Consultation Response

Public consultation on the future of MREL policy

13 February 2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the SRB's **public consultation on the future of MREL policy.** AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is registered on the EU Transparency Register, registration number 65110063986-76.

We provide below our high-level introductory comments, which is followed by answers to the individual consultation questions raised.

Introduction

Firstly, AFME welcomes this initiative of the Single Resolution Board (SRB) to engage with the industry and marks a step change in approach. We would also like to acknowledge that the work the SRB has engaged in over recent years has significantly enhanced resolution planning, the build up of the Single Resolution Fund (SRF) and the accumulation of own funds and stable eligible-liabilities, which has all contributed to enhanced financial stability. Given the progress that has been made in these areas, we believe it is appropriate to review and adjust the MREL policy and levels to take into account the additional features that have been introduced and enhanced since MREL was first designed and implemented, and to recognise the different structures, resolution entity statuses, and resolution strategies for banks across the EU. It is worth mentioning that banks' MREL targets have kept increasing despite all the improvements in resolution planning and resilience following the inception of the resolution framework.

Furthermore, the industry shares the SRB's analysis and concurs with the lessons learnt from recent and older crises as outlined in the introduction to the consultation, especially when it comes to the possible combination of several resolution tools for all banks, including GSIIs, which directly impacts the setting of MREL targets. It is further of the opinion that, under the current legal framework, several changes in the MREL policy can and, ideally, should already be introduced in the coming resolution planning cycle, capitalising on the very significant progresses made since the MREL framework was initially set up.

Nevertheless, we set out our concerns in relation to the proposals. It should be noted that the proposals remain at a high level and without a level of specificity in terms of possible changes to existing MREL policy which would have allowed for a more in-depth analysis as well as better preparedness for the upcoming resolution planning cycle. As such, we believe it would be beneficial for an industry roundtable prior to the finalisation of the policies.

We outline our response to individual questions in the remainder of this paper.

Consultation Questions

Question 1.1. Which criteria would you use to identify the assets / liabilities subject to a transfer strategy in addition to those listed in guiding principles for perimeter identification (e.g. Business activities, size, separability, marketability)?

As a guiding principle, we would first like to note that the application of additional resolution tools is not expected to fit all banks and is mainly applicable for stand-alone parts of the company which can be sold/transferred rather quickly; perimeter setting should take this into account.

Where there are stand-alone parts that can be considered for transfer, we believe that transfer tools, particularly in the case of EU headquartered banks, including for the largest banks, should be considered as a complement to the bail-in tool and where included as part of the preferred resolution strategy ("PRS") – whether or not the PRS is single point of entry – should be reflected in a lower recapitalisation amount as part of MREL target calibration.

At the same time, a clear view of SRB's requirements regarding the operationalisation of these complementary tools (documentation, testing…) versus the extent of the potential impact on the MREL target calculation would be welcome, allowing adequate planning and possible anticipation. In this regard, the banking industry expects that the SRB leverages essentially on the bank's demonstrated capacity to transfer portfolios or sell entities without requiring as detailed documentation as for the bail-in tool that is specific to a resolution context only.

Nonetheless, besides the SRB guiding principles for perimeter identification[1] that focus on the transfer of the core activities of the bank, additional and specific principles should be considered when transfer tools are intended to be used as complements to bail-in. As per the 2021 SRB operational guidance for banks on separability for transfer tools, a number of banks under the SRB remit have prepared an advanced SAR (Separability Analysis Report) and a related transfer playbook. Consequently, these banks must already have identified potential Transfer Perimeters.

This guidance already includes the following principles. Potential transfer perimeters should:

- Represent clear sets of businesses potentially attractive to third party acquirers in case of Sale of Business;
- Preserver the continuity of critical functions (if any is included in the perimeter, implying that the selected acquirer must be able to ensure it)
- Be able to be easily structured from a legal, financial, and operational viewpoint, enabling an efficient transfer under the responsibility of the resolution authority in case of resolution, including, but not limited to business lines and/or entities that are organised in a more standalone manner.

In addition, when envisaged as complements to bail-in, these transfers:

[1] As outlined in the Appendix to the SRB's Operational guidance for banks on separability for transfer tools : https://www.srb.europa.eu/system/files/media/document/20211025%20SRB%20Operational%20guidance%20for%20banks%20on%20separability%20for%20transfer%20tools%20FINAL.pdf

- Should be proportionately impactful from a solvency and/or liquidity standpoint. As transactions generally mobilise key staff in relatively large numbers, which might be necessary to support several resolution actions in times of high stress, dispersion on many different actions with limited impact should be avoided.
- Should be actionable within a short timeframe; to note, when the disposal of the perimeter is an option of the recovery plan, preparatory work would have been engaged in the run-up to the resolution phase.
- Should focus on activities that are not considered as core to the expected post-resolution banking group i.e. the transfer should protect the franchise, and the interest of clients to the extent possible (in the case of a transfer to a 'bridge bank', the transfer should encompass the core activities to ensure a viable post-resolution banking group / franchise).
- As relevant, could include non-performing assets or activities that would harm the reputation, entail important risks (potentially difficult to manage post-resolution) or impede the restructuring of the post-resolution banking group.

