



BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/CP/2014/41 ON
DRAFT REGULATORY TECHNICAL STANDARDS ON CRITERIO FOR
DETERMINING THE MINIMUM REQUIREMENT FOR OWN FUNDS AND
ELIGIBLE LIABILITIES UNDER DIRECTIVE 2014/59/EU

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

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Foreword

The EBA Banking Stakeholder Group (“BSG”) welcomes the opportunity to comment on the Consultation Paper EBA/CP/2014/41 on draft RTS on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU.

This response has been prepared on the basis of comments circulated and shared among the BSG members and the BSG’s Technical Working Group on Recovery, Resolution and Systemic Issues.

As in the past, the BSG supports an initiative that aims at harmonising supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups. The BSG also expects these initiatives to facilitate data sharing between European supervisors and avoid reporting duplications for banks. However, the BSG identifies a number of issues which, unless properly addressed, could lead to unintended results.

This response outlines some general comments by the BSG, as well as our detailed answers to some questions indicated in the Consultation Paper.

General comments

The BSG supports the objective of putting in place a credible and effective resolution framework and addressing the failure of an institution without posing financial stability risks. As the central premise of the new regulatory framework, any banking resolution action will have to be supported in the first instance by shareholders and private creditors through the bail-in tool, minimising moral hazard and risk to taxpayers. In order for this new banking resolution philosophy to be effective, banks must, at all times, have sufficient liabilities of a kind that enable them to absorb losses. That is, banks need to comply with a minimum requirement for own funds and eligible liabilities (MREL), which is the complement of the bail-in tool.

Avoiding bail-outs supported by a credible MREL framework is a desirable objective, but depending on its design it may entail certain costs, in particular related to costly changes in banks’ liability structure and higher costs of funding. Despite these costs, the introduction of the bail-in enhances banks’ fundamentals, encourages positive discrimination between issuers, helps to break the sovereign-banking link, and increases market discipline. It is essential that the design maximises the benefits while minimising the costs.

The BSG recognizes the effort made by the EBA to incorporate the Total Loss Absorption Capacity (TLAC) principles as proposed by the Financial Stability Board into the EU context (BRRD). Part of the difficulty of this task resulted from the fact that the BRRD was approved before the TLAC debate, and the EBA needed to fully respect the BRRD while at the same time approaching (to the extent possible) the agreement in the FSB on TLAC. Despite seeking the same purpose, both ratios are based on different rationales.

BSG welcomes the fact that the EBA has developed a flexible and proportional approach as regards size and business model while at the same time rewarding resolvability. The proposed approach rightly tries to address the institutions' heterogeneity within the European banking sector and tailors the MREL requirement to each entity without harming any particular type of business model or capital structure. Aimed at this purpose, the EBA introduces risk and non-risk based parameters (Risk-Weighted Assets (RWA) and Leverage Ratio) as main determinants of the loss absorption amount calibration. While the combination of these parameters when determining the MREL recognizes the risk profile diversity among European banks, the BSG acknowledges the difficulty inherent in defining a business model-neutral balance between the two measures. The determination of an appropriate equilibrium is critical since it not only ensures the level-playing field but also aligns the MREL with the FSB's TLAC approach. The EBA supports this dual approach whilst also maintaining the BRRD spirit by requiring the MREL to be expressed as percentage of total liabilities and own funds. Furthermore, the requirement that losses up to 8 % of total liabilities and own funds have to be bailed-in before any other measure is applied is one of the cornerstones of the European resolution regime, making credible the aim of minimizing costs for taxpayers and resolution funds. In this regard, the BSG acknowledges the role of the 8% floor's role as a backstop at least in the case of systemic institutions.

