Deutsche Bank

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Dear Mr. Farkas,

DB response to the EBA's consultation on the interim report on implementation and design of the MREL framework

Deutsche Bank (DB) welcomes the opportunity to respond to the European Banking Authority's (EBA) consultation on its interim report on implementation and design of the Minimum Requirement for own funds and Eligible Liabilities (MREL) framework.

We strongly support the EBA's efforts to harmonise MREL and the Financial Stability Board's (FSB) Total Loss Absorbing Capacity (TLAC) standard. The proposed new reference base for MREL (i.e. risk weighted assets and leverage exposure) would be more efficient than the existing complex denominator for MREL. Concerning the introduction of the subordination requirement, we welcome the EBA's proposal for a pragmatic approach in which any of the three types of subordination referred to in the TLAC standard are possible. It is critical, to avoid further uncertainty, that changes to national creditor hierarchies which have already been implemented are not required to be revised again. We also welcome the EBA's recognition of the need to adapt the calibration of MREL to a bank's resolution strategy. Finally, the EBA's proposed approach concerning Article 55 of the Bank Recovery and Resolution Directive (BRRD) would be a helpful solution to address issues identified by the industry and regulators during the implementation of contractual clauses for the recognition of bail-in.

In our response, we have followed the structure of the interim report and also make comments on the treatment of buffers, consequences of a breach, and internal MREL.

Please let us know if you would like more information or would find it useful discuss any of these points raised in this response in more detail.

Yours sincerely,

Matt Holmes
Head of Regulatory Policy

European Banking Authority (EBA) interim report on the Minimum Requirement for own funds and Eligible Liabilities (MREL)

Options for the reference base (denominator) of MREL

We agree with the EBA that the MREL denominator should be based on risk weighted assets and leverage exposure to ensure consistency across the EU and with the minimum TLAC standard. The TLAC denominator refers to existing prudential methods that are harmonised across the EU and well understood by regulators and investors.

The MREL calculation basis (i.e. the amount of own funds and eligible liabilities; with derivative liabilities included in the total liabilities but on the basis of full recognition to counterparty netting rights) is particularly complex as currently drafted in the BRRD and will lead to inconsistencies in calculations as a result of differences in national accounting rules. We welcome the EBA's report, which acknowledges these shortcomings.

Relationship between MREL and other regulatory requirements

1. Treatment of buffers

We agree with the EBA's proposed approach from a conceptual perspective, and we welcome the EBA's call for the interaction of MREL and the Maximum Distributable Amount (MDA) to be carefully considered. Our view is that under the current regulatory framework it would be problematic to place buffers on top of MREL because of this interaction. If buffers, as currently designed, are stacked on top of MREL, an inability to refinance debt in the market or an unexpected increase in the MREL denominator could lead to the automatic triggering of restrictions on voluntary distributions because of the interaction with the MDA calculation. This could have financial stability consequences, as it could compound dislocation in bank debt and equity markets, or could aggravate the stress which caused the increase in the MREL denominator. Moreover, any lack of clarity on the extent of risk of refinancing debt could add to uncertainty and damage investor confidence even without any stress event. As such, the application of MDAs to capital held towards the combined buffer should be addressed as part of the CRD IV review.

Only if MDAs were to be removed from the combined buffer, would it make sense to stack the combined buffer on top of MREL to ensure the usability of buffers and the availability of loss absorbing capacity in resolution. However, the EBA should then also revisit the reference to buffers in the current MREL draft delegated act, to avoid that banks have to hold MREL against them twice (see calibration, below).

2. Consequences of a breach of MREL

Consequences of MREL breaches should not be automatic, but rather assessed on a case by case basis to ensure proportionality. The provisions for supervisory measures in CRD Articles 102-104, for early intervention in BRRD Article 27 and the conditions for resolution set out in BRRD Article 32 already provide a framework to effectively deal with potential breaches of all regulatory requirements and do not need to be amended. The application of this existing framework would allow breaches or likely breaches of MREL to be dealt with without triggering resolution, unless there was also a breach or likely breach of minimum capital requirements (as per the EBA's Guidelines on 'failing or likely to fail'). We also support the inclusion in the existing draft delegated act on MREL of a provision for MREL to be set on a transitional basis following its depletion in a resolution.

