presented below:

- The issuance of bonds convertible into shares or containing a right of pre-emption with respect to subscription shares; or
- Embedding a mechanism of automatic conversion into an equity instrument subject to the occurrence of a trigger in the terms of the bonds (the so-called Contingent Convertible – CoCo).

Where the statutes of the given joint-stock company provide for such possibility, the company may issue convertible bonds. These are bonds entitling the bondholders to subscribe a respective number of shares in lieu of the bonds. The bonds are then redeemed by operation of law at the moment of subscription for the shares by the bondholders through their conversion. The issuance of convertible bonds entails numerous additional obligations: the resolution on the issuance thereof is subject to notification to the National Court Register. The terms and conditions of the issue of such bonds should set out, among other things: the deadline for conversion, the conversion ratio and additional information regarding e.g. procedures in the case of transformation, division, merger or liquidation of the issuer, or a change of the nominal value of the shares before the date on which the claim regarding the conversion becomes enforceable. The conversion of the bonds is effected by way of the submission to the issuer of a written statement on subscription for shares. In addition, a joint-stock company may also issue bonds entitling their holder to subscribe for shares in the company while having the pre-emptive right to purchase or subscribe them before that company's shareholders.

However, it must be borne in mind that in the case of convertible bonds or bonds with an attached right of pre-emption there is no automatic conversion of debt into equity. This is because subscribing for such shares constitutes only an entitlement of the bondholder which he may, but does not necessarily have to exercise (even if such a contractual obligation exists, the lack of fulfilment thereof might result only in potential liability for damages). In view of this, the bondholder may wait until the bonds are redeemed or, in the case of a perpetual instrument, the bondholder may refrain from effecting the conversion into shares. Therefore, in order to obtain particular benefits, it is necessary to apply a mechanism of automatic conversion, envisaged by CoCo type instruments.

An alternative to the solution described above is the issue of bonds incorporating a mechanism for their conversion into subscription warrants which are equity instruments. In such a case, the liability under the perpetual bond is the principal plus possible interest. If a pre-determined trigger occurs, then, in accordance with the terms and conditions of the issue, that liability is modified by way of the conversion of the bond into a subscription warrant (the Act on Bonds allows issuers to shape freely the liability under bonds (as long as this is not in conflict with the generally applicable provisions of laws). Following the conversion, the holder of the warrant (former bondholder) will be able to convert it into shares. However, doing so requires the submission of a written statement to the issuer. It should be noted that Art. 437 of the Commercial Companies Code does not allow a conditional subscription for shares (this results in invalidity). Therefore, the automatic conversion of bonds into shares that would result in a compulsory subscription of an equity security by the bondholder does not seem possible.

At the same time it must be remembered that pursuant to Art. 83 of the Bankruptcy Law, a contractual trigger leading to a change of legal relationship may not be the announcement of bankruptcy or submission of a motion for bankruptcy by the issuer. There is no impediment, however, to specifying, the moment of conversion by reference to a financial ratio (e.g. increase of the issuer's debt above a pre-determined value, or a lowering of the solvency ratio below a pre-determined level).

Due to the principle of protection of the nominal value of shares (except for cases where e.g. the issuer is in possession of unredeemed shares), in the case of both solutions the issuer must take the relevant corporate actions related to a conditional increase in its own share capital, as set out in Art. 448 of the Commercial Companies Code. This may require, in particular, the adoption of appropriate resolutions by the general shareholders' meeting. The resolution regarding the issue of convertible bonds or bonds with the right of pre-emption with respect to the subscription of shares, as well as a resolution regarding the amendment of the statutes, must be adopted by a ¾ majority of votes. A resolution of the general shareholders' meeting regarding the depriving of the shareholders of the right to subscribe shares in full or in part must be adopted by at least a 4/5 majority of votes.

Recognition as an equity instrument

The law requires all publicly held companies as well as banks to conduct their accounting policy pursuant to the *International Financial Reporting Standards (IFRS*) which incorporate certain *International Accounting Standards (IAS*). The standard regulating the recognition of individual instruments on the balance sheet is the *International Accounting Standard 32: Financial instruments – presentation*.

The most important element that differentiates a financial liability from an equity instrument within the meaning of IAS 32 is the presence of a contractual obligation on the issuer to deliver cash or another financial asset to the other party (the holder). The existence of this obligation means that we are dealing with a financial liability, and in the case of a lack thereof, with an equity instrument. The above-mentioned standard also allows, under certain conditions, for a given financial instrument (including an instrument such as a perpetual bond which, in principle, is treated as a financial liability) to be classified as an equity instrument. It may not, however, include a contractual obligation to deliver financial assets to another entity or to exchange financial assets or liabilities with such entity on terms unfavourable to the issuer. In addition, if the instrument is to be additionally settled in equity instruments of the issuer, then this obligation may not include the delivery of a variable number of its own equity instruments. In such a situation, if the given exchangeable security is to meet the standards necessary for it to be classified as an equity instrument, the number should be fixed for each instrument, which means a pro rata settlement. In the case where the above requirements have not been fulfilled, it will still be possible for a given security to be classified as an equity instrument, but only if other, additional conditions are fulfilled.

