CZECH NATIONAL BANK

DATE: SEPTEMBER, 2021

EXTERNAL MREL HOLDINGS
The Czech National Bank's expectations

The Czech National Bank (**CNB**) is the resolution authority for banks, credit unions and certain investment firms (**institutions**) in the Czech Republic pursuant to Act No. 374/2015 Coll., on Recovery and Resolution in the Financial Market (**RRA**).

As part of the process of preparing and regularly updating resolution plans, the CNB, among other things, defines the most appropriate strategies and tools for resolving institutions and groups. At the same time, the CNB identifies and assesses potential impediments to the resolvability of an institution or a group. In the event that the CNB considers an impediment to resolvability to be substantive, it may require the institution to take appropriate measures to address or remove the identified substantive impediment to ensure resolvability. To achieve this without the need to use public funds and without having an adverse impact on financial stability, the CNB sets a minimum requirement for own funds and eligible liabilities (**MREL**) for institutions, which must be met for the effective implementation of the resolution strategy as outlined in the resolution plan.

The achievement of resolution objectives and the ability of institutions to absorb the corresponding losses and be recapitalised to a sufficient level, so that their Common Equity Tier 1 capital ratio (**CET1**) is restored to the level necessary for compliance with the conditions for authorisation, while sustaining sufficient market confidence, could be limited where institutions invest more significantly in external MREL eligible instruments issued by other institutions.

According to the BCBS Standard on TLAC holdings[1] (**BIS TLAC Holdings**), internationally active banks (both G-SIBs and non-G-SIBs), generally have to deduct their investments in TLAC[2] eligible instruments issued by entities from outside their resolution group (**external TLAC**) which do not qualify as regulatory capital from their own Tier 2 capital. This reduces a significant source of contagion in the banking system. Without deduction or other appropriate treatment, excessive holdings of TLAC eligible instruments could mean that the failure of one G-SIB could lead to a reduction in the capacity of another bank/other banks to absorb losses and recapitalise. It could also result in a related potential adverse effect on market confidence and financial stability.

The CNB also perceives increased risks arising from holding external MREL eligible instruments issued by other entities (especially in a relatively concentrated banking sector such as in the Czech Republic). It will therefore assess these risks both in the resolution planning phase, including resolvability assessments and the related setting of individualised MREL requirements of individual institutions and groups, as well as any decision-making on the implementation of resolution

[1] https://www.bis.org/bcbs/publ/d387.htm
[2] Total Loss Absorbing Capacity

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measures, especially for institutions whose resolution plan envisages the implementation of such measures if the institution fails, including institutions identified by the CNB as other systemically important institutions (**O-SIIs**).

In view of the above, the CNB considers it beneficial to limit some such investments using principles similar to those described by BIS TLAC Holdings and those already applicable to investments in equity instruments issued by other institutions (see CRR[3]). However, the procedures and methods for dealing with such investments described by the BIS TLAC Holdings are relatively information intense (MREL disclosure requirements) to enable the investing institution to determine the appropriate treatment of such investments.

In general, the BIS TLAC Holdings has arrived at two types of treatment of investments in the external TLAC eligible instruments that it covers. These are a standard risk weighting of such exposures (up to a specified limit/threshold) and the deduction from its own stock of Tier 2 capital (above a specified limit/threshold).

(i) For sake of simplification, the CNB focuses on the additional treatment of **investments in subordinated debt instruments issued by systemically important institutions**.

(ii) **At the same time, the CNB does not propose a change in or modification of current prudential rules**, but indicates and derives the structure and volume of institutions investing in external MREL eligible instruments, especially debt instruments, issued by other entities without significant effects on the assessment of resolvability (within the indicated threshold).

(iii) **Amounts corresponding to an excessive investment** (exceeding the indicated threshold) **should be covered by the institution's own stock of MREL eligible instruments** (i.e. they should be deducted from its MREL eligible liabilities while meeting its own MREL requirement).

(iv) **The CNB assumes that institutions adjust their internal processes, procedures and limits to be able to meet expectations.** Expectations are closely related to the determined MREL requirement, the fulfilment of which reflects the final treatment of external MREL. The CNB does not plan to introduce additional reporting requirements or disclosure obligations, but assumes that institutions will reflect these expectations by meeting their standard MREL reporting and disclosure obligations (i.e. the reported or disclosed amount of MREL instruments is net of deductions for excessive external MREL holdings).

