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Subject: Public consultation on the future of MREL policy

The members of the European Banking Federation (EBF) welcome the initiative of the Single Resolution Board (SRB) to further engage with and consult the industry on the future of MREL policy. Thanks to the resolution planning carried out in recent years, and to the build-up of the Single Resolution Fund (SRF), EU financial stability has really improved, and this should be reflected today in MREL calibration. We understand that the SRB is considering the possibility of using resolution tools other than bail-in, such as transfer tools, in the Preferred Resolution Strategy of large banks, which may impact MREL requirements. There are however also other elements in the current MREL policy that could be reviewed. EBF members would therefore highly appreciate to be consulted on future MREL policies before being adopted by the SRB.

The banking industry shares the analysis and concurs with the lessons learnt from the recent and previous crises as outlined by the SRB in its introduction to the consultation. 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 in terms of recovery and resolution planning, as well as accumulation of own funds and stable liabilities, among others thanks to the SRB actions, since the MREL framework was initially set up.

Finally, the banking industry also appreciates the SRB approach on transparency about MREL by publishing MREL dashboard on a quarterly basis. The MREL dashboard shows differences and in some cases quite large differences in banks' MREL and subordination requirements. It would be appreciated if the SRB could elaborate more on what drives the large differences.

Below, EBF has prepared the answers to each of the questions.

Adjustment for preferred resolution strategies relying on a combination of resolution tools

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)?

The banking industry understands the scope of this Consultation on the future of MREL policy as an opportunity to extensively comment on MREL-related topics, but only to

About EBF

The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from across Europe. The federation is committed to a thriving European economy that is underpinned by a stable, secure, and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere.

include comments on transfer strategies when this is justified. A separate further discussion focused on the SRB requirements for transfer and separability should, in our view, also take place by separately consulting the industry on these topics.

In general, we favour a pragmatic approach concerning the operationalisation requirements of the transfer strategies as potential complementary tools (documentations, testing, among others) and a view on the potential impact on the MREL calibration. As it is known, part of the assets that might be sold during the resolution process are included in the recovery plan (validated by the Single Supervisory Mechanism) and therefore, the inclusion of these sales should not be burdensome from an operational point of view.

Besides the SRB guiding principles for perimeter identification that focus more on the transfer of the core activities of the bank, alternative and specific principles should be considered when transfer strategies are intended to be used as complements to bail-in.

As per the 2021 SRB operational guidance on separability for transfer tools, most of the banks in the remit of the SRB must have prepared an advanced Separability Analysis Report (SAR) and a related transfer playbook. Consequently, banks must already have identified potential transfer perimeters.

This guidance includes the following principles, for Sale of Business tool (SoB), i.e. that potential transfer perimeters:

- Should represent clear sets of businesses potentially attractive to third party acquirers;
- May include critical functions, the continuity of which should then be ensured by the selected acquirer; and
- Could easily be structured and operated distinctly from a legal, financial, and operational viewpoint, enabling an efficient transfer under the responsibility of the resolution authority in case of resolution.

Considering Asset Separation tool (AS), it 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.

In our view, additional criteria to be considered when transfers are expected to complement other tools include that these transfers should:

- Be proportionately impactful from a solvency and/or liquidity standpoint;
- Be actionable within a short timeframe, taking into account plausible resolution scenarios and the actions that the bank would have taken or would be required to take in the run-up to resolution, such as the preparation of the execution of recovery options;
- Focus on activities that are not considered as core to the expected post-resolution banking group and whose disposal would not affect the capacity of the remaining perimeter to recover over time; and
- Ideally be incorporated in distinct legal entities (preferred solution). Disposal of business units and going concerns to be considered to the extent that they are easily identifiable, well-defined, and easily separable.

The industry would further welcome that the SRB leverages on recovery plans, which are subject to detailed and regular assessment by the European Central Bank (ECB) (including regular tests). Building up on recovery planning and on the ECB assessment, would ensure cohesion between recovery and resolution planning, and would also allow banks and the SRB to effectively manage time and resources.

Recent and more distant crises have shown that transfer strategies could be implemented at very short notice, even without preparation. One prominent example was the acquisition of Fortis by BNP Paribas in 2008. Considering the fiduciary duty of resolution authorities though, we perfectly understand their need for feasibility assurance when including

transfer tools in resolution strategies. In practical terms, we would suggest such assurance to be assessed through:

- Relying mainly on recovery options included in the recovery plan;
- A positive assessment of such recovery plan by the competent authority; and
- Selectively requiring additional separability analyses if and when important issues are identified.

In accordance with the above-mentioned suggestions, we would welcome an update of the 2021 SRB operational guidance on separability for transfer tools. This would allow both clarifying and streamlining of some existing requirements that appear disproportionate and overlapping with existing requirements on recovery planning.

Finally, we would also like to emphasise the importance of coordination between National Resolution Authorities and the SRB as well as third country authorities to avoid potentially contradicting strategies or intents, and also to prevent any additional national fragmentation.

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?

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. In addition, the likelihood of an unexpected entry in resolution at very short notice is null, or extremely close to null, for a large bank, as evidenced by extreme reverse stress exercises run by some banks at SRB request. Accordingly, a recovery phase would necessarily precede resolution and the implementation of recovery options would significantly reduce the size of the ailing bank, hence its recapitalisation needs too.

Yet, it is clear that if a transfer tool is envisaged as part of the resolution strategy, the bank's profile would change and consequently the Recapitalisation Amount, for MREL purposes, should be adjusted.

In addition to these elements, 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 specifically 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 default formula set by the SRB.

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 considered when estimating the required capital buffers of the post-resolution group, which should be calibrated on a smaller, different, and normally less risky and less complex group than the pre-resolution one. Although we understand the impact on the Recapitalisation Amount for transfer strategies as a Preferred Resolution Strategy may differ from that of banks having a combination of bail-in and transfer tools in their Preferred Resolution Strategy, we believe that for the latter a reduction in the RWAs should in proportion lead to a reduction in the Recapitalisation Amount.

