

# INTERIM REPORT ON MREL

## REPORT ON IMPLEMENTATION AND DESIGN OF THE MREL FRAMEWORK

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**EBA**

EUROPEAN  
BANKING  
AUTHORITY

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## Executive summary

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The minimum requirement for own funds and eligible liabilities (MREL) is an essential complement to the bail-in mechanism laid down by the Bank Recovery and Resolution Directive (the BRRD)<sup>1</sup>.

The BRRD<sup>2</sup> mandates the EBA to deliver a report to the European Commission on the implementation of MREL. The report shall cover a number of areas, including proposals on appropriate adjustments to the parameters of the minimum requirement, and consistency with international standards. The report is due by 31 October 2016 and is meant to inform a legislative proposal of the European Commission on the 'harmonised application' of MREL to be issued by the end of the year<sup>3</sup>.

The European Commission has committed to bringing forward, by the end of 2016, a combined legislative proposal reviewing MREL as well as implementing the FSB's TLAC standard<sup>4</sup> in the European Union.

This interim report on the MREL framework is intended to provide timely input into the Commission's deliberations, ahead of the preparation of the EBA's final report, and to elicit input from other stakeholders. It has been prepared by the EBA in close cooperation with the Single Resolution Board (SRB) and national resolution authorities, in order to draw lessons from their experience so far of the early stages of MREL implementation. The Single Supervisory Mechanism (SSM) and European Commission were also involved. The interim report contains a number of provisional recommendations relating to the MREL framework. These recommendations may be revised in the final report based on further analysis or feedback, including broader impact analysis that could not be achieved in this interim report. This interim report does not seek to address all of the issues in the mandate. The remaining issues will be further developed in the EBA's final report.

At this stage the EBA has not identified a need to change the principles underlying the recently endorsed RTS on MREL<sup>5</sup> on criteria for setting MREL on an institution-by-institution basis<sup>6</sup>. These key principles were: first, that for each bank MREL should be set at a level necessary and sufficient to implement the resolution strategy by absorbing losses and recapitalising the institution; and

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<sup>1</sup> Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173, 12.6.2014, p. 190–348.

<sup>2</sup> Article 45(19) and (20) of the BRRD.

<sup>3</sup> Article 45(18) of the BRRD.

<sup>4</sup> Financial Stability Board, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution, Total Loss-absorbing Capacity (TLAC) Term Sheet, 9 November 2015.

<sup>5</sup> Commission Delegated Regulation of 23 May 2016 with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities, not yet published.

<sup>6</sup> Throughout this report investment firms are also meant to be covered insofar as the relevant provisions of the BRRD extend to such firms.

second, that this calibration exercise should be consistent with the prudential capital requirements applicable to the institution before and after resolution. The EBA does, however, provisionally consider that maintaining a coherent link between MREL and capital requirements would be simpler if both used a consistent denominator.

Consistency between the MREL and capital frameworks would also be improved by a consistent approach to the stacking of capital buffers with minimum requirements of all kinds, as proposed in the FSB TLAC standard. Accordingly the EBA's provisional view is that this change should be introduced, following careful consideration of the interaction with automatic restrictions on voluntary distributions.

The EBA's analysis highlights that the choice about whether the subordination of MREL-eligible instruments should be required, and the consequent marginal cost of refinancing existing instruments, will be a major determinant of the impact of MREL on institutions. The EBA intends to carry out further work, in its final report and beyond, on how best to meet the additional information needs of investors, who need to better understand their position in the creditor hierarchy and how these hierarchies differ across the EU.

This interim report provides preliminary quantitative findings on the financing capacity and needs of banking groups operating in the EU. These findings are subject to several methodological caveats and must be treated with caution. In particular, in the absence of MREL decisions for institutions to date, and given the limited information on authorities' MREL policy approach, assumptions had to be made as to the scope and calibration of MREL. These assumptions are by definition different from the actual levels of MREL that will ultimately be determined for each institution and group.

# Provisional recommendations

The EBA invites interested parties to comment on specific questions (in italics below) addressed to stakeholders. The deadline for the submission of responses is 30 August 2016.

