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EACB Comments on EBA Public Consultation on "Interim report on the implementation and design of the minimum requirement for own funds and eligible liabilities (MREL)"

30 August 2016

The European Association of Co-operative Banks (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4,200 locally operating banks and 68,000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 78 million members and 860,000 employees and have a total average market share of about 20%.

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Introduction

The European Association of Co-operative Bank (EACB) welcomes EBA approach to collect views from relevant stakeholders on its provisional recommendations on the implementation and design of MREL. We take note that some of the recommendations are already based on a profound research, while other stances are reserved with a view to collect more evidence.

This paper sets out the EACB initial reflections on the EBA provisional recommendations on the design and implementation of MREL and gives some first industry insight on this topic.

EACB Reflections on EBA Provisional Recommendations

Reference base for MREL requirement (denominator) (Section 4)

Generally, the EACB members welcome the EBA recommendation to change the denominator of the MREL ratio to the RWA with a leverage ratio backstop. We acknowledge that the alignment of the MREL denominator metrics towards the TLAC metrics for the G-SIBs, i.e. determining MREL as a percentage of RWA with the leverage exposure as a backstop, might ensure a higher level of clarity and comparability, both for banks and investors. Regarding this backstop, we support the EBA proposal to assess the impact of introducing a binding leverage ratio on the level of MREL.

Yet, we note that changing the MREL reference base towards the TLAC metrics for the G-SIBs should not lead to a higher calibration of the MREL ratio (in the second step, as decided by the resolution authority) for banks with a higher relative share of RWAs over total assets.

In addition, it should be considered that smaller banks generally use standard methodology and do not benefit from reduced RWA computable by using IRB methodologies[1] (even if this difference should be reduced in the context of Basel 4). Therefore, bearing in mind the difference between IRB banks and non-IRB ones, there is a need for a relevant proportionality measure (see point 4).

Furthermore, the EACB members see merits in the proposal for clarification of the total liabilities and own funds used as denominator in various articles of BRRD (e.g. for the determination of the 8% bail-in before draw down of the SRF). As envisaged by the EBA, we are supportive of the full contractual netting option as defined in section 4.1.3 in relation to derivative liabilities and netting rights. In addition, we support the exclusion of central bank reserves in the total measure of the leverage ratio[2].

<u>Defining total liabilities and own funds</u>

We would note that under MREL, Tier 2 should – at worst – be treated no different than any other eligible MREL liabilities and potentially receive full MREL recognition until maturity and/or

[1] See Pieter De Groen - European Parliament In-Depth Analysis, July 2016, "Total Assets versus RWA: does it matter for MREL requirements?".
[2] In this regard see the UK Financial Policy Committee recommendation and Prudential Regulation Authority statement:
http://www.bankofengland.co.uk/publications/Documents/records/fpc/pdf/2016/record1608.pdf
http://www.bankofengland.co.uk/pra/Documents/publications/reports/prastatement0816.pdf

call (i.e. without the 1-year taper) given it would be better quality MREL and can be written down at PONV.

RELATIONSHIP BETWEEN MREL AND OTHER REGULATORY REQUIREMENTS (Section 5)

The EACB members see the removal of double counting as prudent based on the assumption that the MREL ratio is calibrated accordingly, i.e. recapitalization amounts required under a resolution scenario are measured to achieve capital ratios excluding buffers. Yet this should be applicable for institutions subject to an MREL requirement above capital requirements, while for the smaller institutions we strongly support the EBA finding that for them it would be "more difficult to meet any resulting increase in MREL requirements through instruments other than capital…due to different degrees of access to capital markets." This is particularly the case if the resolution authority comes to the conclusion that an institution will not go into resolution.

Lastly, for the purposes of bringing clarity and certainty for investors as well as for banks, we suggest that the MREL requirement be inserted within the CRR in a different section than the one on "Own fund requirements". This should among other things avoid any misinterpretation with the concept of maximum distribution amount (MDA) restrictions on voluntary distributions.

Breach of MREL

The EACB members are of the view that it is very important for all the requirements on MREL breach to be harmonized in a single framework in order to ensure utmost consistency and avoid any possible conflict of measures between the various authorities involved, while providing procedural certainty to the concerned institutions.

With regard to the treatment of MREL breach, we note that it should not be an automatic indication of failing or likely to fail; rather we strongly believe that the treatment should depend on the underlying cause of the breach. In particular, one may consider at least three different situations:

- MREL breach through non-capital breach (i.e. through a shortfall of MREL eligible debts)
- MREL breach through a capital breach
- MREL breach through both capital and eligible debt shortfalls

Only once the type of breach is duly established, it could be properly determined which authority - supervisory or resolution, is competent to intervene.