Classification depends always on the content of the given financial instrument which for the purpose of describing it in the accounts should be regarded as prevailing over its name or form. In practice, it is assumed that if payments to the holders of the given instrument are at the sole discretion of the issuer who has the right to unconditionally avoid a cash payment, then such instrument may in principle be deemed an equity instrument. If the issuer does not have such a right, and the instrument has an embedded sale option or an option for settlement in its own equity instruments or a conditional settlement clause, the fulfilment of additional conditions set forth in IAS 32 may be necessary.

The accounting treatment of individual items on the balance sheet may depend on many different factors (e.g. on the accounting policy adopted by the issuer as well as on the particulars of the given financial instrument). In each case, the decision as to how a hybrid instrument is to be accounted for (either as a financial liability or as an equity instrument) should be preceded by prior consultation with the issuer's auditor.

Assigning of ratings to instruments

The assigning of a rating to hybrid instruments, especially in the context of the offering thereof, is a material issue. Rating agencies classify hybrid instruments by determining their *Equity Credit* (i.e. in simple terms the percentage in which they constitute an equity instrument) by placing them in one of five baskets (from 0% to 100% *Equity Credit*), which may affect the assigning of the relevant rating. At the same time, in the opinion of rating agencies, the participation of hybrid instruments (according to their *Equity Credit*) should not exceed 30% of the total value of the issuer's equity instruments (which, apart from issued shares, include hybrid instruments according to their *Equity Credit*). It should also be borne in mind that a separate rating methodology is used for banks.

The *Equiry Credit* baskets assigned by a rating agency to hybrid instruments (based on Moody's methodology for *Hybrid Equity Credit*)[4] are as follows:

0%	25%	50%	75%	100%
A	B	C	D	E

Examples of instruments assigned to a given basket:

Subordinated bonds with a maturity period shorter than 30 years, without a conversion mechanism, containing a cumulative mechanism for the optional suspension of payment, with an ordinary degree of subordination.	5-10 year subordinated bonds, with a conversion mechanism or principal writedown mechanism (depending on the trigger), without a payment suspension mechanism, with an ordinary degree of subordination.	Perpetual bonds with a conversion mechanism or principal writedown mechanism (depending on the trigger) and non-cumulative payment suspension mechanism, with a degree of subordination equal to preference shares.	60+ year bonds, without a conversion mechanism, containing a non-cumulative payment suspension mechanism (both optional as well as compulsory, in specific cases), with a degree of subordination equal to preference shares.	Instruments containing a mechanism of compulsory conversion into shares (at a fixed rate) already prior to bankruptcy or maturity and a non-cumulative payments suspension mechanism, with a degree of subordination equal to ordinary shares.

When assigning a specific percentage of *Equity Credit* to a given instrument, rating agencies are primarily guided by the answers to the following questions, which issuers should take into consideration when structuring a hybrid security:

- Does the hybrid instrument absorb losses or provide financial protection for a 'going' concern? This question should be understood as including, among other things, the assessment of the existing coupon skip mechanisms, etc.
- Does the hybrid instrument absorb losses for a 'gone' concern? This question should be understood as including, in particular, the assessment of the degree of subordination of a given hybrid, but also the relevant provisions of the terms and conditions of issue relating to the risk of the issuer's bankruptcy.
- Will the loss-absorbing hybrid instrument be there when needed? This question should be understood as including, in particular, the general assessment in time of the type, quality and maturity of a given instrument, including in the context of issued equity instruments strictly so-called.

Material tax issues

Unlike ordinary equity instruments (such as e.g. shares), hybrid instruments should make it possible, provided they are constructed properly, for the payments made to the bondholders to be recognised as revenue-generating costs, thus reducing the issuer's tax base. It should be remembered, however, that in the case of bondholders who are not tax resident in Poland this may have a negative impact on the possible tax exemptions applicable to income from hybrid instruments in

[4] Available at the following address: http://www.moodys.com/viewresearchdoc.aspx?docid=PBC_156230.

the bondholder's country of tax residence where they are treated as equity instruments in that country (this needs to be verified by the bondholder).

