BANK · VERSICHERUNG

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SRB consultation on the future of the MREL policy
Comments of the Austrian Banking Industry

We are grateful to be invited to contribute to the SRB MREL Policy and hope that in line with the public statements of Chair Mr. Laboureix, every SRB publication will be subject to industry feedback from now on.

Two general points:

- SRB references the market turbulences in the US and in Switzerland. However, the cases in the US and in Switzerland are not comparable to the EU and in particular to the banking union with SSM and SRM. Switzerland would be an example of non-resolution, the resolution framework in Switzerland is not fully aligned and the US resolutions were the result of weak banking regulation in general (exemption from NSFR and LCR, no liquidity planning).
- In general, we believe the framework is now known to resolution entities which aimed at complying with the SRB Policy for years. Therefore, no fundamental change is necessary nor to be aspired. This does not rule out adaptations to the MREL Policy. Lastly, ideas like the "single adjustment driver" instead of the current MREL calibration might be interesting to explore, however, in addition to being used to the MREL Policy approach this approach is based on the legal basis of SRMR. We have some doubts that a single adjustment driver or linking MREL to resolvability score is fully aligned with SRMR.

Questions for consultation

<u>1. Adjustment for preferred resolution strategies relying on a combination of resolution tools</u>

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)?

In general, the guidance could be more explicit and include greater reliance on the work already done by banks on recovery options, including the sale of various portfolios and/or businesses and/or entities. In particular, it is well understood that gone concern scenarios are different from going concern considerations. Still, the perimeter identification should build stronger on the already existing and extensive analysis of recovery options for partial transfer strategies in the Recovery Plan, such as sale of assets / entities, including existing mandatory analyses on liquidity, etc.

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 borderline between recovery planning and resolution planning is quite thin when it comes to an implementation of a partial transfer strategy (e.g. sale of business). In practice many recovery plans include several recovery options, which would meet the criteria for a "partial transfer strategy", e.g. sale of portfolios, assets or subsidiaries. And

the decisive distinction if those actions would be implemented as "recovery" or "resolution tool" actions is SEVERITY of the crisis in terms of TIME. Hence, for banks, whose resolution plans should factor-in a "(partial) transfer" tool, resolution authorities shall in the first place evaluate existing recovery options that would very likely NOT BE executed in an ACUTE, FAST MOVING stress scenario (e.g. liquidity-driven crisis) due to LACK OF TIME. As those options and their impacts are quite well documented in banks' recovery plans, resolution authorities would have at hand reliable information about the potential impacts in terms of Risk Exposure, Leverage Exposure, Capital & Liquidity Impacts that such measures would have under different stress scenarios and use this information to gauge the balance sheet size and composition of the resolved bank, and as a consequence its recapitalization needs.

The analysis on the recapitalisation needs of the resolved bank again could benefit from existing recovery options for partial transfer strategies in the recovery plan, including the mandatory analyses on business model impact, core business line impact, financial impact and long-term profitability impact.

2. Market confidence charge

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 its resolution?

The calibration of the MCC for external MREL, as determined in the SRMR, i.e. MCC = CBR – CCyB, is deemed more than sufficient to ensure a plausible and reliable over-capitalization level of the bank after resolution as it would cover regulatory minimum requirements with a decent cushion on top. In addition, the bail-in of eligible liabilities would likely result in the newly re-capitalized bank to hold almost exclusively CET1 capital, hence it is not only the sufficient quantity of capital, but also the highest quality of capital that the potential application of a "bail-in" would result into. Hence, the calibration of the MCC for external MREL requirements needs no revision.
However, apart from the capitalization level of the bank after resolution, we believe that a key factor for the bank to sustain market confidence is a reliable business reorganization plan and most notably, an access to stable short and long-term funding sources, whereby any such funding sources shall ideally be provided or backed (e.g. guaranteed) by a public institution (e.g. central bank, SRF, etc.) at least for a limited period of time until the bank establishes access to market funding and re-gains the trust of market participants. The later has been also demonstrated by the arrangements made by the Swiss Authorities in the case of Credit Suisse's failure and would be even more relevant in case the failing bank were solely subject to a pure "open bank" bail-in (and not acquired / merged with another institution).