That said, in terms of potential changes to the bank's profile and the potential consideration thereof in the calibration of the Recapitalisation Amount, there may be a difference between:

- taking into consideration balance sheet depletion (and associated reduction of the associated (weighted) risk exposure amounts and reduction of capital requirements) due to the materialisation of credit risk; *versus*
- taking into consideration balance sheet reduction due to asset transfers (e.g. of non-core assets) to another party.

In case of asset transfers (separate or as part of an entire legal entity), the associated (weighted) risk exposure amounts and associated capital requirements may not necessarily have been reduced and are transferred to the acquiring party (such as another bank). This also assumes that the acquirer is either not itself (in a similar manner) subject to capital requirements, is already sufficiently capitalised or can raise capital in the market. This contrasts with having recapitalisation capacity pre-positioned at the resolution entity itself in the form of MREL for which the burden of recapitalisation can be imposed on existing investors on a statutory, involuntary basis by the resolution authority through the use of the bail-in tool. So, as it is already the case for Preferred Resolution Strategies based on Sale of Business, we agree that the potential of asset transfers should be taken into consideration when calibrating the Recapitalisation Amount. Though, this could also be done considering the broad market.

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?

Loss of market confidence is the primary trigger for a bank to be pushed into resolution. In our view, this cannot be restored just over a weekend. Even if, crucial and relevant information is available (credible Business Reorganisation Plan, possible management changes), clients and markets will need time to digest it all and assess the effectiveness of the plan. The fact that a Business Reorganisation Plan has been approved by the resolution authorities and is fully supported by the existing management, as well as a clear plan for management changes may also help to shore up confidence, although its details should not all be made public, as disclosure could weaken the resolved entity's position in potential transactions required to achieve the goals of the Business Reorganisation Plan. Against this background, we think that current timelines for resolution (i.e., the resolution weekend) are not realistic without a credible liquidity backstop and/or some form of state involvement and/or a "white knight", as evidenced in recent cases in March 2023.

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 Failing or Likely To Fail (FOLTF). An extremely high level of Market Confidence Charge (MCC) would not make any difference in the investors and creditors attitude following a resolution and it should be avoided as a higher MREL weighs on bank lending capacity in going concern without a strong justification in resolution. This is particularly true if there are issues with the business model of the bank. Besides this, the MCC is currently being gold plated at European level, and the SRB should be able to exercise its discretion to reduce it and bring the Total MREL's calibration closer to that of typical TLAC requirements. In addition, some of the capital buffers such as systemic risk buffers, can be intended to be used to mitigate systemic risk, i.e. can be released in times of bad economic situations. It is not appropriate to include such buffers as part of MCC.

In our view, the level of regulatory capital, even if very high, cannot, in itself, restore market confidence and is not its main driver, although an adequate path to regain a

reasonable capital level over time will contribute to it. In other words: we do not contest the concept of MCC per se for the resolution entity but believe that a better balance should be struck than is currently the case. The current calibration aligned with the Combined Buffer Requirement (CBR) does not appear relevant indeed. High levels of MCC are detrimental in many respects, including the profitability of the bank, which is critical to ensure the viability in a medium to long-term after a resolution.

In addition to necessary time, here are other essential elements to restore market confidence:

- A clear and credible plan to stabilise the situation, including specifically on the liquidity front, and to gradually restore profitability and solvency. Confidence will only be restored if investors and large customers assess the resolution plan as credible and believe that it will effectively be executed. Therefore, the role of authorities is key, and the SRB will need to communicate on the retained strategy and on identifiable milestones.
- As from the start, a clear, regular and supportive communication by the Resolution Authority as well as the Competent Authority, ideally jointly, explaining in a way that can be easily understood by all the stakeholders, the reasons having led to the FOLTF declaration, the actions undertaken to remedy such situation at short term, including in particular in terms of liquidity if and when relevant, and the plan to restore the situation in a sustainable way for the longer run. Such communication can be complemented as the situation evolves. Details about the longer-term Business Reorganisation Plan do not need to be communicated immediately. At short term, it is essential that the communication by the authorities demonstrates that they have the situation under control.
- A decisive, effective, and timely implementation of the announced plan as updated from time to time, which should demonstrate that the issues having caused the failure are tackled and that business model of the bank is adjusted accordingly, leading rapidly to a stabilised situation and gradually to a reasonably profitable one.
- The avoidance of a post-resolution balance sheet that has become overly-encumbered due to the use of the bank's assets as collateral for funding/liquidity from the central bank or resolution fund.
- In summary: clear and supportive communication demonstrating understanding of the situation and stabilisation first, including liquidity; reasonable profitability and capitalisation second.
- Additionally, and although the scope of this consultation is different, we would like to remind that a solvent and credible liquidity in resolution tool would help to restore the confidence of the resolution procedures not only after the resolution weekend, but also before the resolution takes place.

Restating what has already been mentioned above, in our view, investors will be more inclined to lend to a resolved bank if there is a clear message from the central bank that it supports the resolution (see US and Swiss examples). Liquidity support by a credible liquidity backstop provider should be available to banks resolved under the control of the SRB.

Moreover, investors have long memories, and if authorities have to bail-in more to get a high MCC, that will not help restoring their confidence, rather the opposite. Investors would probably prefer a limited bail-in and a low MCC, if any at all, over a high MCC and a massive bail-in. Furthermore, investors do not expect either that a bank that has just been resolved will pay dividends in the short term (it is likely that there are no more AT1 therefore no more discretionary AT1 coupons to pay anyway), therefore there is no need to fully replenish buffers right after resolution. Finally, investors will react more favourably, and the resolution authorities will build their credibility, when the group resolution plan is executed in line with market expectations. Of course, each resolution is case-by-case, but deviations from the expected path would have the effect of reducing market confidence.

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 see a rationale for applying an MCC for non-resolution entities that are fully owned and funded by the parent/resolution entity. More generally speaking, we also do not agree with the implementation of MCC for internal MREL, as we believe such a MCC would not in fact secure market confidence. The key factors for market confidence in a subsidiary are: (i) the existence of support from the group to the subsidiary, (ii) market perception that the resolution authorities for the group and subsidiary are working together to implement the group resolution plan to address the fundamental issues and are communicating that consistently to the market, (iii) access for the subsidiary to appropriate liquidity facilities at the relevant central bank, and (iv) an understanding that the subsidiary will have a sustainable future as part of its group.

