

Insight

December 2013

Basel III: Subordinated Debt Regulation Amended

On 25 October 2013 the Bank of Russia (the "CBR") issued Instruction No. 3096-U introducing amendments to the CBR Regulation No. 395-P "On the Method of Calculation of the Amount and Assessment of Adequacy of the Net Worth (Capital) of Credit Organizations (Basel III)" dated 28 December 2012.

The amendments to CBR Regulation No. 395-P relate to subordinated loans included in a Russian bank's Tier 1 and Tier 2 capital. The amendments aim to cure certain unclarity and deficiencies identified in the course of implementation of the previous version of Regulation No. 395-P since it was introduced and came into force in March – April 2013.

The principal amendments include:

- (i) The definition of "perpetual" subordinated loans has been amended to include loans granted by non-residents, whose only obligations relate to perpetual subordinated loans for a term of not less than 50 years provided the loan documentation grants the borrower the right to unilaterally extend the term of the loan once each 50 years. The amendments also now allow the borrower to make an early prepayment of a "perpetual" subordinated loan if the Russian legislation is amended in a way that materially worsen the parties' position under the terms of the loan documentation, provided the loan documentation allows such prepayment option.
- (ii) The base capital adequacy ratio triggering the mandatory conversion of the subordinated instrument to equity or its write-down for loss absorption purposes has been changed from 6.4% to 5.5% with respect to "perpetual" subordinated loans (deposits, bonds).
- (iii) Following the CBR earlier clarifications, Regulation No. 395-P now clearly indicates that market participants can choose between the respective options for loss absorption, being conversion to equity or write-down of interest and principal. It is now clear that the loan documentation can include either both or any one of these options. Furthermore, the amendments specifically provide that if a credit organization is suffering losses, as a result of which the base capital adequacy ratio comes down below the levels provided by Regulation No. 395-P, such losses can be covered by a full or partial write-off of the principal amount of the loan, only after the utilization of other sources of the credit organization's base capital (such as reserve fund, undistributed profits, etc.).
- (iv) With respect to the implementation of bankruptcy prevention measures against the respective credit organization pursuant to the Federal Law "On Additional Measures to Consolidate the Stability of the Banking System in the period to 31 December 2014", as amended (the "**Banking System Stability Law**"), it has been clarified that the loss



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absorption event would be triggered under the subordinated loan documentation only if the borrower receives a notice from the Deposit Insurance Agency on the implementation of specific measures envisaged by paragraphs 3 and 4 of part 1 of Article 2 of the Banking System Stability Law. Such measures include: (1) acquisition of a controlling stake in a credit organisation in distress by the Deposit Insurance Agency; or (2) provision of financial assistance to a credit organisation in distress subject to the acquisition of a controlling stake in such credit organisation by either a private investor or the Deposit Insurance Agency.

(v) The procedure for conversion of subordinated loans into equity has been further clarified in the amendments. In particular, pursuant to the amendments such conversion includes early prepayment of the subordinated loan in full or partially by the borrower and the use of the received funds by the respective lender for the payment for additionally issued shares of the borrower in connection with the increase of the borrower's charter capital. Note that the mechanics of the conversion are to be further developed, in particular by amending the existing CBR regulations on the issuance of shares by credit organizations.

(vi) The requirement for shareholders support obligations (i.e., obligations of the borrower's shareholders (participants) to implement measures for keeping the base capital adequacy ratio at certain levels) have now been removed from Regulation No. 395-P. It is now required that the loan documentation to include an obligation (its procedure and term) to notify the shareholders (participants) and the lenders of the respective credit organization of a loss absorption event.

(vii) In line with the provisions of Article 3.5.1 of the CBR Regulation No. 215-P dated 10 February 2003 (**Regulation No. 215-P**), a special carve-out has been introduced to Article 3.1.8.1.1 of Regulation No. 395-P with respect to the determination of the market level of interest rates under subordinated loans (deposits). Now, paragraph 1.1 of Article 269 of the Russian Tax Code is **not** applicable for the purposes of such determination with respect to interest rates expressed in foreign currencies. This would effectively mean that for the purposes of Regulation No. 395-P the average market level of interest rates in foreign currencies pursuant to paragraph 1 of Article 269 is now set at 15%.

(viii) Article 8.2 of Regulation No. 395-P has been amended to provide for a new procedure for gradual deduction of subordinated loans (deposits) raised before 1 March 2013 which provisions do not comply with the requirements of Regulation No. 395-P from the calculation of the credit organization's own funds (capital). In particular, the deduction is made in the amount of 20% on 1 January 2014 and 10% annually (from the amount of the loan fixed as of 1 January 2014) on 1 January of each following year, taking into consideration the limitation on the total amount of the additional capital envisaged by Regulation No. 215-P. It is specifically noted that subordinated instruments raised after **1 March 2013** which provisions do not comply with the requirements of Regulation No. 395-P, should not be considered for the purposes of calculation of the credit organization's own funds (capital).

(ix) Pursuant to the amendments, it is now prohibited to terminate obligations under the subordinated loan documentation by means of novation, set-off or compensation for release (*otstupnoye*).

(x) It has been clarified that the calculation of the bank's own funds (capital) is conducted on the first date of each month and on certain intra-month dates, in cases when the CBR territorial departments request such specific intra-month calculations to be made.

The Instruction No. 3096-U was registered with the Russian Ministry of Justice on 29 November 2013 and will come into force on 1 January 2014.

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