ABI COMMENTS ON THE EBA'S INTERIM REPORT ON MREL

August 2016

POSITION PAPER

Introduction

This document provides a summary of the ABI's findings regarding the implementation and design of the MREL framework.

ABI welcomes the Report and underlines that the right calibration of quality and quantum of MREL-eligible liabilities is a relevant issue for institutions with peculiar legal forms or governance/business models, namely small-middle sized banks, deposit-funded banks, retail banks, cooperative and mutual banks or other institutions with limited access to financial markets.

In particular, the EBA invites interested parties to comment on the following questions:

1. Breach of MREL (page 8 and page 50)

The EBA invites stakeholders' comments on whether and in what circumstances a breach of MREL should result in the Competent Authority making an assessment of whether the institution is failing or likely to fail.

As stated in the interim report, resolution authorities should have clear responsibility and a leading role, although a proper consultation and cooperation with the competent authority is compulsory. A breach of MREL, that "sits below" capital buffers, would imply that the combined capital buffer requirement is already breached. Breaching the combined capital buffer requirement triggers automatic MDA restrictions. The EBA interim report also points to possible problems of automatic consequences and suggests the following: as a result, there could be some measures that are automatic and pre-defined in Level 1/Level 2 provisions, while others would require the judgment of the authorities and depend on the situation.

We consider that breaches of MREL should be taken seriously and that resolution authorities should have clear responsibility and a leading role in responding to a breach of MREL as suggested by the EBA interim report. In particular, we propose to further strengthen the cooperation and coordination between resolution and competent authorities in their responses to a MREL breach, including by notifying and consulting each other in advance on respective actions taken.

However, we disagree with the EBA view of unreasonably broadening the resolution authority powers in making an assessment on whether the financial institution is failing or likely to fail and as consequence meets the conditions for resolution. We believe that such a recommendation would undermine the confidence in the banking sector and would add volatility in financial markets. Moreover, it could seriously reduce the possibility for a bank in breach to issue MREL-eligible liabilities as already considered failing or likely to fail. In such a way a bank in breach only for transitory reasons (i.e. for an unexpected increase of the denominator or for market-wide disturbances preventing the rollover of maturing debt) would see a further deterioration in its position due to resolution authority automatic decisions.

Therefore, we suggest that breaches of MREL are dealt with a step-by-step approach, paving the way to a non-automatic/immediate assessment by the competent authority about the likelihood of bank failure.

First and foremost, a bank that is in breach of MREL shall develop a plan on how it intends to correct the MREL shortfall within an adequate timeframe. Under the control of the CA in co-operation with and guided by resolution authorities previous options can be reviewed and updated, including the timeframe to deliver the required outcome. At this stage a MREL breach shall not oblige a bank to use its combined capital buffers to fill the MREL gap.

In this sense, we agree with EBA that the interaction with automatic MDA restrictions on voluntary distributions should be carefully considered. In fact, the MDA mechanism was not designed also for TLAC/MREL purposes. We believe that Article 141 of the Capital Requirements Directive should not be amended to include MREL. Indeed, any breach of TLAC/MREL should be considered separately from the MDA process and different remedies should be allowed in order to cope with different causes of MREL breaches. For instance, a breach of MREL through the non-renewal of maturing debt may be the consequence of certain market conditions rather than be linked to the under-performance of a given bank.

Furthermore, we believe that a MREL breach shall not automatically lead to MDA restrictions for the following reasons:

• MREL ensures that banks have sufficient loss absorption capacity when entering into resolution. This implies that the capital components of MREL are "gone concern capital" and not "going concern capital" as this is the case for capital requirements and capital buffers. MREL breaches should hence be treated in a different manner than breaches of regulatory minimum capital.

• Bank resolution is a hypothetical scenario as MREL shall ensure that a bank when entering in resolution has sufficient loss absorption capacity to absorb the losses and to re-capitalize the critical functions of the remaining bank (the bank after resolution is likely to be significantly different and smaller from the bank in going concern). Bank resolution plans, which are the basis for the MREL calculation, set out how from todays' perspective a bank can be resolved at any hypothetical future moment.

• The elimination of automatic MDA restrictions puts less pressure on banks for disclosing their MREL requirement.