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 support SRB's current MREL Policy in the sense that we see no justified need for SRB to factor in an MCC charge for all non-resolution entities' iMREL requirement. We deem the current exceptions in SRB's MREL Policy (where SRB imposes an MCC charge) for OpCos and Subsidiaries with complex structures reliant on significant wholesale funding as

completely reasonable and sufficient to achieve the resolution objectives for non-resolution entities.
This is especially the case where the subsidiary and the resolution entity are part of the same resolution group and are located in the same Member State. This argumentation is supported by the fact **that if both resolution and non-resolution entities are located within the same Member State**, there would be no legal, practical or any other restrictions or impediments that would prohibit the resolution entity (local parent bank) to downstream an amount of capital over the minimum regulatory requirement to its subsidiary that is deemed adequate to ensure market confidence. Furthermore, as the resolution entity's external MREL requirement includes an MCC charge, a sufficient amount of capital at the resolution entity / resolution group is ensured and the capitalization level of a subsidiary within the same resolution group and Member State can be seen rather as a matter of corporate governance and strategic preference.
In addition, we would expect market confidence in subsidiaries (non-resolution entities), unless they act as an OpCo or rely significantly on wholesale funding, to be strongly correlated with market confidence in their local parent (resolution entity), which in turn would depend on the factors outlined in question 2.1 above. Hence, in general we deem an extra MCC as not necessarily supportive of market confidence at the subsidiary level.

3. Monitoring of eligibility

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-absorption capacity?

The current eligibility governance and the respective processes are well established. It is always important to bear in mind the "softer" nature of debt liability instruments, in particular their inherent flexibility and the stronger dynamics on debt markets, as compared to "harder" capital instruments.

Article 79a CRR already contains provisions for banks to carry out self-assessments of their compliance with the conditions on own funds and eligible liabilities. It is therefore reasonable to assume that the SRB would require banks to carry out such an assessment and to share and integrate the results as part of their regular interaction with the SRB. However, it is also very important that banks are free to choose how to comply with this self-assessment obligation. It is essential that the SRB refrain from introducing additional extensive reporting requirements that go beyond the mandate of Art. 79a.

Moreover, we are not aware of any deficiencies/shortcomings regarding the management sign-off. We understand that the trend is moving towards considering eligible liabilities as some form of "own funds light". However eligible liabilities are not comparable to own funds in this regard. Eligible liabilities are not issued for the same durability as own funds and for terms- requiring a self-assessment for every new issuance/every amendment would create disproportionate burden- bear in mind every MREL eligible term deposit would be subject to self-assessment and communication to the SRB.
If SRB is convinced to pursue the path of harmonisation with own funds / SSM-practice, we urge to only require it for subordinated eligible liabilities, thus balancing the burden for the industry.

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 monitoring eligibility activities (also in light of the current management sign-off process)?

We do not agree that private placements involve non-standard arrangements. Very often private placements are issued under existing standardized issuance programs and contain standardized language. In our view, non-standard features and arrangements where MREL eligibility may be questionable are where the instruments contain embedded derivatives, i.e. are structured notes and/or in the case of special instruments such as Schuldscheindarlehen or Namensschuldverschreibungen (DE, AT). In this case, however, it is the practice of the SRB to require internal and external legal opinions before the institution is allowed to count them towards its MREL. Therefore, we see this quasi "ex-ante" approval by the SRB as a "best practice" to ensure that banks report only those liabilities as MREL eligible that fulfil the eligibility criteria. We therefore see no need for additional safeguards for non-standardized instruments beyond the current practice established by the SRB. Moreover, the SRB should be aware that private placements are sometimes sought by customers of the bank. They are also an important mean of financing and therefore the financial stability. In any case, we prefer monitoring rather than limiting private placements.

4. Discretionary exclusions

Questions below are aimed at gathering views from the stakeholders on some specific liabilities in order to further inform the thinking of SRB regarding the exercise of its powers under SRMR in planning and resolution. This, however, should not be understood as suggesting a specific policy choice by the SRB or indicate that some liabilities are more or less likely to be considered as excluded on a discretionary basis in resolution. In the planning stage, the SRB will assess all relevant liabilities (including those where no specific questions were raised for the purpose of this consultation).

