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INTERNAL MINIMUM REQUIREMENT FOR CAPITAL AND ELIGIBLE LIABILITIES (internal MREL) AND GUARANTEES PURSUANT TO ARTICLE 131b OF THE RECOVERY AND RESOLUTION ACT

Addendum to the general approach and related expectations of the Czech National Bank

INTRODUCTION

Act No. 374/2015 Coll., on Recovery Procedures and Crisis Resolution in the Financial Market, as amended (Recovery and Resolution Act, **RRA**), allows for the meeting of the internal minimum requirement for capital and eligible liabilities (**internal MREL**) in whole or in part using a "performance obligation" (**guarantee**).

In this regard, the Czech National Bank (**CNB**) assessed the legal nature and basic parameters of the guarantee and at the same time the conditions under which it would allow institutions meeting the requirements set out in the RRA to use the guarantee to meet internal MREL.

A liability is considered eligible for the purposes of compliance with internal MREL if it is a liability of a bank that is not a resolution entity and if the creditor of the claim corresponding to such a liability is a resolution entity or another controlling entity. The guarantee that replaces such an obligation[1] will therefore have to have the nature of a contractual obligation of the resolution entity or other controlling entity (collectively also **controlling entity**) towards the obliged entity which is a controlled entity within the meaning of Article 131b of the RRA (**controlled entity**).

With regard to another regulatory condition that the controlled entity and the controlling entity have their registered office in the Czech Republic and belong to the same resolution group, this construction can be applied within the Czech Republic only for Czech banks (in the position of the controlling entity) and their Czech subsidiaries (in the position of the controlled entity).

[1] The purpose of the guarantee is to replace an eligible liability of the controlled entity to the controlling entity by the controlling entity's contractual obligation to the controlled entity consisting in the controlling entity's obligation to provide monetary settlement, in predetermined circumstances, to the controlled entity.

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In case of a request to use a guarantee to meet internal MREL, the CNB will, among others, require assurances of

- the existence of the guarantee (one-off, for example by a copy of the contract),
- the designation of a pledge or a lien (including in securities depositories) or a transfer by way of security (one-off), and
- regularly, as of 31.12. of a calendar year in which the guarantee is used, or on request, a statement regarding the adequacy of the security (valuation, haircut, repricing, collateral switches, etc.), and/or a description of the bank´s collateral management process.

The following parts of this document set out some of the CNB's additional expectations regarding the parameters of the guarantee (Part 1) and the collateralisation of the guarantee (Part 2). Unless otherwise stated, the terms that are not defined in this document shall have the same meaning they have in the RRA. The CNB assumes that when concluding the guarantee, the parties shall also comply with all the conditions of corporate law and applicable financial or other regulations. The accounting treatment of the guarantees is not the subject of this document. The Czech version of this document prevails.

1. PARAMETERS OF THE GUARANTEE

1.1 Conditions precedent, their evaluation and the role of the CNB

The CNB expects that the guarantee will contain the following **conditions precedent**, according to which the controlled entity's right to performance and at the same time the controlling entity's obligation arise at the moment when the controlled entity

(a) is unable to pay its due debts; or
(b) meets the conditions for the application of write-down and conversion of equity instruments and intragroup eligible liabilities (**write-down and conversion conditions**), provided that the condition under Article 60(b) RRA is fulfiled with regard to Article 62(1) RRA, if the controlled person fails[2],

depending on which event occurs earlier (Article 131b(1)(d) RRA). The controlled entity (and possibly also the controlling entity) should evaluate on an ongoing basis whether the conditions precedent have been met.

Meeting each of the above conditions precedent should be supplemented by the requirement of the controlled entity to notify this fact to the controlling entity and to the CNB. Thus, in the event

[2] https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1156219/ec1279c0-3f2f-4653-86a5-e8d039cee33c/EBA-GL-2015-07_CS_GL%20on%20failing%20or%20likely%20to%20fail.pdf?retry=1

that the controlled entity (or the controlling entity) has reason to believe that at least one of the conditions precedent is met or will be met immediately, the controlled entity shall inform the CNB of this fact and request its opinion. The CNB evaluates the information and subsequently notifies the controlled entity of its conclusion.

In the event of confirmation of the controlled entity's presumption that at least one of the conditions precedent is met, the controlling entity is obliged to perform from the guarantee. CNB also evaluates the conditions pursuant to Article 60 et seq. RRA independently within its activities, while their positive evaluation also establishes an obligation to perform from the guarantee.