In this regard, it is worth to noting that calling for a breach of MREL requirements could produce a relevant damage to financial stability and investors' trust if these breaches are later proved to be temporary (false positive signals). In fact, false positive signals could produce higher costs for investors, the bank itself and, to a certain extent, for the entire banking systems if investors assume that the MREL breach could produce an increase of cost of MREL liabilities for issuers.

In order to avoid such false-positive-signals, a certain degree of flexibility have to be adopted and, accordingly, the MDA framework should be disconnected from MREL breaches.

2. Eligibility (page 9 and page 61)

The EBA invites stakeholders to comment on the appropriate scope of any subordination requirements.

More precisely stakeholders are invited to comment on what the highest priority information and disclosure needs are, in the three areas of i) disclosure of bank balance sheet structures; ii) disclosure of banks' MREL requirements and iii) availability of standardised information on statutory creditor hierarchies.

In terms of information and disclosure, we feel that disclosure of bank's MREL requirements should be avoided at least in the first years and until markets are not fully comfortable with the process. As MREL is set on an individual basis with possible upward and downward adjustments compared to the calculation which according to the draft EC delegated act on MREL calculation are based purely on regulatory capital requirements (for loss absorption and for recapitalization), markets could interpret relative high MREL requirements as a sign that the bank is riskier. In reality various factors impact the MREL decision, not at least the preferred Resolution Strategy.

On the disclosure of bank's balance sheet structure and information on creditor hierarchies, we support the need to give a complete and clear disclosure on the issuer bank: accordingly, we think it is necessary to give in particular material information on the banking prudential capital ratio, on the liability banking structure (including also the financial instruments offered).

However, we believe a priority should be given to the third area regarding the disclosure of standardised information on statutory creditor hierarchy.

We believe that the combination of the balance sheet structure and creditor hierarchy have to permit an investor to understand where, at least in theory and at reporting date, he stands in the "pecking order" in case of a bail-in, including the monetary amounts of the various categories of creditors with reference to specific balance sheet items. To this aim we would see merit and support an effort to define a common reporting standard.

This approach takes into account the different level of information needed for retail investors and institutional ones and it seems also to be aligned with the financial regulation (i.e. Prospectus Directive) market supervisory practices already used in EU countries.

3. Third country recognition (page 9 and page 62)

The EBA invites stakeholders' to comment on the practical difficulties faced in implementing the recognition clauses, specifically in the field of MREL, and on alternative approaches to improve the regime without creating incentives to evade the scope of bail-in.

Article 55 of the BRRD has a very broad scope (significantly broader than that foreseen by the FSB guidance which refers only to debt instruments) and its implementation raises a number of significant issues which are likely to adversely impact the ability of EU banks to access markets and do business outside the EU.

As a matter of fact, there are three main categories of contracts governed by third country law for which the inclusion of a bail-in clause would prove extremely challenging if not impossible:

A. Contracts for which it would be theoretically possible to propose the inclusion of a bail-in clause but this is refused. In case of opposition of the counterpart to include such a clause, EU banks will have to give up the conclusion of the agreement in order to not violate Article 55.

B. Contracts for which it is not possible to propose the inclusion of a bail-in clause such as contracts with foreign public authorities, operational liabilities or contingent liabilities such letters of credit, guarantees and counter guarantees where including contractual recognition provisions poses significant practical and legal challenges.

Contracts with foreign public authorities such as guarantees provided in the context of public procurement procedures and those which are governed by standard terms under local law (e.g. supplier agreements of minimal value like local purchases of land, leases, purchases and rental of equipment or supplies, and liabilities to financial markets infrastructure) normally cannot be readily negotiated either because the public authorities require compliance with standardised guarantee schemes or because the contract is generally concluded very quickly. Challenges also arise in relation to liabilities that are documented through SWIFT messages, are agreed verbally or arise under market conventions which would be difficult to amend.

C. Contracts without a clause specifying the applicable law. Finally, difficulties arise with contracts which do not include a provision specifying the applicable law because and for which, in case of dispute, non-EU contract law might be considered as the reference law although the EU credit institution acted as if the EU law was applicable.

On the other hand, the wide application of Article 55 requires to include a contractual term also to liabilities that realistically are *unlikely* to be subject to bail-in, as they are *structurally unsuited* to such resolution tool.

A case in point are contingent liabilities, especially those which are connected to the financing of international trade (i.e. trade finance instruments such as letters of credit, bank guarantees and performance bonds).