Besides following a business model-neutral approach, the EBA and resolution authorities should take into account the proportionality principle when determining the MREL. The application of this principle is particularly relevant in the context of highly capitalised and deposit-funded banks. For these banks, the MREL requirement risks creating a conflict between prudential policy and resolution policy, by introducing incentives for deposit-funded banks to increase reliance on debt and an artificial rise in leverage, a result that seems at odds with traditional prudential concepts and policies. This concern is particularly acute in jurisdictions with less developed local capital markets, both within the EU and for cross-border groups active in emerging markets. In this regard, a flexible and case-by-case approach is warranted and may require some clearly-defined waivers to deal with these cases.

The balance between a flexible approach that rewards resolvability and the need to apply harmonised rules is a difficult one. It is worth highlighting that the MREL

requirement will influence key financial variables like, *inter alia*, debt instruments pricing, curve spreads and market funding costs. In this regard, while the BSG endorses the MREL case-by-case approach, it shall be coupled with an exercise in both maximum transparency and uniformity of application across borders, thereby ensuring the level-playing field and market-wide comparability across jurisdictions under the MREL scope. Although there is a legitimate concern about a divergent application of the criteria, there are two factors which can play a key role in mitigating it: i) the independent review over MREL criteria that the EBA will conduct in 2016, and ii) in the case of the Eurozone, the existence of a single authority that would apply common criteria in determining the MREL - the Single Resolution Board (SRB).

With the inclusion of the recapitalisation amount, the EBA acknowledges that the resolution plan may not imply that the entire group is recapitalised in the same form as the one that enters into resolution. The preferred resolution strategy in each group may involve discontinuing or winding down some subsidiaries, business lines or activities rather than continuing the entire business. However, we are concerned at the inclusion in the recapitalisation amount of the pillar 2 capital requirements and the combined buffer that the supervisor imposed on the pre-resolution bank, as it may overestimate the required recapitalization amount. To the extent that pillar 2 pre-resolution requirements incorporate the very risk of resolution, the restructured entity will likely not have any Pillar 2 capital surcharge. Moreover, the BSG understands the recapitalization amount as the amount necessary to continue complying with conditions to carry out ordinary activities and sustain market confidence. Therefore, as regards the combined buffer, we subscribe to its exclusion of the recapitalization amount calculation since it is not a suitable indicator for this purpose. The very notion of buffer relates to its ability to withstand shocks and raise resilience under distress periods, thereby protecting the whole financial sector. This seems to suggest that, to the extent that its size is well calibrated, its inclusion in the recapitalization amount unnecessarily duplicates its burden and biases the countercyclical cushion spirit inherent to their design. Furthermore, it would imply more demanding standards than those of the TLAC proposal, which would penalize European banks vis-à-vis peers in other regions.

Moreover, the post-resolution bank would probably be very different, as well as its peer group. This is especially relevant in the context of an idiosyncratic failure. To the extent that the resolution plan contains a consistent identification of the non-critical economic functions and a convincing strategy to dispose them in the recovery or resolution phases, it would be consistent to reward the entity with a lower recapitalisation amount in the determination of MREL. The idea of estimating the recapitalisation amount based on a peer group does not seem to be consistent with the BRRD, nor does it seem straightforward to implement. In any case, if the idea of using the peer group as reference is retained it is important to make clear that the resolution authority should redefine the

appropriate peer group after resolution, according to the new situation of the entity.

The BSG is also concerned about the potential source of conflict between the resolution authority and the supervisor. The EBA Consultation Paper paves the way to this discord as it empowers the resolution authority to adjust the loss absorption amount if it considers that the risks, vulnerabilities and need of loss absorption of the corresponding entity are not adequately reflected in the capital requirements set by the supervisor. This discretionary power of the resolution authority implies that it is able to call into question the Supervisory Review and Evaluation Process (SREP) carried out by the competent authority, and, therefore, questioning its own supervisor's criteria. The EBA should encourage cooperation between the supervisor and the resolution authority and should not endorse the idea that the resolution authority may act as a shadow supervisor by amending -- for resolution purposes -- the regulatory capital decided by the competent authority.

