EU loss-absorbing capacity requirement: final MREL guidelines

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On 3 July 2015, the European Banking Authority (EBA) published the final technical standard[1] on the criteria for determining the minimum requirement for own funds and eligible liabilities for bail-in – the so-called MREL. With the MREL, European authorities seek to **ensure that banks have enough liabilities to absorb losses in case of a bank's failure**. Resolution tools, including the bail-in tool, can be applied effectively and, therefore, shareholders and creditors shoulder much of the recapitalisation burden instead of taxpayers.

Aimed at **ensuring a harmonised** application throughout Europe, the EBA sets five criteria for its determination:

- The default **loss absorption amount** is the capital requirement currently applicable to an institution or group. An upward or downward **adjustment may take place depending on the Supervisory Review and Evaluation Process (SREP)** recommendations which will take into account the idiosyncratic characteristics of each institution,
- The **recapitalisation amount** is the amount necessary to satisfy applicable capital requirements necessary to comply with the conditions for authorization after the implementation of the preferred resolution strategy,
- The **DGS adjustment** the MREL may be lowered according to the resolution authority's assessment on the contribution of the DGS in resolution process,
- In order to comply with the principle of No Creditor Worse off than in Liquidation (**NCWO**), the resolution authority may assess whether senior unsubordinated debt could be MREL-eligible,
- The resolution authorities **should assess** whether the level of MREL is sufficient to ensure the conditions for use of the resolution fund and the contribution to loss absorption and recapitalization be not less than **8% of the total liabilities**.

The MREL could be seen as the European Union's counterpart to the FSB's TLAC.[2] However, **despite having the same purpose, both ratios are different** due to their scope and their definitions. Among others, TLAC is limited to G-SIBs, is based on a common minimum requirement to all G-SIBs, and will not apply before 2019. Conversely, the MREL applies to all EU banks regardless their systemic footprint, its calibration will be set on a case-by-case basis, and its application will be much earlier, from 1 January 2016 with a transitional period of 48 months.

[1] https://www.eba.europa.eu/documents/10180/1132900/EBA-RTS-2015-05+RTS+on+MREL+Criteria.pdf
[2] See the BBVA Research report "Total Loss-Absorbing Capacity (TLAC): making bail-in feasible and credible instead of bail-out" https://www.bbvaresearch.com/wp-content/uploads/2014/11/20141111_Regulation-Watch_TLAC-V-def1.pdf

Loss-absorption requirements in the Bank Recovery and Resolution Directive

The Bank Recovery and Resolution Directive (BRRD), approved in 2014 and whose enforcement began on 1 January 2015, establishes several resolution tools to deal with banks in trouble. Among them, the bail-in is one of its cornerstones. It implies that banks' creditors would be written down or converted into equity in case of resolution and, thereby, they should shoulder much of the burden to help recapitalise a failed bank instead of the taxpayers. In order for this new banking rescue philosophy to be effective, the **BRRD requires banks to have enough liabilities which could be eligible to bail-in – so-called "Minimum Required Eligible Liabilities (MREL)."**[3] This new concept means that when a bank is unviable, these liabilities will be used to recapitalize the institution and guarantee, in turn, that those critical functions which are inherent to financial activity will be maintained.

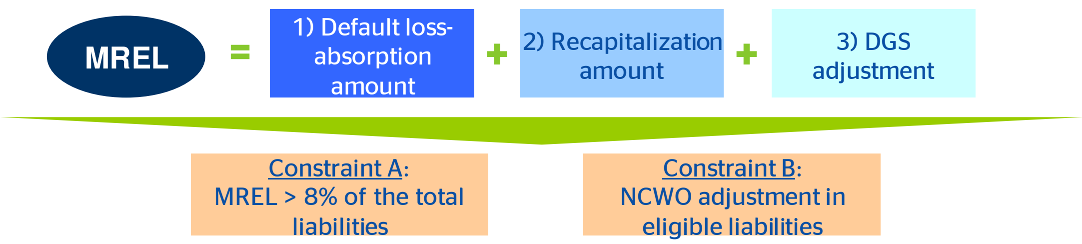
Aimed at ensuring a harmonised application throughout Europe, the BRRD empowered the **EBA to specify the criteria which resolution authorities are expected to apply when setting the MREL** in each institution. In this sense, on 3rd July 2015, the EBA released the final MREL guidelines (EBA FINAL Draft Regulatory Technical Standards).

The final technical standard has changed slightly compared to the consultation paper released in November 2014. As we describe below, the final rule provides greater flexibility for resolution authorities in determining the MREL, following a case-by-case approach.