The MCC for non-resolution subsidiaries is not relevant since trust must be restored via the parent/resolution entity, which must have the means to support its relevant subsidiaries. For such subsidiaries, the conditions to restore confidence are similar to those mentioned in answer to Question 2.1 with the noticeable and essential difference that there would be no write-down and conversion by other creditors than the resolution entity. Indeed, if the subsidiary reaches the Point of Non-Viability (PONV), the recapitalisation is ensured by the resolution entity through internal MREL. Therefore, the main driver for confidence relies on the resolution execution at group level and not on the capital level of the subsidiary. Market confidence for non-resolution entities relies essentially on the parent support in going concern. In our view, an MCC for such subsidiaries is not justifiable as eligible liabilities for internal MREL have to be subscribed essentially by the resolution entity, directly or indirectly and not by third parties.

For subsidiaries that are not resolution entities, the other main difference is who does what. In case of a group-wide crisis, the communication should be closely coordinated between group and local authorities and with the subsidiary itself to ensure overall consistency. In case of a specific crisis limited to the subsidiary and not remediated by the group, which would trigger the application of write-down and conversion powers (Article 59 BRRD), in the communication, particular attention should be paid to the reasons for the intervention by the subsidiary's resolution authority.

In all cases, communication should be tailored to the subsidiary and the market in which it operates. Similarly, and even less than for a resolution entity, it is not believed that the level of capitalisation is in itself necessary or sufficient to restore market confidence. Rather a clear plan, clear communication and decisive actions demonstrating that the situation is understood, under control and being efficiently remediated at short and longer-term is key and, in any event, such market confidence will only come back after a while.

If the SRB persisted in its current approach, a review of the definition of "wholesale funding" would be welcome, as it should not include corporate deposits, and should not be used mechanically by the SRB to assess the need to require a MCC for internal MREL.

In any case, a level playing field should be ensured in the application of the requirements.

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?

In general, we appreciate that resolution authorities reflect the high level of standardisation of TLAC/MREL eligible liabilities instruments, and their considerably lower level of complexity compared to own funds instruments in their approach to eligibility monitoring.

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 only apply to the new issuances and not to the existing stock, and that this monitoring would be undertaken exclusively on an ex-post basis.

As far as eligible liabilities are concerned, namely Senior Preferred (SP) and Senior Non-Preferred instruments (SNP), it is essential to bear in mind that the number of issuances is very different from the volume of own funds instrument issuances (in 2023, four times higher for certain groups). Given the number of eligibility criteria, it would be really burdensome to replicate what is currently done on the own funds for the ECB, without mentioning that such detailed tables would have to be subject to a sign-off by the management body, who already signs off the existing regular MREL reporting. We see areas where the ECB's approach itself could potentially be more pragmatic, in particular for Own Funds instruments (such as Tier 2 Capital) that are issued under a programme rather than on a stand-alone basis.

While we understand SRB's wish to control the compliance with eligibility criteria, we would like to highlight the need for a more pragmatic approach, as well as that a certain proportionality should be envisaged, as bonds issuance are very standardised as noted by the SRB.

In a nutshell, monitoring eligibility of those instruments similar to own funds would not be welcomed, as it would add to the already high administrative burden. The terms and conditions in the programs have been assessed at inception by an eligibility assessment and are standardised across the industry, and the eligibility assessment done by banks was shared with the SRB. Due to the higher numbers of required MREL, diversified funding resources with issuances of smaller size are essential (either in the form of niche currencies or private placements) and result in elevated paperwork.

The existing checklist framework (e.g. *Template for the Management Sign off form* of MREL instruments eligibility criteria) for eligibility assessment should therefore be considered as sufficient.

In any case, if the SRB maintains the idea to report each new issuance it should at least set a floor on the size of the issuance on a case-by-case basis to only report those above it. In addition, new issuances should be scoped to public issuances which are the most relevant compared to private issuances that are more recurrent but have smaller size. Proportionality is essential not to overburden banks.

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)?

No, not to the best of our knowledge. Concerning private placements, we do not see any deviating non-standardised elements.

Discretionary exclusions

The exclusion of derivatives from bail-in may lead to a reduction of the amount of senior liabilities to which bail-in can be applied, and/or may require (*pari passu* or even more senior) ranking unsecured creditors to be subjected to bail-in to a greater extent. This may or may not result in a no creditor worse off (NCWO) breach, but it is important to emphasise that the NCWO principle is ultimately an economic concept. If a bail-in has reached the conversion/recapitalisation 'phase' (which we would deem likely where it concerns senior (preferred) ranking liabilities) those other creditors 'bearing the (additional) burden' from this exclusion and therefore being subjected to a (larger) conversion should consequently also see a commensurate return of value in the form of equity claims in return. This may fully offset or at the very least mitigate any such potential issue. Therefore, the notion that NCWO breaches could result from excluding certain liabilities from a ranking layer should not be presumed to be an automaticity. If the SRB will discretionally exclude derivatives from bail-in, on a case-by-case basis, the banking industry believes that it is appropriate for the SRB to establish a harmonised and transparent approach on the exclusion specifying how it will be done, what exactly will be excluded, and the impact of this exclusion. Related to this, we believe that it is also appropriate for the SRB to implement a harmonised and transparent approach on the SRB assessment of the NCWO tool and potential add-on for the subordination requirement.

As much as possible, the French Banks would rely on the ACPR's working paper¹ on Section 4, and to which they contributed. The conclusion of this paper is that there should be exemptions from the bail-in operationalisation requirements for the liabilities (e.g. derivatives) likely to be excluded at the time of resolution, under certain conditions. However, an exclusion from the bail-in scope would not be made "ex ante" for all the banks under their remit.

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)?

