

**Czech Banking Association Case Study  
Impact of the potential implementation of Draft RTS  
on criteria for determining MREL (EBA/CP/2014/41) in the Czech Republic**

The impact assessment attached to the RTS was done in a simplified way, which disregards vast differences existing among jurisdictions. These large differences relate to the capital requirements imposed by local supervisory authorities, balance sheet structure and source of financing, the size of MREL eligible liabilities relative to equity instruments in the respective countries and also the stage of the development and depth of the markets with MREL eligible instruments.

One of the examples, which were misinterpreted in the impact assessment attached to the RTS, is the Czech Republic.

The Czech banking system is financed predominantly by primary deposits (deposits without monetary financial institutions' deposits), which cover 63% of Czech banking sector assets (only 36% in EMU). The whole market of Czech banks and building societies operates with a liquidity surplus – loan to deposit ratio as of 30 June 2014 was 79.8% (103% in EMU). This is particularly the case of the D-SIBs with average L/D ratio of 78.5%. Among other reasons, as a result of high liquidity surplus in the whole banking sector, the market with senior unsecured debt has not been developed.

| <b>Share on total assets</b> | <b>EMU</b> | <b>CZ</b> |
|------------------------------|------------|-----------|
| Total deposits               | 53%        | 74%       |
| core deposits                | 36%        | 63%       |
| MFI deposits                 | 17%        | 11%       |
| Capital and reserves         | 8%         | 12%       |

The data presented under impact analysis for 128 EU banks, where the estimated ratio of senior unsecured debt with a residual maturity over 1 year to total own funds (equity + subordinated debt) is around 158% (i.e. total MREL eligible instruments are 2.6 times higher than total own funds), show, that European banks in average should not lack MREL eligible liabilities. Aggregate MREL shortfall under the presented scenarios ranges only to 0.04% - 0.11% of the banks' assets.

However, for the Czech Republic the situation is dramatically different. As of 30 June 2014 the total amount of equity & subdebt issued by banks was EUR 14.3 bn., while the amount of senior unsecured bonds issued by the banks authorized in the Czech Republic was almost zero.

What concerns the second largest category of the MREL eligible liabilities - long-term deposits of large corporate clients – the situation is very similar. The overall volume of the corporate deposits with contractual maturity over 1 year as of 30 June 2014 was only EUR 455 mn. This figure even significantly overestimates the actual size of MREL eligible

corporate deposits, since it covers deposits with original (not residual) maturity and incorporates also SMEs, which would not qualify for MREL inclusion. The huge gap between the European market and the Czech market as regards to the relative volume of MREL eligible senior unsecured debt to total own funds - 158% versus 0% - causes that the proposed RTS seriously threatens level playing field in the EU banking sector.

The Czech banks are very conservative, investing their liquidity surplus in highly liquid assets (34.6% of high liquid assets to total assets as of 30 June 2014). They are focusing on lending to domestic retail and corporate clients with only limited cross-border exposures. As a result the Czech banking sector is very stable, profitable and continuously strengthens its capital position. The viability of the conservative business model of the Czech banks was proven also during the financial crisis in 2007-2008, when the banks remained highly profitable and did not require any public support. The return on equity (ROE) of the Czech banking sector has been in the range of 16.2% – 26.4% during 2008-1H2014 (-1.5% to 2.2% in EMU).

The capital structure of the Czech banks is also very strong – they operated with 16.45% CET 1 ratio as of 30 June 2014 (13.4% in EMU). The capital position of the D-SIBs is even stronger - CET1 stood at 17.10% as of 30 June 2014.

Regular stress tests being performed by the Czech National Bank (which are performed under more severe stressed scenarios than those of EBA) also demonstrate high resilience of the domestic banking sector, primarily D-SIBs, against the chosen scenarios of adverse economic developments.

