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MREL REPORT: Frequently Asked
Questions

Process and next steps

1. Why have you issued an interim and a final MREL report? What are the main differences between the two reports?

As per the BRRD, the report was due by 31 October 2016. However the Commission requested the EBA to deliver provisional recommendations and conclusions in relation to MREL and TLAC to assist them in preparing their legislative proposal, which was issued on 23 November 2016.

Accordingly, the EBA issued an interim report on 19 July 2016 and launched a public consultation to gather stakeholder feedback on the provisional recommendations. The final report is being published now in order to take account of this additional procedural stage including the public consultation.

The final MREL report includes the conclusions and recommendations of the interim report but updates and complements some of them to reflect comments received from various stakeholders during the consultation process. In addition, new areas not covered before have been explored. For example, the assessment of MREL ratios and possible funding needs has been updated, and recommendations on subordination requirements or intragroup issues have been further developed. In addition, the final report provides new recommendations on areas not addressed in the interim report, such as restrictions on maximum distributable amount (MDA), cooperation between supervisors and resolution authorities or disclosure requirements.

2. What are the next steps?

The European Parliament and Council will deliberate on the Commission's legislative proposals on loss-absorbing and recapitalisation capacity of credit institutions in the coming months. The conclusions and recommendations of this report are not binding. However, the EBA is confident that they will shed light on a number of technical aspects for discussion.

In the future, the Commission proposals envisage the publication by the EBA of reports on the implementation and impact of MREL every other year. The EBA may also publish reports on its own initiative.

Quantitative work: MREL ratios, possible funding needs, and macroeconomic impact assessment

3. What methodology have you used to estimate MREL possible funding needs?

The quantitative findings are based on the sample data (as of December 2015) collected through the EBA's regular Capital Requirements Directive (CRD) – Capital Requirements Regulation (CRR) / Basel III monitoring exercise. The sample comprises 133 banks from 18 EU Member States selected by their National Competent Authorities (NCAs) and covers approximately two thirds of total EU banking sector assets. The sample includes all but one EU G-SIB, a good proportion of EU other systemically important institutions (O-SIIs)¹, and, to ensure an adequate representation, a number of small and mid-size banks.

MREL ratios and possible funding needs were calculated on a consolidated basis.

The report estimates possible funding needs that banks in the sample would have to meet in order to comply with their MREL requirement at the end of the transitional period. At present, however, no MREL decisions have been taken. Therefore, in the absence of MREL decisions, the report makes assumptions on the calibration of MREL based on two possible scenarios:

- an MREL calibration amounting to twice the capital requirements where combined buffer requirements are only included once for loss absorption purposes (the loss-absorbing buffer, or the 'LA buffer' scenario); and
- a more stringent calibration where banks must meet the higher of the twice capital requirements and buffers, or 8% of total liabilities and own funds (the 'Buffer/8%' scenario).

4. How much MREL would banks need?

Under central estimates, the MREL possible funding needs of banks in the sample would range between EUR 186.1 billion under the LA buffer scenario and EUR 276.2 billion under the Buffer/8% scenario. These estimates assume a full recapitalisation for G-SIBs and O-SIIs, a subordination requirement for G-SIBs in line with the TLAC standard, and a subordination requirement for O-SIIs of 13.5% of RWAs in line with the subordination recommendations made in the report. Estimates for other banks, that are neither G-SIBs nor O-SIIs, assume partial (50%) recapitalisation only and do not include a systematic subordination requirement.

These findings are subject to important methodological caveats, including that the actual levels of MREL will ultimately be determined for each institution and group and will therefore be different from the assumptions made in the report.

¹ As identified under the conditions of Article 131(3) of the CRD.

5. Will markets be able to fully absorb the issuance of MREL-eligible instruments?

A crucial element for the new MREL framework to deliver on its objectives will be the ability of markets to absorb the volumes of new instruments to be issued by banks in order to meet their MREL requirement, and at prices that do not affect medium term viability of the sector.

Market capacity is uncertain and, at this stage, its potential evolution cannot be adequately assessed.

It is expected that G-SIBs and a large portion of O-SIBs should be able to access markets and issue MREL-eligible instruments. On the other hand, some O-SIBs and other banks currently have limited or no access to liquid international markets.

In this context, the following mitigating factors should be taken into account:

- MREL will not be met overnight but built up over appropriate transitional periods determined on a case by case basis. This should help to mitigate this challenge as banks will be given more time to comply with the MREL requirement.
- For a number of banks, particularly where the resolution strategy foresees that substantial parts of a group would not undergo resolution, MREL might be close or equal their capital requirements.
- The current effort in the context of the Capital Markets Union will facilitate cross-border flows of investments in the medium-term and may help banks to issue MREL eligible instruments in countries with a limited market capacity.

