# Management Comments

# IEvD Evaluation: “Forging Resilience: Evaluation of Transition Impact and Additionality of the EBRD’s MREL Bail-in-Able Products (2016-2023)”

## Executive Summary

Management thanks IEvD for this important Thematic Evaluation of Transition Impact and Additionality of the EBRD’s investments in Minimum Requirement for Own Funds and Eligible Liabilities (MREL) Bail-in-Able Products (2016-2023). The study provides an overview of the concept of the Bank’s investments in bail-in able products and a portfolio summary covering the delivery of 95 investments during the period of December 2016 – September 2023.

BRRD requirements changed banks’ wholesale funding strategies, so much so that MREL issuances have become their main source of funding over the past three years. EBRD initiated its investments in this space to support the resilience of the financial sectors in its COOs. Investments intensified especially at a time when banks were caught in a double bind: the need to comply with the regulatory requirements was at its peak, while markets were dislocated due to the war in neighbouring Ukraine. Systematic investments in bail-in-able instruments evolved over time with this asset class largely replacing other senior unsecured wholesale funding of European banks and becoming an indispensable financial tool to deliver EBRD’s transition priorities. Indeed, as MREL debt becomes the mainstream financing instrument, its transition impact will increasingly depend on the use of proceeds rather than its contribution to the resilience of banks.

EBRD approach to bail-in-able investments has been selective to ensure the Bank remains at the sound banking, financial additionality and delivering impact. Our multi-faceted approach aims to strike the right balance between helping to improve the resilience both at the issuer and sector level as well as an immediate impact on the real economy by way of targeted use of proceeds. These novel instruments with the support of EBRD – *both in terms of investments and guidance to clients and wider market stakeholders* – paved the way for innovation and pivoted the labelled bond issuances in our markets with Green and Sustainable Bonds, contributing to further systemic change. EBRD will continue to consider bail-in-able loans on a selective basis.

Successful capital market development is not a linear process. It requires continuous support in repeat issuances until two phenomena converge: banks (and other issuers) need to establish regular access to capital markets and become regular issuers; and fostering a credible and reliable investor base emerges. This is a highly complex, largely idiosyncratic process in each country, and depends on a number of factors such as geopolitical events, financial crises, regulatory framework changes, to name a few. This explains that EBRD has a holistic approach to capital market development with market infrastructure, regulatory support, new product introduction, deepening the investor base among others. The Bank’s investments in bail-in-able bonds have eminently contributed to this important goal by increasing the scale and volume of issuances and crowding in commercial investors. Thanks to its tailored, disciplined bidding strategy, the Bank has a proven track record of financial additionality. Management disagrees with the report’s statement that there is no indication of meaningful contribution towards “systemic change” given the actual outcomes and refers to paragraph 101 and Figure 10 states that: *“There are clear examples from the case studies of where the Bank has supported capital markets development. In Romania, for example, the role of the EBRD along with other IFIs was critical in supporting the MREL bond market initially, which highlights the pivotal role of IFI financing at the outset of the market, market development, and the rapidly increasing interest from non-IFI participants.”* Romanian banks achieving their targeted funding levels, gradually progressing away from IFI club deals to international issuances with EBRD support is not an isolated example.

When it comes to financial resilience, it is embedded in the established TI methodology and financial sector stability features on individual country strategies. Bail-in-able debt projects are also consistent with the country strategies from a capital market development and use of proceeds angles. Bail-in-able instruments foster transition and drive systemic change in multiple ways. Management notes that achieving “resilience” has been one of the key drivers, with capital market development and regulatory compliance being the critical outcomes of EBRD’s investments fostering systemic resilience and financial stability, which are in the heart of the Financial Sector Strategy approved by the Board of Directors on 15 December 2021. Resilience, both at the issuer and systemic level have been analysed for all the investments. While regulatory compliance is not the Bank’s objective “per se”, failing to meet these have financial repercussions for banks and signals a weak position to the market. This could destabilise the financial sector that is sensitive to market signals, especially for systemic banks.