There is nothing to prevent the parties to the guarantee from agreeing on other conditions precedent, the fulfilment of which would trigger the guarantee. However, such conditions must not interfere with compliance with the requirement under Article 131b(d) RRA. These must therefore be conditions that are more stringent than those required by the RRA. They must also be formulated alternatively so that failure to meet any additional condition precedent does not delay the performance from the guarantee pursuant to Article 131b(d) RRA. Typically, these will be conditions precedent that have occured before the controlled entity ceases to be able to pay its debts, or when it meets the conditions for the application of write-down and conversion of capital instruments or intragroup eligible liabilities under the RRA.

1.2 Performance from the guarantee

In order to achieve effective resolution, it is necessary that the guarantee includes a **clearly formulated payment obligation** of the controlling entity towards the controlled entity, at least in the amount corresponding to the part of the internal MREL it replaces (Article 131b(1)(c) RRA).

The performance from the guarantee must also take the form of subordinated debt with features of an MREL-eligible instrument (with reference to subordination according to the RRA) or a surcharge beyond core capital; it is essential that the **form of performance from the guarantee is clearly declared**.

After fulfilling the conditions precedent from Part 1.1, the controlling entity should **perform from the guarantee preferably in full amount**. If, however, partial performance from the guarantee is sufficient for loss absorption and subsequent recapitalisation of the controlled entity, the controlling entity shall not be obliged to perform from the guarantee in full amount. However, any partial performance must effectively ensure that the loss absorption and recapitalisation is adequate.

1.3 Duration, prohibition of termination and grounds for termination of the guarantee

The **CNB prefers that guarantees are concluded for a definite period of time**, while they may contain early termination clauses of the controlled entity, similar to debt instruments (non-call), with impact on the effective eligibility of the guarantees to meet internal MREL.

In order for the guarantee to provide sufficient flexibility for controlled entities and controlling entities, it may also contain a termination clause that would allow its termination before the contractual maturity date. This clause could assume that up to the amount to which the controlled entity meets internal MREL in the form of a guarantee, this guarantee could be replaced by another eligible liability pursuant to Article 130 RRA no later than on the date of its termination, and that such a termination would not breach the obligation to meet MREL at the level of the controlled entity.

In order to ensure the effectiveness of such a mechanism, the CNB will require that it is notified of the possible termination of the guarantee sufficiently in advance. Such a notification requirement should be included directly in the guarantee. As this is mainly a matter of compliance with its internal minimum requirement, the controlled entity should be the notifying party. It should also be borne in mind that, in the event of termination of eligible liability instruments not covered by Article 77 (1) CRR, the institution must obtain a prior approval of the CNB under the terms of Article 78a of CRR before their contractual maturity.

1.4 Conditions subsequent

Guarantees should also include conditions subsequent that will reflect the conditions for permission to meet internal MREL in the form of the guarantee and allow its termination before the contractual maturity date due to non-compliance with the requirements defined in Article 131b RRA.

The notification requirement of the controlled entity specified in the previous point also applies to these cases, as well as the conditions for the use of the notice, in particular the need to ensure compliance with internal MREL by the controlled entity; the controlling entity cannot be automatically released from its payment obligations at the moment / only due to the fact that the conditions for permission to use the guarantee to meet internal MREL are no longer met. In such a case, this obligation lasts until the termination of the guarantee (in accordance with the information in Part 1.3); however, the possibility of the controlled entity to use it to meet internal MREL is limited. The CNB will assess each such situation individually in relation to resolvability.

1.5 Exclusion of dispositive provisions of the Civil Code

The parties to the guarantee should exclude the application of the following provisions of the Civil Code: Article 1765 (substantial change of circumstances, especially gross disparity in the rights and obligations of the parties, resumption of negotiations on the contract), Article 1766 (the right of the court to change the obligation under the contract by restoring the balance of rights and obligations of the parties) and Article 1805(2) (the creditor delays exercising the right, the interest has increased to the amount of the principal, the loss of the right to further interest until the application of the right in court). For the avoidance of doubt, guarantees should also stipulate that they do not create liability as defined in Article 2018 et seq. of the Civil Code, a financial guarantee as defined in Article 2029 et seq. of the Civil Code or a guarantee contract as defined in Article

1769 of the Civil Code. The CNB does not consider it necessary to exclude other dispositive provisions of the Civil Code.