6. Why are the estimates of possible funding needs significantly lower than in the interim report?

The interim and final reports were based on different data (June 2015 vs December 2015) and on a slightly different dataset (sample of 114 banks vs a slightly larger sample of 133 EU banks for the final report).

- In the interim report, possible funding needs ranged:
 - o From EUR 48 billion in a 'Pillar 1 only' calibration scenario without subordination ; or EUR 127 billion in the 'LA buffer' scenario without subordination;
 - o To EUR 1,259.6 billion in the 'Buffer / 8%' calibration scenario' with full subordination.
- In the final report, possible funding needs range:
 - o From EUR 58 billion in the 'LA buffer scenario' without subordination;
 - o To EUR 908 billion in the 'Buffer / 8%' calibration scenario with full subordination.

As can be seen, the range of estimates in both reports is very large; the final report tightens a bit this wide range of possible funding needs.

Additionally, methodological refinements were made in moving from the interim to the final report and in particular:

- The 'Pillar 1 only' calibration was removed from the calibration exercise because it was assessed that excluding Pillar 2 and lately, Pillar 2 requirement from the MREL requirement was not a realistic assumption/proxy of actual MREL decisions.
- MREL ratios and funding needs are calculated on a consolidated basis, in contrast to the interim report which considered issuances of parent entities only. This approach is pragmatic at this point in time, given that resolution authorities intend to set MREL at a consolidated level initially. In addition it appropriately captures issuances made at subsidiary level which are relevant for banks which would undergo multiple-point-of-entry resolution strategies.
- Due to the retroactive effect of the German statutory subordination law which will enter into force on 1 January 2017, senior unsecured debt instruments issued by banks in Germany have now (i.e. in the final report) been treated as subordinated. Senior unsecured debt instruments issued from non-operating holding companies in the United Kingdom have also been treated as subordinated as per the Bank of England's approach to subordination.

Finally, in the summary of findings on page 67, as well as for the purpose of the impact assessment, the focuses on central estimates which narrow down the possible combinations in terms of eligibility criteria and recapitalization scenario:

- G-SIBs are assumed to be subject to a minimum subordination of 14.5% of RWA in line with the T-LAC term sheet (assuming the derogations to subordination under the term sheet are fully granted);
- O-SIBs are assumed to be subject to a requirement of 13.5% of RWA in line with the EBA recommendation in this area;
- Banks are neither G-SIBs nor O-SIBs are not assumed to be subject to a legislative subordination requirement. They are also assumed to be subject on average to a partial (50%) recapitalization scenario rather than full recapitalization.

In those central estimates, funding needs range from EUR 186.1 billion to EUR 276.2 billion.

7. Have you considered various business models, such as smaller or mainly deposit-funded institutions?

The report suggests that the calibration of MREL should, in all cases, be closely linked to, and justified by, the institution's resolution strategy.

Business models may be worth considering when calibrating MREL to the extent that they translate into differences in resolution strategies. In this vein, the report acknowledges the specificity of smaller institutions which are more likely to be subject to liquidation strategies or partial transfer strategies.

Accordingly, for banks that are neither G-SIBs nor O-SIBs (67 banks out of 133), a 50% recapitalisation scenario has been assumed. This would be a proxy for resolution strategies based on which substantial parts of a group would not undergo resolution.

Under that partial recapitalisation scenario, possible funding needs would be reduced from EUR 12 billion and EUR 30 billion to EUR 3.6 billion and EUR 17.8 billion under LA buffer or Buffer/8% scenarios respectively.

8. *What is the MREL macroeconomic impact assessment? Are the results reliable?*

The Report contains a macroeconomic impact assessment, which is a quantitative exercise comparing the possible benefits from the introduction of MREL (in terms of reduced likelihood of a crisis occurring, and a reduced economic cost of any crisis that does occur) with the possible costs of the introduction of MREL (in terms of increased funding costs for banks, and possible knock-on implications for lending and the real economy).

As with all such exercises, the macroeconomic impact assessment in the Report is based on a number of assumptions and it is, by definition, a limited exercise. The actual impact of MREL will depend, inter alia, on the capacity of markets to absorb the volume of MREL issuances needed for the build-up of MREL, and the corresponding capacity of banks (especially deposit-funded banks) to access markets, including access to deep, developed markets.

Nevertheless, the macroeconomic impact assessment follows a methodology in line with comparable exercises such as the one conducted by the FSB expert group for the impact assessment on the implementation of the TLAC standard.