We would also like to emphasise the importance of coordination between Resolution Authorities to ensure that the SRB's regulatory perimeter is protected in a crisis, such that other jurisdictions do not prescribe actions for entities that fall under the SRB's remit and vice versa. Further, the SRB should take actions consistent with the Group resolution strategy, whether that be MPE or SPE. Any regulatory actions deviating from the set strategy, including where the SRB is not the Group resolution authority, should be clearly justified and used only in exceptional circumstances.

Noting all of the above, we would like to caution that the application of additional resolution tools should not endanger the set SPE or MPE strategy and lead to national ringfencing. Furthermore, where the use of a variant resolution tool is considered for non-EU banks in order to execute the group SPE or MPE strategy, this should be agreed with the home / group resolution authority as part of a regulatory college or otherwise.

Question 1.2. Do you have comments on how a partial transfer would influence the composition and risk profile of the balance sheet of the resolved bank for the recapitalisation needs?

The answer to such a question primarily depends on the resolved bank's characteristics in terms of its risk profile, size, funding and business model, and inherently calls for a case-by-case analysis. The following necessarily relies on theoretical projection, yet we have still tried to draw out relevant criteria to be taken into consideration across the board.

If transfer perimeters are proportionally impactful from a solvency and/or liquidity viewpoint, partial transfers would very directly reduce the recapitalisation needs of the resolved bank.

Furthermore, the business model of the post-resolution group should necessarily change compared to the pre-resolution one (which would likely have proven inappropriate). Partial transfers would help adapting the business model. Besides the size impacts, these transfers should be taken into account when estimating the required capital buffers of the post-resolution group, which should be calibrated on a smaller, different, and normally less risky group than the pre-resolution one. Similarly, P2R evolution post resolution would be expected to reflect such lower risk.

Next to these elements, we would like to draw to your attention that the natural business attrition of a bank in the run-up to resolution should also be considered when calibrating the recapitalisation needs. This is particularly true for corporate and institutional banking activities and even more so for global market activities where clients and counterparties would necessarily limit their business volumes with a banking group of which the situation deteriorates. As a matter of fact, rating downgrades below defined thresholds constitute automatic triggers of termination of business for certain transactions and counterparties. This business attrition will entail a material reduction of the balance-sheet well beyond the "balance sheet depletion" as used today in the MREL calibration by the SRB. Crédit Suisse's market activities, for example, significantly reduced in just a few months before the crisis.

Question 2.1. External MCC for resolution entities: what do you view as the main factors for a bank to be able to sustain market confidence during and immediately following resolution?

When considering the merits of the MCC, we conclude that as an addition to existing requirements, in going-concern, it would create a drag on profitability and reduce a bank's lending capacity – in a sense, the opportunity cost of the MCC in going concern is the retained earnings i.e. capital generation that has been sacrificed through the lower lending capacity. Further, the impact on development of the balance sheet to generate capital will also hinder future recapitalisation efforts after resolution, with lower income generation capacity is more likely to impact market confidence in the first place. At the same time, and as previously stated, there is little evidence that the MCC is an important determinant that affects market confidence post-resolution. Overall therefore, we believe it is beneficial to avoid the MCC and resulting costs brought from the otherwise higher MREL requirements imposed on banks.

As a matter of general considerations, we would like to emphasise that market confidence is a matter of credibility that can only be recovered over time after an institution has gone through severe troubles, and even more so after it has been formally declared FOLTF. Even a very high MCC would make little difference in the investors and creditors attitude following a resolution in the industry's view. As such, it appears incongruent to expect buffers to be in place immediately, notwithstanding the fact that a bank will have 3 years[2] to build up MREL.

In the short term, banks that have been recently resolved are unlikely to distribute dividends as assumed by investors. In the case of a resolution, AT1 capital is likely to be depleted, therefore there is no need to pay discretionary AT1 coupons. Thus, there is no immediate requirement to fully increase capital buffers after a resolution takes place.

In our view, rather than focussing on re-building capital buffers after a resolution therefore, here are some other important elements that should help to restore market confidence:

- The resolution plan must be credible and effective for there to be market confidence. As a result, the SRB must communicate and keep an open dialogue to highlight that there is an effective approach in place, and important timelines must be identified and relayed to the industry and stakeholders. Communication from authorities is key to support market confidence following a resolution. A case study for good financial communication over the years is that of Novo Banco.

[2] In line with EBA Guidelines on improving resolvability for institutions and resolution authorities (EBA/GL/2022/01)

- If central banks provide a clear message that they support a resolution, then investors are more likely to lend to resolved banks that receive support from the central bank. More specifically, this could be achieved if programmes such as the Emergency Liquidity Assistance (ELA) or ad hoc ones can be utilised for resolved banks. Clarity with regards to a liquidity backstop is a very important factor for market confidence.
- Confidence will only be restored if investors assess the resolution plan as credible and see it executed. In this sense, it is essential that the execution of any announced plan is decisive, effective, and timely. This should demonstrate that the issues having caused the quasi-failure are tackled and that business model of the bank is adjusted accordingly, leading rapidly to a stabilised situation and gradually to a sustainable (profitable) business model.

Question 2.2. Internal MCC for subsidiaries that are non-resolution entities: when setting an MCC for subsidiaries, what do you view as the main drivers for subsidiary banks to regain market confidence after the application of write-down and conversion powers?

