Why MREL matters even more for banks in CEE

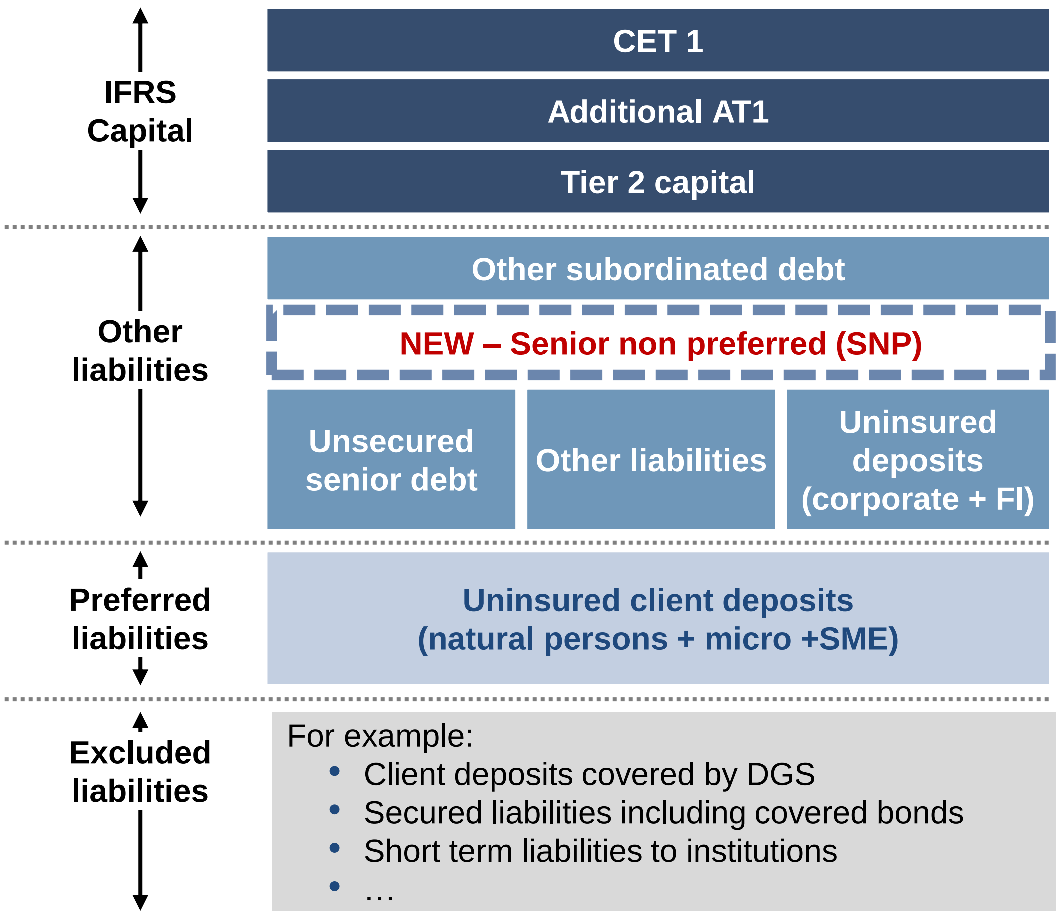
Discussion materials for the Vienna Initiative12 March 2018

Main topics for CEE banks' MPE approach

The markets	▪ Capital markets in CEE at **different stages of development** and even not existent in some countries
The investors	▪ **Foreign investors** often not familiar with the characteristics of the CEE markets ▪ **Retail investors** (affluent clients) should be allowed to invest ▪ **Parent companies** to be allowed to invest within a transition period in MREL instruments issued by a subsidiary
Supranationals	▪ Supranationals to play a **door opener** for investors in these countries ▪ Supranationals to accept a **stand alone risk** of the banks in CEE
Legislation	▪ The legislation (BRRD rules) is **not yet adopted** in the local insolvency law of the countries ▪ **No clear criteria** what is MREL eligible in the respective countries ▪ **Resolution Groups** additionally affected by **Legal Lending Limits and Tax implications** ▪ **Tax treatment** of coupons in different tax jurisdictions (Additional Tier 1) ▪ **Thin capitalization rules** (tax treatment) of internal MREL

Changes to the creditor hierarchy to be transposed into national legislation by YE 2018

Equity and Liability Structure of a Bank



Amendment Article 108 BRRD

- New senior non preferred asset class
- Instrument features:
  - need to have an original contractual maturity of at least 1 year,
  - are not derivatives/no embedded derivatives,
  - contract explicitly refers to subordination
- Transition into national legislation by 29 December 2018