In order to achieve better procedural certainty and clarity, a new section in the recovery planning which deals with a MREL infringement might be introduced. Recovery planning should be integrated by scenarios and options in case of a MREL infringement. By doing so, there is an enhancement of articulations between recovery planning and resolution planning, including allocation of responsibilities between authorities involved and the supervised institution. As the recovery plan assessment falls under the responsibility of the CA subject to the right of the RA to provide observations, scenarios and options dealing with a MREL infringement should be assessed jointly by the CA and the RA[3]. In a first stage, a bank that is in breach of MREL shall

[3] MREL is set by the RA when drawing up the resolution plan; however, when setting the MREL, the RA should consult the CA. Therefore, the proposed solution enhances articulations and consistencies between recovery and resolution planning.

enacts options foreseen in the recovery plan, under the control of the CA (previous options can be reviewed and updated, including the timeframe to deliver the required outcome). In this first stage an MREL breach shall not oblige a bank to use its combined capital buffers to fill the MREL gap. A second stage may be triggered if shortly before the end of the first stage, the competent authority takes a decision that the bank is likely not able to re-establish the MREL requirement in the agreed timeframe. Such a decision shall empower the resolution authority to instruct further corrective measures.

In the same vein, the nature of the breach shall characterize the proportionality of supervisory or resolution authority measures. Thus, it is necessary to make sure that the intervention regime avoid a situation where there is no breach with respect to the capital ratios set by the competent supervisor, but at the same time the resolution authority is already entitled to initiate intervention measures. More specifically, while the EACB Members agree that the breach of capital levels must be considered very seriously and is already addressed in CRR/CRD IV, we note that the breach of eligible debts (without a breach of capital levels) should, in first instance, result in a discussion between the bank and the authority upon the means to remedy the shortfall. It should not be considered as an emergency situation given that eligible debts are only gone concern elements. Thus, in the case of an MREL breach through a shortfall of eligible debt, we recommend that the regulation introduce a “grace period” of 6 months, renewable once to cope with temporary closing of financial markets that may prevent a bank to renew its eligible debt instruments. In the light of this, we oppose the EBA proposal that any breach of MREL should result systematically in an assessment of whether the PONV is reached.

Furthermore, we are of the view that MREL breach should not automatically lead to MDA restrictions. Firstly, 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. Secondly, a 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. Finally, the elimination of automatic MDA restrictions puts less pressure on banks for disclosing their MREL requirement.

<u>Approval for redemption of MREL – eligible liabilities</u>

In order to ensure a smooth and efficient liability management, early redemption of MREL-eligible liabilities should be allowed without a prior approval from the resolution authority, where this redemption does not breach MREL. It would otherwise become very complicated for an institution to be a market maker for the eligible instruments that it has issued although this is essential for liquidity purposes. This aspect has been extensively discussed at the FSB level during the course of the TLAC discussion and eventually agreed upon in the final version of the TLAC Term sheet. Additionally, the introduction of a compulsory approval for any redemption of MREL-eligible liabilities would lead to a significant burden for both, institutions and competent authorities.

We therefore are in favor of the last option proposed by the EBA (see page 51).

ELIGIBILITY CRITERIA FOR MREL (Section 6)

Subordination

We support the harmonization process on EU level with regard to the subordination rankings, while at the same time we note that the national specificities and legal regimes have to be well reflected in the process of harmonization. The EACB members acknowledge that EBA outlines the variety of existing legal methods for subordination and takes note of the existing policy initiatives on subordination on national level aimed at improving the resolvability of banks and assist in compliance, while not providing swift estimations on their potential impact. Indeed, a more profound analysis is required and the EACB members will gladly provide expert input in such an initiative.

Third country recognition of resolution powers

Considering the overall goal of market-transparency and equal terms of competition within the EU, we are of the view that implementing certain additional product-related exemptions and avoiding different solutions on the national level in this case would best fit the purpose of reducing the burden of compliance with third country.

In addition, waivers from Art. 55 BRRD should be included in the provision itself. Thus, for instance, if it is not foreseen for an institution to go into resolution, contractual recognition clauses (especially for existing contracts) regarding bail-in, respectively write-down or conversion rights of resolution authorities, are obviously redundant.

CALIBRATION OF MREL (Section 7)

We are fully supportive of the intention to ensure different business models will be considered in the calibration of MREL and that a differentiated approach is applied to all firms to ensure that no business models are competitively disadvantaged by a heterogeneous approach.

In our view the TLAC requirement should be considered as the reference point for G-SIBs, given that it has benefited from G20 political endorsement, in addition to a comprehensive quantitative impact study which demonstrated that it was enough to encompass both loss absorbing capacity as well as recapitalization amount. Any further requirement should be duly justified by the resolution authority on a sole basis of factual and major impediment to the resolution. And the level resulting from the application of the RTS on MREL should be viewed as a cap for the calibration of this possible further requirement.