We do not believe that an MCC is a relevant consideration for a subsidiary that is not a resolution entity. In fact, we struggle to envisage any circumstances in which it would be appropriate to set an MCC for such an entity. Rather, the key determinant of market confidence for a subsidiary is the support that is provided by the group and the ongoing ability of that subsidiary to operate as part of and benefit from the franchise of its group.

Further, another key determinant of confidence in a subsidiary would be the clear understanding by the market that the group resolution strategy is operating as envisaged and that home and host resolution authorities are demonstrably cooperating, with consistent messaging to the market and exercising their resolution powers consistent with the group resolution strategy.

In summary, to ensure market confidence for the subsidiary, effective execution of group resolution plans is most important, as opposed to the capital base of the subsidiary.

Were the SRB minded to set an MCC despite the prevailing arguments against it (see above and response to question 2.1), we would ask that the SRB review the definition of “wholesale funding” and the determination of a firm as “complex”:

Wholesale funding

In our view, the definition of “wholesale funding” should not include client-related funding as corporate deposits nor some institutional deposits. Further, the circumstances in which use of wholesale funding by an entity necessitates an MCC should be extremely limited. In circumstances where the subsidiary has other sources of funding and other means of ensuring market confidence (e.g., funding from Group through a support agreement), such that it would not be materially reliant on wholesale funding as a core part of its post-resolution business model, an MCC would not be appropriate. Rather than a purely statistical approach, an institution-specific one should be adopted.

Determining Complexity

Any determination that a firm is “complex” should be done on a firm-specific basis considering different indicators such as business model and products offers, and should not merely use size or activity in capital markets as indicators of complexity. In addition, this determination should be linked to the determination made under Principle 7 of the Expectations for Banks on complexity and the SRB should provide a clear

justification if it deems a non-resolution entity as complex. In any case, a level playing field should be ensured in the application of the requirements.

Question 3.1. Do you have any comments on the described approach for eligibility monitoring that a resolution authority should implement to ensure effective loss-absorbing capacity?

Although the SRB has an interest in ensuring regulatory compliance with respect to the eligibility criteria, there must be a balanced approach for the issuance of bonds due to the standardised nature of such issuances. These issuances are becoming more prevalent, continuing the trend noted in the EBA's TLAC / MREL monitoring report in October 2022[3] where the EBA observed "a substantial increase in new SNP issuances from jurisdictions where no issuers had issued previously". As such, to simplify the process of bond issuance, the SRB should consider whether banks can provide a self-assessment of their respective issuance programmes every year, in contrast to producing and sending a self-assessment at each issuance which would help to reduce the workload burden on banks. Alternatively, a simplified template would help facilitate a more efficient and proportionate approach or rather than requiring management sign-off for each issuance, SNP issuances could be sample tested (on a random basis) during onsite inspection visits.

In any case, if the SRB maintains the idea to report each new issuance, materiality should be considered; the SRB should at least set a minimum threshold on the size of the issuance, on a case-by-case basis, above which individual issuances are subject to the reporting requirement. In addition, new issuances should be scoped to public issuances as these are most relevant compared to private issuances that are more recurrent but smaller in size. Proportionality is essential to not overburden banks.

In addition, and for the avoidance of doubt, the banking industry would appreciate a confirmation from the SRB that there will not be a double declaration on the monitoring of eligibility regarding the own funds instruments: to the ECB on the one hand and to the SRB on the other hand. It is important as well to confirm that this eligibility check would apply to the new issuances only and not to the existing stock.

Question 3.2. While MREL-securities traded on capital markets and/or subscribed by professional investors show a high degree of standardisation and harmonisation of practices, liabilities arising from different legal arrangements (i.e., incorporated into private-placement agreements) do not. Are you aware of any specificities presented by non-standardised claims that would be worth taking into account for the purpose of eligibility monitoring activities (also in light of the current management sign-off process)?

We are not aware of any specificities presented by non-standardised claims that would be worth taking into account for the purpose of eligibility monitoring activities.

[3] https://www.eba.europa.eu/sites/default/files/document_library/Publications/Reports/2022/1040363/TLAC-MREL%20instruments%202nd%20Monitoring%20Report.pdf

Question 4.1. Closing of derivative contracts (valued on a net basis) through bail-in may lead to replacement costs incurred by the bank, particularly in respect of open positions for the bank which require re-hedging. In your view, under what circumstances would the costs related to close-out be high enough to lead to destruction of value (meaning that holders of other/non-excluded liabilities would be better off when particular derivative contracts are excluded from bail-in than if derivatives were bailed-in)?

The bank whose transactions are bailed-in needs to re-hedge the corresponding risk, leading to high-re-hedging costs when the corresponding market risk is significant. The effect will be magnified where the bank has little or no market access in the context/aftermath of the bail-in as market counterparties can be expected to stay away from a stressed institution to which they are already exposed. One also needs to bear in mind that the re-hedging exercise would consume scarce trading resources at a difficult time. Closing out of derivatives with clients, including non-financial counterparts who themselves will have entered the trade for risk management purposes, will also be detrimental on the franchise value due to the business disruption and need for the client to re-hedge its position with the market or retain an unhedged risk due to inhibitive costs of re-hedging.