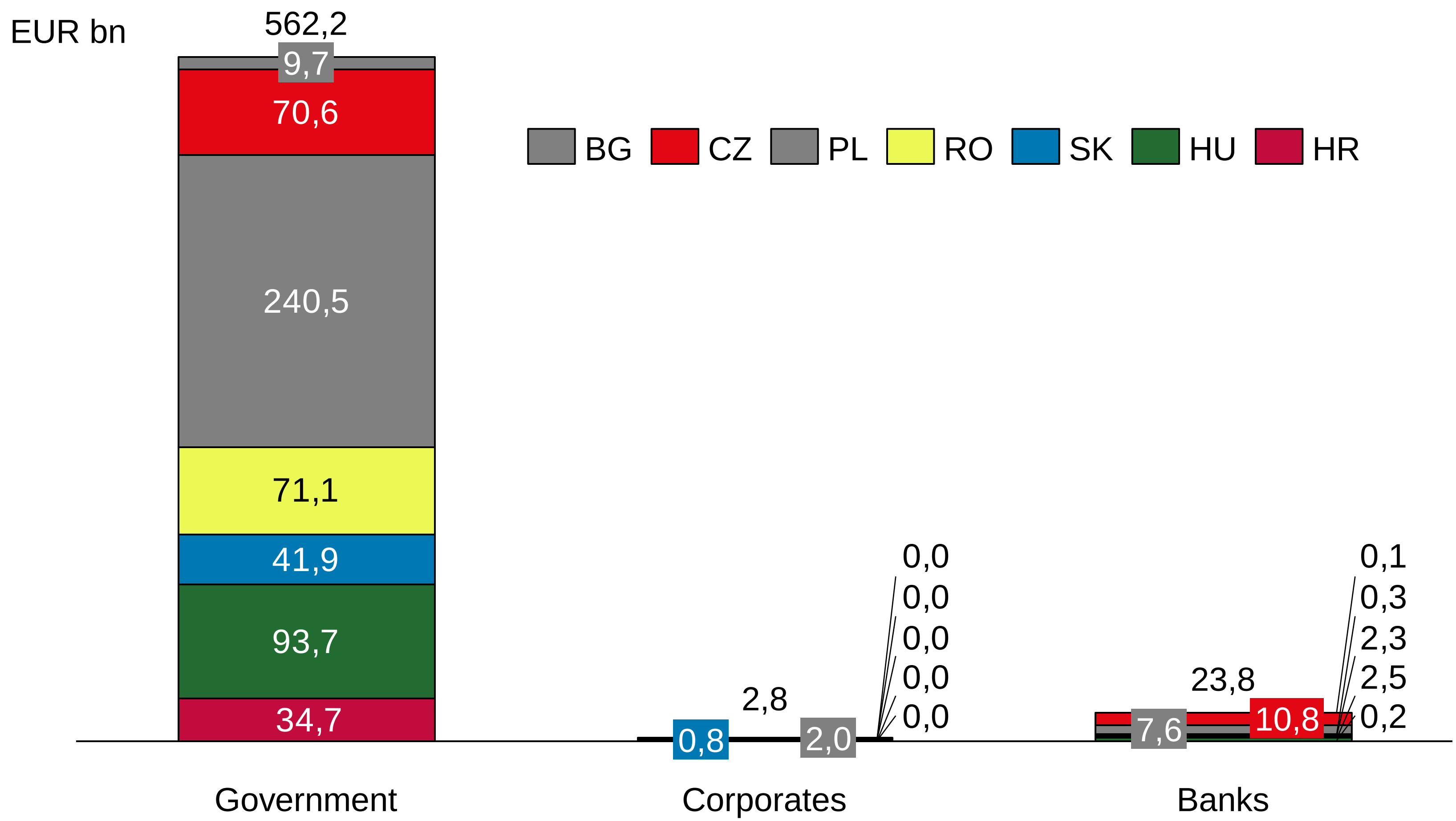
BRRD/CRR package kicked off in 2016 with EU COM proposal changing the MREL terms

Proposed new Article 72b (2) CRR in combination with Article 108 BRRD as per original proposal

Subordination	• CRR: Liabilities are wholly subordinated to claims arising from the excluded liabilities • BRRD: Senior non preferred (SNP) subordinated to ordinary unsecured claims
Collateralisation	• Eligible instruments cannot be collateralised, otherwise they would be excluded from bail-in
Acceleration rights	• Bondholder do not have the right to accelerate the future scheduled payment of interest or principal, other than in case of insolvency/liquidation of the resolution entity
Set-off rights	• No set-off arrangements or netting rights allowed that would undermine the loss absorbing capacity in resolution
Callable structures	• Bonds may only be called, redeemed, repurchased or repaid early subject to regulatory approval
Contractual provisions	• Contractual provisions need to be included, that resolution authority can write down the bond on a permanent basis or convert to Common Equity Tier 1 instruments