3. Redemption of MREL-eligible liabilities

Introducing an approval requirement for MREL-eligible liabilities would be problematic as it would prevent banks from promptly buying back senior bonds in times of market stress, which is an important tool to reassure investors and bring stability to the markets. Indeed, the existing approval process is generally quite long. In the case of own funds, a share buyback or early redemption of capital instruments can take anything between several weeks to close to a year to be approved by the competent authority; whereas currently a bond buy back can take place within a week (as no approval is required). If a similar approval process was introduced for bond buybacks, banks would not be able to use it as an efficient tool in a stress situation.

Experience has shown that prompt bond buybacks can be important in times of market stress and when there are concerns, justified or otherwise, about a bank's financial position. In February 2016, DB offered a buyback of bonds that were trading significantly below face value. This provided liquidity to bond investors in challenging market conditions and was seen as a sign of DB's strength. Although the buyback itself only took place for a volume of around €2 billion, DB bond levels ("risk premium") in the secondary market tightened by around 40-60bps compared to peers, following the announcement and execution of the bond buybacks.

4. Relationship between MREL and NSFR

We agree with the EBA's analysis concerning the interaction between MREL and Net Stable Funding Ratio (NSFR) as regards to 'external' MREL.

However, another element to take into account is the relationship between 'internal' MREL and the NSFR when applied to individual institutions within banking groups. If MREL is required to be held on balance sheet in an individual subsidiary at a level that exceeds its current capital and liquidity requirements, long-term debt will need to be "down-streamed" (i.e. lent from the parent resolution entity to its subsidiary). This may result in this subsidiary having surplus funding from an NSFR perspective that it cannot deploy usefully elsewhere in the group, effectively trapping liquidity in the subsidiary.

Equally, by loaning some of its long-term debt to a subsidiary, the NSFR of the parent entity (on an individual institution basis) may face a shortfall. This would require the parent to raise more long-term funding than would otherwise be necessary under consolidated NSFR and MREL requirements, artificially inflating its stand-alone balance sheet and inadvertently increasing its external MREL requirement.

Such an increase purely as a result of down-streaming long-term funding to a subsidiary is not an intended consequence of internal MREL requirements, which are designed to relate to the distribution of MREL raised by the parent entity around its group rather than the amount of MREL that the parent has to raise.

Annex 1 contains a graphical representation of our concerns. We urge the EU to delay application of the NSFR at individual institution level until the framework for internal MREL is more fully developed and these interactions can be better understood.

Eligibility criteria for MREL

1. Subordination

The FSB requires TLAC instruments to be subordinated to other liabilities, so that they absorb losses first, without risk of legal challenge during resolution or giving rise to valid

No-Creditor-Worse-Off claims. In the EU, TLAC including the subordination requirement should be introduced for any bank which has bail-in as its preferred resolution strategy. In order to achieve subordination, we agree with the EBA that there should be discretion for Member States and each of the three types of subordination set out by the FSB should be allowed. To ensure a harmonised outcome and alignment with the TLAC term sheet, certain safeguards should be introduced in EU legislation:

- **Where there is structural subordination**: Member States should ensure that existing non-operating holding companies are "clean" – i.e. have no activity other than issuance of debt and own funds, subject to the 5% (or 10%) 'de minimis' exception for 'excluded liabilities';
- **Where there is a contractual approach to subordination:** Any impediments to issuance of MREL-eligible debt should be removed, by offering the possibility to position claims in a way that does not create conflicts with any contractual covenants in outstanding subordinated debt (be it under a single governing law or multiple laws); and
- **Where there is a statutory approach to subordination:** Member States should ensure that only non-structured tradeable capital markets instruments are pari passu with MREL-eligible instruments. ESMA and EBA should further define 'non-structured'. For instance, the approach chosen in Germany describes the characteristics of plain vanilla bonds. Structured notes are then defined as all the remaining forms of securities. Furthermore, the German authorities have published guidelines with examples of borderline cases for what is considered as a plain vanilla bond and what is a structured note.