As a matter of fact, contingent liabilities only come to existence upon the occurrence of a certain future event and do not become actual until the bank receives a valid claim from the relevant beneficiary; from an accounting perspective, they are not included on the balance sheet of the bank (representing instead off balance sheet obligations of the company) and *can be hardly quantified* - as it is the case, for instance, of bank guarantees - before the guarantor is obliged to pay.

As such, it would be impractical/impossible to value such liabilities under a resolution scenario and, as a consequence, no financial benefit could derive to the bank under resolution from their write-down or, said otherwise, *giving no benefits in terms of loss absorbency they will not help in terms of bank resolvability.*

Besides, in the field of trade finance a lot of *practical* challenges to the application of Article 55 come on a more operational level from the circumstance that contractual language in this business area is highly standardised and, in most cases, it is simply *not feasible* to add contractual bail-in terms in contracts governed by globally accepted standard documentary rules set by international bodies such as the ICC (as it is the case of the International Stand-by Practices 98 for the Stand-by letters of credit) or operationally performed via long established, industry-wide electronic message formats (for example the SWIFT Messages).

Application of Article 55 requirements under such circumstances turns out to be very challenging and the likely result, in practice, will be resistance from non-EU trade finance counterparties, which will feel ultimately forced to choose non-EU banks or simply not undertake the transaction at all. It is clear that this would place European banks at a relevant competitive disadvantage vis-à-vis the banks outside the EU not having to comply with such requirements.

At a more general level, however, one should also bear in mind that even without the express inclusion of the bail-in terms in such contracts (in contravention therefore with the requirement of Article 55), the power of the resolution authority to impose bail-in measure to trade finance liabilities *still exists* and may in any event impact the willingness for counterparties to accept them on competitive terms. The concern to be underlined is that the competitiveness of European banks in winning international trade finance business is adversely affected when non-EU institutions not subject to such resolution measure can offer more attractive, commercially "safe", instruments.

That said, in order to face the challenges outlined above with reference to trade finance liabilities it does not appear to be sufficient, in our view, simply to modify the scope of Article 55 by excluding such liabilities from the field of application of the contractual recognition of bail-in.

Taking into account that trade finance transactions are, as any other "contingent liability", unlikely in principle to be bailed in because of their contingent nature and their uncertain value, the only option that could effectively help to overcome all operational difficulties connected to trade finance business is to exclude such transactions from the application of bail-in, in other words adding a new case of exclusion among those provided under Article 44, 2 BRRD.

The industry is facing a number of practical difficulties in implementing the recognition clauses also in the context of derivatives, especially due: (i) to the lack of consistency of application and the consequent need for harmonization; (ii) the uncertainty concerning the secured liabilities exclusion in a derivatives context and (iii) a broad definition of liability together with conflict with applicable third country laws and regulations.
With reference to penalties to be applied only when the absence of the clauses would prevent resolvability, we feel that it would be difficult to evaluate beforehand this condition whereas the market needs certainty.
Pursuant to the foregoing, in the derivative context we agree with proposing solution (iii) limiting the scope of art. 55 only to instruments which are eligible for MREL (so excluding derivatives); this seems to us the only effective and clear solution.

On the issue of penalties, we certainly agree that it would be of help for the market if the resolution authorities would make it clear that – given the situation - they will have a common sense approach to enforcement and explicitly delay the application of Art. 55 to a date when all the present doubts concerning – among others - scope, exclusions related collateralisation and impracticability have been clarified.

Furthermore, we agree that a statutory framework entailing reciprocal recognition between e.g. EU and the USA should be seen as the optimum solution to this problem, to be pursued as soon as possible.
In consideration of the above and apart from the case we outlined above with reference to trade finance liabilities, in our view Article 55 should not apply to those liabilities for which the institution has made a reasonable effort to include a recognition clause, including derivatives, with the onus on the

institution to prove this. The Commission should consequently amend Article 55 in the context of the BRRD review it is currently preparing for end year.

Since the BRRD and its national implementations have already entered into force, and the non-compliance with this provision entails in many Member States - amongst which Italy – significant administrative sanctions (up to 10% of the turnover) in the meantime, new EBA Guidelines should delay the application of Article 55 and support resolution authorities and institutions to understand what reasonable efforts and impracticability would mean. In this last regard, an approach similar to the one proposed by UK’s PRA could be adopted.

