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From: General Secretariat of the Council
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Subject: FI Non-paper on Selected options on the MREL Shortfall and the BtG

Selected options on the MREL Shortfall and the Bridge the Gap Issue

The Issue

The European Commission adopted on 18 April 2023 a proposal to adjust and further strengthen the EU's existing bank crisis management and deposit insurance (CMDI) framework. In the proposal, the focus is on medium-sized and smaller banks and, more specifically, the Commission's objective is to enlarge the group of banks that would be under the resolution regime rather than liquidated through insolvency procedures.

One of the challenges that has been raised by some MSs in this respect is the difficulty of medium-sized and smaller banks' to access the debt market and the resulting MREL shortfall. MREL shortfall is widely seen as the main impediment for a credible and effective bail-in tool application. Falling behind the MREL targets would also mean that the access to the SRF funds in times of distress is not available.

Most of the European banks that currently have a resolution strategy and thus an MREL target higher than the capital requirement, have managed to fulfil the MREL target levels. A number of banks, however, seem to continue to struggle to meet this criterion, although it is unclear now (April 2024), how serious this problem is actually on the European level¹. It should be noted that in some MS also smaller banks have been successful in debt issuances. Moreover, banks have always the possibility to raise MREL through retained profits or equity issues, not just by issuing debt.

One of the arguments raised by some MSs and the SRB is that some smaller banks would have serious difficulties in organizing MREL debt issuances or that this debt would be very costly. These difficulties could depend also on economic fluctuations. Debt issuance involves usually various incremental fees and commissions paid to third parties, including investment banks, law firms, auditors, rating agencies and regulators. It also requires adjustments to the IT systems and other related costs.

It is also always uncertain, how the markets perceive the risk and price of a smaller bank's debt issue. Market liquidity could also be seen as doubtful, especially if the market situation deteriorates. Overall, in some cases, the debt issuance could be costly and the yield demanded by the investors possibly relatively high.

In the following, we illustrate three options on how to alleviate the banks' shortfall problem and to help to bridge the eight percent gap. These options are a so-called investment deposit account, senior standardized MREL bond and pooling the smaller banks' debt issuance. The options are not mutually exclusive. Thinking below is very preliminary and needs to be refined further.

Investment deposit

In order to overcome the problem of costly debt issuance, we could think of a non-preferred investment deposit. In the MREL framework, the deposit would be MREL

¹ See for example: <https://www.eba.europa.eu/sites/default/files/2024-01/17a0a1a7-1cd8-4e91-9ca1-33f1382387f9/MREL%20Dashboard%20-%20Q2%202023.pdf> and https://www.srb.europa.eu/system/files/media/document/2024-02-12_MREL-dash-board-Q3-2023.pdf

eligible as long as its maturity is (for example) 6 months. The bank could have the right to redeem it when the maturity falls under the given threshold for MREL eligibility.

The bank would inform the public clearly and transparently that this deposit instrument does not have a deposit guarantee protection under DGSD and it could be written down in case the bank would be resolved. Additionally, in order to avoid any misunderstandings by the retail customers, the minimum size of the investment deposit could be for example 100 000 euro. Inspiration for the possible conditions and limits for this type of deposit could be sought also for example from Article 44a of the BRRD.

The investment deposit's position in the creditor hierarchy would have to be determined, depending also on the structure of creditor hierarchy that would be chosen in the CMDI review. This has an important effect on how investors view the product and what its cost to the issuer would be (in terms of the interest rate offered).

In the creditor hierarchy, it could rank, for example, below all other deposits, and above ordinary unsecured liabilities thus creating a new tier to the hierarchy, or on the same level than ordinary un-secured debt. The MREL eligibility of the investment deposit would need to be specified in the legislation. Currently, CRR Article 72c (1) states that eligible liabilities instruments with a residual maturity of less than one year shall not qualify as eligible liabilities items. Hence, an exception of this would be required for the investment deposit.

It is conceivable, that this somewhat simple and (probably) cost-effective instrument could be an interesting alternative for smaller banks. It depends naturally on the interest rate offered on the deposit and the regulatory treatment, how interested the investors would be.

Senior standardized MREL eligible bond

In order to reduce the costs of debt issuance, we could think of a MREL eligible senior bond, which would include a standardized description of the issuer and instrument, in other words a standardized prospectus drawn up by for example the EBA. This would reduce the direct costs related to debt issuance, which can be relatively high with a small issuance, and hence could lower the bar for issuing debt for some banks. The necessary provisions on the standardized MREL eligible senior bond could be included in BRRD, which would clarify its characteristics and status and possibly make it more attractive to banks and investors.

Open questions are obviously how this debt instrument differs from other senior debt (apart from the prospectus) and where the trading would take place. It is also likely that the debt issues would be relatively small and thus the question of adequate liquidity arises. In some cases, further measures would probably be needed to ensure the attractiveness of smaller issuances of smaller banks.

Pooling the smaller banks' debt issuance

One way to bypass the liquidity challenge could be to pool several smaller banks' debt issues together and offer them as one debt issue. Pooling could be done for senior standardized MREL eligible bonds. Pooling offers also possibilities to simplify issuance and reduce the borrowing costs for issuing banks. Sharing the risks could also lower the yield that the investors require for the issue and the larger size of the issuance could increase demand and thus enhance the liquidity in the financial markets.

From the investor's point of view, such pooling would reduce the bank-specific risk related to a debt investment, since all members of the pool would be liable for the debt in case one of them defaults. This should make the investment less risky overall and hence lower the required yield under normal circumstances.

Possible pooling arrangements include, nevertheless, some open questions. Would the pooling take place only among the banks in the same Member State or is there a possibility also for cross-border arrangements? What is the extent of the free-rider risk inside the pool? Would there be effects on financial stability through contagion among the pool members?

Pooling would create new interdependencies within the banking sector, which may add to possible contagion and financial stability risks if there are wider problems in the sector. Shared debt also creates moral hazard issues, but there may be contractual arrangements within the pool that would mitigate these concerns (e.g. covenants or requirements to post collateral in specific circumstances).