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	m
Subparagraph	-
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Not applicable
Article/Paragraph	Not applicable
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Disclose name of institution / entity	No
Type of submitter	Law firm
Subject matter	Eligibility Criteria for Tier 2 Capital in light of the replacement of LIBOR/EURIBOR
Question	1. If the replacement reference rate proposed in the context of a change to a different benchmark rate, such as in the context of LIBOR transition, could result in a greater credit spread on an own funds instrument, whether as a consequence of a one-off adjustment to the credit spread at the time the replacement reference rate is implemented or as a consequence of an agreement to reset the credit spread at any future date or dates (whether or not in the context of any call option dates), would this potential outcome be considered to be a feature that provides an incentive to redeem for the purposes of Article 63(h) CRR? 2. If the replacement interest rate proposed by an issuer for its LIBOR-linked floating rate Tier 2 own funds instruments is a rate which is based on the credit standing of the issuer or its parent undertaking (or any intermediate parent undertaking), for example through the credit spread incorporated within a coupon derived from an overnight, or averaged overnight, risk-free rate, would that replacement rate of interest result in those instruments

	failing to satisfy the criterion specified in Article 63(m) CRR?
Background on the question	Since the mid-1980s, EU credit institutions and parent undertakings of EU credit institutions have issued both dated and perpetual subordinated Tier 2 debt instruments bearing a floating rate of interest determined by reference to LIBOR, and in particular, USD, GBP and JPY LIBOR. Many of these issuances remain outstanding; in the case of perpetual instruments, any redemption, in circumstances other than an insolvency of the issuer, would be at the option of the issuer only, as these instruments have no contractual maturity date. LIBOR (in any applicable currency) reflects an average of quotations given for interbank borrowing rates, so is not directly linked to the credit standing of a particular credit institution. LIBOR benchmark rates are expected to be phased out by 31 December 2021, and the general consensus is that LIBOR benchmark rates for each LIBOR currency (including USD, GBP, JPY and EUR, in the latter case for EUR LIBOR (as distinct from EURIBOR)) will be replaced by a risk-free rate for the applicable currency; the risk-free rates are overnight interest rates, not term interest rates. LIBOR benchmark rates are not risk-free rates, so there are ongoing market consultations on how to address the difference in credit spread between LIBOR for a particular currency and tenor, and that currency's proposed risk-free rate. Against this background, is the EBA able to give any guidance on whether a one-off adjustment to the credit spread of an own funds instrument made or proposed to be made in the context of a transition from LIBOR to a risk-free benchmark rate, or an agreement to adjust the credit spread over a risk-free rate applicable to an own funds instrument at specified future dates, in particular in the context of a perpetual AT1 or Tier 2 instrument, where the issuer has the option to redeem the instrument at any time, subject to the necessary permissions under Articles 77 and 78 CRR, would be considered to be an incentive to redeem for the purposes of Article 63(h)? We note the provisions of Article 20 of Commission Delegated Regulation (EU) No. 241/2014 of 7 January 2014, which provide examples of circumstances in which an incentive to redeem may be deemed to be present in AT1 and Tier 2 own funds instruments, and that EBA Q&A 2016_3076 contains further guidance on Article 20, but neither addresses the specific Question we raise. As regards Article 63(m) CRR, is the EBA able to give any guidance on whether a replacement floating rate of interest for LIBOR-based Tier 2 own funds instruments, where the replacement rate is determined by reference to overnight risk-free rates (whether a backwards-looking averaged overnight rate, or a forward-looking term risk-free rate) together with a credit spread, would be considered to be a rate which is based on the credit standing of an issuing credit institution or its parent undertaking? If there is insufficient transparency in the composition of any credit spread adjustment to a risk-free rate, how can Article 63(m) CRR be determined to be satisfied?
Final answer	According to Article 20(1) of Delegated Regulation (EU) No 241/2014 (RTS

	on Own Funds), an incentive to redeem shall mean a feature that provides, at the date of issuance, an expectation that the capital instrument is likely to be redeemed. Amendments to the contractual terms of capital instruments pursued solely for the purpose of implementing benchmark rate reforms will not be considered as a material change as defined in Q&A 2013_16 and therefore will not result in them being treated as new instruments, however the instrument needs to continue meeting all eligibility criteria. Therefore, a greater credit spread as a consequence of a one-off adjustment to the credit spread at the time the replacement rate is implemented, would not be considered to be a feature that provides an incentive to redeem for the purpose of Article 63(h) CRR. In a similar vein, greater credit spread as a consequence of an agreement to reset the credit spread at any future date or dates (whether or not in the context of any call option dates) in the context of the implementation of the benchmark rate reform, would not be considered to be a feature that provides an incentive to redeem for the purpose of Article 63(h) CRR. All the above is limited to the inclusion of the new rates (e.g. SOFR as alternative for LIBOR) in the Terms and Conditions (T&C). It has to be recalled that any other change, going beyond the mere implementation of the benchmark rate reforms, might be considered as a material change in accordance with Q&A 2013_16 and would require a case-by-case assessment. Furthermore, features that refer to credit standing of the institution or its parent undertaking as described by the submitter are not compliant with Article 63(m) CRR.
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