Management notes the IEvD’s revised Theory of Change for MREL and bail-in-able debt investments in the report and would like to stress that as part of the revised TOMS 2.0 methodology Management will aim to put more emphasis on systemic effects, however, it should be noted that it will not always be possible to precisely measure the market level effect of each project.

Management welcomes the report’s findings on the Bank’s long-standing partnership and bilateral engagement with PFIs including MREL and other instruments, and the significance of such engagement in building knowledge and influencing the clients’ behavioural change towards green financing (both in quantity and quality/robustness) and broader climate practices. Management disagrees with the report’s conclusion that GET-eligible MREL investments have limited impact on Green Transition and that the current structure of GET-eligible MREL bonds does not necessarily lead to increased green financing. The Bank’s engagements through GET-eligible (MREL and non-MREL) bonds have contributed to creating an enabling environment for a paradigm shift of PFIs in their green transition journey, which entails not only the commitment to new green financing but also introduction or improvement of relevant strategies (e.g. development of green financing into a new market segment), internal systems (e.g. assessing and tracking green lending pipelines and portfolios) and improving reporting and disclosure.

Management acknowledges the IEvD observations on the lack of clarity on the GET Handbook regarding GET eligible MREL bonds and will improve the definition. However, Management disagrees that GET eligible MREL bonds might not meet the threshold set for GET-eligibility according to the guidelines set out in the GET Handbook. Management reiterates that new GET-eligible financing is considered additional while the hypothetical example in Box 10 is generic and contradicts the real outcomes as recorded under the monitoring of the allocation to GET sub-projects.

Management is selective in utilising limited Technical Cooperation (TC) resources, especially for Advanced Transition Countries. In addition to technical support provided, the GET multiplier is another tool EBRD uses to drive behavioural change of the issuers towards more green financing and greater disclosure on green asset allocations. Quite often, EBRD is the only investor with such demands for general purpose bonds. Furthermore, policy statements signed by issuers need to comply with EBRD's strict GET criteria. These are tracked and monitored annually.

Management also welcomes the recognition of the financial additionality of EBRD's investments in bail-in-able instruments. Naturally, shocks may trigger a market set-back at any time. The dynamic nature of capital markets reinforces the fact that financial additionality is neither static not linear. Management has a well-established, tested and efficient bidding strategy approach with the ability to react quickly to the prevailing market conditions at the time of issuance. The governance in place also allows that in cases of increased market demand, EBRD is being appropriately scaled-back at the discretion of the issuers, to crowd-in commercial investors.

Management agrees with the conclusion that using bail-in-able instruments as a vehicle to deliver other transition objectives provides for internal coherence, however, does not concur with the conclusion that MREL / bail-in-able products are a high-risk product. The Bank's robust risk framework has resulted in a high-quality portfolio of bail-in-able investments with a strong risk & reward profile. Risks of transition impact delivery should not be mixed with financial risks, as the financial risk of a project and expected transition impact are not correlated. Factually, the average risk of MREL products (as measured by their PD rating) is among the better half of risk exposures of EBRD's FI sector (which has itself a much lower ratio of non-performing loans than the rest of the Bank, including no MREL debt currently in arrears). This is presented every year in the Financial Intermediaries Report and has not markedly changed over the past few years.

Management comments on the recommendations and the key findings of the study are presented below.

## 1. Management Comments on IEvD Recommendations

**Recommendation 1.** ***"In order to foster resilience transition at the systemic level, the EBRD should develop a set of clear principles and guidelines, focusing more on targeting sustainable market-level strategic outcomes with bail-in-able instruments"***

Management **Agrees** with the recommendation.

The recommendation is in line with the Bank's current practices and ambition. Management notes that all bail-in-able investments have been fully in line with the "Financial Sector Strategy 2021 – 2025" approved by the Board on 15 December 2021, achieving multiple objectives which have been prescribed as explicit priorities in the sector's strategy, including but not limited to:

- Capital support and strengthening loss absorption capacity.
- Capital markets support.
- Green partnership and alignment of the sector to objectives of Paris Agreement.

Bail-in-able investments have also been consistent with the respective country strategies approved by the Board supporting capital market development and delivering EBRD's transition targets by way of use of proceeds. Bail-in-able instruments are financial tools to achieve the Bank's strategic objectives in a country, rather than a targeted investment goal in themselves.