The basic threshold the CNB considers decisive for further treatment is 10% of CET1 capital determined in accordance with the prudential rules pursuant to CRR on the aggregate amount of investments in external MREL (capital and debt) issued by other (systemically important) entities, provided that the investing institution does not hold a significant investment in the issuing financial

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms, consolidated version.

sector entity/entities.[4] The basic threshold is further supplemented by a specific threshold corresponding to 5% of the investing institution's CET1 capital for investments in the defined external MREL eligible liabilities of such entities. The specific threshold will also be used for external MREL related to market-making activities.

The CNB's objective is clear, i.e. to limit the risks arising from holding external MREL eligible instruments issued by other entities. The rules should be applied by institutions and the investments concerned should be assessed with this in mind. The simplified description of the treatment of investments below cannot cover all combinations and situations. Therefore, in the event of any ambiguity, investing institutions should take the CNB's objective into account and assess investments in a sufficiently prudent manner and consult the CNB's Resolution department if needed.

CNB's expectations, detailed overview

INSTITUTIONS IN SCOPE	**These expectations apply to institutions with a registered office in the Czech Republic for which the CNB has assessed potential liquidation as part of normal insolvency proceedings as not credible, i.e. institutions whose resolution plan assumes the use of resolution measures in the event of their failure.** – The group of institutions above includes both institutions for which the CNB Resolution Department's preferred resolution strategy assumes the use of a bail-in tool (or the power to write down and convert relevant capital instruments and eligible liabilities) and institutions whose resolution plan assumes the use of one of the transfer tools (primarily sale of business). – These expectations do not apply to institutions for which the CNB has assessed liquidation under normal insolvency proceedings to be credible and for which it has set no recapitalisation amount (RCA) under MREL.
INSTRUMENTS IN SCOPE & RELEVANT AMOUNTS	**These rules deal with the acquisition of/investments in:** (issuer perspective) **a) direct, indirect and synthetic external[5] MREL eligible liabilities which do not qualify as regulatory capital of financial sector**

[4] See CRR, where one of the conditions/defining features is the direct, indirect and synthetic capital investments of the institution in the CET1 (*Common Equity Tier 1 instruments*) of the issuing entity, which together are equal to or no more than a 10% share of the issuer's CET1 items. Institutions with significant investment in the issuing entity are subject to different treatment.

[5] I.e.: issued by an entity outside the investing institution's resolution group.

	entities classified as other systemically important institutions, i.e. O-SII (or their subsidiaries).[6] **b) direct, indirect and synthetic external MREL or external TLAC eligible liabilities which do not qualify as regulatory capital of financial sector entities classified as global systemically important institutions, i.e. G-SII** (or their subsidiaries).[7] (type of instrument perspective) Given the current limitations of the MREL/TLAC disclosure requirements (i.e. it may not always be clear to what level of MREL/TLAC the issuer must comply, whether and what subordination is required, what percentage of non-subordinated instruments can count towards MREL/TLAC, what instruments are *pari passu* with MREL/TLAC eligible subordinated instruments), **these expectations only apply to subordinated instruments for the time being; i.e. eternal MREL/TLAC eligible liabilities (which do not qualify as regulatory capital) that are subordinated:**[8] i. Statutorily (including senior non-preferred (SNP)), ii. Structurally (issued by a non-operation holding company that is resolution entity), iii. Contractually (i.e. by the relevant clause in the instrument/contract documentation). (relevant amount perspective) The total **gross long position**, as defined in CRR, on all the above instruments **in both the trading and banking book** *(investment portfolio)* of the institution shall be included in the calculation of external MREL holdings. Hereinafter referred to as "**defined MREL eligible liabilities**".
RECIPROCAL CROSS-HOLDINGS	**The CNB will not include reciprocal holdings of MREL eligible liabilities, which are designed to artificially inflate the MREL of the institution meeting the requirement, in the institution's own MREL eligible instruments** (in such a case, the CNB will require the institution to cover such reciprocal positions fully using its own MREL, i.e. they must be deducted in full from the institution's MREL instruments). Reciprocal cross-holdings can be considered as holdings that have arisen on the basis of active action by the relevant entities *(...held pursuant to an agreement to swap, exchange or otherwise intend to*

[6] https://www.eba.europa.eu/risk-analysis-and-data/other-systemically-important-institutions-o-siis-

