Comments

EBA Interim Report on the implementation and design of the MREL framework (EBA-Op-2016-12)

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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I. Comments on provisional recommendations

1. MREL-Denominator/ Reference Base

We are in favour of a consistent definition of the denominator used as the basis for calculation of the required loss-absorbing capacity, amongst TLAC and MREL requirements. This would reduce complexity and realise a more linear and transparent management of loss-absorption requirements across the EU. Referring to risk-weighted assets (RWAs) as the preferred MREL denominator avoids further complications in operative bank management. We very much support this approach.

As a consequence, the current additional volume-based benchmark "total liabilities and own funds" should be omitted.

Regarding the Leverage Ratio Exposure (LRE) as a backstop, the German Banking Industry Committee (GBIC) has proven in numerous discussions and studies that a non-risk sensitive measure (Leverage Ratio) has various weaknesses. Therefore, no Leverage Ratio Exposure backstop should be introduced in Europe for MREL purposes.

However, we note that the determination of the Leverage Ratio backstop as described on page 36 (third paragraph) is not a backstop but a new stand-alone requirement. It proposes translating the absolute amount of MREL determined by the resolution authority into a percentage of RWAs and LRE. This would imply a RWA and a LRE limit of the same level.

2. Relationship with regulatory requirements

<u>Stacking of CET1 buffers</u>
We do not share the EBA's provisional view that the usability of regulatory capital buffers would be best preserved if they stack on top of MREL (page 44) – i. e. that banks would not be able to use CET1 capital to meet MREL and also to meet regulatory capital buffers.

Rather, we support option c) (page 42) to maintain the status quo in the Banking Union. In line with the MREL RTS and the SRMR, use of CET1 for both, regulatory capital buffers and MREL should continue to be possible for all institutions.
The EBA correctly points out that an expansion of the TLAC requirement, and thus the increase in MREL requirements to be met by other instruments as own funds, to all institutions may lead to problems particularly for institutions with limited access to the capital markets.

If double use of CET1 for MREL and capital buffers for all institutions is not allowed and capital buffers have to be explicitly counted towards MREL (option a) on page 42), it should be made clear in this context that the capital buffer requirements are not included in determination of the loss-absorption amount/should remain limited to the recapitalisation amount.

<u>Redemption of MREL-eligible liabilities</u>
We do not agree with the proposal that the resolution authority might enforce the maturity structure. MREL eligible liabilities are an important part of the funding structure of the bank and help to manage interest rate and liquidity positions. In addition, there is no legal requirement for a particular MREL term structure, i.e. the only requirement is that maturities are in excess of one year.

With respect to redemption, we are also not in favour of a general approval requirement for MREL-eligible liabilities. The approval process is too long and as a result, banks will not be able to use bond buybacks as a technical tool to optimise the liability structure. If banks had to ask for approval of redemption of any MREL liability, it might significantly worsen flexibility towards clients and limit interest rate and liquidity management. Also, so as not to endanger the practicability/maintenance of market cultivation activities and in order to allow a smooth and efficient liability management, early redemption of MREL-eligible liabilities should be allowed without the prior approval of the resolution authority if this redemption is not causing an MREL breach. Where there is an MREL shortfall, the institutions concerned should be given a reasonable period of time (grace period), as proposed by the EBA, to restore their MREL.

For the sake of clarification, this refers to redemption of a liability currently counting towards MREL prior to its contractual maturity. Contractual maturities of liabilities always have to be honoured in any case, which should not cause a problem as these liabilities anyway do not meet the requirement of over one year remaining to maturity and thus no longer count towards MREL.

Resolution financing arrangements, Art. 44 (5) (a) and (b) BRRD
We acknowledge the consideration by the EBA that MREL and the denominator for resolution financing arrangements in Art. 44 (5) (a) and (b) are treated as separate topics (among others, see page 39 of EBA's report).

Regardless of the decision about the denominator in MREL, we would welcome a change of the conditions for resolution financing arrangements by harmonising the netting treatment of derivatives and secured financing agreements in the BRRD with the insolvency procedure. The netting agreements should be recognised in all cases on a net basis, which means full contractual netting (page 34).

3. Breach of MREL

In our view, a breach of MREL should not result in determination that a bank is failing or likely to fail. As already mentioned in recital 41 of the BRRD, MREL is not an indicator that a bank is entering into resolution ("*The fact that an institution does not meet the requirements for authorisation should not justify per-se the entry into resolution, especially if the institution is still or likely to still be viable*."). As a consequence, a breach of MREL should not trigger any early intervention power on the part of the competent authorities. It must be understood that MREL is an instrument in the context of resolution only.