In the following paragraphs we will explain in greater detail the "circumstances" leading to a destruction of value, especially in the case of commercial hedging in line with Reasonably Expected Near-Time Demand in accordance with the US Volcker Rule (RENTD) requirements, using concrete examples. These will be further supplemented by an overview of the assessment results provided in the above mentioned ACPR's working paper in this regard.

Where a bank mainly uses commercial hedging, it is left in almost all cases with a very small net exposure compared to the notional of the derivative. The cost of a failed derivative under the current market's structure (e.g., collateral agreements) cannot exceed 100% of the current market value (i.e., in case of a total wipe-out). However, in a bail-in scenario, the cost can exceed this amount for the three following reasons:

¹ "Enhancing the credibility of the EU bail-in design: the example of the treatment of discretionary exclusions", by Riad Benahmed, July 2023 ([link](#))

1. Corporate clients are likely to face higher replacement cost compared to a default scenario.²

- a. The cost of covering their financial and/or commodity exposure for which hedging has just been unwound if their bank has just been subject to a bail-in. The replacement cost for these hedges will exceed the cost of the hedges that were in place prior to resolution as only exposures were bailed-in where the bank had a liability towards the client. This replacement cost is likely to be higher than the cost the corporate would incur in case of a default, where they are able to claim compensation from risk-mitigating activities (such as central clearing, insurances, default swaps).
- b. Immediately after the implementation of a bail-in, a large number of corporates have to rush to find replacement hedges. Many hedges will point in the same direction, increasing prices over the pricing levels assumed in point (a) above.
- c. A likely cause of a bail-in are turbulences in the financial markets. In a market that is already in disarray, the application of the bail-in tool is likely to further increase pricing levels for the large number of corporate clients which rush in to find replacement hedges. Pricing will thus be even higher than in point (b).
- d. Some market participants may be incentivised to build speculative positions, seeking to benefit from the likely market volatility and hedging needs mentioned, further increasing prices over point I.
- e. On top of the previous points, a further burden is added to the corporate sector. The construction of the bail-in tool, i.e., the fact that it will only cancel netting sets that are a liability to the bank, means that some clients will lose their hedging protections while others will not. It is entirely possible that two almost identical companies have netting sets that are different enough that one has a positive Net Present Value (NPV), and one has a negative NPV. After a bail-in, only one of the two firms is saddled with the replacement cost as outlined above while the other retains all hedge protection with the same bank. This opens the bank up to litigation risk as the affected client may claim to have been treated unfairly while their direct competitor remains unaffected.
- f. The sole compensation for corporate clients is that they receive an equity stake in the re-capitalised bank. However, most corporates are not set up (and may not be permitted under their constitutive documents) to hold equity in the failing/recovered institution, causing them additional effort to cash in this compensatory element.
- g. In summary, there's a clear case for value destruction in the corporate client segment caused by the application of the bail-in tool to derivatives compared to a default situation.

2. For the Market Counterparties, the net effect of a bail-in is unclear:

- a. Cost of rebalancing their hedge book in a stressed environment which is difficult to estimate as it will be a compound of the various NPVs. Market counterparties require each other to exchange ('post') collateral. If CSA³-based activity is exempted from a bail-in, there would be no impact on market counterparties as their trades are almost all CSA-backed. If positions secured by a CSA are not exempted from a bail-in, the contribution to the bail-in will be minimal (i.e., limited to the daily variation or minimum transfer amount which are small compared to the overall outstanding amount) in relation to the disruption created thereby.

² This statement only covers the derivatives aspect and does not include the loss of bond or cash positions, which would hit the corporate on top, especially clients who rely on one or few banks for their banking needs.

³ CSA: Credit Support Annex; a legal framework regulating the collateral for derivative positions.

- b. Most market counterparties should be in a position to recover from the losses imposed by a bail-in against one of their counterparties. This is due to the market counterparties managing their counterparty risk and limiting single-name exposure to amounts they can manage. A stressed market environment may add additional strain on them, but the pressure would likely be less than in the corporate sector.
 - c. It is unclear if for market counterparties the cost of a bail-in would exceed the cost of a default. It is thus not possible to finally determine whether a bail-in would risk a value destruction from this perspective.
 - d. N.b.: Some market counterparties are set to gain from increased margins and higher trading profits in the aftermath of a bail-in, mainly due to the corporate clients who just lost their hedges rushing to re-cover their positions. Furthermore, some actors may aim to pre-empt the additional hedge requirements from the affected corporate clients and the bailed-in institution by building contrarian positions, further increasing the prices in the immediate aftermath of a resolution event.
3. For the bailed-in institution, the replacement cost will be substantial:
- a. Cost of rebalancing the remaining hedge portfolio while having a negative outlook in the capital market: a bail-in order comes with a very real risk for the institution of no longer being accepted as a market counterparty, thus having a hard time finding hedge counterparties and paying higher prices to rebuild the market hedges needed to protect their derivative exposure.
 - b. Non-EU counterparties may stop repayments (amounts due for closed-out positions; collateral held) until the bailed-in institute litigates in court. This is in contrast to a default scenario where the globally accepted practices apply. Thus, a bail-in amount needs to be higher to compensate for the risk that some of the expected funds will be held up in lengthy litigations.

In our opinion, the points above amount to a general destruction of value as the losses resulting from the application of the bail-in tool to the hedged derivative portfolio exceeds the loss of a full wipe-out⁴ which itself exceeds the loss in a collateralised workout, which in turn is very likely higher than the cash gained from the bailed-in NPV – which, as noted above, may be in part withheld by counterparties until successfully litigated for.

According to the ACPR's working paper on discretionary exclusions, it is mentioned that the closure of derivative contracts (valued on a net basis) through bail-in may result in replacement costs borne by the bank, especially for open positions requiring new hedging. The question seems to focus on the circumstances under which these closure-related costs would be sufficiently high to lead to value destruction.