Determining the MREL, five elements should be taken into account:

Based on BRRD, the MREL will be determined case-by-case at individual level in each banking group. Although the MREL is expressed as a percentage of total liabilities and own funds of each institution, its **quantum will be determined in monetary terms** based on several factors, in which the capital and leverage ratios play a central role. As shown in Figure 1, the EBA sets five criteria for its determination:

Figure 1
Minimum Required Eligible Liabilities (MREL) criteria



Source: BBVA Research

1. **The "default loss absorption amount" definition.**

The BRRD establishes that the MREL shall be calculated as an amount of own funds and eligible liabilities. As the MREL incorporates the own fund amount, the first criterion should be the minimum capital prudential requirements that the institution must comply with on a going-concern basis (including Pillar 2 and the combined buffer). Bearing in mind that capital prudential requirements are composed of

[3] Article 45 of the BRRD

two standards: the capital and leverage ratios, the "default loss absorption amount" is the maximum of both:

Maximum (capital ratio requirement or leverage ratio requirement or Basel 1 floor)

The capital ratio requirement should include any Pillar 2, Basel 1 floor, and the so-called "combined buffer", which includes the capital conservation, countercyclical, systemic entity (either G-SIB or D-SIB) and a systemic risk buffer. The introduction of the capital buffers thus would be one of the main differences with the FSB's TLAC proposal, as Table 2 shows.

Moreover, the BRRD also requires authorities to determine the MREL by taking into account the idiosyncratic characteristics of each institution (i.e. business model, risk profile, governance, etc.) and using the outcome of the supervisory review and evaluation programme (SREP). Regarding this outcome, the loss-absorption amount could be adjusted either upwards or downwards according to several criteria. Given the discretionary feature of this adjustment, the dialogue, coordination and information-sharing between the resolution authority and the supervisors are critical.

Table 1
Loss absorption amount adjustment by the resolution authority

Higher if	Lower if
• The need to absorb losses in resolution is not fully reflected in the default loss absorption amount, taking into account information requested from the competent authority relating to the institution's business model, funding model, and risk profile.	• Additional own funds requirements, which have been determined based on the outcome of stress tests or to cover macroprudential risks, are assessed not to be relevant to the need to ensure losses can be absorbed in resolution
• If necessary to reduce or remove an impediment to resolvability or absorb losses on holdings of MREL instruments issued by other group entities.	• Part of the combined buffer requirement is assessed not to be relevant to the need to ensure that losses can be absorbed in resolution.

The rationale behind the adjustments is that some elements of the combined buffer, such as the countercyclical buffer, are not considered relevant in terms of loss-absorption capacity in a resolution scenario. In fact, it makes complete sense as the countercyclical buffer, which is required when the credit growth is higher than the GDP growth, would probably not be active when an institution enters into resolution, especially in a systemic crisis.

It is worth highlighting that the final version of the MREL also clarifies that the resolution authority is empowered to adjust the default loss absorption amount with regard to capital requirements determined by the supervision authority. But in order to enhance cooperation and confidence between the supervisor and the resolution authority, the latter is required to provide an explanation of the reasoning behind the adjustment. Thus, it may remove the potential source of conflict between both authorities.

Last but not least, the introduction of the leverage ratio loss-absorption amount rightly recognises the diversity of business models among European banks. Banks with low RWA density may breach the leverage ratio before the capital ratio, and therefore the TLAC liabilities and the bail-in tool would be used to restore the leverage ratio first. The opposite would be true for retail banks (RWAs would be binding and not the leverage ratio).

2. The "recapitalisation amount" definition

The EBA acknowledges that the resolution plan might not imply that the entire group is recapitalised in the same form as that in which it enters resolution. The preferred resolution strategy in each group might involve discontinuing or winding down some subsidiaries, business lines or activities rather than continuing the entire business. Therefore, this would require fewer resources for recapitalisation, and would not double the pre-resolution minimum prudential requirements as the EBA clarifies in Article 2 (5). This approach, opposite to that of the FSB's TLAC, rightly creates incentives for banks to reduce barriers or impediments to resolvability.

When estimating the regulatory capital needs after the resolution process, the resolution authority shall use the most recent values of RWA or leverage ratio denominator. However, any additional requirement (Pillar 2) or buffer required by the entity before resolution, but which is regarded as non-applicable after resolution, shall be deducted from the estimate of the recapitalisation amount.