We consider that any EU proposal must avoid imposing a subordination solution which might not be adaptable to all national specificities or which comes into conflict with existing measures to meet the FSB's objectives, in line with the principle of subsidiarity. In particular, any EU proposal for harmonisation must avoid reversing changes to national insolvency hierarchies that have already been implemented. This is particularly important given that further changes would create significant uncertainty and confusion in funding markets. This would be the case even if an EU-wide approach to subordination could be agreed quickly, which is far from certain given the co-decision process can last a considerable time. The EBA should therefore focus its recommendation to the EU Commission on ensuring a harmonised outcome, as outlined above.

The FSB has established the minimum requirements for TLAC in such way that it is composed of liabilities that can be effectively bailed-in, without any doubt, to ensure an efficient process. We support proposals to implement TLAC through MREL and to avoid having two, very similar, parallel sets of loss absorbing capacity requirements. When looking at eligible liabilities, TLAC is a subset of MREL. MREL may include some instruments that are excluded from TLAC but which may still be feasible to bail-in (e.g. non-subordinated debt, structured notes or deposits >1 year). When preparing the legislative proposal, we agree that the EBA should recommend that the Commission exclude these instruments from the 'Pillar 1' MREL necessary to implement the minimum TLAC requirement of 16% of risk weighted assets (RWA) or 6% of leverage ratio exposure (LRE) by January 2019 (rising to 18% of RWA or 6.75% of LRE by January 2022) as set out by the FSB. However, in light of the wider set of banks to which MREL will apply, we believe calibration of Pillar 2 MREL requirements should be adjusted accordingly and the resolution authority should be able to recognise a wider set of instruments which could also be credibly and feasibly bailed-in. This should include those currently eligible for MREL but could also count debt instruments <1 year, subject to appropriately conservative haircuts.

All capital instruments, including legacy capital instruments that meet the TLAC criteria but not necessarily the fully loaded requirements of the EU capital regime, should be counted in full towards 'Pillar 1' MREL requirements.

2. Third country recognition

DB supports the EBA's report which acknowledges the issues associated with the wide scope of Article 55. The current scope of Article 55 is so broad that it presents significant operational challenges for questionable benefits in terms of loss absorbency capacity and resolvability. The need for contractual recognition is also lessened once MREL and TLAC are fully integrated (including subordination), and liabilities other than MREL become remote from risk of bail-in. Article 55, as currently drafted puts EU banks at a competitive disadvantage, particularly since no other resolution regime envisages contractual recognition clauses in such a broad range of liabilities.

To give one example of operational challenge: it is extremely difficult, if not impossible, for banks to add contractual bail-in terms to some types of trade finance liabilities because there are globally accepted standard documentary rules set by international bodies such as the International Chamber of Commerce (ICC) and industry-wide electronic message formats, for example, the Society for Worldwide Interbank Financial Telecommunication ("SWIFT") Message Types. The message formats do not feature a data field that is capable of including the necessary information called for in the provision. The cost of implementation is disproportionate when instruments like trade finance do not provide any benefit to resolvability, in terms of loss-absorbing capacity.

We agree with the EBA that a revision of the BRRD should include a narrowing of the scope of Article 55 and we recommend limiting Article 55 to instruments eligible for MREL. Then, if the resolution authority deems it necessary to ensure the bank's resolvability, it could ask the bank to implement the contractual clause in further instruments. This would ensure a more proportionate approach that would avoid putting EU banks at a competitive disadvantage in the global marketplace. This would balance the need to give market participants clarity about what liabilities will in practice make a contribution to loss absorbency in bail-in, while retaining the flexibility for resolution authorities to expand the scope if necessary for a specific bank's resolution strategy.

Calibration of the MREL requirement

It is important to determine MREL on the basis of a bank's resolution strategy. For Global Systemically Important Banks (G-SIBs), the level of MREL should be aligned with the FSB's approach for TLAC. In addition, we recommend that this approach also apply to banks that have bail-in as the preferred resolution strategy, including domestically systemically important banks, to ensure that these banks have enough loss absorbency capacity. For smaller or non-significant banks whose primary resolution strategy is not bail-in, the resolution authority should also adapt MREL, calibrated accordingly.