The consequences of an MREL breach should not be automatic, although we agree that a breach of MREL should be taken seriously and thus support authorities starting a supervisory dialogue to identify corrective actions, i.e. to eliminate within reasonable time any impediments to resolvability in respect of the relevant MREL-eligible own funds and liabilities (e.g. by requesting institutions to issue new eligible liabilities within a short time) and other impediments to resolvability. This should be assessed on a case-by-case basis, i.e. the specific resolution plan of the institution and the situation of the institution and the market environment if and when such a breach occurs. At any rate, anything that could cause uncertainty or doubt with respect to the state of an institution must be avoided.

The resolution authorities should be furnished with a broad array of powers to address the breach of MREL but should also be afforded a broad degree of discretion on whether and, if so, how they use these powers in order to address the specific situation. In this context, any regulatory measures triggered or enacted under regulatory requirements other than the recovery and resolution regime, in particular under capital requirements, would of course need to be taken into account. In the case of breaches concerning capital requirements, the remedies and powers granted to the supervisory authorities will generally be the most appropriate and should also generally be considered to be sufficient in themselves. Consequently, we strongly believe that MREL breaches should not automatically trigger consequences. Instead, as proposed by the EBA, the institutions concerned should be given a grace period to restore their MREL.

4. Adequacy and calibration

We welcome the EBA proposal to closely link MREL calibration to the resolution strategy, including resolution actions, defined by the resolution authority in respect of the specific institutions, as opposed to a standard/uniform MREL requirement or binding MREL floor. In respect of G-SIBs, we believe that the TLAC requirement should be considered the reference point for calibration, given that it has benefited from extensive and comprehensive quantitative impact studies – which have demonstrated that it was enough to both encompass loss-absorbing capacity as well as recapitalisation amount – as well as G20 political endorsement. Additional requirements should only be imposed in view of and proportionate to material resolution impediments.

We are opposed to the idea of a de facto extension of the TLAC requirements to all financial institutions. At any rate, the principle of proportionality would need to be observed (meaning a proportional MREL requirement, i.e. determined by the resolution authority, depending on the resolution strategy e. g. on the possibility of regular insolvency, complexity, etc. of the bank). Any further requirement should be duly justified by the resolution authority. But there must be no mandatory MREL floor.

When setting the MREL ratio, besides membership of a statutory deposit guarantee scheme, membership of a voluntary deposit guarantee scheme or an institutional protection scheme, along with the special situation of development banks whose purpose is to promote the public good, should also be taken into account. When setting the MREL ratio, consideration should additionally be given to whether, in the case of the institution concerned, there is a public interest in resolution and consequently in use of the bail-in tool. With medium-sized institutions in mind, particularly those with more strongly deposit-based business, we also welcome and support the EBA’s plans to expressly allow longer introduction and implementation periods.

5. Eligibility

In the view of the German Banking Industry Committee, the efforts at European level to achieve a common approach on the issue of subordination are to be welcomed. With this issue in mind, the European Commission has already been mandated – following the Council’s conclusions on completion of banking union – to draft proposals for appropriate harmonisation. We therefore suggest first awaiting the Commission’s proposals before discussing explicit requirements for subordination of MREL-eligible liabilities.

6. Third country recognition

a) Reduction of the scope of Art. 55 of the BRRD – options to be pursued: We fully support the EBA´s recommendation to narrow the scope of the obligation under Art. 55 of the BRRD to impose contractual recognition clauses in agreements creating eligible liabilities:

In order to achieve such a reduction, we believe that the best approach would be a combination of both option iii, i.e. a general limitation of the scope of Art. 55 of the BRRD, and the main elements of option ii, i.e. having the competent authorities review and assess the level of implementation achieved as part of and in the context of the assessment of the resolvability of the institution in question. To this end, the scope of Art. 55 BRRD should be limited to MREL-eligible liabilities (thus excluding, inter alia, contingent and other types of liabilities, which by their nature are not suitable for bail-in). To ensure that the resulting scope does not capture liabilities which may be considered to qualify as MREL-eligible, but are nevertheless not suited for a bail-in, there will be a need for further clarifications to the effect that liabilities which are not suited for a bail-in or where a bail-in would be counterproductive, for any of the practical or legal challenges addressed below under lit. b) are outside the scope of Art. 55 BRRD, in particular, in the case of legal impediments or where the liabilities are not certain enough or do constitute payment liabilities. Such a clear limitation of the scope of Art. 55 would provide institutions and the competent regulatory and resolution authorities with the necessary flexibility to address the complex issue at hand. It would, however, ensure that institutions will provide for sufficient bail-in eligible liabilities in order to fulfil or even surpass the MREL-requirements; either with liabilities which are subject to the laws of a Member State or include the contractual recognition clauses in those agreements subject to third country laws which because of their nature, market practice and types of counterparties involved are better suited for such clauses – and which are also more likely to provide a meaningful contribution in the case of a bail-in.