2. COLLATERALISATION OF THE GUARANTEE

2.1 Nature of the collateralisation of the guarantee

Guarantees shall be secured by financial collateral (**collateralisation**) as defined in Act No. 408/2010 Coll., on financial collateral, as amended (**AFC**). As the subject of the controlled entity's receivable from the guarantee will be cash, it will be a receivable of a financial nature as defined in Article 2(a) of the AFC and will therefore be eligible to be secured by financial collateral. Such financial collateral will have the nature of either a pledge or a lien on financial collateral or a transfer of financial collateral under Article 4(1) of the AFC. The resolution entity or other controlling entity and the controlled entity will always be entities entitled to arrange financial collateral.

2.2 Nature and quality of financial collateral

The CNB expects the guarantee to be predominantly collateralised by financial collateral in the form of investment securities, collective investment securities or money market instruments (collectively **financial instruments**), or funds credited to an account in Czech or foreign currency.

Requirements for the quality of financial collateral are contained in the RRA, as amended, where they are linked, inter alia, to the provisions of 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, as amended by subsequent regulations (**CRR**).

In addition to its nature, the quality requirements for financial collateral depend largely on the credit assessment of financial collateral by a credit rating agency registered or certified in accordance with Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009, on Credit Rating Agencies (**CRA Regulation**) or a central bank issuing credit ratings that are excluded from the scope of the CRA Regulation.

Although the parties to the guarantee will have to comply with the above requirements when choosing eligible financial collateral, they will also have to rely on the range of assets accepted by the CNB as collateral for its repo operations, including haircuts. If they meet the above requirements, the CNB sees no reason why financial collateral for the guarantees could not also take the form of mortgage-backed bonds issued pursuant to the provisions of Section 28 et seq. Act No. 190/2004 Coll., on bonds, as amended, which are also acceptable financial collateral for repo operations with the CNB. See also https://www.cnb.cz/en/financial-markets/money-market/parameters-of-the-liquidity-providing-repo-operations. However, short-term treasury bills cannot be expected to meet the requirement under Article 131b(1)(h) of the RRA.

The CNB does not believe that mortgage bonds are, by their nature, encumbered by the rights of third parties within the meaning of Section 131b(1)(g) of the RRA. This provision of the RRA is

aimed at situations where financial collateral is encumbered by a lien or is otherwise used as collateral. The CNB also does not consider that mortgage bonds, by their nature, contain impediments specified in Article 131b(1)(i) of the RRA. Resolution entities or other controlling entities that are banks can issue mortgage bonds into their own books and subsequently pledge mortgage bonds to the controlled entity as financial collateral. See also https://www.cnb.cz/cs/financni-trhy/penezni-trh/parametry-dodavaci-repo-operace/kriteria-prijatelnosti-pro-hypotecni-zastavni-listy-hzl-a-nastaveni-haircutu/ *(in Czech language only).*

2.3 Parameters of financial collateral of the guarantee

The simplest and safest variant of financial collateral for controlled entities is the transfer of ownership of financial collateral (see Article 4 of the AFC). The guarantees should include provisions under which the resolution entity or other controlling entity transfers financial collateral to the controlled entity up to the agreed amount. Although the resolution entities or other controlling entities will be able to provide financial collateral in the form of a lien, its performance is inherently slightly slower. The risks are comparable in both alternatives.

The CNB considers it desirable that the obligation to provide financial collateral arises as soon as the guarantee is executed. This is not hindered by the fact that the controlled entity's receivable from the guarantee will be conditional until at least one of the conditions precedent specified in section 1.1 is met, because a contingent receivable may also be secured by financial collateral (Article 6(2) of the RRA). The CNB expects minimum collateralisation of the guarantee to be 100%. With regard to the wording of Article 131b(1)(e) of the RRA and Article 45(f)(5)(c) of the BRRD there is nothing to prevent the CNB from setting the required collateralisation amount of the guarantee above the required minimum of 50%, all the way up to 100%.

In CNB's view, this approach significantly reduces the risks that would otherwise be inherent in the guarantee. Eligible liabilities as set out in Article 130 of the RRA, which can be used to meet internal MREL, will be "prepaid", i.e. issued by the controlled entity and held by the resolution entity or other controlling entity, or liabilities that will be subject to write-down and conversion. These instruments and liabilities will exist as soon as the controlled entity fails and will provide it with immediate capacity to absorb losses.