With the methodology used and under the assumptions made in the Report, the macroeconomic benefits from the introduction of MREL outweigh the associated macroeconomic costs. Under the assumption of full market capacity to absorb MREL possible funding needs, and under the assumed MREL calibration level and eligibility criteria (e.g. subordination for G-SIBs and O-SIIs), the overall net MREL benefits are positive and range between 0.17% and 0.91% of annual GDP. However, MREL market capacity is uncertain in a number of EU jurisdictions and the macroeconomic impact of MREL can only be estimated making certain assumptions regarding the cost of funding, the calibration of MREL requirements and MREL market capacity. For the purposes of the macroeconomic impact assessment, full market capacity has been assumed. However, MREL market capacity is uncertain and, at this stage, its potential evolution cannot be adequately assessed at this juncture.

Policy recommendations

9. What should be the consequences of a breach of the MREL requirement?

MREL represents a minimum regulatory standard that is to be met by institutions at all times. A breach of MREL must be treated in no less serious a manner than a breach of capital requirements. Therefore, it is of utmost importance that resolution authorities and competent authorities should engage in active monitoring of compliance with their respective requirements and have the appropriate tools to respond to such a breach. The response to a given breach should depend on the source of that breach, with the lead authority clearly specified, and the other authority in a consultation role. The report sets out in detail how this interaction should occur.

The final report recommends that the powers of resolution authorities to respond to an MREL breach should be enhanced. In particular, resolution authorities should be given the power to: (i) require the preparation and execution of an MREL restoration plan; (ii) utilise powers to remove impediments to resolvability relating to MREL compliance on an expedited basis; (iii) request that distribution restrictions be imposed on the institution by the competent authority; and (iv) request a joint restoration plan where an institution breaches both MREL and minimum capital requirements.

10. How should cross-holdings of MREL instruments be treated in order to avoid contagion?

In order to reduce the risk of contagion, recommendation 15 of the TLAC term sheet provides that *'G-SIBs must deduct from their own TLAC or regulatory capital exposures to eligible external TLAC instruments and liabilities issued by other G-SIBs'*. The rationale is similar to that for deductions in the field of capital: to avoid the build-up of artificial capacity that would vanish upon failure and cause contagion via cross-default.

The EBA report recommends that exposures to MREL-eligible instruments issued by all credit institutions should be deducted from MREL on a like-for-like basis. This means that credit institutions should deduct MREL holdings of other G-SIBs from their own MREL ("like-for-like").

The TLAC term sheet on this matter recommends a deduction from an institution's Tier 2 base. The EBA like-for-like recommendation aims to retain the spirit of the TLAC term sheet while addressing EU-specific issues at the same time. The proposed approach reflects the existence of MREL as a cross-cutting requirement, applicable to all banks in the EU, and is less costly while continuing to discourage cross-holdings.

The report does acknowledge that, as an alternative approach, there could be a deduction from the Tier 2 base with a view to achieving full compliance with the BCBS recommendation.

In addition, the report suggests the introduction of a large exposure limit approach for the issuance of MREL-eligible instruments by non-G-SIBs to facilitate market access for these institutions.

11. How should MREL be calibrated in order to comply with the TLAC standards?

The calibration of MREL should, in all cases, be closely linked to, and justified by, the institution's resolution strategy. The implementation of the TLAC term sheet within the EU, which suggests a hard floor for all G-SIBs, raises the question of whether a minimum non-firm-specific requirement (or Pillar 1 MREL) should or could be introduced into the MREL framework and, if so, how it should interact with the current firm-specific requirement.

The principles underlying the current assessment methodology set out in the RTS on MREL provide an appropriate basis for the calibration of firm-specific Pillar 2 requirements in addition to any Pillar 1 floor based on the resolution strategy. The EBA in this context suggests that the current MREL assessment framework (under Article 45 of the BRRD and the RTS on MREL) should be retained as the basis for setting Pillar 2/firm-specific MREL requirements. This means that MREL should be set as the higher of the requirement resulting from this firm-specific assessment and any Pillar 1 requirement, should one be introduced. Firm-specific requirements should be set only at levels necessary to implement the resolution strategy.

12. What are the benefits of a subordination requirement?

The BRRD (Article 74) prescribes a no creditor worse off (NCWO) principle, which states that shareholders and creditors should not suffer more losses in resolution than in liquidation. One way to reduce the risk of a breach of this NCWO principle is to ensure that the creditor hierarchy in insolvency is aligned with the likely treatment of creditors in resolution. Concretely, if the liabilities that can most credibly contribute to loss absorbency (senior unsecured debt) are subordinated to operational liabilities, then the risk of such a breach is likely to be significantly reduced because they would also have borne losses first in liquidation.