One of the main objectives of the bail-in tool is to recapitalise the failed institution at a level that promotes market confidence and meets the going concern regulatory capital requirement. However, what is the optimal level to promote market confidence? In this regard, the EBA's new guidelines propose that the optimal capital level to restore market confidence after resolution would be assessed by the resolution authority taking into account the capital position of peer institutions. The specific reference to the CET1 median of a peer group has been removed from the text.

A particular doubt may arise when applying the market confidence level approach only for global systemic banks (G-SIBs). Although it is true that G-SIBs rely on market financing to a greater extent than domestic systemic institutions (D-SIIs), recovering the market confidence is aimed at achieving funding not only in the long term but also in the short term. In this sense, focusing on both the short- and long-term funding needs, both types of institutions (either G-SIBs or O-SIIs) shall regain market confidence regardless of their systemic footprint.

3. The "DGS" criteria

The resolution authority shall determine an estimate of the potential losses to the deposit guarantee scheme (DGS) if the institution were liquidated under normal insolvency law, preserving the DGS contribution limit to the resolution (the amount of covered deposits or the 50% of the target level). When the resolvability assessment concludes that liquidation of an institution under normal insolvency proceedings would be feasible and credible and the DGS contribution limit is preserved, the resolution authority may reduce the MREL in order to take into account any estimated contribution.

In addition to the previous three criteria, the EBA consultation paper sets two criteria when determining the MREL in an institution:

A) The "No Creditor Worse off than in Liquidation" adjustment principle (NCWO)

The MREL should consist of instruments that can be legally, feasibly, effectively and operationally written down or converted into equity in case of resolution. Based on these principles, the EBA is concerned about the legal and operational problems which could arise when senior debt is eligible for bail-in and uncovered corporate deposits are excluded. In fact, there is a consensus among authorities that unsecured debt may pose credible or legal loss-absorbing risks. Whether or not liabilities that are *pari passu* with normal unsecured creditors, and which cannot effectively be written down or converted into equity (for example those arising from derivatives or corporate deposits), would be excluded from bail-in due to the "no creditors worse off than in liquidation" principle is a heated debate.

In this regard, the EBA proposes a flexible *de minimis* approach empowering the resolution authority to analyse carefully whether the senior debt could be included in the MREL. On this subject, the EBA proposes that if the **unsecured debt** accounts for more than 10% of the total liabilities in the same rank, it could be a legal challenge (no creditor worse off than in liquidation) and it could not be included in the MREL. This approach may be consistent with the BRRD, which states that authorities may force the institution to issue or substitute it with senior debt with subordinated clauses.[4]

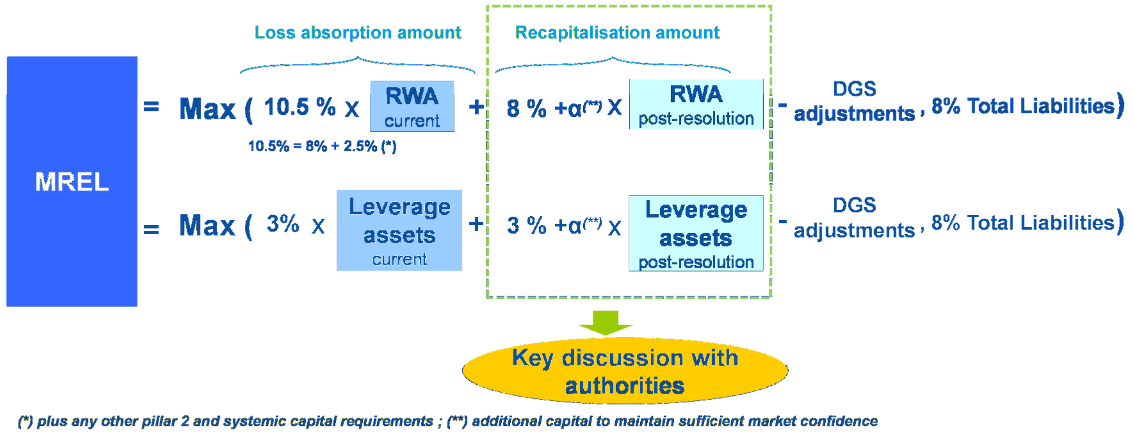
B) The "8% of total liabilities floor" constraint

Finally, the EBA reasserts in the new guidelines the role of the 8% of total liabilities as a MREL floor, recognising the threshold set by the BRRD which may complement the bail-in. This requirement that losses up to 8% of total liabilities and own funds have to be bailed-in before any other measure is applied (i.e. using the resolution fund or public stabilisation tools in exceptional circumstances) is one of the cornerstones of the European resolution regime, making credible the aim of minimising costs for taxpayers and resolution funds. In this sense, the **EBA ensures that banks**, at least the significant ones (i.e. global SIBs and domestic SIBs), **have enough liabilities before deciding to use other measures**.