Unlike eligible liabilities complying with internal MREL, a guarantee for the purposes of meeting internal MREL is only as reliable as the ability of the resolution entity or other controlling entity to meet such obligation immediately after it has been triggered pursuant to Article 131b(1)(d) of the RRA and according to the mechanisms proposed in section 1.1 above. Meeting internal MREL in the form of a guarantee is therefore exposed to the credit risk and liquidity risk of the resolution entity or other controlling entity.

A provision in the guarantee that will establish the financial collateral may include a relatively simple agreement on the reverse transfer of the financial collateral after the obligation has been settled. In their preparation of the guarantee, mechanisms contained in standardised documentation of collateral management may be simplified and copied (for example, the Collateral Management Annex to the Framework Agreement on Trading on the Financial Market of the Czech Banking Association, various types of Credit Support Annexes to ISDA Master Agreement, etc.).

These provisions shall:

(a) allow the parties to the guarantee to select eligible financial collateral in accordance with Section 2.2 above;
(b) determine the amount of collateralisation (this should be in line with the wording of CNB authorisation pursuant to Article 131b of the RRA),
(c) specify that the agreed term of the financial collateral, as well as the residual maturity of the subject of the financial collateral, shall be at least one year,
(d) set a reasonably conservative haircut in relation to the financial collateral; and
(e) prohibit the resolution entity or other controlling entity from using financial collateral that is encumbered by third party rights (in particular, financial collateral may no longer be used as collateral for other guarantees).

The use of standardised documentation setting out financial collateral as defined in the AFC, in compliance with the requirements set out in this document, should provide banks and the CNB with a sufficient degree of certainty that there are no legal, regulatory or operational barriers to the transfer of financial collateral from the resolution entity or other controlling entity to the relevant controlled entity, including situations where resolution measures are applied to the resolution entity or other controlling entity (Article 131b(1)(i) and Article 131b(2) of the RRA).

In assessing the absence of such barriers, the controlled entity will focus on the following areas:

(a) national insolvency or corporate law does not materially affect the transfer of funds in the pre-FLTF scenario or in the resolution scenario;
(b) the ownership of shares and the legal structure of the group do not impede the transferability of capital or the repayment of liabilities;
(c) formal decision-making processes regarding the transfer of capital between the parent undertaking and the subsidiary do not prevent prompt transfers;
(d) the articles of association of the parent company and the subsidiaries, any shareholder agreement or any other known agreement do not contain any provision which might impede the transfer of capital or any other form of performance from the guarantee by the parent undertaking;
(e) there have been no serious management difficulties or problems in the administration and management of the company in the past which could have a negative impact on the prompt transfer of capital or other form of performance from the guarantee by the parent undertaking;
(f) no third parties can exercise control or impede prompt transfer of capital or any other form of performance from the guarantee by the parent undertaking;
(g) the guarantee will be duly reflected in the recovery plan of the group;

(h) the guarantee does not have any negative effects on the possible implementation of the preferred resolution strategy.

If the given area also concerns the controlling entity or the other resolution entity from the group as a whole, the CNB assumes that the assessment will be prepared in cooperation with and/or consulted with these entities as well.

The assessment shall be performed for the following two scenarios:

(a) no resolution measures are taken at the level of the resolution entity or other controlling entity; and
b) the controlled entity is facing (financial) difficulties and, at the same time, resolution measures are being taken at the level of the resolution entity or other controlling entity, ie both entities are in a state of failure / resolution.

The bank shall provide an in-house or external reasoned and independent legal assessment of compliance with this condition and the (non-) existence of such risks as set out in Article 131b(2) of the RRA, in the same way as similar risks in legal assessments of the validity and enforceability of financial collateral are assessed under Articles 194 and 207 of the CRR.

The CNB also expects the controlled entity to describe the functioning of the mechanism triggering the performance from the guarantee and the subsequent transfer of losses and recapitalisation. In accordance with published resolvability rules, the controlled entity will subsequently incorporate into its ILTRM Playbook a detailed description of such mechanism, including a scenario where the resolution entity or other controlling entity would not want to perform from the guarantee for an unspecified reason, and the controlled entity will be forced to use the collateral provided.

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