Finally, we consider that a comprehensive QIS exercise in Europe is very important (in parallel to the ongoing TLAC one). In particular, the QIS should review the MREL impact on: business models; the depth of debt markets; the willingness of investors to buy this type of debt; the base of retail deposit funding; refinancing risks, and financial interconnectedness. An appropriate transitional period to comply with a MREL requirement as defined in article 8 of the draft RTS should also be considered.

Replies to Questions

1. Do you consider that any of these components of the overall capital requirement (other than minimum CET1 requirement) are not appropriate indicators of loss in resolution, and if so why?

The BSG considers the components of the overall capital requirement as broadly appropriate indicators of loss in resolution, but we would like to highlight some nuances.

The assumption that a bank in resolution has already depleted its capital seems too extreme. Although there have been some such cases in the recent crisis, if account is taken of the already adopted and ongoing reforms this hypothesis seems too conservative and could transmit a very negative view of the capacity of supervisors to carry out their job with certain efficiency.

With regards to precautionary buffers, we would like to highlight that the role and objectives of these buffers relate to the institution in going concern, e.g. its ability to withstand shocks and sustain confidence that the banking sector in

aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned.

2. Should paragraph 5 (article 2) refer only to the resolution authority increasing the loss absorption amount, rather than adjusting it? Are there specific circumstances under which resolution authorities should allow a smaller need to be able to absorb losses before entry into resolution and in the resolution process than indicated by the capital requirements (for example, due to the use of national discretions in setting capital requirements)?

First, the BSG endorses the potential adjustment of the loss absorption amount in both directions. In our view, exclusively adhering to an increase would constrain one of the main objectives of the MREL approach, i.e. creating incentives for banks to reduce barriers or impediments to resolvability. In this vein, the possibility that the recapitalisation amount *adjusts* the final MREL requirement is more appropriate than *increasing* it. Moreover, we are of a similar view with respect to pillar 2 requirements: they could move in both directions so as to reward or penalize (as appropriate) resolvability.

Nonetheless, while supporting the term “adjust”, the BSG is concerned about the potential source of conflict between supervisors and resolution authorities implied in Article 2 paragraphs 4 and 5. They empower the resolution authority to assess the Supervisory Review and Evaluation Process (SREP) outcome and, therefore, questioning its own supervisor’s criteria. This discretionary power of the resolution authority implies that it is able to adjust the loss absorption amount if it considers that the risks, vulnerabilities and need of loss absorption of the corresponding entity are not adequately reflected in the capital requirements set by the supervisor.

The competent authority is setting any additional capital surcharge resulting from the SREP under the assumption of a going concern situation, whereas the resolution authority will take a differentiated approach, e.g. focussing on a gone concern situation.

The EBA should encourage cooperation between the supervisor and the resolution authority. However, article 2 (4 and 5) paves the way to a potential conflict between both authorities in the MREL determination. The BSG believes that the EBA should not endorse the idea that the resolution authority may -- for resolution purposes -- call into question the loss absorption amount set by the competent authority.

3. Should any additional benchmarks be used to assess the necessary degree of loss absorbency? If yes, how should these be defined and how should they be used in combination with the capital requirements benchmark? Should such benchmarks also allow for a decrease of the loss absorption amount compared to the institution's capital requirements?

Along the lines of the comment to question 2, the Consultation Paper should not open the way for a conflict between the supervisor and the resolution authority. We would suggest, therefore, the deletion of article 2.(4, 5 and 6).

As a more general comment, and according to the case-by-case MREL proposal, the EBA should avoid using any sort of automatic benchmarking. The loss absorption amount should be based on the institution's idiosyncratic characteristics and resolution plan.

In any case, as mentioned in our reply to question 2, if this approach is retained we support a symmetric treatment, implying that the resolution authority would be able to adjust in both directions, and not only upwards.

4. Do you consider that any of these components of the overall capital requirement are not appropriate indicators of the capital required after resolution, and if so why?