Moreover, where the SRB expresses an opinion in resolution planning that a liability is likely to be excluded based on the criteria of Commission Delegated Regulation (EU) 2016/860, this does neither indicate nor bind the SRB that write down and conversion powers under SRMR will not be exercised in relation to such liability in case of resolution, which will exclusively be governed by the specific circumstances at the point in time of adoption of the resolution scheme.

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)?

For banks running a universal business model (retail and/or corporate business, but no pure investment banks) we regard the scope of impact as very low. The reason is that under EMIR the derivative exposure vs. financial counterparties (i.e. credit institutions,

investment firms, insurance, assurance and re-insurance undertakings, UCITs, institutions for occupational retirement provision, AIF, CSD) shall be fully collateralized. Hence, we would expect that derivative liabilities towards financial counterparties would anyway be excluded from bail-in as they reflect secured liabilities. As a consequence, the spread of contagion for the financial system shall be quite limited.
Derivative liabilities to non-financial counterparties can be collateralized voluntarily but are often not collateralized especially due to potential operational burden for those non-financial counterparties. Hence, a potential bail-in would affect rather non-financial counterparties, however, we do not expect a destruction of value for holders of other/non-excluded liabilities. Derivative liabilities to non-financial counterparties should be treated in the same way as corporate deposits, namely they should not be excluded from bail-in.

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?

See answer to Q4.1.

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 general, why should the bail-in of a derivative lead to destruction of value if at the same time the bail-in of a non-covered deposit would not lead to destruction of value?
In particular regarding derivative liabilities we do not see a scenario where the exclusion from bail-in would lead to a profit or lower loss in resolution, generating value for holders of other/non-excluded liabilities.

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

1) 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 Directive 2014/59/EU? If so, do these challenges concentrate in any particular category of derivatives?

No challenges expected since this information is covered in bank IT systems.

2) 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?

For the following types of secured liabilities our assessment is as follows:

- Covered bonds: no operational challenges expected due to daily valuation of collateral pool
- Repos: no operational challenges expected due to daily valuation of underlying collateral
- Derivative liabilities: no operational challenges expected for those subject to netting and CSA agreements due to daily valuation and collateral posting
- Collateral swaps: no operational challenges expected for those subject to netting and CSA agreements due to daily valuation and collateral posting
- Pledges provided for collateralized guarantee (iMREL) and the financial resilience of critical service providers: no operational challenges expected due to daily valuation of underlying collateral

3) 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?

No operational challenges expected as the position is part of the bail-in dataset and has to be available within 24 hours.

5. Long-term policy considerations: Rethinking approach to adjustments in the MREL policy

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?

First and foremost, it shall be ensured that the MREL calibration methodology is **transparent, understandable and does not violate the level playing field for banks competing on the Common Market.**

Therefore, we believe that **all the banks shall be subject to the same, harmonized MREL calibration methodology,** which ideally includes elements to reflect each bank's resolution strategy, business model, size, complexity, risk profile, governance, and balance sheet structure in order to guarantee an adequate amount of MREL resources are available in order to ensure the smooth implementation of the preferred resolution strategy ("bail-in").
In this respect, **we consider the current MREL Policy of SRB largely adequate** in capturing those specificities. Therefore, we believe that **SRB shall keep the MREL calibration methodology as defined in its 2023 MREL Policy unchanged and stable** for the future and consider the resulting MREL & Subordination requirements **not as a "floor" but rather as a "cap"** that can be adjusted only downwards on a case-by-case basis given an objective and harmonized score across other resolution dimensions (resolvability, liquidity in resolution, operational continuity, etc.).
By doing so SRB would achieve two goals simultaneously:

- **The current (and adequately conservative) MREL Calibration Methodology will be kept stable** – which, given the current complexity is a very important feature, so that banks, market participants, investors, rating agencies, etc. do not have to be re-educated about MREL and banks can reliably plan the issuance of MREL eligible instruments.
- **Create an incentive tool for SRB to stimulate banks to deliver on other resolution dimensions** (e.g. liquidity in resolution, resolvability, operational continuity, reduction of complexity, etc.) through the introduction of a potential "MREL relief factor" awarded to banks excelling in other resolution dimensions.