Trilogue negotiations between European Commission, Council and EP to start at mid-year 2018

Bonds in CEE are dominated by government bonds



*) issues below USD 100 mn equivalent excluded

Banks in local markets have been tapping debt capital markets mostly through covered bonds

Amount outstanding EUR m	Covered	Senior Unsecured	Subordinated
BG	-	130	-
CZ	10,016	452	359
HR	-	176	-
HU	1,921	-	553
PL	2,464	3,708	1,463
RO	-	272	-
SK	2,162	111	-
Total	**16,562**	**4,847**	**2,061**

*) issues below USD 100 mn equivalent excluded

MREL issuance in CEE likely to start in 2019 – depending on pace of transposition and authorities

Current status

- (Current) BRRD transposed in all EU countries in CEE (Serbia enacted a similar regime)
- No binding MREL targets published in CEE

1 Change creditor hierarchy in BRRD

- Political compromise between European Parliament, Council and Commission on bank creditors' hierarchy in insolvency and in resolution - done
- Entry into force of Creditor Hierarchy on 28 December 2017 - done

2 Transposition in national law

- Member States will have 12 months to transpose the Directive into national law

3 First issue

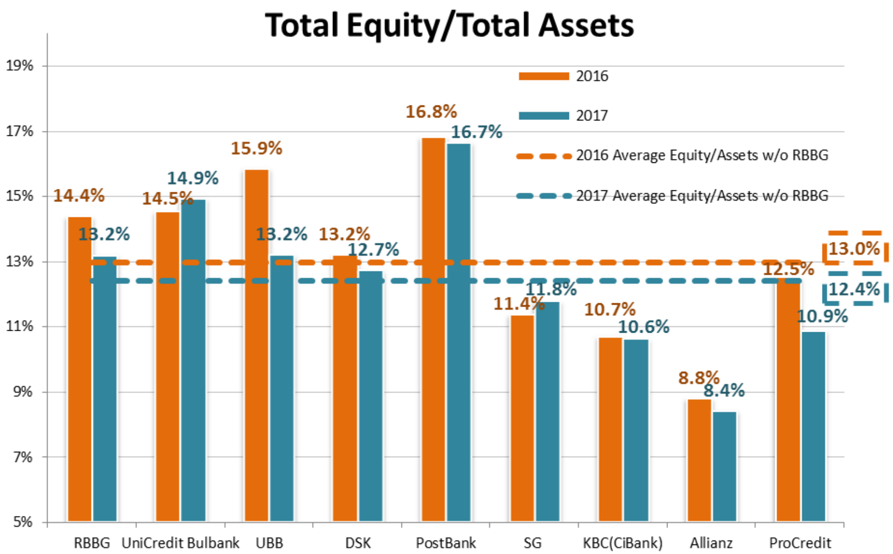
- In France, first issues took place within a week of the enactment in December 2016 – but only by G-SIBs subject to known minimum requirement as set in the TLAC term sheet

Banks in CEE likely to issue new MREL instruments only in response to concrete requirements by the resolution authorities and when the changes in national creditor hierarchies have been made