According to the EBA Consultation Paper article 3 (6 b), the recapitalisation amount should “include any requirement to hold own funds in excess of these requirements pursuant to Article 104 (1) letter (a) of Directive 2013/36/EU.” According to this approach, when assessing the recapitalisation, resolution authorities shall include any Pillar 2 requirement that the failed institution may have prior to entering into resolution. The rationale of this approach is not straightforward. Any pre-resolution Pillar 2 capital requirement imposed by the supervisor would be based on the bank's risk and vulnerabilities (mainly based on the SREP outcomes), including in particular the very risk of resolution. Once this risk has materialised and the institution enters into resolution, authorities would impose a tough restructuring plan which may eliminate, or at least significantly reduce, all the previous capital, liquidity, business and governance uncertainties. As a consequence the restructured entity would likely not have any Pillar 2 capital surcharge.

Against this backdrop, the BSG proposes removing paragraph 6b from Article 3 insofar as it imposes a Pillar 2 capital requirement for the restructured institution based on its pre-resolution idiosyncratic characteristics.

5. Is it appropriate to have a single peer group for G-SIIs, or should this be subdivided by the level of the G-SII capital buffer? Should the peer group approach be extended to O-SIIs, at the option of resolution authorities? If yes, would the appropriate peer group be the group of O-SIIs established in the same jurisdiction?

While we understand the rationale underlying the requirement for a sufficient recapitalisation amount to maintain market confidence after the resolution, we tend to think that this requirement should not be applied immediately to an institution that would be subject to a resolution plan. Recovering market access should be an objective subject to a phase-in period.

In any case, if the current approach is retained, we believe that the notion of “peer group” used to calibrate this additional amount, is not appropriate and may be overly conservative. Indeed, a peer group today may be not a peer group post-resolution. Moreover, EU institutions expected to be subject to the Global Systemically Important Institutions (G-SII) buffer and pillar II capital requirements are materially heterogeneous, and their CET1 capital ratio are affected by national discretions. Therefore, their capital levels are not an appropriate metric for MREL purposes.

6. The approach outlined in Articles 2 and 3 will reflect differences between consolidated and subsidiary capital requirements, Are there additional ways in which specific features of subsidiaries within a banking group should be reflected?

Article 45 of the BRRD states that institutions shall comply with the MREL at individual and consolidated level. It also clarifies that the MREL will be tailored to each resolution strategy (Multiple-Point-of-Entry, MPE, and Single-Point-of-Entry, SPE). In fact, the TLAC will be applied at the consolidated level in SPE banks and at individual level in MPE ones.

In this regard, when determining the MREL at individual level under MPE banks, the resolution authority should not include any capital requirement set at the consolidated level. This is particularly the case of the systemic capital buffer or any Pillar 2 capital surcharge imposed at the consolidated level. For example, the global systemic capital buffer is set in relation to the whole group based on, among others, the overseas presence of the group.

7. Do you agree that there should be a de minimis derogation from this provision for excluded liabilities which account for less than 10% of a given insolvency class?

We do agree with the rationale for this provision, but believe that its approach is too restrictive. Indeed, under 10% of a given insolvency class, it is very unlikely that the NCWOL principle is endangered. We would suggest raising this threshold to at least 20% or 30%, and clarify that above the decided level the resolution authority should assess whether there is a risk from the NCWOL point of view.

Moreover, in paragraph 4 of article 5, it seems rather conservative to consider only instruments which qualify for MREL to absorb losses. In fact, several other liabilities could support the losses, including shorter-term debt. Shorter-term debt should be considered in the assessment of the resolution authority, for example by haircutting it with a ratio taking into account the probability that it is no longer in the balance sheet of the resolved institution at the time of resolution (50% for example).