Management has been investing in bail-in-able instruments utilising the currently established TI methodology focusing on strengthening the PFIs' resolvability and consequently the financial stability in its CoOs, while facilitating access to and simultaneously supporting the development of efficient capital markets. In parallel, Management has been approaching bail-in-able investments as critical vehicles to pursue other strategic objectives, including the development of pathways to Paris Alignment, supporting lending to green economy transition, inclusion and beyond. Management has been selective in pursuing these investments, with partners where we can have the highest impact while adhering to sound banking principles in terms of credit quality and commercial pricing.

Management agrees that a separate position paper outlining guiding principles for bail-in-able investments could complement the already established objectives in the Financial Sector Strategy and Country Strategies and provide additional clarity on the usage and appropriateness of the specific investment tools. Such position paper will also make references to Transition Impact objectives linking it to the ongoing re-development of the TOMS 2.0 system which will provide further clarification and linkages to the systemic impact of the Bank's investments. Such position paper will be part of the next Financial Sector Strategy document.

Although Management appreciates that secondary sales can create some traction in secondary markets, it cautions on any secondary market sales as a mechanism for capital market development. Selling in an illiquid market would artificially and inadvertently impact the price of the bond, a position the EBRD should not expect to take. In addition, it would be challenging to measure the ex-post impact of the trading activity and thus evaluate the outcome, as bond sales are generally on OTC markets. However, where possible, secondary market activities can be considered. If the Bank chooses to be active on secondary trading, internal classification and the accounting treatment of the bond investments under the Banking will need to be changed and such impact on Bank financials needs to be considered.

**Recommendation 2.** ***"To ensure that GET-eligible MREL / bail-in-bonds deliver a tangible impact on green financing levels, the Bank should incentivize and monitor partner financial institutions to increase the quantity and quality of their green financing."***

Management **Partially Agrees** with the recommendation to set green finance objectives that gradually increase the requirements for environmental outcomes. Although management agrees the Bank's overarching goal is to encourage and contribute to the greening of our client balance sheet, Management disagrees with the recommendation to set issuer-level targets linked to individual capital market transactions.

Green use-of-proceed products such as GET-eligible MREL investments need to be distinguished from issuer-level engagement and green counterparty transition. The latter are rolled out by the Bank via several initiatives and products that are part of the overall green toolkit.

GET-eligible MREL investments act as a conduit to 1- induce new lending in line with our GET eligibility criteria and 2- encourage issuers to increase their green standards.

1 - By definition and for all our use of proceed instruments (lending, GEFF loans or capital market), the commitment of our clients is proportional to the amount deployed by the Bank. In this context, GET-eligible MREL investments are used to "go the extra mile" as the EBRD, where possible, requests an additional commitment through the multiple by which a client commits to deploying additional future green lending beyond EBRD investment ("GET multiple"). In this sense, Management believes that the GET-eligible MREL investments have encouraged an increase in green lending.

2 - GET-eligible MREL investments help increase the capacity of the issuer to identify and expand its green asset pool, to improve their robustness in terms of ESG and technical eligibility criteria, and to improve reporting quality, which will ultimately contribute to the issuer's increase in green lending.

The impact of GET-eligible MREL investments is no different (as in, no less than) from any of the Bank's GET eligible lending and the green ABI generated through intermediated transactions.

Management does not believe it is the place for GET eligible bonds to include issuer level targets. This is contradictory with the use of proceed nature of the product and is already covered by the work done to support clients in their transition planning or support in disclosure obligation.

Management agrees data is a limiting factor in tracking and understanding our partner financial institutions overall green financing journey. EBRD should continue to encourage more transparency and help its clients to better identify and report on their green activities. The GET-eligible product is a step in this direction and accessing a structured and comprehensive TA program to support at country or client level would increase the Bank's transparency of impact. However, management would like to draw attention to constrained resources available to realise that ambition.