However, there are other important benefits of subordination. The possibility to write-down or convert non-operational liabilities first, without having to consider exclusions, may increase resolution authorities' speed of action at the resolution stage, especially in the early stages of the development of resolution plans.

In addition, subordination can increase market transparency and help to ensure that certain debt instruments are perceived and accordingly priced as clearly most loss-absorbing by investors. This is likely to increase market discipline and incentivises better risk diversification. Clarity over loss absorption should also reduce the risk of market-wide pricing shocks when a resolution actually occurs.

Finally, senior liabilities (such as unsecured deposits) are typically prone to risks of a bank run in cases of financial distress, while these risks are less acute if a cushion of subordinated debt absorbs losses first.

13. Do you recommend extending subordination requirements beyond G-SIBs?

Subordination facilitates resolvability and alleviates risks of NCWO compensation. Those risks are particularly acute for G-SIBs that are, by essence, resolved rather than liquidated. However, those risks are not confined to G-SIBs. For this reason the final report recommends to introduce a subordination requirement at a level of 13.5% of RWAs (with an appropriate transitional period) for O-SIIs.

This subordination requirement would improve the resolvability of O-SIIs, which by definition are systemic, and alleviate NCWO concerns while preserving the level playing field compared with G-SIBs. Furthermore, a large number of O-SIIs are more likely to be subject to resolution rather than liquidation, and in particular to the use of the bail-in tool.

However, in its recommendation the EBA acknowledges the heterogeneity of O-SIIs across the EU. While an automatic subordination requirement appears to be justified for a large number of O-SIIs, there are some O-SIIs for which it may not be justified, having regard to their resolution strategy (e.g. those with a strategy involving liquidation, or those with a strategy involving the transfer only of preferred liabilities such as preferred deposits). In the report the EBA therefore advocates that the approach taken to subordination for O-SIIs should allow for adjustments to the 13.5% subordination requirement to take account of these issues.

14. Member States across the EU have differing approaches to subordination. Does the report recommend that a single approach be adopted, and if so, which one?

Subordination may be implemented through three different legal methods: (i) statutory subordination, where MREL instruments rank junior to operational liabilities in the statutory creditor hierarchy; (ii) contractual subordination, where MREL instruments are subordinated, as a result of their own contractual terms, to operational liabilities in the creditor hierarchy; and (iii) structural subordination, whereby MREL is issued by an entity (for example, a holding company) that does not have operational liabilities on its balance sheet that rank *pari passu* or junior to MREL-eligible instruments.

In principle, none of the three approaches is superior as long as the objective of subordination is achieved and the legal method does not affect instruments' probability of default or loss given default.

The EBA therefore does not recommend a particular form of subordination. Nevertheless, different legal approaches to (statutory) subordination across EU member states may lead to fragmentation and complexity. Differences in legal method may increase the difficulty for investors to understand their position in the creditor hierarchy, potentially increasing risk premia and/or market segmentation. The report therefore advocates that the various national options for statutory subordination should be harmonised. A single statutory subordination option would improve investor clarity and facilitate resolution planning (including the identification of NCWO concerns) and resolution action, especially for cross-border groups.

15. Will banks have to disclose their MREL requirement?

The EBA underlines the benefits of disclosure in terms of market discipline and investor clarity. This is especially positive in order to accompany the development of a market for MREL instruments.

The report therefore recommends that institutions should be required to disclose the quantum and composition of their MREL-eligible liabilities, as well as the MREL level required from them by the resolution authority in the steady state. This shall be done in line with international standards, such as the BCBS recommendation that still needs to be finalised.

In the transitional period until the build-up of MREL, and pending finalisation of the BCBS recommendation in this area, credit institutions in the EU should at least be required to disclose to investors the quantum and composition of their stack of MREL-eligible liabilities, as well as information on the creditor hierarchy.

16. What are the main problems related to third country recognition? What does the report recommend to address them?

Institutions with a cross-border presence are faced with practical difficulties in implementing the BRRD (Article 55) requirement to include bail-in recognition clauses in contracts governed by third country law. For some categories of contract, such clauses would be operationally expensive to implement (e.g. utility contracts, small value contracts) or rejected by counterparties. For other contracts, such clauses would be impractical because they would require a change in broader market practices in the host country (e.g. contracts under standardised terms such as trade finance contracts) or are in conflict with local law or regulation (e.g. central counterparty (CCP) membership agreements). Therefore, the final report recommends that some reduction of the burden of compliance with third-country recognition requirements be introduced. This could be achieved by narrowing the scope of the requirement while maintaining the effectiveness of contractual recognition for MREL liabilities.