[7] https://www.fsb.org/work-of-the-fsb/market-and-institutional-resilience/post-2008-financial-crisis-reforms/ending-too-big-to-fail/global-systemically-important-financial-institutions-g-sifis/

[8] The CNB assumes that the institutions have sufficient information in the investment risk assessment process to determine/assess the subordination of an instrument.

	hold each other's instruments).
MARKET MAKING	*Note*: The definition of market making is not relevant to the CNB's temporary simplified approach, as the specific threshold of 5% CET1 capital (described below) applies to all types of investments in external MREL eligible liabilities regardless of whether the motive is market making. Investments for market making purposes are considered to be investments that are: – held in a trading book; – sold within 30 business days of their acquisition; and – whose aggregate gross long position does not exceed 5% CET1 capital of the investing institution.
UNDERWRITING POSITIONS	**All underwriting positions in defined MREL eligible liabilities held for five business days or less, are excluded.** Underwriting positions held for longer than five business days must be included and are further treated as set out in this document (see also the specific threshold of 5% of CET1 capital of the investing institution).
TEMPORARILY EXCLUDED POSITIONS	Subject to the prior consent of the CNB, investments in defined MREL eligible liabilities may be temporarily excluded from the scope of these rules if such investments were made in the context of the resolution of a failing institution.
INVESTMENT IN OWN MREL ELIGIBLE INSTRUMENTS, in particular liabilities	**MREL eligible instruments held by the issuing institution itself should not be counted towards meeting the institution's MREL** (unless the accounting standards and procedures applied by the institution cause derecognition). Furthermore, investment in own MREL eligible instruments may be subject to the permissions regime under the CRR.
SPECIFIC THRESHOLD OF 5% OF CET1 CAPITAL **for investment in defined MREL eligible liabilities**	**The investing institution shall apply a specific threshold corresponding to 5% of its own CET1 capital for investments in defined MREL eligible liabilities.** – if the aggregate amount of investments in defined MREL eligible liabilities does not exceed the specific threshold, such investments are disregarded for further treatment (e.g. to calculate the aggregate threshold of 10% of an institutions CET1 capital mentioned below) – if the aggregate amount of investments in defined external MREL eligible liabilities exceeds the specific threshold, the amount which is above the threshold of 5% of CET1 capital is used to determine further treatment (i.e. it must be counted towards meeting the below-mentioned aggregate threshold of 10% of the

	institution's CET1 capital on all investments (capital and debt).
AGGREGATE THRESHOLD OF 10 % OF CET1 CAPITAL **for investments in capital and defined MREL eligible liabilities**	**The aggregate threshold corresponding to 10% of the investing institution's CET1 capital (under CRR) for investments in capital and the defined MREL eligible liabilities issued by designated financial sector entities are essential for the resolvability assessment and for determining further treatment.** – Total investment (in both capital and debt, i.e. defined MREL eligible liabilities) below 10% of the investing institution's CET1 capital will not, as a rule, be deemed by the CNB to constitute a significant risk to resolvability. – On the contrary, if total investment (in both capital and defined MREL eligible liabilities) exceeds 10% of the investing institution's CET1 capital, it must be fully covered by the investing institution's MREL eligible instruments (i.e. it must be deducted from the investing institution's eligible instruments to comply with the MREL) **This threshold will take into account all capital and defined MREL eligible liabilities issued by defined financial sector entities (G-SIIs and O-SIIs), unless the investing institution has a significant investment in such a financial sector entity.** [9] – As a first step, the investing institution will assess whether it has significant or insignificant (capital) investment in the defined financial sector entity. – If the existing (capital) investment in the defined financial sector entity is assessed as insignificant, further exposures in the form of purchased defined MREL eligible liabilities will be subject to a specific threshold of 5% of the investing institution's CET1 capital and, if applicable, the amount which exceeds the specific threshold of 5% is included in the total exposure volume and assessed against the aggregate threshold of 10% of the investing institution's CET1 capital. – If the existing (capital) investment in defined financial sector entity is assessed as significant, any other exposures (e.g. in the form of purchased defined MREL eligible liabilities) shall be treated as excessive/above the threshold (see below).
TREATMENT OF MREL HOLDINGS BY INVESTING INSTITUTIONS WITH SIGNIFICANT INVESTMENT	**If the institution already has significant investment in the financial sector entity, all (subsequent) investments in defined MREL eligible liabilities issued by such financial sector entity must be covered by the investing institution's own MREL eligible instruments.**

[9] i.e. an institution's aggregate direct, indirect and synthetic capital investments in instruments qualifying as Common Equity Tier 1 capital are less than 10% of the issuing entity's CET1; ***non-significant investments in unconsolidated financial institutions.***

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LEVEL OF APPLICATION	The abovementioned requirements shall be applied at all levels for which the CNB has determined the MREL.