Other comments, further to the ones above solicited in particular by EBA:

A. Quantitative impact analyses

For the scenario that studies, amongst others, the impact of an 8% minimum, the quantification has been performed assuming an 8% minimum for all banks, not for all large banks only. Also, the impact of the 8% minimum alone is not clear, as there was no separate scenario to calculate this (the milder scenario is without 8% minimum AND without recapitalization capital buffers). It would be interesting to understand what the impact of the 8% minimum alone would be and what the difference would be if this was applied to all banks or only to the larger ones.

There are some assumptions or simplifications that (admittedly) influence the outcomes. In particular:

1. only external MREL at the parent level is considered, but the denominators are at Group level. This distorts the outcome significantly, especially for banking groups with subsidiaries that issue important amounts “locally”. While EBA states that the denominator cannot be corrected due to the absence of data, we wonder if EBA ran an additional exercise considering all external MREL and how this changed the outcomes

2. static balance sheet: the recapitalization requirement is based on the assumption that the bank after resolution has the same risks and balance sheet size. This is overly conservative and real gaps should be lower in reality. The EBA Report states that for smaller banks, a 50% recapitalization instead of a 100% would lower the gaps by 31-47 bn (pp. 23, 30). It would be informative to understand what the impact of a 75% recapitalization for the bigger banks would be.

B. Leverage ratio back-stop

The determination of the backstop as described on page 36 is not a real backstop (intended to limit something) but a new stand-alone requirement. Authorities would take the euro amount of the MREL requirement (based on the calculation methodology of loss absorption and recapitalization identified by the draft EC delegated act) and simply divide it by the leverage ratio exposure measure, creating a new ratio (limit).

However, by doing so, if a bank's RWA were to remain constant but the leverage ratio exposure was to increase, the backstop ratio would be breached. Or if the RWA were to decline with a constant balance sheet, the ratio MREL/RWA would not be the binding ratio, but the MREL/exposure ratio would be. The backstop should be set at some distance from the current level (to "back-stop" RWA calculation deficiencies as in the CRR leverage ratio's intention).

C. Use of the SRF

In the Report there is the assumption that GSIBs should have at least an 8% MREL so the SRF can be used: "In particular the fact that an institution is of systemic significance and its disorderly failure would be likely to have adverse effects on financial stability will support the conclusion that the resolution fund might need to be accessed in order to resolve it." (page 69).

This is conceptually wrong as for all banks MREL should be set in a way that the resolution strategy can be executed (as stated more than once in the same Report). The resolution strategy cannot foresee the use of the SRF as it can only be used in exceptional circumstances if the resolution strategy cannot be executed.

D. Calibration – floors

Chapter 7 touches the concept of an MREL floor, without giving an opinion (only pros and cons). The floor seems not correct to us as the MREL requirements should be exclusively based on the Resolution strategy and on the assessment by the resolution authorities. The MREL requirements, in force for all banks in the EU, should be always applied taking into account the specific features of each bank. To this extent, we believe that the MREL requirements should remain a bank specific Pillar 2 requirement to be determined on the basis of the business model and the proportionality principle, in order to avoid an excessive and inappropriate burden. To this end, we hold the view that the computation of the quantum of MREL-liabilities is, so far, a difficult exercise. Banks, markets, media and investors have not yet determined the potential demand and supply of MREL financial instruments, nor they have a clear view on market aspects such as pricing and liquidity of such instruments. It seems clear that small/medium banks, cooperative/mutual banks and retail banks which are not accustomed to regular liaisons with financial markets, nor have a rating, could be facing difficulties. These banks could be forced to issue MREL liabilities at (yet unknown) rates and conditions. The fact that the MREL requisites have to be achieved within a limited time frame do introduce further problems for these kind of banks, as market could be stressed by relevant issue of MREL liabilities and limited demand, given the current risk adverse stance of several investors.

D. Relationship with regulatory requirements – regulatory capital buffers

While the EBA's provisional view is that, in principle, the usability of regulatory capital buffers would be best preserved if they stack on top of MREL, preventing double-counting could increase banks' MREL financing needs. However, this consequence can be avoided by lowering, in the same proportion, the calibration of MREL levels to take into account the elimination of double-counting. To this end, it is important to highlight that the similar UK proposal was paired by the exclusion of the capital buffers in the recapitalisation amount. Otherwise we could experience an unmotivated increase of the required ratio.