Finance Watch
Making finance serve society

Finance Watch response to EBA's consultation on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU

Brussels, 27 February 2015

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Question 1
The draft text describes comprehensively capital requirements under the CRR/CRD IV framework, which includes minimum CET1, AT1 and total capital requirements, capital buffers required by CRD IV, Pillar 2 capital requirements set on a case-by-case basis, and alternative backstop capital measures. The EBA is seeking comments on whether all elements of these capital requirements should be considered for the assessment of the loss absorption amount. Do you consider that any of these components of the overall capital requirement (other than the minimum CET1 requirement) are not appropriate indicators of loss in resolution, and if so why?

We acknowledge the fact that estimating historical losses in a consistent manner across Member States is a challenging exercise. We also understand the rationale behind the choice of the capital requirements framework as a basis for assessing the loss absorption amount (as chosen by the ICB in the UK or FSB when determining the basis for the calculation of TLAC).

Although much has been done to improve the Basel framework, Risk Weighted Assets are not the best predictor of G-SIB resilience, due to the so-called bank regulators' paradox*: "that large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis*." [1]

A simple leverage ratio has been shown to be a better predictor of G-SIB resilience (as an indicator of banks' distance to default), hence we strongly welcome the inclusion of a leverage ratio requirement in Article 2. However, since according to the Regulation 2013/575/EU the leverage ratio is not a binding Pillar 1 requirement, the wording of the Regulatory Technical Standard should be amended to make it clear that this requirement is binding in the context of MREL.

We also welcome the introduction of the Basel I floor in Article 2. Due to the well-known shortcomings of internal models there is a need to maintain the Basel I floor and to effectively benchmark banks' internal models against a standard portfolio.

Furthermore, should the loss absorbency amount be based on capital requirements all the elements mentioned in Article 2 must be taken into account. In particular, the Pillar 2 add-on, namely a supervisory estimate of an institution's risk not covered by the CRD IV/ CRR framework, needs to be taken into consideration.

Nevertheless, additional comment needs to be made in relation to large, systemically important and complex banks.

The resolution authority under the proposal has the power to determine if the loss absorption amount is adequately reflected in the capital requirements of an institution (and adjust the amount appropriately), taking into account its **business model, funding model and risk profile** (as provided for in Article 2 (4) of the draft RTS, which refers to Article 6 of the draft RTS).

[1] Adrian Blundell-Wignall, Paul Atkinson and Caroline Roulet, *Bank business models and the Basel system: Complexity and interconnectedness*, OECD

The resolution authority should base its judgment on the outcomes of the supervisory review and evaluation process (SREP) conducted by a competent authority (as mentioned above the Pillar 2 add-on is taken into account). In this assessment, the resolution authority should also take into account whether measures to remove impediments to resolvability, as provided for in Articles 17 and 18 of Directive 2014/59/EU (BRRD), address risk and vulnerabilities adequately. The resolution authority might adjust the loss absorbency amount if it deems that capital requirements do not adequately reflect all the risks and vulnerabilities and should provide the competent authority with a reasoned explanation.

Taking into account the regulator's paradox described above, which boils down to the fact that there is no reasonable ex-ante amount of capital that would protect large banks from failing in a system wide stress, we doubt that it is possible to quantify the impact of business model, funding model and risk profile on the appropriate loss absorbency level in the case of very complicated institutions of systemic importance. This is why the "*Separation of fundamentally different business segments is required to deal with this problem*". [2]

The measures to remove impediments to resolvability as provided for in Articles 17 and 18 of Directive 2014/59/EU (BRRD), which are to address risk and vulnerabilities not covered by the CRD IV/CRR framework, will also be difficult to implement as rightly pointed out in EBA's opinion: *"in the absence of a legal segregation, as proposed by the High Level Group, it might be extremely difficult for a supervisory authority to exercise its discretionary judgment and impose a break up of a universal bank, especially if other competent authorities are not responding with similarly harsh measures in comparable cases."*[3]

Therefore Finance Watch is convinced that only effective ex-ante measures aimed at the banking structures (such as bank structural reform) would deal with the problem of inadequate loss absorbency, hence enabling effective resolution of systemic institutions.

Question 2 Should paragraph 5 refer only to the resolution authority *increasing* the loss absorption amount, rather than *adjusting* it? Are there specific circumstances under which resolution authorities should allow a smaller need to be able to absorb losses before entry into resolution and in the resolution process than indicated by the capital requirements (for example, due to the use of national discretions in setting capital requirements)?