We would also propose to SRB to confine the potential MREL Relief within certain, sufficiently wide, boundaries, similar to the Balance Sheet Depletion formula where the relief cannot exceed more than 10% of Total Assets. These boundaries / limits should not apply to other decreasing factors which necessarily must be higher and are already included in the SRB MREL Policy, in particular the scaling factor with an upper limit of 25% of RCA and MCC (para 35 SRB MREL Policy).

While MREL calibration according to the SRB Policy might be complex, it nevertheless allows for resolution entity specific necessary adjustments. While a harmonized floor would be of little effect, just one single adjustment driver seems to be a too easy solution for the complex issue of MREL.
P2R reduction (para 32 SRB MREL Policy) should be refined.

- The legal basis for the SRB to consider P2R downward adjustments has always been enshrined in Regulation (EU) 806/2014 as the recapitalisation amount. It should allow the resolution entity/group resulting from resolution to restore compliance with *"[] its P2R at the consolidated resolution group level <u>after</u> the implementation of the preferred resolution strategy*" (Art 12d para 3 a) ii) and b) SRMR).
- In its MREL Policy 2021 SRB according to our understanding SRB acknowledged possible P2R downward adjustments. As of today, the SRB MREL Policy 2023 stipulates in para 32: "*The SRB, in consultation with the competent authorities, estimates the P2R post resolution (for its use in the MREL formula) on the basis of the outcome of the latest SREP process. For banks with a high-risk profile, the resolution actions are expected to yield a risk-reducing effect that could potentially be translated into a lower post resolution P2R level for both external and internal MREL.*"

Current SRB practice is to only grant a P2R reduction for resolution groups with <u>SREP score 3 minus or higher</u> and <u>capping</u> the reduction <u>with 0.5%</u>.
We believe this approach is not proportionate as granting a reduction only to resolution entities/groups with SREP score 3 minus or higher seems too high and not in proportion with severe supervisory consequences: SREP score 4 can be (based on the specific case of course) the basis for a determination that an institution is FOLTF (EBA/GL/2015/07, para 31).
Therefore, the methodology should be refined in the SRB policy in order to allow for incentives and to better align the Policy with the SRMR.

Additionally, in general, whether a single adjustment driver linked to resolution strategy and resolvability would improve the current MREL calibration methodology will heavily depend on its concrete shape and design. Without any more concrete questions, we identified at this stage the following areas where complexity in the current MREL calibration methodology could be reduced and current shortcomings addressed:

1. for the MREL calibration of banks with a Multiple-point-of-entry (MPE) strategy, the SRB references to the rules in Article 72e(4) CRR. It is important to note the scope of these rules in the CRR is limited to global-significant institutions only – and does not apply to all banks with MPE strategy as currently interpreted by the SRB. The rules in the CRR also target the crossholdings between institutions but not within institutions. Lastly, the rules constitute a deduction mechanism of MREL Liabilities but not MPE Add-ons as currently interpreted by the SRB. Summarized, the MREL calibration for banks with a MPE strategy is still assessed as complex and lacks a legal basis in the Level-1 legislation.

2. Supervisory and resolution authorities have not yet developed the prudential requirements and processes for the MREL calibration for entities where the resolution group does not match the prudential consolidation. It is important that authorities can adjust the consolidated Pillar-2 requirement as input factor for the MREL calibration for resolution groups where consolidated risks are not present, in line with and respecting Article 2 Delegated Regulation (EU) 2021/1118.

3. The current risk-based approach for the MREL calibration methodology leads to a double counting of risk for a sample of MPE banks. On the one hand, the SRB imposes significant MPE Add-Ons to cover the risk of contagion from exposures towards other MPE resolution groups. On the other hand, the current MREL calibration methodology builds upon prudential requirements (P2R and CBR) as input parameter for the MREL calibration which already contain capital add-ons for exposures towards other MPE resolution groups. Adding to that, MPE banks confront RWA increases for the additional MREL issuances necessary to meet the MPE Add-ons.

4. The current risk-based approach for the MREL calibration works under the flawed assumption that all MPE resolution groups would fail at the same time. The MREL calibration methodology must be corrected and introduce a risk diversification factor for the calibration of MREL for banks with MPE strategy.

5. Overall the current MREL calibration methodology would benefit from more transparency, including but not limited on the calculation of MPE Add-ons but also on the value-based NCWO methodology the SRB is currently using for setting case-by-case MREL subordination requirements.

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.