In order to protect the Czech depositors and as a result of high risk aversion and usage of macro prudential tools to counter the build-up of systemic risk by the Czech supervisory authority, the Czech systematically important banks are facing very high capital buffers – systemic risk buffer at 1 - 3% additionally to the individual SREP buffers under Pillar 2. In addition, the whole Pillar 2 capital requirements must be covered by Tier 1 capital. The Czech supervisory authority has implemented the 2.5% conservation buffer since CRD IV entered into force which together with systemic risk buffers for D-SIBs results in combined buffer requirements of 3.5 - 5.5% covered by Tier 1 capital in Pillar 1. Under such specific conditions, simply taking the prudential capital requirements as a basis for setting the loss absorption amount and for recapitalization amount will lead to overestimating the required amount of MREL eligible liabilities, while in reality the high capital requirement already makes the banks' loss absorption capacity being on a solid level. Also, the additional buffers are to certain extent a way to protect the existing capital levels rather than a reflection of risk profile of the Czech banks.

Thus as a result of the very conservative business model of all Czech D-SIBs, the prudent approach of the local supervisory authority and large liquidity surplus of the market, the impact of the proposed RTS on MREL on Czech banks is disproportionately high in comparison with western European markets. As the Czech systematically important banks focus on their core business – lending to the domestic retail and corporate clients - a potential resolution would not result in significant change of their size. Thus we can reasonably assume their MREL requirement to end up well above 30% of their RWAs, which

highly likely exceeds the TLAC requirement for G-SIBs. This indicates significant competitive disadvantages for the Czech banks rather than consistent approach across the Union.

A similar impact is very likely also for other CEE countries.

Based on the estimates of the Czech D-SIBs, the required amount of the senior unsecured debt the banks would have to raise represents 151.5 bn. CZK (= 5.5 bn. EUR), or 4.9% of their assets, which is significantly higher than the amount to be issued by 128 largest EU banks in average (0.04% - 0.11% of their assets). This leads to several conclusions:

- As the market for senior unsecured debt of domestic banks is non-existent in the Czech Republic, it will require substantially longer period of time to build the investor base for the required amount of debt to be issued, than proposed transition period of 48 months. Based on preliminary estimates of the local banks, under ordinary course of business it would take at least 5 years to raise 60% of the required amount. However it is challenging to estimate the market reaction when all the D-SIBs simultaneously approach the market.
- For this reason, we recommend to perform a market analysis (similar to the intended FSB QIS for TLAC) where the market appetite for MREL eligible instruments would be tested especially for issuers, which are not currently present on the senior unsecured market or for the CEE markets in general.
- Due to missing investors base in the local market, it is highly likely the Czech banks will be forced to raise majority of the funding in foreign currencies, which will bring unnecessary FX risk (or related risks associated to FX hedging) into the banks' balance sheets.
- Additional funding raised by the banks will increase the balance sheet size and leverage, which goes against prudential requirements.
- Increased balance sheet size of the low-risk banks might lead to breaking the leverage ratio requirement (depending on the binding level to be defined in EU), which would require further increase of already high capital ratios of the Czech banks. This would subsequently lead to spiral increases of the MREL eligible liabilities.
- The conservative business model of Czech banks makes it extremely difficult for them already now to invest the liquidity surplus into high quality assets available in the Czech market. Adding large amount of liquidity into their balance sheets will make it practically impossible to continue in their conservative investment policies. They will be forced to invest into riskier assets, or cross-border in the markets, which does not correspond to their traditional local focus and low risk appetite. This will increase the riskiness of the banking sector in general and also build undesirable interconnections and dependencies among individual markets which likely increase the systemic risk in the EU.
- Part of the additional funding raised due to MREL requirement will be invested into Czech government bonds, which would further increase the interconnectedness of the financial and government sectors. Already now Czech banks have high portion of their

assets invested into government bonds. The share of domestic government bonds in financial institutions' balance sheets (14% in 2013) significantly exceeds the EU average (6%).

- The large amount of funding to be raised will bring substantial increase in funding costs, which will have negative impact on profitability of the banks and thus lower their capital generation capacity. This impact is again disproportional for Czech banks, whose existing funding costs are traditionally extremely low.

In general the change of business/funding model in the market characterized by the large surplus of deposits over loans is impossible without increase of the balance sheet size, increase of leverage of the banking sector and increase of the riskiness, which is hardly the aim of the prudential regulation. The alternative way how to comply with MREL requirement would be conversion of the domestic retail depositors into senior unsecured creditors, which would go against one of the main objectives of BRRD and against efforts to harmonize protection of retail depositors in EU (DGSD).