The 8% of total liabilities floor will only apply to significant institutions in Europe, but it may be extended to all institutions, not only the G-SIB or O-SIBs, with a resolution strategy which does not entail liquidation. Additionally, this constraint would not apply if the resolution authority considers that there are no resolvability impediments to carrying out the resolution strategy without using the resolution fund.

To sum up, Figure 2 shows an illustrative example of how the MREL may be assessed. There are mainly two components: the loss absorption, and the recapitalisation amount. The most critical aspect in the discussions between the bank managers and the resolution authority will be the determination of the RWAs after the resolution. Moreover, as explained above the other criteria should be taken into account to determine the MREL (additional adjustments: SREP, DGS and the constraints that MREL is subject to).

Figure 2
Illustrative example of the determination of the minimum Required Eligible Liabilities (MREL)



Source: BBVA Research

[4] See article 13 and 14 of the BRRD

The resolution authority will play a key role in determining the MREL

In contrast to the FSB's TLAC, where the minimum would be primarily driven by a common standard, in the European MREL the role of the resolution authority is crucial when determining the specific requirement in each institution. This approach rightly recognises that not all banks are the same, even among G-SIBs, and their resolution strategy, resolvability assessment, size, business model, etc. should be taken into account on a case-by-case basis. Against this backdrop, the resolution authorities will have the following **discretionary powers**:

- They may adjust the "**default loss absorption amount**" upwards or downwards, taking into account the information requested by the supervision authority relating to the institution's business model and risk profile.
- They will determine an amount of recapitalisation which would be necessary to implement the **preferred resolution strategy**.
- They should include any additional amount to **maintain market confidence** after resolution that will be the combined buffer by default but that may be reduced, even down to zero.
- They should assess whether the potential **exclusion from bail-in** may pose any future legal or operational risk due to the NCWO clause.
- Finally, they should assess whether there are any resolvability impediments and that the resolution **strategy is credible and feasible**.

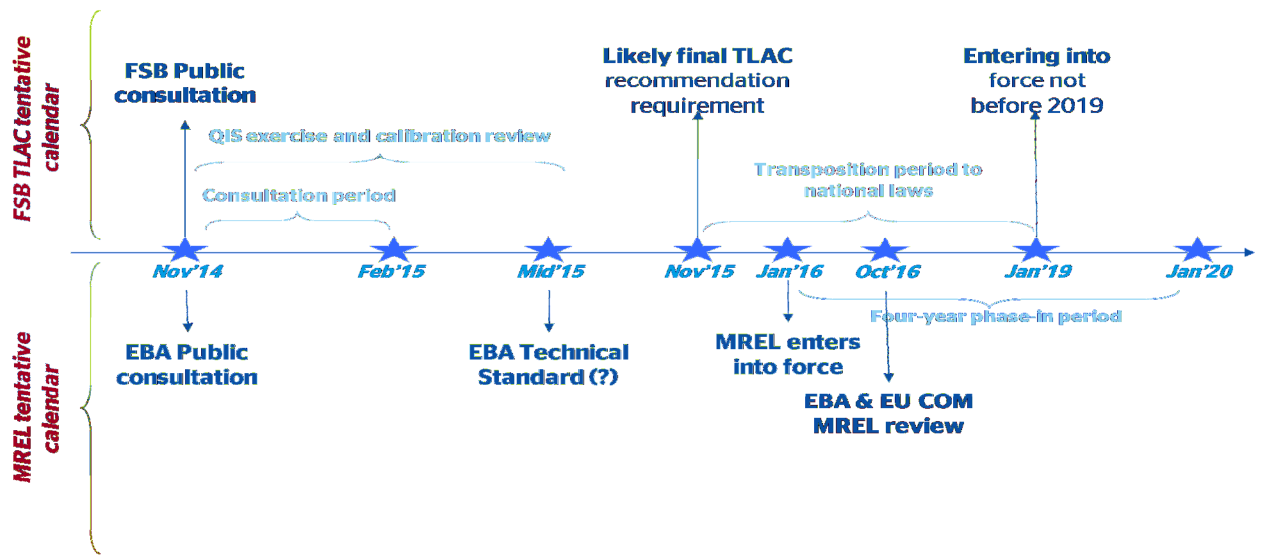
In order to ensure a harmonised application of the previous criteria, the **EBA will submit a report** to the European Commission by 21 October 2016, analysing whether there have been any divergences in the levels set for comparable institutions in Europe.[5] This report will be critical to maintaining **the level playing-field and enhancing transparency among European banks**.