We oppose linking the MREL calibration with the resolvability assessment. MREL calculation should be foreseeable to the highest extent for resolution entities. Therefore, the calibration according to the SRB Policy could and should in our understanding be refined, but not changed fundamentally. Resolvability assessment and the result was and is subject to a high level of discretion of the resolution authority.

We believe that there is a negative correlation between the amount of necessary MREL resources and a positive overall resolvability assessment "score" in the sense that banks scoring high on resolvability assessment would likely need less MREL resources in case of failure and vice versa. Nevertheless, if the SRB decided to move in this direction anyway, we would expect that the SRB would only be allowed to reduce the MREL requirement for banks scoring good on resolvability assessment. But without the option to increase it based on a poorer score.

Furthermore, merits and disadvantages depend on the concrete shape and design of any future MREL calibration methodology. Closer aligning the MREL calibration with the resolvability assessment could in principle have the following merits:

1. Allows to decrease the MREL Target for MPE resolution groups where satisfactory progress towards resolvability is assessed, for example resolution groups are compliant with the MPE requirements as laid down in MPE action plans and overall effective arrangements for MPE are in place, including a detailed justification in the resolution plan.

2. Considers the overall better resolvability of banking groups with MPE strategy. Under an MPE strategy, every resolution group is subject to individual resolution planning. As previous resolution cases have shown, banks tend to be international in life and national in death (S&P Global Ratings Briefing dated 04.03.2022, The Failure of Sberbank Europe). Managing resolution of banks with MPE strategy is empirically proven easier as compared to resolving monolithic banks with a Single point of entry strategy - for all the reasons known and publicly discussed. Despite their upside resolvability, the current MREL calibration methodology imposes significant MPE-Add-Ons on-top of current MREL requirements for banks with MPE strategy.

3. The MPE strategy fits the rationale of supervisory initiatives such as the Vienna Initiative (Vienna Initiative", by the EIB, the European Commission, the EBRD, IMF and the World Bank) with the aim to strengthen local capital requirements and self-funded subsidiaries in some EU regions, but also the development of local debt markets and the availability of non-deposit liabilities in those markets.

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

As outlined under 5.1 above, we do not support the introduction of a "floor" and advocate the retention of the current MREL calibration methodology as representing an MREL "cap" and introducing a potential possibility for an "MREL Relief factor", based on an overall score awarded to banks that excel in achieving the goals under other resolution dimensions.

The natural floor for MREL is P1R and P2R (loss absorption amount), which in any case is increased by the CBR when assessing MREL plus CBR. There is no real additional need for a floor.

Following the experiences in the US and Switzerland and considering the upcoming Review of the Crisis Management and Deposit Insurance Framework, the SRB should allow partial transfer strategies as preferred resolution strategy also for larger banks, including for top-tier banks and global significant banks. The MREL calibration methodology must better reflect and facilitate efforts from making transfer strategies possible and link the discounts in MREL requirements to milestones achieved towards a credible and feasible transfer strategy in the course of ongoing resolution planning.

Another important element in any re-worked MREL calibration methodology are the cooperation and decision-making processes between authorities. Well-designed mechanism must avoid ring fencing in a cross-border context and local policies and laws should be aligned between authorities as close as possible within the boundaries of the BRRD and SRMR.

The further development of MREL calibration methodology must be viewed together with the European Union's Capital Market Union (CMU) and both should benefit from each other. The completion of CMU could further support EU banks to meet their MREL capacities on deep and liquid capital markets by facilitating locally issued subordinated debt with the support of supranational bodies. For example, CMU regulation could encourage long-term investors, such as pension and insurance funds, to take on more significant exposures through requirements for capital coverage and asset valuation in the regulation of insurance funds (see Lehmann, A. (2019) 'Developing resilient bail-in capital', 29 April 2019, Bruegel Blog post).

At the same time, by requiring maintaining local MREL capacity, the MPE supports the development of local capital markets and ultimately the proper functioning of the EU single market and CMU objectives. Further harmonization of MREL calibration methodologies, bank insolvency rules and uniform protection of the same category of investors and depositors across EU Member States would strengthen the CMU, as investors would have more certainty when investing cross-border. Improving cooperation between resolution authorities and broadening the narrow-qualified investor base for MREL bonds would benefit the objectives of CMU to the same extent.