To assess this, several factors could be relevant, including:

- Significance of derivative positions: If derivative positions are significant in terms of size or exposure relative to the bank's capital, the execution of re-hedging transactions may take time and leave the bank subject to changes in market conditions (interest rates, FX rates, equity prices) leading to substantial replacement costs;
- Market volatility: Volatile market conditions can increase replacement costs, as it might be more expensive or difficult to hedge positions; and
- Nature of derivatives: Some derivatives may be more complex to replace, especially if they involve less liquid assets or less efficient markets; in addition, there probably will be less counterparties willing to transact bilaterally with a bank subject to a resolution and bank may only be able to access simple hedging products.

⁴ A full wipe-out does not cause any replacement cost as there are no unhedged positions that require immediate re-hedging to bring the bank back into its risk limits.

Based on these factors, if replacement costs are deemed excessive, it could lead to value destruction. Holders of other liabilities/non-excluded liabilities could then be better off if certain derivative contracts are excluded from bail-in rather than opting for bail-in. However, it is essential to consider these circumstances in the specific context of the bank, its activities, and market conditions at a given time.

Besides, 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 mobilise scarce trading resources at a difficult time.

One should not assume that the risk to be re-hedged would be low thanks 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 above re-hedging on the bank and other market participants, some general market contagion would be expected (higher risk premia, higher transaction costs, lower liquidity, among other). The systemic impact would be negative and its size difficult to quantify in advance.

The magnitude of the above issues can be lowered by narrowing the bail-in perimeter. For example, excluding all counterparties for which there is a CSA, whether there is a bail-inable net exposure or not (present value lower than the value of the received collateral) would remove the counterparties whose exposures have the highest market risk (interbank counterparties and hedge funds). Having a blanket exclusion of these counterparties would lower the contagion risk and rehedging costs, as they include all GSIBs. It would also maintain a degree of market access for the bank and increase its ability to manage its risks in the post bail-in period. For the non-collateralised counterparties which remain in the perimeter (mostly corporates), the issues described in 4.2 and 4.4 would still have to be considered.

Without prejudice to the considerations above, discretionary exclusions should anyway be carefully handled to avoid NCWO implications and unjustified subordinated MREL increase. In this sense the authorities should consider such aspects in the future development of SRB NCWO assessment methodology/tool on which transparency and consultation with the industry would be welcome.

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?

In accordance with the ACPR's working paper, the bail-in of net derivative exposures (post-closure) could have a negative impact on a bank's operations, potentially leading to value destruction under certain circumstances. Here are some points to consider:

- Banking business models: Different banking business models can influence how derivatives are utilised. For instance, a bank focused on market and trading activities may be more sensitive to fluctuations in underlying asset prices, while a retail bank could be more exposed to interest rate risks. The consequences of bailing-in net exposures may vary based on these models.
- Types of derivative products: Some derivative products can be more complex, illiquid, or sensitive to market conditions. The impact of a bail-in may depend on the specific type of derivative products involved. For instance, complex credit derivatives might be more challenging to assess and manage post-closure, thereby increasing the risk of value destruction.
- Exclusion of other liabilities: The exclusion of other types of liabilities could potentially influence the effects of a bail-in. If certain liabilities are excluded from the bail-in, it could affect how costs are distributed and how the bank manages its liabilities. However, this would depend on the specifics of the excluded liabilities and their impact on the overall financial position of the bank.

In conclusion, the circumstances and extent to which the bail-in of net derivative exposures could lead to value destruction depend on various factors, including the bank's business model, the types of derivative products involved, the exclusion of other liabilities, and the impact on investor confidence. A thorough analysis of each specific situation would be necessary to assess these risks.

The risk of ending-up in an over/underhedging position at overall Balance Sheet level (after the forced unwinding of derivative transactions, be they netted and collateralised or not), should be taken into account as potential factor of "destruction of value".

The cost-benefit analysis should also carefully balance the magnitude of amount of bail-inable liabilities stemming from the unwinding of derivatives, which may turn out to be tiny at the end of the valuation process. An approach based on proportionality should be adopted, keeping in mind that the conversion process should be worthwhile to be pursued.

A bail-in of net liabilities under derivatives would lead to trading and banking books being massively mis-hedged which would trigger further losses that can exceed the original write-down amount.

The credit risk of the counterparty whose exposure is bailed-in increases, which can negatively impact the bailed-in bank (and other creditors) when it is also a borrower. Such an issue arises if 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. 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. Taking the possibility into account makes the *ex-ante* determination of the bail-in perimeter much more complex, as detailed in Question 4.4.

(A) The bail-in of derivatives leads to clients bearing substantial economic losses

As an illustrative example, assume a bank selling an airline a \$100m hedge to manage their fuel cost. The strike price of the option is set to \$120 per barrel. As a result of the transaction, the bank has a short position in the oil market of 833,333.33 barrels, for which it buys an offsetting long position to stay within its risk limits.

At the time of the bail-in event, the fuel price has risen to \$200/barrel. The bank now owes \$80 per barrel to the airline. Assuming that this trade is the only transaction in the specific netting set, the set will be included in the bail-in order. Comparatively, if the oil price moves into the other direction, the airline owes money to the bank and the position will remain in place. The Present Value of the obligation is \$80 per barrel x 833,333.33 barrels = \$66.67m.

This amount will be bailed-in. At a 90% haircut, the airline receives \$6.67m worth of the bank's equity and the \$100m hedge is cancelled.

The bank gains $\$66.67 - \$6.67\text{m} = \$60\text{m}$ in balance sheet relief.

Both parties now have unhedged open positions.

Airline: Needs to cover its jet fuel exposure for 833,333.33 barrels at the higher price of \$200 per barrel. Assuming that the airline can sell the equity stake for \$6.67m, it now needs to pay \$160m for the same hedge. That's \$60m more than previously and is an economic loss for the company.

Bank: Now has an unhedged \$166.67m long position in the oil market (833,333 barrels at \$200 per barrel). This has the following effects: (A) The open position breaks the bank's risk limit. (B) The bank now needs to find a market participant that is (i) willing to trade with a recently bailed-in bank, (ii) act swiftly as market participants may guess the direction of the bank's open positions, driving prices further to increase profits.

If the bank needs to sell at a 5% lower price to close its position within 1-2 days, the cost is $\$166.67\text{m} \times 5\% = \8.3m . This cost needs to be offset against the \$60m gain from the cancellation of the hedge. The result in the net balance sheet relief being lowered to \$51.67m.