In the case of instruments issued by Polish entities the construction of an appropriate issue structure may prove to be a challenge, in particular due to the adverse tax rulings issued in this respect by the tax authorities. Pursuant to their opinions, for payments under financial instruments to be deemed interest for the purpose of being recognised as revenue-generating costs they must be calculated using an interest rate applied to principal. If the remuneration for making money available takes on a different form – e.g. is dependent on profit or turnover – then, pursuant to the interpretation of the tax authorities, we will not be dealing with interest, but with a separate form of remuneration, such as, for example, a share in profit, which does not constitute a revenue-earning cost.[5] This also applies to participation bonds issued on the basis of Art. 18 of the Act on Bonds of 15 January 2015[6]. Pursuant to the opinions expressed in individual tax rulings, it should be possible to calculate interest by simply multiplying the interest rate by the amount of principal, without taking any other additional circumstances into account.

This does not mean, however, that it is not possible to create a structure for the issue of hybrid bonds under which the payment of interest can constitute a revenue-earning cost for the issuer. For example, there is a possibility of issuing bonds with a fixed or variable interest rate, but with the possibility of suspending interest payments. There is also a possibility of limiting the amount of interest by reference to one of the issuer's financial indicators (e.g. EBITDA or the level of debt) or to apply various levels of fixed interest (e.g. 4%/8%/12%), subject to this applying on the occurrence of specified circumstances. The spread of the interest rate may be wider in this case because, pursuant to Art. 12 of the Act on Bonds, the provisions on maximum interest rates do not apply to interest on bonds. However, this interest should in no case exceed the market rate, as interest above the market rate will not constitute a tax deductible cost.

However, there is no assurance how the tax authorities would treat a mechanism in which the payment of interest would be totally dependent on decision of the issuer. It would certainly not be possible to recognise interest which has not in fact been paid as revenue-earning costs. On the other hand, doubts may arise in the situation where payment of interest is cyclical and interest is calculated as a percentage of the nominal value but the issuer has the right to unconditionally suspend the repayment - will in such a case the interest paid constitute a cost? It is difficult to provide an unequivocal answer to this question, for as yet there are no rulings that could provide a clear indication as to how the tax authorities will treat the payment of interest, from which the issuer can unconditionally refrain. It should be remembered, however, that the suspension of repayment should not involve the write-off of interest for the period of suspension, or be equivalent to interest-free periods, as in such a case the risk would arise on the part of the issuer of income being deemed to accrue for the gratuitous use of capital.

In each case, in order to be sure, an individual tax ruling should be applied for thanks to which it will be possible to confirm the taxpayer's position (and in the case of the lack thereof – to consider preparing a different interest structure).

Case study – issue of hybrid bonds by EDF in 2014

In 2014 Electricite de France S.A. issued, as part of an EMTN programme with a value of EUR 30,000,000,000, hybrid reset perpetual subordinated bonds of a total value of EUR 2,000,000,000 and GBP 750,000,000 and an initial interest rate varying from 4.125% to 5.875%. The above-mentioned bonds were issued as hybrid securities, qualified as equity instruments within the meaning of the IFRS, which were assigned a 50% *equity credit* and assigned the ratings BBB+ (S&P), A3 (Moody's) and A- (Fitch), respectively.

[5] Such a position was presented by the Director of the Tax Chamber in Warsaw in an individual tax ruling of 30 August 2011, file ref. no. IPPB3/423-433/11-2/JG.

[6] Such a position was presented by the Director of the Tax Chamber in Poznań in an individual tax ruling of 3 November 2015, file ref. no. ILPB3/4510-1-372/15-2/AO.

The bonds issued by EDF have the following features thanks to which they could be classified as hybrid capital (and equity instruments, pursuant to IAS 32):

- No fixed maturity date, but may be redeemed at the issuer's option under certain circumstances (including, among other things, in the case of adverse changes to the tax regime; a change of the accounting standards that would preclude these bonds being recorded as equity; and also a change of the methodology applied by rating agencies that could impact on the *equity credit* assigned to them).
- Deep subordination in relation to any other obligations, equal ranking only with respect to other obligations with the highest level of subordination, and priority only over ordinary shares (*actions ordinaires*) and preference shares (*actions de préférence*).
- Fixed interest, subject to reset in the relevant periods of time (8/12/15 years – depending on the series).
- An interest deferral mechanism, which is unconditional and dependent on the issuer's decision, and the deferrals are subject to compounding and accrual of additional interest.
- Forced payment of the deferred obligations in one of the following three cases:
  - the lapse of 10 business days following the occurrence an event triggering the forced payment, being payment of a dividend on shares or the repurchase of treasury shares by the issuer;
  - the redemption of the bonds; or
  - an order by a competent court for the voluntary or judicial liquidation of the issuer (*liquidation amiable ou judiciaire*) or the sale of the whole business (*cession totale de l'entreprise*) of the issuer.
- There is no conversion or reduction of the nominal value of the bonds. There is also no *negative pledge* clause or list of events of default.
- Dematerialised form (they were dematerialised with the participation of Euroclear France), for the purpose of the admission of the instruments to trading on Euronext Paris.

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