In addition, the text does not say which liabilities are likely to be excluded from bail-in under resolution, giving way to level-playing field issues and uncertainty on the application of the regulation. It would be preferable to determine precisely which liabilities are concerned, and to reduce them to the liabilities which are excluded from bail-in as stated in the BRRD Article 44 (2,3)

Finally, we welcome clarifications on how the ex-ante assessment as to when the NCWOL principle would be breached for the purposes of article 5 of the RTS, would be conducted in practice, because this will depend upon the level of losses that are assumed. The framework of the analysis should be transparent and communicated to the banks.

8. Do you agree that resolution authorities should seek to ensure that systemic institutions have sufficient MREL to make it possible to access resolution funds for the full range of financing purposes specified in the BRRD?

Yes: the BSG does agree with such a provision.

It is of our opinion that the 8% of total liabilities and own funds floor included in the article 7 of the consultation paper adheres to the BRRD spirit and its backstop role should be preserved. The level 1 text explicitly states that the resolution fund may make a contribution subject to the requirement that losses totalling not less than 8% of total liabilities including own funds have been already absorbed.

The EBA proposal refers to systemic institutions (GSII and OSII), for which it is difficult to argue that the 8% of total liabilities should not be taken into account by resolution authorities when setting the MREL level. For other institutions, the 8% level should be a reference as well, although the principle of proportionality may also play a role.

9. Is this limit on the transition period appropriate?

Yes: we generally agree with the transition period. However, as said in our general comments, we consider that a comprehensive QIS exercise in Europe is important to ensure that this transitional period is workable.

10. Should the resolution authority also set a transitional period for the MREL of banks which are undergoing or have undergone a resolution process?

Yes: enough time should be given to these banks to reconstitute their recapitalisation capacity. This will be unavoidable as the amount necessary to ensure loss absorption is likely to have disappeared for a significant part in the resolution process.

11. Overall, do you consider that the draft RTS strikes the appropriate balance between the need to adapt the MREL to the circumstances of individual institutions and promoting consistency in the setting of adequate levels of MREL across resolution authorities?

While we agree in general with the balance between both options, by giving too much flexibility to the resolution authorities in some aspects, there is a risk that this RTS will create confusion in the markets about the required levels. It would be preferable to have a more clear regulation, notably concerning the inclusion of senior liabilities in the MREL.

We strongly advocate for MREL levels not higher than TLAC levels in order to restore a level playing field between European and Non-European G-SIBs.

Moreover, in order to ensure a harmonised application of the MREL's discretionary criteria, the EBA will submit a report to the European Commission by 21 October 2016 analysing whether there have been any divergences in the levels set for comparable institutions in Europe. This report will be critical to maintain the level-playing field and enhance transparency among European banks.

12. Are there additional issues, not identified in this section, which should be considered in the final impact assessment?

Despite having a regulation which aims at a recapitalisation of the institution based on its debtors instead of tax-payers, its ambiguity might lead to the

interpretation by the market that only own funds and subordinated liabilities are allowed to integrate the MREL. This would double capital requirements, hence making it more difficult for banks to finance the economy and increasing the costs for bank clients. At a time when growth is low in Europe, a more effective way to deal with the subject would be to have a more clear regulation that can be anticipated by banks and the markets, and making it clear that under some conditions senior debt can integrate the MREL.

In case of promotional banks that fulfil the criteria of Art. 4 (1) (8) EU 575/2013 (“public sector entity”) and where explicit guarantee arrangements exist for the liabilities of the institution and exposures to the institution are treated according to Art. 116 (4) EU 575/2013, the MREL requirement should reflect this exceptionally low risk situation accordingly. In case of resolution, any creditor (subordinated and senior) is fully covered (on first demand) by the above mentioned guarantee system and the resolution authority should take this additional safeguard feature into account when setting the MREL.

A clarification on the recognition of counterparty netting rights according to Art. 45 (1) 2014/59/EU in the context Art. 8 (2) draft regulatory standard on calculating the MRE would be helpful.

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Submitted on behalf of the EBA Banking Stakeholder Group

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