(B) The bail-in of small exposures can result in the overall loss for the bank exceeding the balance sheet relief

This example assumes a very high balance sheet relief (\$51.67m on a \$200m book). If the oil price were to raise by only \$2/ barrel from \$120 to \$122 per barrel, the transaction would still be bailed-in. However, the balance sheet relief would be only \$1.67m (\$2 per barrel on 833,333.33 barrels). The airline is facing a much smaller loss, but the bank is not creating any significant net balance sheet relief by unwinding its \$102m long position. If the bank has to offer the same 5% haircut to sell its long position quickly, it incurs a loss of \$5.1m ($\$102\text{m} \times 5\%$). This loss exceeds the amount of balance sheet relief (\$1.67m), resulting in an overall loss of \$3.43m.

In practice, haircuts of 5% are not unusual for large trades, even in markets as liquid as the oil market. In less liquid markets, haircuts can reach 20%. If the netting set contains some difficult to value legacy positions, such positions may be basically illiquid.

(C) Small exposures can be the result of large offsetting positions

Netting sets tend to contain several transactions. The sum total of a netting set may be small but may be the result of two or more large positions in opposite directions (say, a gain in the oil future is offset by a similar loss on an interest rate swap with the same client). In that case, economic losses will be significantly higher. The client faces losses on the oil position and on the interest rate swap while the bank may gain or lose, depending on the haircuts it has to offer to the market to cover its open positions.

To prevent the destruction of value for the bank (and perhaps limit economic hardship for certain client groups/ economic sectors), it would be very informative to assess how a given netting set would react to a bail-in order, i.e., how the NPV would change if the derivative positions were to be cancelled/ haircut in a specific way. The problem is that this would require a scenario analysis to be conducted prior to a bail-in order, which – given the tight timeframe of a bail-in weekend – may not be feasible.

(D) Further issues

- It is market practice that derivative trades with corporate clients are mostly not collateralised while trades with other financial institutions are collateralised. There have been cases where corporate clients already have asked for unilateral collateralisation agreements whereby banks are asked to pledge collateral to the client that can be seized in case of a bail-in. Such a collateral pledge can become much more common and would significantly reduce the balance sheet relief that could be attained from a bail-in. In the worst-case scenario, it could lead to a

situation where all large positions are collateralised, and only smaller/ less sophisticated investors bear the cost of a bail-in.

- Banks tend to reuse non-cash collateral. Example: a car manufacturer pledges their own bonds as collateral for a derivative position. The bank taking the collateral in will value the bonds with a haircut. It may later decide to lend the bonds out against cash. In a bail-in event, the bank will have to deliver the non-cash collateral to the client. Given the disruptions caused by a bail-in, buying back the pledged non-cash collateral will be more costly. This can lead to significant price spikes (For an example of such a price spike, cf. the 2008 Volkswagen short squeeze).

Despite the points raised above, the bail-in tool can be a helpful instrument when dealing with large unhedged portfolios. For example, a bank that sees its financial situation degrading to a level where it must assume that it is likely to be placed into resolution, may be tempted to issue large amounts of one-sided derivatives to raise funds in a last-minute attempt to prevent almost certain failure. Without the application of the bail-in tool, the bank's bond holders would suffer all losses. However, bailing-in such unhedged positions would effectively ensure that the market counterparties who bought these last-minute derivative issuances will share the losses.

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. Relevant may be 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 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 and usually under a hedge accounting regime. Should some of these liabilities be subject to bail-in, the corresponding hedging derivatives would be partially winded down according to the

notional percentage that would be converted into equity shares (the derivative notional amount, if any, after the partial unwinding will match the notional amount of the bond after the application of the bail-in). For vanilla instruments, this process might be easier and with relatively less 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) 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;

- Issued own investment certificates, with full, partial or no capital protection (on different asset classes, such as equity, foreign exchange, commodity) and with economic hedges that might be either exchange traded or external over-the-counter (OTC) derivatives (under bilateral agreements or centrally cleared); the risk management and the accounting regime would be different from the above described case, 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 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 position, and therefore the corresponding winding down of the external hedges will be greatly reduced in size. About the latter (NCP) part, made by deposits of natural persons and SMEs 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 above-described cases 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.

As a 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) would apply here too, this possible destruction of value is 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 minimises 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 Directive 2014/59/EU? 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.*

Several operational considerations could hinder a bank's ability to operationalise bail-in effectively, especially concerning derivative contracts, collaterals, and deposits. Here are some key points:

- Operational challenges related to derivative contracts: it is suggested that operational difficulties might arise regarding the bank's ability to promptly provide necessary information about its derivative contracts. This could include challenges related to collecting, managing, and communicating data on derivative contracts. These difficulties might be heightened in the case of diversity or complexity among the derivative products held by the bank.
- Collaterals and operational challenges: the question also mentions potential operational challenges related to the swift determination of the value of liabilities secured by collaterals. Rapidly identifying to what extent, the value of secured liabilities exceeds the value of assets can be a challenge, especially if the collaterals are diverse or complex. This could affect the ability to adequately assess the amount available for bail-in.
- Specific challenges for deposits: the question also raises the possibility of operational challenges in the quick identification of the amount of a deposit exceeding the coverage level stipulated by the Deposit Guarantee Schemes Directive. This could involve the need to rapidly determine which portions of a deposit are eligible for bail-in in case the guaranteed limits are exceeded.
- Specific challenges for identifying the amount of deposits: operational challenges in rapidly determining the portions of a deposit which are eligible for internal bail-in in case the guaranteed limits are exceeded arise when requested in the context of resolution / bail-in reporting as these are distinct from the Deposit Guarantee Scheme reporting.

In particular, the "redistribution" of the coverage sums to multiple deposits of one creditor if the total sum of all deposits exceeds the maximum coverage proves challenging. The law on deposit insurance simply adds up all deposits of one customer to determine the amount of compensation. However, resolution authorities demand a percentage distribution of the maximum coverage sum to each single deposit (with the same insolvency rank) for the bail-in reporting. This two-step calculation and distribution is very complex as the coverage sum of a creditor with multiple deposit accounts may need to be allocated firstly between deposits of that creditor in different insolvency ranks, and secondly between different deposit accounts within the same insolvency rank.

