Single Rulebook Q&A

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Status	Final Q&A
Legal act	Regulation (EU) No 575/2013 (CRR)
Topic	Own funds
Article	63
Paragraph	1
Subparagraph	h
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Regulation (EU) No 241/2014 - RTS for Own Funds requirements for institutions
Article/Paragraph	20
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Disclose name of institution / entity	Yes
Name of institution / submitter	SID-Slovenska izvozna in razvojna banka, d.d., Ljubljana (SID Bank)
Country of incorporation / residence	Slovenia
Type of submitter	Credit institution
Subject matter	Is a financial counter-incentive which is triggered in case of a default of a borrower on certain specific contractual obligations considered as an incentive to redeem?
Question	Would a subordinated loan agreement clause, under the terms of which contractual penalties or other similar financial counter-incentives are

	triggered in case of a default of a borrower on certain specific contractual obligations be considered a provision, which includes an incentive for the principal amount of the subordinated loan to be repaid prior to its maturity?
Background on the question	With reference to Article 63(h) of CRR and Article 20 of RTS for Own Funds requirements for institutions, it is unclear whether a subordinated loan agreement clause, under the terms of which: (i) a contractual penalty is triggered if the borrowing bank fails to on-lend the loan received under the loan agreement to its own borrowers, in respect to which the subordinated loan agreement sets out various eligibility criteria, within a specified term (being 4 years and 11 months after the date of the loan agreement), or thereafter fails to maintain a predetermined exposure level to such qualified borrowers and such contractual penalty is in all cases determined as a percentage (typically not more than 0,25 per cent) of only that part of the subordinated loan, which – in breach of the subordinated loan agreement – is not on-lent or is in fact on-lent, but not to eligible (qualified) borrowers; or (ii) prior to the subordinated loan draw-down the borrowing bank pays a loan handling fee to the lender (a one-time fee paid on approval of the subordinated loan to cover the lender's expenses related to handling the loan throughout the term of the subordinated loan agreement), it being agreed that the borrower will be entitled to receive a full reimbursement of the handling fee, provided that the borrower complies with the commitments described in paragraph (i) above, and in addition: (a) does not breach its covenant to refrain from on-lending the subordinated loan to non-eligible (qualified) borrowers and/or non-permitted purposes, which includes the borrowing bank's commitment to monitor the use of on-lent funds, and recall the respective loans in case of breaches. In the alternative, in case the borrower breaches a stipulated commitment, a deductible is applied to the reimbursement amount in the following manner: actual reimbursement = full reimbursement x [number of years free of breaches / actual term of the subordinated loan]. In any case, the actual reimbursement of the loan handling fee (with deductibles applied as explained above) is executed after 10 years, i.e. after expiration of the full term of the subordinated loan, regardless of potential early repayment; would be considered a provision, which includes an incentive for the principal amount of the subordinated loan to be repaid prior to its maturity. In 2019, the bank commenced a financing programme for commercial banks (intermediary credit institutions) offering subordinated loans that meet the Tier 2 criteria under CRR. In the template Subordinated Loan Agreement the incentives described above would be incorporated as a contractual mechanism aiming to achieve objectives and goals set forth by the country's Development Bank Act. Under that Act, the bank is allowed to provide financial services (e.g. loans) only on specific areas (e.g. SME, RDI and other areas where market gaps/failures exists) and provided that such loans are passed on to the final beneficiaries (qualified borrowers) primarily via credit institutions (i.e. on a non-competitive basis). In accordance with development banks' best practices,

	such transactions with special purpose must be stipulated in the contract between the bank and intermediary credit institution, monitored on regular basis and in addition remedial measures must be in place in case of breaches as well. The normal sanction in non-subordinated contracts between the bank and intermediary credit institutions is termination of the contract between the bank and the intermediary credit institution - which in case of subordinated loans is not applicable – therefore the contractual penalties and/or the loan handling fee reimbursement mechanism are introduced as incentives for compliance with the specific requirements stemming from development banks' special purpose. There is no clear and unambiguous regulatory regime in terms of consistent application of such incentives in the practice of subordinated loans eligible as Tier 2 capital in banks pursuant to the conditions and criteria set forth in Article 63(h) of CRR and in Article 20 of RTS for Own Funds requirements for institutions. EBA's answer in this respect will add value in terms of providing legal certainty and harmonised application of Article 63(h) of CRR and Article 20 of RTS for Own Funds requirements for institutions in practice.
EBA answer	Article 63(h) CRR provides that instruments should not contain any incentive to redeem in order to be eligible to Tier 2. The notion "incentive to redeem" for the purposes of Article 63(h) CRR is specified in Article 20 of the Delegated Regulation 241/2014 (RTS on OFs). Article 20(1) of the RTS defines incentives to redeem as features that provide, at the date of issuance, an expectation that the capital instrument is likely to be redeemed. Paragraph 2 of this article provides a non-exhaustive list of potential "incentives to redeem". In particular, point (f) of Article 20(2) of the RTS sets that a marketing of the instrument in a way which suggests to investors that the instrument will be called is a form of an incentive to redeem. Furthermore, Article 63(k) CRR prohibits the provisions governing the instruments to indicate explicitly or implicitly that the instruments would be called, redeemed, repaid or repurchased early, as applicable, by the institution other than in the case of the insolvency or liquidation of the institution and the institution does not otherwise provide such an indication. In the present case, an institution issues an instrument the terms and conditions of which impose that the issuer should maintain a certain level of credit exposure towards certain sectors (in the case at hand SMEs and RDIs) or it will have to pay penalties to the borrower. Such provisions in the marketing of the instrument could be understood as an indication or could rise expectation that it is likely to be redeemed. This would even be more true in case the instrument would contain a call option. This could be particularly the case if the issuing institution has reduced or wants to reduce its exposures to the penalty-associated sectors. In such a situation, the

	institution is expected to have an incentive to redeem the instrument in order not to pay the penalty charge in case the level of on-lending is not achieved. In this regard, penalties and counter-incentive features provided in the terms and conditions of an instrument could produce similar effects as a step-up clause. They would be considered as an incentive to redeem under the provisions laid out in Article 20(1) and 20(2)(f) of the RTS and as an indication that the instrument will be called in case of a breach of the warranted level of credit exposure. Furthermore, it is recalled that the incorporation of some features into the issuers' ratings by credit rating agencies might reduce the credit standing of the issuer, potentially creating a link between the interest on the bond in case of step-up/fees and the issuer's own credit standing, which would contradict the provisions of Article 63(m) of the CRR.
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