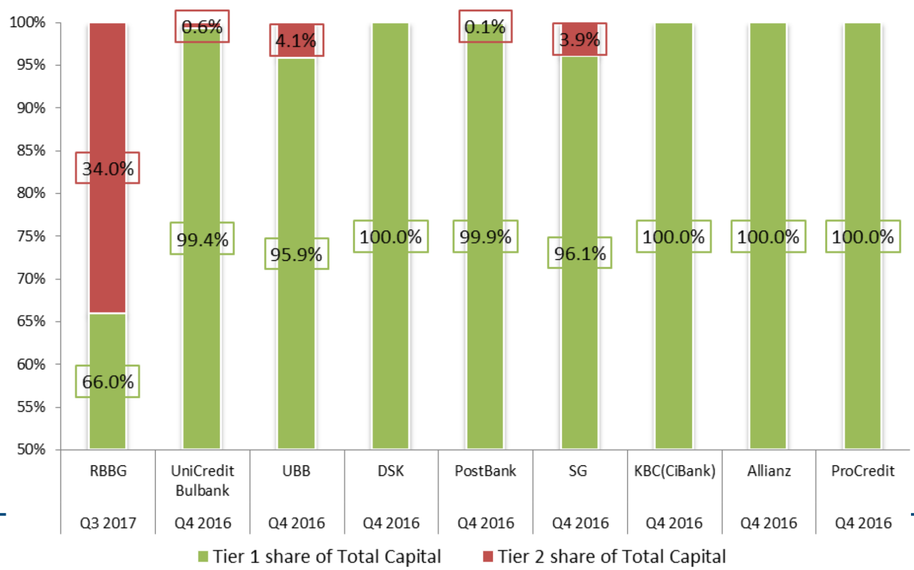
THE LOCAL PERSPECTIVE
MPE BANKS in CEE

MREL potential market in Bulgaria

Capital Adequacy Ratios for Raiffeisenbank (Bulgaria) EAD and Direct Peers



Core Equity Tier 1 is the capital: In contrast to RBBG, none of its main peers rely significantly on capital instruments other than CET1 capital. The still developing and illiquid financial markets in Bulgaria remain slow to adopt financial innovations.



Rare use in Bulgaria: instruments with some CoCo-like features have been used on rare occasions by smaller players in jeopardy of breaching capital adequacy regulations.

Sold over the counter Such instruments have been sold to shareholders of the same banks or connected parties.

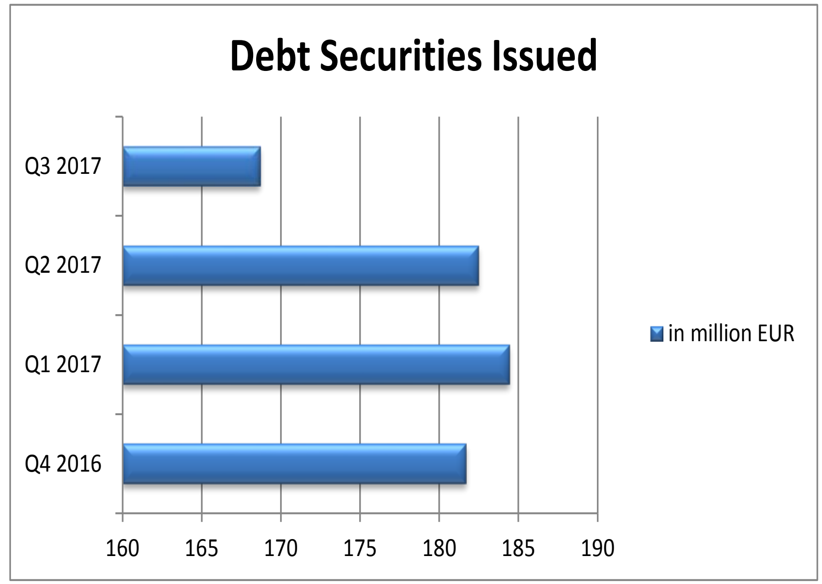
High yields expected: If third parties were to be compensated for the asymmetric information on such banks' actual financial state and performance, the extremely high required yields on such debt would make it an impractical alternative.

Issued Bank Debt

Debt Securities Issued by the Banks on the entire market (source: BNB) are scarce

CCB and FIB (Local banks) have issued such instruments. Currently TBI Bank is also working on an issuance, but it is hardly possible to find investors.

Market issuance is standing at c.a. EUR 720 mio. For 1 year which is testifying to a non-liquid market.



How to make a mature MREL market In Bulgaria

Clear and applicable local legislation of all MREL eligible instruments (especially senior non-preferred debt).

Active role of local Regulator - especially Directorate in BNB Restructuring of Credit Institutions in respect to clear definitions and individual MREL targets

Avoid **redundancy and double counting in terms of MREL requirements**, currently there are already 5 capital buffers:

- ✓ Bank-specific countercyclical capital buffer;
- ✓ Systemic risk buffer;
- ✓ Buffer for global systemically important institutions - G-SII buffer;
- ✓ Buffer for other systemically important institutions - O-SII buffer.

Individual external credit rating for each institution from ECAI: This is a must in order to attract local institutional investors even and retail professional investors with adequately structured bond emissions

At least 5 bank issuers with know-how to make a market: At least 2-3 foreign owned financial institutions with international know-how and Multiple point of entry resolution strategy as well as several large local banks interested in issuance of MREL

More investors: **Permission of local pension funds to invest part of their resources**

Other stimulus for investors: Tax reduction

Establishment of Funds to Invest in MREL bonds issues by Banks (local)

MREL in CEE Region:
Local Perspective from CZ Bank

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CZ market & MREL instruments