Please refer to our general remarks on determining loss absorption amount above.

[2] Ibidem

[3] Opinion of the European Banking Authority on the recommendations of the High-level Expert Group on reforming the structure of the EU banking sector

In our opinion paragraph 5 should refer only to an increase in the loss absorption amount. The national divergences in setting capital requirements should diminish after the phasing-in period and we believe that for market confidence purposes and to ensure a level playing field there should be a floor on the loss absorbency amount[4] (leverage ratio or capital requirements including Basel I floor and buffers). The flexibility of MREL is already guaranteed by taking into account other elements of this requirement.

Question 8 Do you agree that resolution authorities should seek to ensure that systemic institutions have sufficient MREL to make it possible to access resolution funds for the full range of financing purposes specified in the BRRD?

Yes, we agree. Given the high potential social costs of systemic bank failures it is essential that the preconditions for use of the resolution fund are met. In the case of systemic banks the bail-in will be probably the most credible resolution strategy (even if ex-ante resolution planning does not imply the use of this tool) given the complexity and systemic importance of core banking functions.

The provisions of article 7 introduce a floor to MREL, as defined in article 44 of BRRD, of 8% of total liabilities and own funds or, in specific cases, 20% of RWA. The introduction of a floor to MREL for systemic banks will have a positive impact on market confidence and ensure a level playing field.

This requirement will most likely also capture the banks with lower RWA density, which is a positive development.[5]

Moreover, it is the only provision addressing the sixth criterion from the Level 1 text (as defined in Article 45 (6) (f) of BRRD), which requires resolution authorities to take account of the potential adverse effects on **financial stability, including, due to its interconnectedness with other institutions or with the rest of the financial system through contagion to other institutions**. Please note that in our opinion the Level 1 requirements were not fully addressed by the draft RTS in this respect. Please refer to our answer to question 12 in this respect.

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[4] Please note that the Single Supervisor also wants banks to raise more equity because of a clampdown on national exceptions to capital rules: "*Danièle Nouy told the Financial Times that banks would have to raise more and better quality capital as a result of her new agency's drive to harmonise more than 150 national variances in capital rules*." http://www.ft.com/cms/s/0/4d0aa116-bc2b-11e4-b6ec-00144feab7de.html

[5] Given the density of RWA of the biggest banks in Europe (app. 35% according to an EBF study) the requirement amounting to 8% of total liabilities and own funds will be most likely met when establishing loss absorption and recapitalization amounts (depending on buffer requirements and Pillar 2 add-ons applicable), but in the case of banks with lower RWA density this constraint will be binding.

Question 11
Overall, do you consider that the draft RTS strikes the appropriate balance between the need to adapt the MREL to the circumstances of individual institutions and promoting consistency in the setting of adequate levels of MREL across resolution authorities?

We welcome the introduction of the floor to MREL for systemic banks (based on the requirements set in Article 44 of BRRD), which promotes consistency and market confidence. Moreover, given the construction of MREL (loss absorbency and recapitalization amounts based on capital requirements) the 8% of total liabilities floor will be binding for systemic banks with low RWA density, which is a positive development especially given the shortcomings of internal models. Please refer also to our answers to question 8.

Since the loss absorbency amount and recapitalization amount are based on capital requirements, we would like to point out again the necessity and importance of keeping the Basel I floor and of effectively benchmarking internal models against a standard portfolio.

Moreover, the inclusion of the leverage ratio as a binding constraint for MREL purposes is crucial in our opinion as it is the better predictor of bank resilience.

Question 12
Are there additional issues, not identified in this section, which should be considered in the final impact assessment?

We fully understand that the BRRD framework was designed with a microprudential focus and concentrates on individual institutions. We also take into account that the aim of MREL is to ensure that the institutions have appropriate liability structures to go smoothly through a resolution process when there is a need to apply the bail-in tool.

However, according to Article 45 (6) (f) of BRRD, the resolution authority should take into account the extent to which the failure of the institution would have adverse effects **on financial stability, including, due to its interconnectedness with other institutions or with the rest of the financial system, through contagion to other institutions**.

This criterion was addressed by the draft Regulatory Technical Standard by introducing a floor to the MREL for systemically important institution, which should make it possible for the institutions to access resolution funds. It is an important construction and should be maintained, however it does not fully addresses the Level 1 text, in our opinion.