MREL should be calibrated carefully to avoid putting European banks at a competitive disadvantage to international peers. Moreover, it will be challenging to maintain market appetite for European banks' debt if the MREL calibration is not carefully thought through and the requirement is too high. The investor base for TLAC/MREL instruments is already quite narrow, given that institutional investors have established limits in their mandates for subordinated debt and that there are regulatory restrictions to the distribution of bail-in debt to retail investors. Prudential constraints limiting investment in TLAC/MREL for all banks will further narrow the investor base. As a result, there will be limited market appetite for MREL/TLAC instruments.

To ensure proportionate calibration, we recommend the following:

- Currently, the minimum required for the resolution financing arrangement to make a contribution in resolution, according to article 44.5 of the BRRD, is 8% of total liabilities and own funds. This should not be a reference point when setting MREL as the resolution funds including the SRF should not be relied upon as a source of recapitalisation in resolution. The BRRD makes clear that resolution funds cannot be used for direct recapitalisation and any use of resolution funds for indirect recapitalisation (e.g. to replace liabilities excluded from bail-in) is only possible in specific exceptional circumstances, so the threshold for its usage should not be relevant to resolution planning and MREL. In addition, as recognised by the EBA, the reference to 'total liabilities' in the current MREL denominator leads to inconsistencies due to differences in national accounting rules. If banks' MREL were linked to the threshold for use of the resolution fund, it would result in significant variation in requirements between Member States.
- Under the current EBA RTS on MREL, there is a risk that buffers would not be usable. The Bank of England, in its draft implementation paper on MREL, would exclude buffers from the calibration of MREL; instead it stacks the combined buffer on top of MREL. We believe this is correct conceptually, but as outlined above (see relationship with regulatory requirements) it would only be possible if the interaction of buffers with MDAs is addressed as part of the CRD IV review. If this is addressed and the combined buffers sit on top of MREL, then buffers need to be removed from the criteria for determining MREL as outlined in the current EBA MREL RTS. The inclusion of the combined buffer requirements in the loss absorption amount results in buffers becoming a de facto minimum requirement, contrary to their original purpose. They would not be usable without depletion of MREL. And if they are included in the recapitalisation amount, it would appear that they would not be usable in the context of a resolution scenario, which is by definition of a stressed scenario. As acknowledged by the EBA, buffers should only be relevant as one factor in assessing what level of recapitalisation will be necessary post-resolution to ensure market confidence. Therefore, we believe references to the buffers should be removed from the criteria for determining MREL, in order to keep them usable on top of MREL as intended by the FSB.
- Finally, to ensure appropriate calibration, we urge the EBA to distinguish between the instruments necessary to meet the 'Pillar 1' MREL requirement – fully aligned with TLAC – and allowing resolution authorities to recognise a broader set of still feasibly bail-in-able instruments in the 'Pillar 2' calibration (see 'eligibility', above)

Intra-group issues

We recommend that the concepts of "resolution entities" and "resolution groups" in the TLAC term sheet should be introduced in EU legislation. The EU should be seen as one jurisdiction for internal TLAC. At the very least, it is essential to ensure that the Banking Union is treated as a single jurisdiction.

Currently, the BRRD requires MREL for each subsidiary, regardless of its materiality, unless the requirement is waived within an individual Member State (under Article 45 (12) of BRRD). We strongly recommend the EU follows the FSB's approach and introduces an element of materiality so that MREL does not automatically apply (or applies only at a calibration no greater than the applicable minimum own funds requirement) to individual non-material subsidiaries unless authorities take a joint, reasoned decision that it should. Imposing additional subsidiary requirements could lead to significant costs, in effect imposing increased leverage requirements on the balance sheets of immaterial entities, which would not be justified by economic fundamentals. This has also limited benefits from a resolvability perspective given their non-material status. At the very least, waivers should be able to be applied at the level of the Banking Union, given the Single Supervisory Mechanism (SSM) is the ultimate prudential regulator.

Annex 1: Graphical representation of interaction of internal MREL and NSFR