As an additional example MREL requirement significantly interferes with business model of the Czech building societies, which are in terms of size comparable to the middle sized banks. These financial institutions operate on the principle of collective (the same principle which is used by the German building societies, which have exceptions to the Basel III rules according to BaFin decision). Their purpose is to acquire retail deposits from private individuals and provide purpose loans to the same group of private individuals. They operate with significantly lower L/D ratios than commercial banks and potential issuance of senior debt would have even more pronounced consequences given the limited investment opportunities they have according to the law.

The above Czech banking sector case study demonstrates that the compliance with the MREL requirements as they have been drafted by EBA will have a completely opposite consequences than was the original intention of this regulation, i.e. riskier, more leveraged, less profitable banking sector, becoming more dependent on secondary market, in the Czech Republic. This will certainly negatively influence the overall economy.

As written in the accompanying documents to the draft RTS the aim of EBA was to ensure a sufficient degree of harmonization of required MREL ratios for institutions with similar business model across the Union. However this is not possible without harmonizing of the phasing period for implementation of capital buffers under Pillar 1 across all Member States. Coming back to the Czech example, the draft RTS imposes within short term horizon significantly more severe requirements (with more severe consequences) on loss absorbing and recapitalization capacity of the Czech banks than the fully phased FSB proposal, addressing the required TLAC of G-SIBs. Thus the Czech banks will not have the same chance to naturally increase their capital base through retaining profits until 2019, since they will face significantly larger P/L impact compared to their European peers. This goes against the level playing field on the EU market and decreases the competitiveness of the Czech banks compared to their European peers.

Thus if EBA intends to impose such a strict guidelines on MREL as defined in the draft RTS, the Czech Banking Association strongly recommends doing so only after a certain

monitoring period, which will enable EBA to collect sufficient data about MREL levels of various type of institutions across Union.

This will enable comparison of the capital & MREL positions of the institutions with various business models across Union, assessment of their adequacy for a given business model and subsequent adjustment of the requirements in a way which leads to the harmonized approach across Union. Only afterwards a final impact analysis can be done, which will objectively assess the impact of a harmonized MREL requirement on the institutions with various business models across the markets, which are in various stage of development. Additional benefit of such an approach would be a possibility to harmonize the MREL requirement with final FSB proposal on TLAC of G-SIIs, which would be released in the meantime.

In the meantime we would recommend retaining sufficient flexibility for resolution authorities in setting up the MREL, which should include among others the following:

- The default LAA determined by the resolution authority shall be set at the level of own funds requirements pursuant to Article 92 and 458 of CRR (total capital ratio of 8%), and let the inclusion of some of the elements of capital requirements (especially capital buffer required by CRD IV and SREP requirements pursuant to Art. 104 1a. of CRD IV) into LAA only as a national discretion of a resolution authority. This would help to eliminate different phase-in period for implementation of capital buffers by the individual Member States
- Possibility to decrease the loss absorption amount and recapitalization amount in a case the institution has a credible recovery plan and the recovery triggers are defined at sufficiently high levels so as it is reasonable to assume, that the probability of the institution entering resolution is substantially reduced
- Possibility to adjust recapitalization amount downwards in the case the final MREL level would lead to undesirable consequences, contradicting the prudential requirements (higher leverage, increased interconnectedness of the financial sector, increased riskiness of the balance sheet of the institutions concerned, etc.)
- Possibility to set the recapitalization amount to 0 in the case of institutions with specific business model implicitly assuming financing by retail deposits acquired from private individuals and investing within limited range of highly liquid assets defined by legal framework (i.e. building societies). Mortgage banks financed by covered bonds are already excluded from MREL requirement.
- Possibility to adjust the MREL requirement reflecting the size of IG guarantees/ payment commitments provided to the institution by the parent company
- Possibility to extend the transitional period for issuers, who are not present in the senior unsecured market or in the case the domestic market does not have the capacity to absorb the necessary amounts of MREL eligible liabilities.