In summary, operational difficulties in the context of bail-in could stem from the complexity of derivative contracts, the evaluation of collaterals, and the rapid identification of eligible deposits. Operational challenges may vary depending on the specific nature of the financial instruments and coverage mechanisms involved. Effective management of these aspects would require robust information systems and well-defined operational processes.

Focus on the derivative contracts

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 often 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 they 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.
- Last, 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 set offs 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, and bearing in mind that the applicable terms of the master agreement will likely differ by counterparty.

We also believe and we deem worth to clarify that the challenges above illustrated are relevant in case of a close-out of derivatives contracts, while on the other side there are not operational matters that may limit the banks’ ability to answer in a short notice to the requirement of having all information regarding derivatives contracts specially referred to the valuation on a daily basis by reference to an active and liquid two-way market for an

equivalent instrument without credit risk, in accordance with Articles 104 and 105 of Regulation (EU) No 575/2013, including in this the valuation of the derivatives embedded in structured notes and investment certificates issued by the banks, regardless of whether they feature full, partial, or no principal protection.

Beyond the abovementioned challenges posed by derivatives' valuation, one should also keep in mind the potential difficulties/impediments that a bank could face in the process of conversion of such liabilities into equity, which often entails several complex process steps de facto lengthening (if not hampering) the operationalisation of the bail-in, which are very challenging to complete with the very limited time-window of the "resolution weekend".

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?

We welcome the idea of, reducing the complexity, of the MREL calibration and would further support that increasing its predictability and transparency, particularly for investors. The current methodology to determine MREL requirements is, while for its rather mechanical aspects predictable for those involved at the individual bank level, perceived as unduly complex, subjective, and hard to compare with other banks or jurisdictions. In addition, the requirements are calibrated (and subject to a backstop) taking into account a bank's rather outdated static 'snapshot' TLOF metric. This manner in which the TLOF metric currently plays a role in the MREL calibration framework should be re-evaluated. Furthermore, the total MREL requirement and subordinated MREL requirement are determined based on a different calculation, and this should also be aligned. Reducing complexity is particularly important for all banks where the calibration appears overly sophisticated.

Though linking the MREL calibration to the outcome of the resolvability assessment in its current form would lack transparency as further laid down under Question 5.2 and not all aspects of resolvability have a clear linkage with and/or are not mitigated or influenced by the bank's level of loss-absorption and recapitalisation capacity. In our view, it is extremely important that institutions have a clear vision on how their strategy impact MREL requirements. It is also important that any such process does not result in distortions in level playing field across banks within the Banking Union and wider European Economic Area as well as globally with large international banking groups.

An overly complex MREL calibration methodology:

The currently applicable general principles at the basis of the MREL calibration could appear as sound and reasonable. However, the extremely conservative approaches adopted by the Competent Authorities for the calibration of the capital requirements, equating the Loss-Absorption 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 abnormally high MREL levels (on average 20%-25% above the TLAC). The complexity of the Level 1 Texts complemented with not necessarily clearer and often very constraining and more conservative Level 2 Texts and policies, the articulation of the MDA and of the M-MDA, render the EU/BU framework hardly understandable for non-initiated, non-specialised stakeholders (counterparties, investors, shareholders, and third country authorities). We would also like to stress the importance to respect the principle of the hierarchy of norms, and that consequently, a policy cannot be more restrictive or prescriptive than level 1 texts. This complexity and the MREL regulatory framework

contribute to put EU/BU banks at a clear competitive disadvantage vis-à-vis their international competitors, notably the US ones. Equity investors disregard EU/BU banks that trade at an important discount vs. US ones and debt investors require significant premiums from them compared to what is required from US banks.

A single adjustment driver would go in the direction of simplification and would therefore be welcome. It should anyway be easily understandable, objective, predictable and transparent and it should not entail by itself a higher MREL requirement neither be detrimental to the principle of proportionality. The concept of resolvability appears too vague and discretionary in that respect.

Using a resolvability score as single adjustment driver would be misguided in our view, in particular for those banks who have been assigned a transfer tool as Preferred Resolution Strategy (which would likely be the most affected by such a change), for a variety of reasons, including:

- (i) The introduction of a single score would not reduce complexity; it could instead increase complexity and lack of transparency, in that such a score should take into account a large number of rather subjective factors (with specific weights to be associated to each factor, following an ad-hoc calibration); and
- (ii) As a consequence, under the apparent objectivity of a mathematical formula leading to a score, this would leave excessive room for discretion, potentially hampering transparency and level playing field.

The MREL subordination requirements framework could also be reconsidered:

Indeed, the complexity of the framework the competitiveness issues also come 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, or the full subordination requirement for Holdco structures). 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 MREL calibration methodology disadvantageous in terms of competitiveness:

The current methodology was determined by the European Banking Authority (EBA) in 2015, at a time where under the BRRD almost all liabilities were eligible to MREL (structured notes, debts issued by subsidiaries, large deposits, among others). EBA's impact assessment at that time noted that almost all banks complied with the envisaged ratio (based on 2014 data)⁵.

With the CRR2/BRRD2, MREL features have been aligned with FSB's TLAC requirements comprising:

- A high proportion of subordinated debts for large banks;
- Requirements in contractual conditions to ensure an easy bail-in (no set-off, bail-in clause) and stability over time (no acceleration possible, regulatory approval to repay the debt before maturity);
- Limitation to vanilla remuneration (except if a capital is guaranteed continuously); and
- A restriction to debts issued by the point of entry.

Eligibility criteria have been strengthened while the calibration has not been aligned with the FSB's one. Currently for a bank earmarked for an open bank bail-in strategy, the MREL consists roughly in doubling all capital requirements in RWAs (2 times Pillar 1, plus 2 times

⁵ [EBA-RTS-2015-05 RTS on MREL Criteria.pdf \(europa.eu\)](#) – see page 35.