Procedure for applying the rules, graphical illustration

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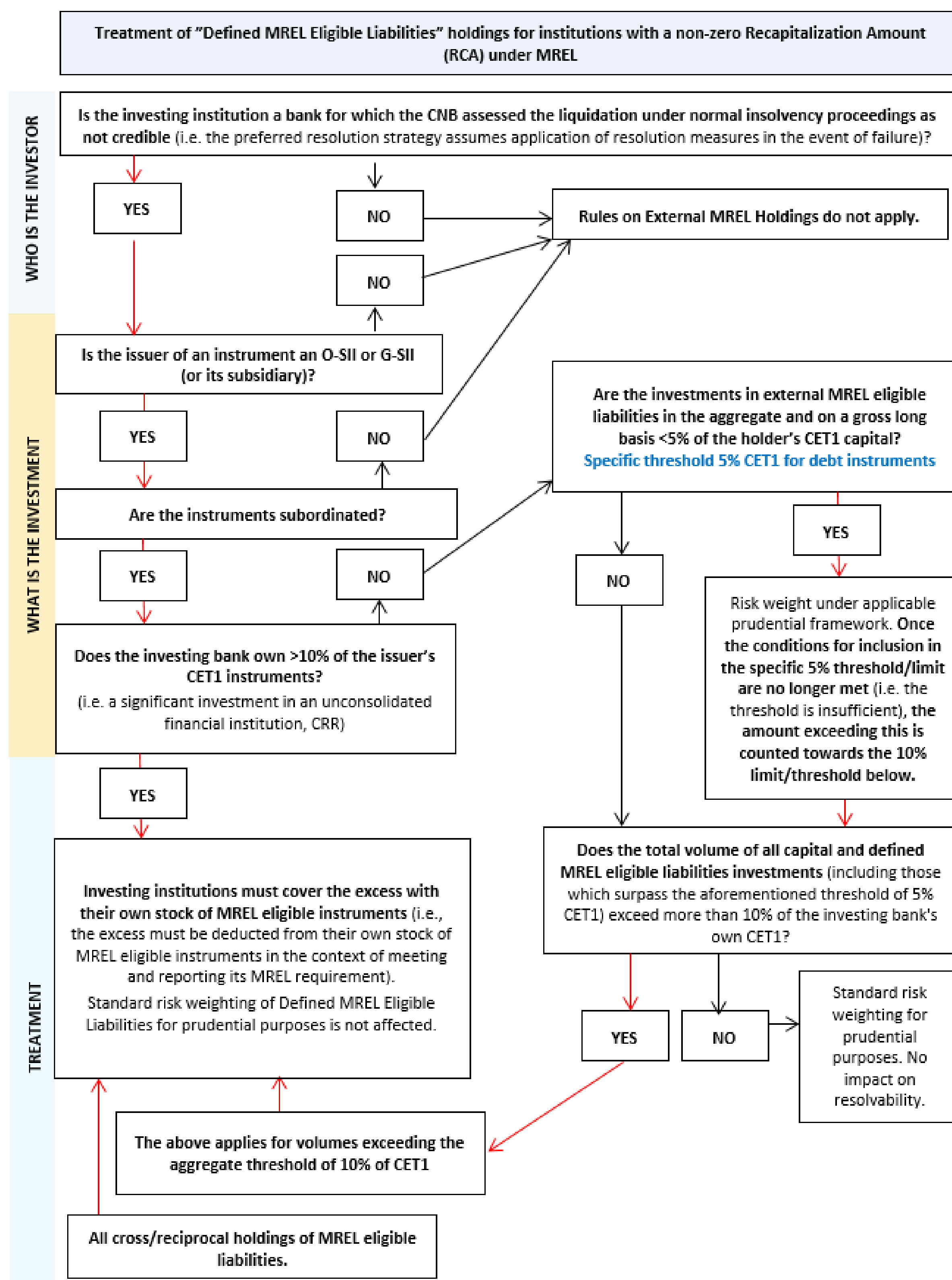

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