Number	Topic	Provisional recommendation.
1	<b>Reference base for MREL requirement (denominator)</b>	<p>The EBA's provisional view is that the preferred option should be to change the reference base of MREL to RWAs. The changed reference base should be complemented with a leverage ratio exposure backstop in parallel with the phase-in of the leverage ratio requirement within the capital framework. This approach achieves alignment with CRR / CRD regulatory requirements and with the FSB's TLAC proposal standard and reduces complexity without major substantive changes to the MREL setting process.</p> <p>If this change is not made, the EBA recommends changing the reference base of MREL from total liabilities and own funds to the leverage ratio exposure as a more consistently applied non-risk sensitive measure.</p> <p>If neither of these changes is made, the EBA considers that clarification of the definition of the existing denominator is necessary, either in the Level 1 text or through the introduction of a Level 2 mandate.</p>
2	<b>Relationship with regulatory requirements</b>	<p>The EBA's provisional view is that, in principle, the usability of regulatory capital buffers would be best preserved if they stack on top of MREL – i.e. that banks would not be able to use CET1 capital to meet MREL and also to meet regulatory capital buffers.</p> <p>However the implementation of this approach should carefully consider the interaction with automatic maximum distributable amount (MDA) restrictions on voluntary distributions and the supervisory review and evaluation process (SREP). This is particularly relevant for banks which rely mainly on capital instruments to meet MREL because of limited access to debt capital markets.</p> <p>The EBA's provisional view is that interactions between MREL and the net stable funding ratio (NSFR) do not give rise to any need for policy change.</p>

3	<b>Breach of MREL</b>	<p>The EBA provisionally considers that resolution authorities should have clear responsibility and a leading role in responding to a breach of MREL. Achieving this objective would require additional powers and an accelerated procedure for the use of their powers to address impediments to resolvability. This accelerated procedure should allow resolution authorities to act on the basis of a previous assessment of resolvability and to shorten the timeline currently foreseen by the BRRD (in the context of Art 17). An accelerated procedure should be without prejudice to the need for proper consultation and cooperation with the competent authority.</p> <p>Competent authorities may also respond to breaches of MREL. Where this is the case the EBA’s provisional view is that the legal basis for the use of competent authorities’ existing powers in response to a breach of MREL should be further strengthened. The existing reference in EBA guidelines on triggers for use of early intervention measures<sup>7</sup> could be incorporated in the Level 1 legislation and the ability to respond based on a persistently low level of MREL as well as a rapid deterioration clarified.</p> <p>Resolution and competent authorities should closely cooperate and coordinate, including by notifying and consulting each other in advance, on respective actions taken in response to a breach of MREL.</p> <p><i>The EBA invites stakeholders’ comments on whether and in what circumstances a breach of MREL should result in the Competent Authority making an assessment of whether the institution is failing or likely to fail.</i></p>
4	<b>Adequacy and calibration</b>	<p>The EBA provisionally recommends that 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 they translate into /lead to differences in resolution strategies.</p> <p>The EBA provisionally recommends that the current MREL assessment framework (under BRRD Article 45 and the RTS on MREL) be retained as the basis for setting ‘Pillar 2’/firm-</p>

<sup>7</sup> Guidelines on triggers for use of early intervention measures pursuant to Article 27(4) of Directive 2014/59/EU, EBA/GL/2015/03, 28 July 2015, available at [https://www.eba.europa.eu/documents/10180/1151520/EBA-GL-2015-03\\_EN+Guidelines+on+early+intervention+measures.pdf/9d796302-bbea-4869-bd2c-642d3d817966](https://www.eba.europa.eu/documents/10180/1151520/EBA-GL-2015-03_EN+Guidelines+on+early+intervention+measures.pdf/9d796302-bbea-4869-bd2c-642d3d817966).