One should not assume that the risk to be re-hedged would be low due to some portfolio effect. There is a likelihood that all the portfolios which have a negative value (from the bank's point of view) share the same directionality with respect to some market factor (EUR swap rates, USD/EUR exchange rate …) and their risk would aggregate rather than diversify away. In some cases (energy hedges), the offsetting risk would clearly come from trades which are not bailed-in because they have a positive value for the bank (the value of trades with producers has generally the opposite sign of those with utilities). One could not assume only a subset of markets / underlying products would be affected and would have instead to expect a general disruption.

Beyond the direct impact of the above re-hedging on the bank and other market participants, some general market contagion must be expected (higher risk premia, higher transaction costs, lower liquidity …). The systemic impact would be negative and its size difficult to quantify in advance. As such, the bail-in of derivatives would create potential systemic risk for relatively low added value as derivatives are partly collateralised.

However, the following points can be made:

Bailing in a balanced portfolio of commercial derivatives and their market hedges is likely to cause significant destruction of value for the affected clients of the bailed-in bank as they have to rush to re-hedge their commercial exposure in a stressed market environment.

The effect of bailing in a directional portfolio is more difficult to estimate. However, if one assumes that a bank finds itself in resolution in consequence of their directional derivative position taking, one can assume that a specific directional (i.e. unhedged) derivative bubble is the cause of significant losses, pushing the bank to the brink. In such a case, bailing in a specific set of derivatives will be value accretive. However, the net effect of bailing in all derivatives under master agreements that pose a liability to the bank is hard to generalise.

- If a well-diversified commercial bank took a large bet in e.g. the energy market by placing a few large hedges with energy producers, bailing in on master agreement levels may de-risk the bank without harming their corporate client base unduly.

- If the same well diversified commercial bank decided instead to engage in a directional play on a key industry in their portfolio (by not hedging the commercial risk in the market), bailing in all negatively valued master agreements will severely harm their corporate client base to achieve sufficient de-risking.

These points illustrate that there will be circumstances where it may be in the interest of the failing bank and its customers if only a selected set of master agreements (as opposed to all master agreements presenting a liability for the failing bank) or of derivative types would be included in the bail-in. However, without a market risk-based analysis of the bank's portfolio, it is not possible to determine which master agreements and/ or derivative types would lead to the required de-risking levels while causing the least harm to the client base.

Question 4.2. Under which circumstances and to what extent could bailing-in net liabilities under derivatives (after close out) negatively impact a bank's business, leading to destruction of value? Please elaborate (e.g. potential differences across different banking business models or types of derivatives themselves). Do you think the exclusion of other types of liabilities could lead to such effects?

Such an issue arises when there is an adverse impact on a bailed-in counterparty that also happens to be a debtor to the bank in resolution or other third parties. This could result from the counterparty having suffered a loss and being no longer properly hedged, and therefore having a worsened credit profile as a consequence. In some cases, issues with the hedging program could trigger some covenants and lead to a direct acceleration or deterioration of financing structures. The resulting increase in Expected Loss on the bank in resolution's financing exposures will have adverse consequences, possibly in the very short term if it triggers new accounting provisions and will eventually lead to higher realised credit losses, lowering retained earnings and capital.

Consider a few extreme cases of banking business models:

Case 1: a European lender to mainly EU-focussed corporates. These corporates each have some small international business for which they hedge their EUR/ USD risk with the bank. Let us assume that half of the master agreements present as liabilities. In this case, half of the bank's client base lose their commercial hedges. As the EUR/ USD business is only a small part of their operations, cost for re-hedging will be limited and can be absorbed (i.e. not causing the client to fail). The client faces higher cost which in some cases may be sufficient to cause a rating downgrade. Overall, the clients absorb the loss without causing their credit risk to become a concern for the bank.

Case 2: as Case 1, but the clients' business is more international and besides currency derivatives, they rely on commodity hedges to cover the cost of their production material. In a bail-in, the cost for the clients will be significantly higher. Some clients may see their cost situation degrade below a level where credit covenants are breached and financial losses drive some companies into bankruptcy, harming the newly recapitalised bank's credit book, reducing their client base and causing an economic shock to the domestic economy.

Case 3: a bank with a significant business model selling to banks and non-bank financial institutions (FI & NBFI clients). The bank provides prime brokerage services to hedge funds, lending to investment vehicles

through its trading book. In such a case, there are several points where a speculative bubble large enough to threaten the bank's survival may form (e.g. failing hedge funds causing losses; investment vehicles defaulting on their obligations; trading book amassing losses). In a situation where the main business of the bank is healthy, but the losses in their trading book become unmanageable, simply cutting hedging for all clients with a net negative derivative position would cause economic loss to clients while not addressing the root cause of the FOLTF situation (i.e. the trading positions). In such a situation, a tailored intervention by the regulator, targeting only selected derivative types or client groups would reduce the overall economic consequences of the intervention.

Beyond the cases above, we would encourage the SRB to expand their policy analysis / thinking to cover other type of liabilities, beyond derivatives, where bail-in is not a credible tool for the purposes of meeting resolution objectives e.g. custody related liabilities - operational deposits.