In view of the fact that, even in the case of a reduction of the scope of the obligation under Art. 55 of the BRRD, there may be situations or cases where an institution will not be able to impose the contractual recognition clauses in all MREL-eligible liabilitities or where this would not be appropriate or proportionate in relation to the consequences to be borne, the competent authorities will, however, still need to be afforded a degree of discretion to grant general or specific waivers: Specifically, they need to have the right to determine the appropriate consequences and measures to be taken where an institutions is not able to implement the clauses in all liabilities falling within the scope of Art. 55 of the BRRD, taking into account the relevancy of the liabilities in question and the impact the failure to implement the clauses will have on the resolvability of the institution. Such discretion would be entirely in line with the BRRD, which does not prescribe any specific or automatic consequences in the event of a failure to include such contractual recognition clauses in each and every agreement falling within the scope of the obligation (other than that the liabilities under the relevant agreements would not count towards MREL). Such flexibility is necessary as the business models of institutions and their portfolios of liabilities will always differ significantly.

Instead, institutions should be able to develop a concept on how to implement Art. 55 of the BRRD that conforms to their specific situation and their business model. Such a concept would set out and explain, where (despite taking reasonable efforts) implementation of Art. 55 of the BRRD – (with the proposed reduction) – proves to be unnecessary, counterproductive, difficult, impractical or impossible, and set out the criteria chosen to determine decisions taken and the priorities set. This would also be consistent with the approach currently pursued under a common understanding reached between the German Banking Industry Committee and the German resolution authority FMSA. The understanding not only covers Art. 55 of the BRRD but also a further requirement under German law to include contractual recognition clauses regarding resolution stays.

In this connection, we would like to take the opportunity to highlight the importance of pursuing the implementation of binding agreements between authorities within the meaning of Art. 55 (1), second subparagraph. Contractual recognition clauses will never be able to provide for the same degree of legal certainty as such binding intergovernmental agreements.

b) Practical and legal challenges: Institutions face considerable practical and legal when they implement Art. 55 of the BRRD. In the following, we set out some examples of such challenges. It should, however, be noted that these are only selected examples; there will be many more cases, instruments and circumstances where the inclusion of contractual recognition clauses will be impossible, impractical or may result in unreasonable/disproportionate effects:

- Under certain circumstances and in relation to certain types of contractual arrangements, it will be impossible to impose the contractual recognition clauses because the relevant third country counterparties will not or cannot accept such contractual clauses for valid reasons (including for legal reasons as such an acceptance of unilaterally imposed rights adversely affecting the position of the counterparty may raise legal questions under local law, especially in relation to public authorities, investors/consumers or small and medium-sized entities). One example is transactions of members of third country market infrastructures such as central counterparties or settlement systems which are governed by rules and regulations which cannot be unilaterally amended by a counterparty. Similar issues arise where the instruments creating the liabilities are governed by international standard market terms and practices which do not allow for the inclusion of contractual recognition clauses, or where the relevant contractual agreement is concluded by means which do not permit the inclusion of such clauses, i.e. because of the involvement of intermediaries such as trading platforms or brokers (practical examples are certificates of deposit/commercial paper).
- In relation to agreements forming the basis for liabilities with comparatively low values, the effort associated with an attempt to include the clauses may also be clearly disproportionate in relation to what these liabilities may contribute in the case of a potential bail-in (if any).
- Some liabilities are not suited for a bail-in because of their nature and structure. One case in point is contingent liabilities: contingent liabilities only come into existence upon the occurrence of a certain future event and upon the making of the claim by the relevant beneficiary. Until such time and such making of the claim, there will simply not be any liability which could be subjected to a bail-in. Practical examples are guarantees and documentary credits (letters of credit): Here, the payment obligation only arises upon occurrence of the guarantee event or the presentation of the documents and subject to the beneficiary actually making the claim.
- Likewise, contractual agreements which do not have the purpose of creating a payment liability but which may give rise to liabilities in cases of a breach of contract (incidental liabilities) are clearly not intended to fall within the scope of Art. 55 of the BRRD, as they are incidental only, are typically dependent upon court judgement as to reward and are too unpredictable to be taken into account for resolution planning purposes (we already assume that Art. 55 of the BRRD is only intended to cover liabilities which have the – primary – purpose of creating a payment liability, but this could be clarified).
- In many cases, a bail-in of liabilities nominally falling within the current scope of Art. 55 of the BRRD will not have any net-effect since a bail-in of the relevant liabilities would directly be neutralised by a corresponding introduction of a payment receivable or reduction of counter-claims with equal and opposite effect “balancing out” the relevant bailed-in liability. Again, a practical example is guarantees and documentary credits which are regularly covered or secured by corresponding counterclaims against a third party, often the client of the bank in question.