Last but not least, the phase-in period

Based on the BRRD, the MREL requirement will come into force in January 2016 at the latest. However, the EBA rightly recognises the enormous impact of this requirement on banks' funding structures and costs. Therefore, it proposes a **long phase-in period of 48 months (four years),** that is to say until 2020, smoothing the impact and complying with the FSB proposal on not being before 1 January 2019.

[5] See article 45 (19) of the BRRD

Figure 3
FSB's TLAC and European MREL tentative calendar



Source: BBVA Research

MREL and TLAC: equivalent concepts but not exactly the same

The Financial Stability Board (FSB) has proposed the TLAC ratio whose final version will be approved by the next G20 summit in Turkey in November 2015, based on the outcome of the consultation paper and the comprehensive Quantitative Impact Study (QIS).According to the current proposal, G20 countries will have to transpose the TLAC requirements into their own jurisdictions but not before January 2019.

This state of the art results in two parallel ratios - MREL and TLAC – which, despite having the same purpose, are different due to their definitions and are not totally consistent in all their features (as shown in Table 2). In this vein, the main differences are the following:

- Scope: The MREL applies to all institutions independently of their size and systemic footprint, whereas the TLAC only applies to G-SIBs.
- Sizing: The MREL is determined on a case-by-case basis based on each bank's idiosyncratic characteristics and the resolvability assessment, whereas TLAC is a common minimum standard for all institutions. In fact, TLAC is perceived as a Pillar 1 requirement whereas MREL is seen as a Pillar 2, and therefore the latter is more aligned with the resolution process of an institution.
- Comparability: The MREL may difficult market comparability and raise level playing-field issues, since its tailor-made approach may result in a different requirement for each institution. In order to minimize these concerns, the Single Resolution Board's role in the Eurozone is critical.

Table 2 shows the main differences between the final MREL Technical Standard and the FSB TLAC proposal of November 2014.

Table2

Differences between MREL and TLAC requirements

	MREL	TLAC	Comparability
Scope of covered firms	• All credit Institutions and investment firms	• Global systemically important banks (G-SIBS)	✗
Objective	• To ensure that there is an appropriate level of loss-absorbing and recapitalisation capacity for the relevant group to be resolvable, and that the critical functions can be continued without taxpayer (public) funding and avoiding adverse effects on the financial system.		✓
Eligible Instruments	• Equity, junior debt, senior debt, and other unsecured liabilities with residual maturity over one year. • Senior unsubordinated debt may be excluded if it accounts for less than 90% of the total liabilities in the same rank.	• Equity, junior debt, senior subordinated debt and part of the senior unsubordinated debt which is *pari passu* with excluded liabilities. The latest may account for an amount equivalent to 2.5% RWA.	≈
Pillar 1 vs. Pillar 2 approach	• Case-by-case approach (Pillar 2) based on each bank's characteristics: resolvability assessment, complexity, risk profile, etc.	• All banks should have the same Pillar 1 minimum TLAC requirement plus a Pillar 2 firm-specific requirement.	✗
Sizing	• MREL shall be calculated based on the minimum capital including capital buffers and leverage requirements and the recapitalisation needs after resolution. • Additionally, some adjustments may be applied based on risk profile, resolution strategy, etc.	• Pillar 1 standard minimum: (16-20% of RWA or 6% of leverage assets) plus Pillar 2 case-by-case requirements. • TLAC minimum requirements do not include capital buffers.	✗
Denominator	• MREL is expressed as a percentage of total liabilities and own funds of each institution. • However, the MREL's quantum will be determined in monetary terms based on several factors where the capital and leverage ratios play a central role.	• The TLAC is determined by the capital or leverage ratio	✓
Come into force	• MREL requirement is already approved and will come into force in 2016. • The EBA proposes a 48-month phase-in period (four years)	• No earlier than 1 January 2019	✓

In any case, above the aforementioned features of each ratio, it is critical to guarantee the consistency between the TLAC and MREL requirements in order to avoid a misleading interpretation of the ratios and to maintain the level playing-field among banks worldwide. Against this backdrop, once the FSB's final TLAC proposal has been released in November 2015, and bearing in mind that the BRRD empowers the EBA and European Commission to review the MREL by the end of 2016, the European authorities should seize on this opportunity to bring the European approach closer to the TLAC features, in order to make both ratios compatible while preserving the local idiosyncrasies in Europe.

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