Question 4.3. Some instruments have been hedged externally and thus their bail-in would also require a winding down of the corresponding hedge. In your view, can this lead to destruction of value (meaning that holders of other/non-excluded liabilities would be better off when such liabilities are excluded from bail-in than when they are bailed-in)? If yes, under which circumstances (e.g. does it depend on the hedging purpose such as economic or accounting)? Do you think this could be the case for structured notes with embedded derivatives? In such case, please provide concrete examples of structured notes where destruction of value could appear.

In case of a bail-in of one or more externally hedged instruments (which could be any bond, not just structured notes) this could indeed result in changes to the bank's interest rate (risk) and foreign exchange positions, which may require a winding down of the bailed-in instrument's corresponding hedge and associated (derivative) trades, or alternatively closing or changing of the open positions with a counter-hedge. This could either be achieved on a per instrument or more aggregated basis. The latter could be more operationally and/or cost efficient than winding down individual positions and underlying derivatives (where such connection can be made) on a hedge-per-instrument basis, but this is highly situational and indeed there is also a market dependency depending on the approach taken. There may be relevant cases in which the principal amount of an issued instrument is only partially bailed-in, especially where this part concerns only a small fraction, although the P&L impact and unwinding costs of the associated hedge or re-hedging costs may also be lower in those cases. A case-by-case evaluation would be necessary to determine the specific risk in each situation. That said, we would generally expect that the bail-in of the principal amount of an instrument and the contribution to loss absorption and/or recapitalisation would outweigh any negative impact and hence no (discretionary) exclusion should be applied for that reason.

Since question 4.3 refers to generic financial instruments, and provided that - in general – we deem that the position of the Industry about the impacts of bail-in of derivatives contracts (different from those embedded in structured notes and from investment certificates securities) have already widely explained in previous answers 4.1 and 4.2 , here below we identify some other *("other" with respect to pure derivatives contracts*) broad classes of bail-inable instruments which cover most of the bail-inable eligible instruments and we analyse the implications of a bail-in on their corresponding external derivatives hedges:

- issued own bonds that can be both vanilla or structured (naked bond plus embedded derivatives) with different degrees of subordination/seniority and usually under a hedge accounting regime. Should some of these liabilities be subject to bail-in, the corresponding hedging derivatives would have to be partially wound down or the position should be re-hedged taking into account, amongst others, the notional percentage of the bailed-in instrument that would be written down or converted into equity shares as a result of the bail-in. For vanilla instruments this process might be easier and with relatively lower costs than for structured notes. Even if all considerations already presented in previous answers (e.g. possible distressed market conditions, less liquid inputs with larger bid-ask spreads, etc.) would apply here too, and they would be more evident and pronounced for structured notes, we think that this will be a necessary consequence of the bail-in process and generally we would expect that the loss-absorbing / recapitalisation effect resulting from bailing-in (the principal amount) of an issued instrument would not be outweighed by the impact/costs associated with hedges that may arise as set out above, and hence not a reason for excluding such issued instruments from bail-in;

- issued own investment certificates, with full, partial or no capital protection (on different asset classes, such as equity, fx, commodity, etc.) and with economic hedges that might be either exchange traded or external OTC derivatives (under bilateral agreements or centrally cleared); the risk management and the accounting regime would be different from the case described above, but should some of these liabilities be subject to bail-in, the corresponding economic hedges should be wound down or sold according to the equity conversion percentage and similar considerations as above would apply;

- to the extent that deposits would be bail-inable, liabilities represented by the parts of deposits non covered non preferred (NCNP) and of deposits non covered and preferred (NCP) that have been hedged externally: about the former (NCNP) part, which is likely the more heavy part of the external coverage related to deposits, SRB methodology for the NCWO assessment assumes that most of the NCNP deposits will be withdrawn in the run-up to resolution, as they are the deposits of large corporates and financial institutions who are very reactive in case of deterioration of a bank's position, and therefore the corresponding winding down of the external hedges will be greatly reduced in size. About the latter (NCP) part, consisting of deposits of natural persons and SME above 100.000 EUR, in some Member States the current depositor preference rule makes them less likely to be impacted in a bail-in. As above, the risk management and the accounting regime would be different from the cases described above, but should some of these liabilities be subject to bail-in, the corresponding economic hedges should be winded down or sold according to the equity conversion percentage and similar considerations would apply.

In conclusion, we can say that the Industry believes that although in some cases the considerations already presented in previous answers (e.g. possible distressed market conditions, less liquid inputs with larger bid-ask spreads, etc.) would apply here too, the possible costs are not an obstacle to the inclusion of bonds, structured notes, investment certificates, deposits instruments in a bail-in.

Our opinion is also supported by the fact that the NCWO principle does not state that the Authority should follow the path that minimizes the losses for any stakeholder, but that it states only that the losses due to the bail-in process should be lower than those in insolvency, giving floor to the Authority to follow paths that could increase the losses of some stakeholders and at the same time allow a better result of the bail-in process as a whole.