- In all of the above situations and cases, not entering into the relevant transaction or offering the relevant instrument and service to customers is likely to have a very significant adverse effect on the competitiveness of an institution and may also affect its core business operations and/or its access to key markets and market infrastructures. Not being able to enter into the relevant transactions because of the need to impose contractual recognition clauses in the underlying agreements would thus not only severely affect existing business operations but also be a greater impediment to resolvability than any failure to impose the contractual recognition clauses in these agreements (especially considering that the lack of a contractual recognition clause does not preclude a bail-in).

II. Comments on quantitative findings

The EBA's interim report includes a section on quantitative findings which is based on a sample of banks from across the EU. The analysis highlights issues due to differences in business models, banking systems, etc. and analyses the impact of MREL under a number of scenarios. While the analysis appears relatively comprehensive, it still suffers from a number of weaknesses, according to our observations:

- **Completeness**: the analysis does not cover the entire EU, i.e. a number of countries are missing entirely. While they, in aggregate, do not account for more than 30% of banking assets in the EU, issues that may affect individual countries are not considered.
- **Consolidated vs. solo level**: since MREL is a requirement at individual institution level, any quantitative impact analysis needs to be undertaken at individual institution level The majority of the analysis is undertaken (as in previous exercises) at consolidated level. As a result, the reported shortfall may significantly underestimate the actual shortfalls at legal entity level.
- **Pillar 2 requirements**: while we appreciate the data constraints that led the EBA to consider a 'standard' Pillar 2 add-on of 2% for all banks, this vastly underestimates the true Pillar 2 add-on for many institutions and – as a result – leads to a significant underestimation of MREL requirements in all scenarios. The issue is particularly acute in some jurisdictions that set comparatively high Pillar 2 requirements.
- **Buffer requirements**: the analysis only includes the capital conservation buffer and G-SII buffers where applicable, but excludes countercyclical buffers, O-SII buffers and systemic risk buffers. As, in particular, systemic risk buffers are significantly higher than G-SII buffers in most cases, and apply to a larger number of banks, the analysis vastly underestimates the actual MREL requirements of institutions across the EU and in specific jurisdictions.
- **Deposit-funded banks**: Related to this point, we have concerns about the construction of Figure 6 in the report, which depicts the composition of MREL for different categories of banks. We assume the 'stacks' represent aggregate data, although this is not clear. More importantly, the stacks would look significantly different if disaggregated by jurisdiction, as the preponderance of deposit funded banks in some markets would be evident. As presented at the moment, this graph does not accurately represent the funding structure in many jurisdictions and as such creates an inaccurate picture of the situation in the EU banking sector. Moreover, the analysis mentioned some specifics of deposit-funded banks and chose two thresholds for identification of a deposit-funded bank (30% and 40%). However, there are banks which are funded over 50% from retail deposits. Such banks were not analysed even though the 10% delta means a significant difference in the funding structure and a significant lack of MREL liabilities for such banks.

- **Calibration scenarios**: the report includes three calibration scenarios, with the first and third scenarios described as unrealistic (and therefore for illustrative purposes only). While we agree that scenario 1 could be considered a 'best-case', scenario 3 is still far from a 'worst-case' scenario that could occur on the basis of the current RTS on MREL. Both scenario 2 and scenario 3 include only a standardised Pillar 2 add-on, no countercyclical, O-SII or systemic risk buffers and any buffer requirement (capital conservation and G-SII buffer where applicable) only once in the loss absorption amount. As already outlined above, actual buffer requirements (Pillar 2 and others) are higher than those assumed in the analysis and the EBA RTS also allows for the inclusion of all buffers in the recapitalisation amount. Including significantly higher buffer requirements and including them twice in the total MREL requirement would show the 'real' worst-case scenario for European banks (and actually a scenario that is contemplated in interactions with the SRB), and should, as such, be quantified, since the analysis otherwise underestimates the true effects on the European banking system. In addition, the EBA mentions at several points in the report that the scenarios 'are likely to be too conservative' for some banks and then makes 'more realistic' assumptions. While we agree with this assessment, the scenarios are also not conservative enough for some banks and a more realistic assumption in their case would result in much higher MREL requirements (this is especially relevant with respect to Pillar 2 add-ons and systemic risk buffer requirements).

As a result of the shortcomings listed above, we believe that the current quantitative analysis is not fully appropriate to convey a true picture of the impact of MREL requirements in the EU. Not only does it lack detail in terms of requirements at individual institution and/or jurisdiction level, 'glossing over' real national differences and issues for banks with particular business models, but, in our view, it also vastly underestimates true funding needs by ignoring significant amounts of buffer requirements and the possibility of the EBA RTS (and emerging practice of some national resolution authorities and the SRB) to require buffers also as part of the recapitalisation amount. With regard to further, possibly more detailed quantitative impact studies we would appreciate a close coordination with the activities actually undertaken by the resolution authorities.