Management agrees to continue exploring ways to use GET-eligible MREL investments as part of a "learning journey" towards the issuance of fully-fledged green bonds and appreciate the recognition those two products need and will continue to coexist. Management also salutes the recommendation highlighting the need for a flexible approach looking at each issuer individually. The Bank already engaged with several issuers in this way, out of 11 Client Banks issuing labelled MREL Bonds, the EBRD had strong engagement on GET-eligible Bonds issuance preceding the labelled Bond issuance with 9 of them.

Management would like to refer to the action plan following the recent IEvD Green Bond evaluation to address this point. This work indeed involves proposal for additional technical assistance program to encourage the above and is well covered in the MAP.

**Recommendation 3**. ***"In order to enhance its additionality and to incentivize the most impactful MREL / bail-in-able projects, the Bank should develop an adequate results-based approach that 1) clearly differentiate between project-level results (focus on client capital adequacy and ability to lend in the real economy) and market-level effects (focus on capital market development); and 2) be able to monitor and measure progress towards both."***

Management **Agrees** with the recommendation.

Based on the current Transition Impact methodology, EBRD's objectives in MREL investments are to strengthen banks' resolvability and strengthen financial stability, i.e., resilience that is an important aspect of sustainable market economy and access to finance. Management would like to emphasise that currently client level results are already differentiated from market level development aspects: e. g. under the Resilient quality there are at least three objectives that apply to MREL: (i) meaningful increase in capital adequacy or MREL base, i. e. client level outcome, (ii) contribution to capital market development in terms of novelty of these products; (iii) private sector participation (market level outcome). For bonds there are also objectives featuring listing and rating. Currently all core objectives under the Resilient quality have equal weights, and the novelty of products is rated even higher than the other objectives. If the capital market development aspect of the transaction is weak, the project has a low ETI score.

Management agrees, that as part of the revised TOMS 2.0 methodology, we will aim to continue differentiating between client-level results and market-level outcomes as well as emphasise and recognise more strongly from an impact perspective the projects that have a systemic effect as supported by novel projects, private sector participation, as well as the projects aimed at market deepening, and will aim to closer monitor capital market development claims of the proposed projects. It should be noted, however, that it would not always be possible to precisely measure the market level effect of each project, therefore it will be important to present each project against the background of capital market development priorities for each country.

It is also worth noting that, as MREL products become mainstream, the focus of MREL investments will gradually shift to achieving transition through uses of proceeds in addition to through additional resilience and market-level capital markets development.

**Recommendation 4.** ***"In order to ensure MREL / bail-in-able products are additional and conducive to systemic change, the Bank should enhance transparency and strengthen the ability to assess MREL / bail-in-able products at any point in time, not just at signing, without adding burden to Board members or Management"***

Management **Partly Agrees** with the recommendation.

Management fully supports methods of enhancing transparency and effective assessment of the Bank's projects and notes that the Board is informed through the currently established reporting mechanisms including:

- Board approval project documents that report in detail all investments with a specific issuer as well as country level cumulative bail-in-able investments and overall utilisation of relevant bail-in-able limits,
- Investment information for the first issuance under a specific project via the existing Capital Markets Investment Notification, and
- Quarterly aggregate information on the utilisation of Bail-in instruments concentration limits (per product and country) under the Quarterly Performance Report (QPR).

1) Management agrees with the enhancement of the already established Board notification template to ensure key metrics on bail-in-able investments are reported, when available.

2) As per the Bank's established practices, capital market transactions, irrespective of the type of instrument (e. g. bail-in-able, covered bond, senior bond or other), Management reports the investment details of the first issuance only. This has been the approach for efficiency purposes. Any subsequent investments under a bail-in-able project are reflected in the aggregate information provided under the QPR and FIR. Management can include the available headroom details and certain key analytical metrics on the annual MREL investments under FIR going forward to provide further transparency. If ARC decides additional reporting after each MREL bond investment would be useful, Management could report back to the Board after every investment rather than only for the first issuance, in the same standardised format.