Question 4.4. Without prejudice to the considerations for discretionary exclusions regime, as regards bail-in operationalisation:

- **Are there any operational challenges that may hamper the bank's ability to provide, on short notice, the information about its derivative contracts as required for the purposes of valuation pursuant to Articles 36 and 49 of BRRD? If so, do these challenges concentrate in any particular category of derivatives?**
- **Are there particular types of collateral that might create operational challenges to determine – in a short timeframe – the extent by which the value of secured liabilities, or a liability for which collateral is pledged, exceeds the value of the assets, pledge, lien or collateral against which it is secured?**
- **Are there particular challenges – in a short timeframe – in identifying the amount of a deposit that exceeds the coverage level provided for in Article 6 of the Deposit Guarantee Scheme Directive which would be eligible for bail-in?**

For derivative contracts, one must consider the operational challenge of looking at the whole portfolio, valuing it according to the requirements of Article 36 BRRD and making the assessment required by Article 49 BRRD. These tasks will necessarily take a long period, even if one has access to significant resources. Article 49 BRRD requires an analysis much beyond the valuation of derivatives exposures: one must not only evaluate the credit impact of the bail-in on the counterparty, but also consider its liabilities (which would be assets of the bailed-in bank).

As a point of comparison, while the termination of derivative transaction in a "regular" default situation (single entity, no significant market impact or systemic dimension) can take place very quickly, the process of finalising the computations and preparing the resulting claim notice to communicate the claim amount to the counterparty typically takes several weeks. In a bail-in scenario, a similar process must be run concurrently for a large number of claims / counterparties, in what is likely to be a similarly stressed market where there are potentially numerous stressed entities.

One must also take into account that the evaluation of replacement transactions is a complex exercise as these transactions can be done in a number of ways:

- Replacement transactions can be "exact" replacement transactions for which the suitability review needs to assess "only" the correctness of pricing / timing, which requires using some difficult-to-estimate parameters, such as various value adjustments that can differ between counterparties. The same replacement transaction for two different counterparties could therefore be done at different prices because of different adjustments. Further, making any assessment about fairness is not straightforward; if one set of replacement trades is not accepted, one of the bailed-in counterparties will be at a risk of further loss through no fault of their own, particularly where they follow the contractual close-out process. Put another way, counterparties cannot know ex ante what process will be deemed "reasonable" for these purposes, particularly where this departs from the contractual close-out provisions which have been pre-agreed and which are standardised in the market.
- Replacement trades can also be "at market", where the bailed-in counterparty is instead hedging its overall market risk without looking to replicate exactly the bailed-in trades. While the quality of "at market" trades is easier to assess, one would then need to factor in other pricing parameters to value the bailed-in exposure (value adjustments for example). Note that replacing the exposure in that way

can create accounting issues for some counterparties, leading them to try "exact" replacements even if it is likely to take longer.

- Lastly, one must factor in the possibility that a bailed-in counterparty will have provided replacement trades for only part of its exposure. One must then determine whether the exposure that has not been replaced must be valued in line with the (partial) replacement trades or with another data set.

When there are some contractual or legal set-off rights between the derivatives and other exposures, they must be taken into account in order to fully assess the total impact on the counterparty. This requires access to additional data (beyond the definition of the derivative portfolio) and a methodology for considering the impact of the set-off. However, where the bail-in process would not take into account such setoffs which would be permitted and/or mandatory in liquidation, it is likely that it will be in contradiction to the "NCWO" principle.

For all the above, there is a clear trade-off between running the process as speedily as possible to minimise uncertainty or market impact and as thoroughly as possible for fairness reasons and to lower the risk of some bailed-in counterparties contesting the valuation. There is no clear criterion to establish how to strike the balance between the two objectives.

The above challenges exist for all derivative categories, as the relevant framework for the work that needs to be done is the master agreement with each counterparty, where all derivative products are commingled.

Without prejudice to the points made above regarding close-out of derivatives contracts, we see no significant impediments which could prevent banks from meeting the specified conditions under Article 45b(2)a BRRD for MREL eligibility of debt instruments with embedded derivatives, including investment certificates issued by the banks, regardless of whether they feature full, partial, or no principal protection.

Question 5.1. What are your views on the current MREL calibration methodology? How do you assess the complexity of the current framework and would you support an approach to MREL by developing a new methodology with a harmonised floor and a single adjustment driver? In your view, does a single adjustment driver based on factors like resolution strategy, resolvability, etc., reduce complexity?

MREL = TLAC + additional complexity + higher requirements

Additional Complexity

The complexity of the level one texts complemented with not necessarily clearer and often very constraining and more conservative level two texts and policies, the articulation of the MDA and of the M-MDA, and so on render the EU/BU framework hardly understandable for non-initiated, non-specialised stakeholders (bank customers and counterparties, investors, shareholders, staff, third country authorities, …). That contributes to putting EU/BU banks at a clear competitive disadvantage vis-à-vis their international competitors, notably US banks. In this regard, EU/BU banks that trade at an important discount are disregarded by equity investors and debt investors require relatively higher premiums from them.

As such, a simplified MREL calibration framework with a harmonised floor is highly desirable and a default calibration similar to the internationally adopted and recognised TLAC standard would make it easily readable to almost all stakeholders; adjustments, if any, should remain exceptional and duly justified.

The MREL subordination requirements framework could also be reconsidered. Indeed, the complexity of the framework and the disadvantages in terms of competitiveness also comes from the MREL subordination requirements framework (notably the TLOF indicator on top of the TREA and the TEM, the NCWO assessment the methodology of which is complex and not transparent and that the full MREL for HoldCo bank structures is required to be structurally subordinated). Banks need medium to long-term visibility on SRB MREL subordination requirements, in order to have time to monitor and adapt, if need be, their MREL allocation between senior and subordinated parts. A TLAC-like system for the subordination requirements would be beneficial to all in our view.