Pillar 2 Requirements (P2R), plus 2 times CBR)⁶, while TLAC is only two times Pilar 1 +2 % +one-time CBR.

According the SRB's Q2 2023 MREL dashboard, average subordinated MREL in RWAs (without CBR) amounts to 20.5%, while TLAC minimum requirement (without CBR) is 18%, or 14.5% if the bank uses the Senior debt allowance. The total MREL requirement (without CBR) is 23.7% in average. With a total RWA of EUR 7434 bn, the 5% differential between MREL and TLAC represents about an additional EUR 370 bn of SNP/eligible SP instruments to issue and roll for banks in the SRB's remit, compared to the TLAC minimum requirement. Assuming an average annual yield of 3.60%⁷, those EUR 370 bn additional issuance volume represent a significant cost to EU-banks (and the cost of bail-in bonds has a significant risk premia over non-bail-in bonds).

The consequences of a high MREL requirement are manifold:

- The depth of the EU bond market is not infinite and is already partly filled with non-EU banks that offer large issuances volumes, at wider spreads (on average), thereby limiting the overall market liquidity available to EU banks. As an illustration, issuances from non-EU banks represented 20%-30% of the annual financial EUR bond supply on average in the last 5 years, and about 10% per year coming from US banks, which is significant. To be able to issue large volumes, EU banks are obliged to diversify their funding away from their EU domestic market in order to access other pockets of liquidity for SNP/SP or Own Funds. This comes at a cost. As an illustration, major EU banks issue a large portion of their MREL in the US-market, whereas on average it is ~30-40bp more expensive than EUR;
- Markets are very volatile and can close suddenly as shown in the recent years (pandemic, war, Credit Suisse case). High requirements force EU banks to issue during sub optimal (high cost) market windows;
- The constraints on issuances limit the room for manoeuvre to finance the economy at a stage where the green and digital transition financing needs are huge. This paves the way for non-EU banks that have less constraints and creates a significant dependency of the EU industry as well on non-EU banks;
- MREL/TLAC issuances weighs on the banks' profitability, and the situation will worsen with Basel IV RWAs (see EBA's QIS).

The case of banks with MPE strategies:

In particular, for MPE banks, the MREL calibration would merit further improvements on the following aspect: currently for MPE banks, cross-exposures between different resolution groups within the same banking group have a different treatment under the TLAC and MREL requirements. Under the TLAC requirement, according to the CRR, these exposures to other resolution groups are deducted from the Own Funds and Eligible Liabilities. On the other hand, for the MREL requirements, the SRB applies the MPE add-on in its MREL policy (paragraph 47) instead of deductions on the base of eligible instruments. While the rationale of these is the same (i.e. reducing exposures between resolution groups), having both approaches entails a misalignment, hampering comparability and creating unnecessary complexity for investors. Therefore, the calculation should be aligned for those exposures.

Furthermore, considering that the MREL add-ons for MPE banks are updated only when a new MREL decision is issued, this approach could potentially generate a mismatch between the requirement in place and the real need for loss-absorption and recapitalisation capacity of the bank. This is because of the time lag in the decision to be included in the calculation.

⁶ To be precise, the CCYB only counts once, and a small reduction of Balance Sheet in resolution is applied by the SRB.

⁷ 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%.

While the time lag issue is common to all banks (regardless of their preferred strategy), it is particularly challenging for MPE banks subject to an MREL add-on because of these cross-exposures. Therefore, 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, therefore unifying the approach.

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.

Eight years after the EU resolution framework entered into force, the EU banking sector has made significant progress in terms of resolvability. Yet, such progress has not yet led to the decrease of the MREL requirements, including the subordination requirement. We believe that there is room to improve the methodology of setting the MREL requirements and make it more consistent with the progress of banks in terms of resolvability.

However, linking the MREL calibration to the outcome of the resolvability assessment of the IRT in its current form would lack even more transparency as the assessment methodology and criteria are currently not shared with the banks. Banks would then need to rely on resolvability results that are currently neither transparent, nor reviewable, nor comparable.

Today, calibrating the MREL according to resolvability criteria is not possible. But if this approach were to be adopted, it could lead to an excessive discretionary calibration method. Whereas, adjusting the MREL does not necessarily directly address the issue of resolvability. There is no obvious link.

Resolvability in itself is neither a clearly measurable concept, nor a very objective one. Actually, 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. It would not remove the inherent subjectivity attached to that kind of assessment.

Accordingly, the calibration of MREL should not be linked to resolvability assessment except where impediments to resolvability are related to the use of bail-in tool and a predetermined surcharge of subordinated MREL is justified. In situations where impediments to resolvability are related to other aspects (e.g. MIS) than the use of bail-in tool, a surcharge of subordinated MREL will not remove the impediments. Instead, measures to improve the resolvability should be related to the relevant areas where the impediments are identified.

Finally, sufficient loss-absorption capacity (MREL) is a key variable/determinant of the result of resolvability assessment – having MREL as an output as well create a circular loop – as MREL serves as both input and output. The methodology of the resolvability assessment should be amended to solve this issue.

Question 5.3:

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

In our view, the MREL calibration can be reviewed on several aspects:

- Loss-Absorption Amount: the assumption in BRRD/SRMR that the bank has lost all its capital in resolution seems rather unrealistic and it is rather likely that some capital would remain.
- Recapitalisation Amount: BRRD/SRMR provide that the Recapitalisation Amount must be calibrated according to the bank's shape post resolution. The resolution authority should make an assessment of the downsizing of certain activities and take into account transfers that are deemed realistic and operational.
- Market Confidence: as explained above it is not justified to add buffers for market confidence purpose.

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

A calibration system with (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 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 would appear in line with those criteria.

Finally, a minimum floor for every bank that will be resolved, whichever the strategy retained, should be defined, and ideally applied 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 capitalisation of the remaining part.

Similarly, and consistently with our recommendation for simplicity, transparency and predictability of the system, a cap could be introduced too, allowing the resolution authority to treat exceptions with duly justified add-ons within pre-set limits.