3) Management carefully considered the suggestion of limiting the approval period to one year in the context of potentially reduced additionality and disagrees that such an approach would have an improvement on its operations or corporate governance. EBRD’s well established governance and risk framework led to a high credit quality portfolio with a proven track record of crowding in commercial investors. In addition, reducing the approval period to one year from the original multi-year approach (as the case in tranched disbursements of EBRD loans) would not only lead to inefficiencies but also would not provide the desired market visibility to the Board, as EBRD additionality will be possible to be analysed only during the book building period based on the capital market dynamics of the day. Reducing the approval period would negatively hamper smooth delivery of such investments in multiple ways:
   - ***Timing*****:** Capital market investments are dependent on the market conditions and are highly time sensitive. Standard EBRD approval processes are not compatible with the requirements to operate in this dynamic space, where issuance decisions are taken based on certain windows of opportunity. The suggested approach would lead to EBRD missing multiple opportunities to support our PFIs.
   - ***Capacity:*** In order to have an established limit present, Management will need to initiate the approval process for the same investment programme with the same issuer, Use of Proceeds and ETI objectives roughly every nine months (given our 3-stage approval processes, time to Board approval, completion of the legal documentations and relevant conditions precedent) which will add an unjustified burden on the already stretched FTE capacity of Banking, Risk, Treasury, Impact, CSD, ESD, OGC as well as the approval bodies of the Bank.
   - ***Market Transparency:*** At times, issuances do not take place until months after the Board approval. The final investment decision is delegated to Management who verifies the continued appropriateness of the investment and gauges the investment parameters based on prevailing market conditions. Therefore, introducing additional Board approvals does not guarantee any additional market transparency as true market conditions are only available around the issuance date.

## 2. Comments on study analysis and findings

Management would like to clarify that although a public placement is the most effective way to market an instrument to the wider investor base it is not necessarily the most efficient choice for the PFI to raise bail-in-able debt in terms of cost-benefit analysis. As the report indicates, a natural transition has been observed in the EU region from bilateral loans to private placements and subsequently public issuances as banks have been developing their loss absorption base, nevertheless the optimal structure depends on many factors including the size of the potential liability, its seniority, the country, and the costs involved in an open market transaction. Irrespective of the choice of structure, EBRD always encourages its PFIs to reach out to private investors in order to ensure a strong private base, either in parallel lending or in a majority private sector participation to a private or public bond. It is noted that private placements still need to adhere to good corporate governance and market discipline, just like public issuances, and are marketed to a number of private investors (could be up to 100).

Management would like to illustrate, as highlighted in the report, the allocation of GET eligible MREL bonds have been successful. Indeed, 54% of GET eligible bonds investments as of the end of 2023, have been fully allocated, representing EUR 1.2 billion of new financing to GET-eligible projects. To date, all the issuers demonstrated full allocation of the proceeds within the agreed allocation period.

Management welcomes the recognition of IEvD that examples provided in the report in relation to PFIs public disclosures of green projects depends on the issuer's definition of green or sustainable financing, rather than the EBRD's requirements, and that not all this financing may comply with the GET criteria. The Bank's GET criteria are in line or above best market practices ensuring high green quality portfolios.

Management also welcomes the report's conclusions that GET eligible bond and Green/sustainable bonds will and need to co-exist. Client uptake of both GET-eligible bonds and green bonds demonstrates the market need for both instruments. The use of both products contributes to increasing the overall green ambition of clients.

Management disagrees with the view that participation in a bail-in-able issuance could be seen as distorting competition [Box 7], especially when the said issuance is a public placement whereby EBRD's involvement is limited to up to 20%.

Management disagrees with the linkage of estimated RAROC to the appropriateness of a three-year headroom. Irrespective of when an approval is granted, RAROC is looked at each individual deal when the bidding strategy is prepared, and that is the time when the approval of the RAROC takes place - it is clearly earmarked in the Board document that the RAROC is only indicative at time of approval and that this is delegated to Management which approves bidding strategies.

Management wants to clarify that references to "regulatory capital" and "capital base" are not always correct given that Senior Preferred and Senior Non-Preferred liabilities are debt instruments and not capital instruments. These two types of instruments support the loss absorption capacity of a PFI in case of resolution but structurally remain senior unsecured liabilities that rank higher to common equity and Tier 2 capital.