4 MDA: the definitive explanation?

EBA's opinion on the Maximum Distributable Amount

At the end of last year the EBA published an opinion on the interaction of Pillar 1, Pillar 2 and the combined buffer requirements and restrictions on earnings´ distribution. In this regard, the EBA clarifies how the limitation on payment of dividends, coupons of AT1 and/or variable remuneration will work. This refers to the MDA framework.

Capital requirements: a primer

European regulation defines the capital requirements that a financial institution must hold for prudential purposes. To be more precise, the CRR establishes (in Part Two) the own funds requirements that financial institutions must comply with (i.e. Pillar 1). In addition, competent authorities carry out their Supervisory Review and Evaluation Process (SREP) to assess the institution-specific level of own funds and therefore require additional capital above the Pillar 1 requirement (i.e. Pillar 2). Finally, and generally more based on macroprudential factors, financial institutions must comply with the combined buffer requirement (i.e. capital conservation buffer, systemic risk buffer, etc.). Normally, these capital requirements are defined in CET1 terms but in some cases they could include AT1 or Tier 2 requirements.

Origin of the debate: the problem

The CRD establishes that when a financial institution´s CET1 is not enough to cover the above-mentioned combined buffer, financial institutions must compute the MDA and, as a result, competent authorities will be able to impose restrictions on the distribution of earnings (i.e. dividends, AT1 coupons or variable remuneration). Even if this is clear, the problem is how to assess whether a financial institution has sufficient capital to avoid the computation of the MDA. In other words, how to compute the capital level that a financial institution must have in order to be able to make distributions. From a practical perspective, it is necessary to know exactly what the capital stack is, or how Pillar 1, Pillar 2 and the combined buffer interact with each other.

The EBA´s opinion: the solution?

The EBA recommends a stacking order, where Pillar 2 is located between Pillar 1 and the combined buffer. As such, financial institutions would have to take Pillar 2 into account in computing whether or not they would face restrictions on earnings´ distribution.

General assessment

The EBA tries to put some clarity into a very complex part of the European banking regulation. As such, it recommends competent authorities to take into account Pillar 1, Pillar 2 and the combined buffer in the computation of the MDA or, in other words, to discourage what is called the Danish approach (i.e. Pillar 2 was not included in this computation). Furthermore, in the same opinion, the EBA recommends competent authorities to ensure the funding continuity of financial institutions when revising capital plans due to the MDA computation. And finally, competent authorities should, at least, not prevent or dissuade any institution from disclosing Pillar 2 information. Moreover, the EBA's opinion includes some recommendations to the European Commission: first, to simplify the wording of the CRD article related to the computation of the MDA and therefore avoiding misinterpretations and, second, that the European Commission should revisit the prohibition on distribution when no profits are made, notably on AT1. In a nutshell, this opinion represents an important step towards increasing transparency, and it supported the decision taken by some European financial jurisdictions to encourage banks to disclose their SREP requirements.

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