The interconnectedness and contagion risks should be given much more weight since it is crucial for the resolution authority to ensure that an institution not only holds an appropriate amount of bail-in-able debt but also that the holders of the debt can bear the losses without putting financial stability at risk. Given that most holders of bail-in-able debt are likely to be other financial institutions highly

correlated with one another, additional measures should be integrated to capture this, such as the degree to which the risk of an institution is conditional on the distress of other financial Institutions. The BRRD also recognizes clearly that the resolution authority should be able to decide not only on the quantity but also on the quality of the eligible liabilities: resolution authorities should *"be able to require, on a case-by-case basis, that that percentage is wholly or partially composed of own funds or of a specific type of liabilities*."[6]
As the European Commission notes in its Staff Working Document ***Initial reflections on the obstacles to the development of deep and integrated EU capital markets***: "(…) *corporates account only for some 7.5% of the total EU debt securities outstanding, whilst governments account for some 42.5% and financial firms account for almost 50%. In fact, the growth in debt capital markets over the last two decades is largely driven by financial entities, essentially, selling and trading debt with each other. Indeed, bonds issued by financial firms are bought by other financial firms. Not all of this intrafinancial trading may contribute to improved financial services to end-users but instead* ***may simply reflect a lengthened intermediation chain and greater interconnectedness, thereby enhancing contagion and systemic risk"***[7] (our emphasis).

Another issue that should be considered, in our opinion, is the **unfavorable development of institution's liability structures**, especially when liquidity conditions are stressed.

The structure and composition of bank balance sheets are dynamic and although BRRD requires that the institution have robust MREL at all times (Article 45 (1) of BRRD) there are no automatic safeguards provided for in the Directive that would explicitly monitor possible breaches to the MREL requirement.

Moreover, the construction of MREL concentrates on loss absorbency and capital requirements but the problems are more likely to result from liquidity risks. As we argue in our recent position paper, liquidity risks linked to securities financing transactions have not yet been fully addressed, either by LCR or by NSFR.[8]

If a bank encounters liquidity problems but not solvency problems (e.g. it has a sound solvency position but due to market stress cannot roll over its debt) and the central bank acts to provide extraordinary liquidity assistance it will not (and should not automatically) trigger any resolution

[6] Recital 79
[7] http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/staff-working-document_en.pdf
[8]Finance Watch position paper on long term financing: *A missed opportunity to revive "boring" finance*? p.82, "*Although NSFR and LCR within CRD IV try to address liquidity risk some argue that the liquidity ratios in CRDIV mostly aim at reducing maturity mismatches between assets and liabilities at an institution level. Maturity mismatch in core institutions is indeed a key financial stability risk in wholesale funding markets but it is not the only one. As described by Fed governors Stein and Tarullo "Even if an intermediary's book of securities financing transactions is perfectly matched, a reduction in its access to funding can force the firm to engage in asset fire sales or to abruptly withdraw credit from customers. The intermediary's customers are likely to be highly leveraged and maturity transforming financial firms as well, and, therefore, may then have to engage in fire sales themselves. The direct and indirect contagion risks are high. (..) The LCR and, at least at this stage of its development, the NSFR, both rest on the implicit presumption that a firm with a perfectly matched book is in a fundamentally stable position. As a microprudential matter, this is probably a reasonable assumption. But under some conditions, the disorderly unwind of a single, large SFT book, even one that was quite well maturity matched, could set off the kind of unfavourable dynamic described earlier."*

action (please bear in mind that BRRD excludes any automaticity in determining if a bank is failing or likely to fail based on extraordinary liquidity support from central banks[9]). However, the liquidity inflows from the central bank being collateralized funding, they will change the institutions' balance sheet composition (liability structure and level of asset encumbrance). Hence, if this situation persists and/or liquidity problems turn into solvency problems, and if the decision to initiate a resolution action is taken at a later stage, there is a possibility of a structural subordination of liabilities. The liquidity inflows from a central bank will replace liabilities that cannot be rolled over and since the secured liabilities are exempted from bail-in, the amount of bail-in-able liabilities will shrink, leaving the unsecured liabilities structurally subordinated to central bank claims.

In such a case, when resolution actions are taken and bail-in is to be applied, the amount of bail-in-able liabilities might already be limited (because of collateralized central bank funding) although the MREL was initially set in a manner consistent with the proposed draft technical standard.

Therefore there is a need to ensure timely and appropriate resolution/ supervisory actions and close monitoring of MREL requirement and balance sheet structures.

[9] BRRD: "*The need for emergency liquidity assistance from a central bank should not, per se, be a condition that sufficiently demonstrates that an institution is or will be, in the near future, unable to pay its liabilities as they fall due*"