Current Status	• Transposition of EU directive 2017/2399 on insolvency hierarchy expected by end of 2018 • MREL issuance likely to start in 2019
Expected MREL shortage	• Could be significant, depending on final MREL targets
Potential CZ Investors	• Banks, insurance companies, pension funds, mutual funds, retail (affluent) • Estimated capacity of the local investors: € 2-7 bn
Challenges	• Market for unsecured instruments shallow at the moment, driven by low need for unsecured funding* (€ 450 m total amount of senior unsecured bonds of CZ banks) • Limited knowledge of the instrument among investors; missing reference for pricing • Building up the risk appetite & set up of issuers' limits takes time • Market capacity in a small open economy may significantly change over time, reflecting economical environment & global market development

** see L/D ratio of CZ banks in Appendix*

Opportunities for market development

Opportunities for MREL issuers

- Good reputation of Czech Republic among investors
- Stable investment grade rating of the Czech Rep. & D-SIBs*
- Large liquidity surplus in the CZ market (L/D ratio of CZ banks below 80%)
- Limited investment opportunities in the CZ market
- Strong capital position of CZ banks**

Conclusions

- CZ market has the potential to absorb the expected MREL shortfall
- Full transition period of 4 years should enable building up the necessary market capacity
- Support of IFI especially during the transition period could speed up the market development

Erste Group

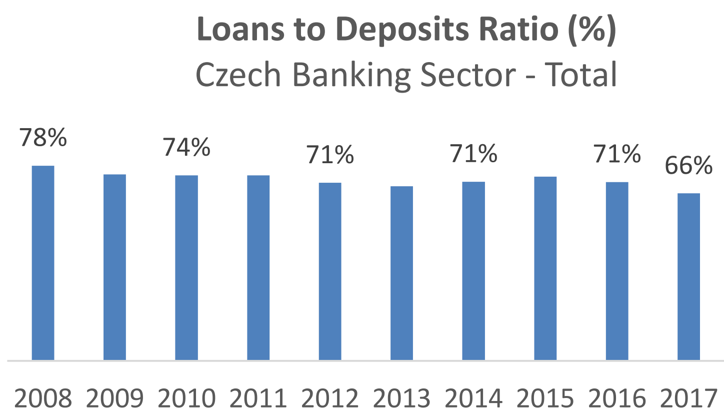
* *ratings of D-SIBs in Appendix*

** *capital position of CZ banking sector in Appendix*

Česká Spořitelna

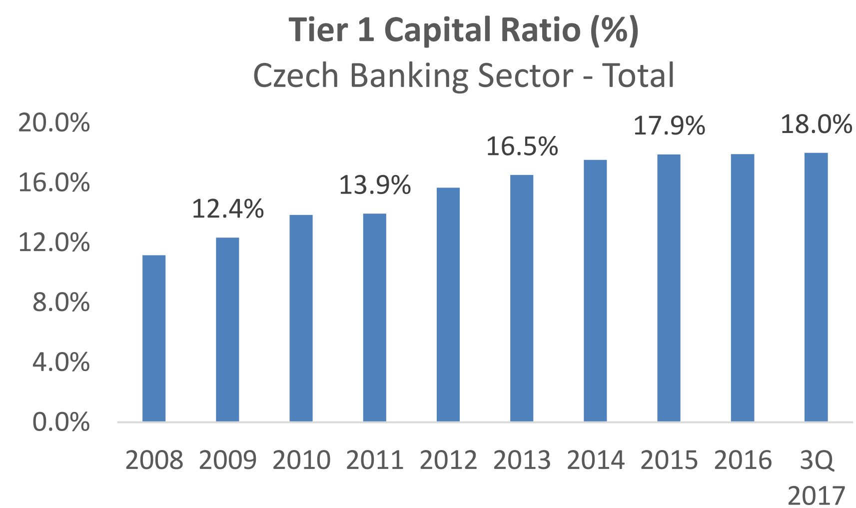
Appendix

Strong LQ & capital position of the CZ banks



- CZ banks focusing on core business (lending to domestic retail & corporate clients)
- They operate with large structural LQ surplus => limited funding needs

- Conservative business model of CZ banks ensures, that the banking sector is very stable, profitable and continuously strengthens its capital position



CZ sovereign and D-SIB ratings

Long-term ratings: As of 7 March 2018

	Moody's	Fitch	Standard&Poor's
Czech Republic	A1	A+	AA
Česká spořitelna Erste Group	A2	A-	A
Komerční banka Societe Generale Group	A2	A-	A
Československá obchodní banka KBC Group	A2	*x*	A

- Czech Republic as well as D-SIBs have stable investment grade ratings
  - Other 2 D-SIBs UniCredit and Raiffeisenbank do not have rating for their Czech subsidiaries)