Furthermore, we welcome the EBA view that the 8% consists only as an amount of liabilities to be bailed-in in order to benefit from the access of the SRF and cannot be envisaged as a floor for calibrating the MREL.

From a procedural perspective, we suggest that the MREL yearly assessment should be carried out at the same time as the SREP assessment.

Internal MREL

The general principle should be that internal MREL is not required if there is a sufficient level of confidence between authorities: this should be the case in the same jurisdiction, and within Europe, at least in the euro area, where there is a single supervisory authority and a single resolution authority. This would be consistent with the TLAC Term Sheet provisions.

In case of mixed capital ownership with minority shareholders, it should be allowed to issue also external MREL (to the extent of the minority interest share) provided that the conversion of this MREL does not trigger a change of control which is a condition in the TLAC term sheet.

INTRAGROUP ISSUES (Section 8)

While the EBA notes that there is no need to change principles of setting MREL on an institution-by-institution basis, we shall outline that there are many different resolution mechanisms in the private sector which should be taken into consideration in an appropriate manner - notably Article 10 CRR groups with joint and several liability schemes, cooperative models under Art. 113 (6) CRR and IPS systems. Recital 23 and Art. 32 BRRD explicitly acknowledge private sector measures. Indeed, Article 10 CRR groups have built in resolution mechanisms for individual member banks which are widely recognized in banking legislation. These mechanisms provide such a protection on individual institutions that a group level MREL requirement would be sufficient, while also observing the NCWO principle. Otherwise, MREL requirements on individual institution level for such models could lead to capital requirements on individual level through a back door and therefore contradict Article 10 CRR waivers. In this context, we also recall CEBS Guidelines regarding revised Article 3 of Directive 2006/48/EC (18 November 2010), according to which article 10 CRR group's central body and its affiliates form a unity and should thus be treated equally to one institution with many branches (see section 6).

Additionally, we note that the relevance of an IPS has been recently acknowledged by the ECB in its Guide on the approach for the recognition of institutional protection schemes (IPSs) for prudential purposes. According to the Guide, the ECB assesses whether the IPS can provide sufficient support in the event that a member institution faces severe financial constraints regarding liquidity and/or solvency. In ECB's views intervention by the IPS is deemed to be triggered, at the latest, where there is no reasonable prospect that any alternative measures, including the recovery measures provided for in the recovery plan, would prevent the failure of that institution. Against this background, the case that a member institution of an IPS will go into resolution and the resolution instrument of bail-in will be applied is negligible. This has to be carefully considered for the purposes of the determination, respectively calibration of MREL.

In any case for institutions not going into resolution determination, respectively calibration of MREL beyond the relevant own funds requirements is not justified. Due to the high impact of MREL (especially on medium-sized, predominantly deposit-funded institutions where resolution measures are planned), it is necessary to set longer transitional periods to phase-in MREL requirements after the final determination of the MREL eligibility criteria has been concluded.

FURTHER COMMENTS PARTICULARLY SOLICITED BY THE EBA:

Is there a sound market for MREL liabilities for small/medium banks?

The computation of the quantum of MREL-liabilities is, so far, a difficult exercise. Banks, markets, media and investors yet haven't 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.

Moreover, regulators of different countries have already indicated that bail-inable instruments should be deemed unsuitable for retail investors. However, retail investors represent the main investors base for small and medium size banks. For local cooperative banks whose members are also the principal customers, retail investors represent the sole investor type they deal with. Small and medium size banks may find themselves obliged to issue a certain type of debt instruments to meet MREL requirements but constrained to sell those instruments in their main investor basin.

In particular, certain provisions on of the MiFiD financial instruments could become relevant for bail-inable debt instruments/MREL eligible instruments (especially when issued for retail customers) MREL eligible instruments especially if they comprise subordination requirements would be qualified as complex products under MiFiD rules.

Proportionality. Small – medium – less complex banks

These banks should benefit of proportionality measures. As they are less likely to create a systemic risk, any MREL measures should take duly account of the marginal systemic relevance of risk embedded in their activity, even in a resolution scenario. Furthermore, banks that use standard IRB approach should benefit of a reduction on MREL measures. We would like to underline that the quality and quantum of MREL-eligible liabilities is a particular issue for institutions with peculiar legal forms or governance/business models, namely deposit-funded banks, cooperative banks or other institutions with limited access to financial markets. To this end, we agree with the point 6, on page 16 but we would like to propose to envisage specific legal provisions and thresholds (in terms of greater percentages of eligible senior bonds and less percentage of MREL) aimed at such types of institutions.

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