A single adjustment driver would also go in the direction of simplification and would therefore be welcome too. Any such driver should be easily understandable, objective, predictable and transparent. We believe a simpler approach was intended by the BRRD / SRMR and the overlay of level 2 MREL policy and supervisory practice has departed from this. As noted in response to Question 5.2 however, we do not believe the adjustment driver should be based on the resolvability assessment due to the lack of transparency of the methodology, the idiosyncratic nature of the assessment and therefore the lack of consistency and comparability across the industry.

Higher Requirements

In 2015, the EBA developed the current MREL calibration methodology, where in the BRRD, the majority of the liabilities were eligible to MREL, such as (but not limited to): structured notes, debts issued by subsidiaries, and large deposits. The impact assessment from the EBA duly noted that the majority of the banks met the MREL ratio as of end-2014 data[4].

In the context of the CRR2 / BRRD2, the calibrated MREL requirement aligns with the TLAC requirement developed by the Financial Stability Board (FSB). Both requirements are compromised by the following characteristics:

- A high proportion of subordinated debts for large banks.
- Contractual conditions to ensure there is an easy bail-in (no set-off and/or bail-in clause) and stability in the medium to long-term (no acceleration possible and/or regulatory approval to repay the debt before maturity).
- Prudential restrictions in the case of a breach of buffer requirements.

The eligibility criteria for the MREL methodology have been enhanced, although the calibration diverges from the FSB's criteria. Currently, MREL requirements (as a % of RWAs) of a bank with an open-bank bail-in strategy is almost double its capital requirements i.e. almost 2 x (Pillar 1 + Pillar 2 + CBR)[5]. Meanwhile, for the FSB's requirement, we find that TLAC is (2 x Pillar 1) + 2% + CBR.

According to the SRB Q2 2023 MREL dashboard, the average subordinated MREL in RWAs (without CBR) stands at 20.5%, while TLAC requirement (without CBR) amounts to 18%, or 14.5% if the bank uses the senior debt allowance. The total MREL requirement (without CBR) is 23.7% on average (vs. 18% TLAC). With a total RWA of € 7,434bn, the 5% differential between MREL and TLAC represents an additional c. € 370bn of SNP/eligible SP instruments to be issued and rolled for banks in the SRB's remit, compared to the

[4] EBA-RTS-2015-05 RTS on MREL Criteria.pdf (europa.eu) – see page 35

[5] To be precise, the CCYB only counts once, and a small reduction of B/S in resolution is applied by the SRB

TLAC requirement. Assuming an average annual yield of 3.6%[6], those € 370bn additional issuance volume cost c. € 13.3bn[7] per year to EU-banks.

As such, although the currently applicable general principles at the basis of the MREL calibration could appear as sound and reasonable, on closer inspection the extreme conservatism is an issue; the highly conservative approaches adopted by the Competent authorities for the calibration of the capital requirements, equating the Loss Absorbing Amount (LAA), on the one hand, and by the SRB as resolution authority for the calibration of the Recapitalisation Amount (RCA), on the other hand, lead to excessive MREL levels (on average 20%-25% above the TLAC).

There are several implications of having such high requirements:

- The EU bond market is not extremely deep and non-EU banks play a large part in the market, where they offer large issuances volumes at wider spreads (on average). This limits the level of liquidity available to EU banks. For example, in regard to the annual Financial EUR bond supply, issuances from the non-EU banks represented 20%-30% on average in the last five years, and c.10% per year coming from US banks. In order to meet their requirements, EU banks are under pressure to increase their issuance volume and in order to do so, must diversify their funding away from their EU domestic market and tap into alternative markets; this is necessary in order to access other pockets of liquidity for SNP/SP or Own Funds, although this approach is associated with a heavier cost. Major EU banks must issue a large portion of their MREL in the US market, whereas on average it is approximately 30-40bp more costly than EUR.
- There is also high market volatility and markets can close rapidly with possible negative ramifications, particularly during crisis periods as evidenced by the recent pandemic, war, and Credit Suisse for example. During such periods, the higher the requirements imposed on banks, the higher the costs and the higher the risks of breaches and contagion.
- Funding requirements for green and digital transition are building up rapidly. However, the progress of this transition is impeded by constraints imposed on EU banks, limiting their capacity to fund the transition, thus favouring the non-EU banks who do not face as many restrictions as their EU counterparts.
- The profitability of banks is already affected by their MREL issuances, where the effect will become more pronounced given the impact of the finalisation of Basel III on the RWAs of large EU banks (see EBA's QIS).

In particular, for MPE banks, the MREL calibration would merit further improvements on the following aspect:

- Currently for MPE banks, cross-resolution group holdings are dealt differently for TLAC and for MREL. For TLAC, those exposures are deducted from the Own Funds and Eligible Liabilities base of the parent entity whereas for MREL, the SRB applies the MPE add-on. This entails a misalignment and hampering comparability and creates unnecessary complexity for investors. Therefore, calculation should be aligned for those exposures.
- Considering that the MREL add-ons are updated only when a new MREL decision is issued and potentially generates a mismatch between the requirement in place and the real loss absorption and

[6] As of 15 December 2023, the annual yield of the iBoxx EUR Banks Senior Bail-In (i.e. for Senior HoldCo or Senior Non-Preferred) stood at 3.68% and the annual yield of the iBoxx EUR Banks Senior Preferred stood at 3.49%.
[7] Gross interest charge

recapitalization capacity of the bank due to the timelag in the decision to be included in the calculation, we believe that the most appropriate solution would be for the SRB to perform deductions from Own Funds and Eligible Liabilities of these specific exposures to other resolution groups of the same banking group for MPE strategies.

Additionally, we note that the use of the final supervisory review and evaluation process (SREP) decisions and Pillar 2 requirements applicable in a given year as well as the previous year's balance sheet data to set the MREL applicable in that year creates a time lag which means that any benefit recognised from managing down capital requirements is not reflected in MREL requirements until a year later.

Finally, it is important to reiterate that despite the enormous improvements in resolution planning and resilience of banks since the outset of the resolution framework, MREL requirements have not been adjusted accordingly.

Question 5.2. Do you see any merits or disadvantages to linking the calibration of MREL with the resolvability assessment? If so, please explain and elaborate.

At the moment, we believe it would not be possible to use the resolvability assessment for the calibration of MREL in a transparent, predictable and objective way. The resolvability assessment is performed subjectively according to the IRT knowledge of the bank on a individual basis.

Despite the efforts undertaken by the SRB to render the concept of resolvability comparable and transparent across the different types of banks, the resolvability assessment itself is and should remain idiosyncratic and bank specific.

Establishing a more or less complex scoring system based on the 7 dimensions and related principles of the Expectations for banks would only provide the illusion of transparency and predictability in our view, especially if the scoring system is based on peer groups and horizontal analysis in order to ensure comparability. Such an approach would not remove the inherent subjectivity attached to that kind of assessment.

Accordingly, the calibration of MREL should not be linked to resolvability assessment.

In the case of subsidiaries of non-EU banks subject to a group single point of entry resolution strategy, we are however of the view that the calibration of internal MREL should, in line with the FSB TLAC requirement, be tied to the feasibility and credibility of the group resolution strategy and the extent to which that group strategy provides for the support of the subsidiary in resolution.

We note that the FSB framework specifies there should be a scalar for internal MREL, while the SRB approach does not currently apply any such scalar. The FSB guiding principles specify that for subsidiaries of G-SIBs a reduced TLAC requirement is appropriate on the basis that there is sufficient internal TLAC to cover the loss-absorption and recapitalization needs of the subsidiary/ material sub-group and to support the agreed resolution strategy of the resolution group. The framework identifies that the reduction should be guided by certain criteria including "the overall credibility and feasibility of the home authority's resolution strategy for the resolution group".

On this basis, we suggest that internal MREL calibration for subsidiaries of non-EU G-SIBs should include a mechanism to adjust this down in cases where the resolution strategy of the resolution group is assessed to be feasible and credible.

Question 5.3. Which other factors should be included in the calibration of MREL? How could a harmonised floor be determined?

The MREL calibration could be reviewed on several aspects:

- **Loss absorption amount**: In times of resolution, it is assumed the bank's capital will be fully depleted, although this is inaccurate, given the fact that some capital will remain for the bank during periods of resolution. This assumption of full capital depletion is outlined in BRRD/SRM. Interestingly, recent failures were not based on bank losses, but rather liquidity issues.
- **Recapitalisation amount**: For the purposes of recapitalisation, the BRRD/SRM regulation notes that this should be based on the size of the bank which is under resolution. As a result, the resolution authority should take caution in ensuring that there is an assessment of downsizing bank activity and considering transfers that are viewed as realistic.
- **Market confidence**: As mentioned above, it is not feasible to impose buffers for market confidence.
- More importantly, the calibration of MREL should be closely aligned to the TLAC requirements (for instance on the use of an MREL add-on for banks' investments on eligible liabilities to other resolution groups within the same banking group). Consequently, this will facilitate the competitiveness of the EU banks.

As suggested hereabove, the calibration of MREL (including subordinated MREL) should be easily understandable, predictable, and transparent and should provide more room for manoeuvre for EU banks while restoring competitiveness.

Introducing a MREL floor

It is key that any reviews of the MREL calibration framework ensures close alignment to TLAC / international standards to ensure global cooperation among regulators and cross-border recognition of resolution actions.

A TLAC-like calibration system for an MREL floor, based on the following criteria would offer an easily understandable, predictable and transparent approach:

(i) a risk-based standard level expressed as a percentage of TREA, potentially slightly adjusted for resolution strategies based on sale of business with market exit compared to open-bank ones and that preserves the neutrality of MREL with regard to the resolution strategy chosen; and

(ii) a simple non-risk-based level expressed as a percentage of LRE

This floor should apply to all bank across the EU, or at least across the BU, and not just to banks under the SRB remit as a matter of level playing field to absorb losses and contribute to the capitalization of the remaining part.

The industry estimates and recommends that 16% RWA and 5% LRE should be the total MREL floor for every bank that is designated to be resolved.

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