		<p>specific MREL requirements. This means that MREL should be set as the higher of the requirement resulting from this assessment and any Pillar 1 requirement, should one be introduced. Firm specific requirements should only be set at levels necessary to implement the resolution strategy.</p>
5	<b>Eligibility</b>	<p>The EBA's provisional view is that for at least some banks mandatory subordination of MREL-eligible liabilities would improve resolvability and contribute to clarity for investors. Subordination requirements introduced in Level 1 legislation should focus on establishing to which other liabilities MREL-qualifying liabilities need to be subordinated, rather than specifying the legal form of that subordination (contractual, statutory or structural).</p> <p>Regardless of whether additional subordination requirements are introduced, the EBA's provisional view is that relevant information should be available to bank creditors on banks' creditor hierarchies and the effects of national insolvency law.</p> <p><i>The EBA invites stakeholders to comment on the appropriate scope of any subordination requirements.</i></p> <p><i>More precisely stakeholders are invited to comment on what the highest priority information and disclosure needs are, in the three areas of i) disclosure of bank balance sheet structures; ii) disclosure of banks' MREL requirements and iii) availability of standardised information on statutory creditor hierarchies.</i></p>
6	<b>Third country recognition</b>	<p>The EBA's provisional view is that some reduction of the burden of compliance with third country recognition requirements is necessary. This could be achieved by narrowing the scope of the requirement, while maintaining the effectiveness of contractual recognition for MREL liabilities.</p> <p><i>The EBA invites stakeholders' to comment on the practical difficulties faced in implementing the recognition clauses, specifically in the field of MREL, and on alternative approaches to improve the regime without creating incentives to evade the scope of bail-in.</i></p>

# 1. Introduction

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The 2008 financial crisis led to government bailouts of banks around the world. The subsequent impact on public finances, and the undesirable incentive effects of socialising the costs of bank failure, have underscored the fact that a different approach is needed.

Significant steps have been taken to address the potential spill-overs between banks and sovereigns, and thereby to reduce the systemic risks of failing banks. The BRRD provides a common resolution regime in the EU that allows authorities to deal with failing institutions as well as ensuring cooperation between home and host authorities. In the future, the costs of bank failure will have to be borne first and foremost by shareholders and creditors, minimising moral hazard and risks to taxpayers. Removing the implicit subsidy of systemic banks by governments will avoid the build-up of excessive risk and leverage within banks and the banking system as a whole.

To avoid institutions structuring their liabilities in a way that impedes the effectiveness of bail-in or other resolution tools, and to avoid the risk of contagion or bank runs, the BRRD requires that institutions meet at all times a robust minimum requirement of own funds and liabilities eligible for bail-in expressed as a percentage of the total liabilities and own funds (TLOF) of the institutions. This MREL requirement should ensure that shareholders and creditors bear losses regardless of which resolution tool (e.g. the bail-in tool or the bridge bank tool) is applied. In this way MREL ensures sufficient loss-absorbing and recapitalisation capacity to enable orderly resolution, facilitating the continuity of critical functions without recourse to public funds.

These policy goals have also been recognised at the international level, where the Financial Stability Board's Total Loss-absorbing Capacity (TLAC) standard<sup>8</sup> has set minimum levels of loss absorption and recapitalisation capacity at the largest, globally systemically important banks (G-SIBs).

Although the TLAC term sheet and the MREL provisions of the BRRD are already compatible in most respects, the European Commission has committed to bringing forward a legislative proposal amending the MREL framework to ensure full implementation of the TLAC standard in the European Union. This proposal is also expected to address the mandate in Article 45(18) of the BRRD for the European Commission, if appropriate, to bring forward proposals on the harmonised application of MREL by the end of 2016.

Article 45(19) of the BRRD mandates the EBA to deliver a report to the European Commission which should serve as a basis for the European Commission proposal on the harmonised application of MREL. The report shall cover a number of areas, including proposals on appropriate adjustments to the parameters of the minimum requirement, and consistency with international standards.

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<sup>8</sup> <http://www.fsb.org/2015/11/tlac-press-release/>

This interim report is intended to provide timely input into the European Commission's deliberations, ahead of the preparation of the EBA's final report, and to elicit input from other stakeholders. It has been prepared by the EBA in close cooperation with the Single Resolution Board (SRB) and national resolution authorities, in order to draw lessons from their experience so far of the early stages of MREL implementation. The SSM and European Commission were also involved. The interim report contains a number of provisional recommendations. These recommendations may be revised in the final report based on further analysis or feedback, including broader impact analysis that could not be achieved in this interim report.

### **Next steps**

This interim report does not seek to address all of the issues included in the EBA's mandate in Article 45(19) and 45(20) of the BRRD. Analysis of the remaining issues will be further developed in the EBA's final report, which will be provided to the European Commission by 31 October 2016. As the implementation of MREL by resolution authorities is currently at a relatively early stage, further work may be necessary in future to monitor the implementation of the MREL framework.

## 2. State of play on MREL and TLAC implementation

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The BRRD entered into force on 1 January 2015 with a requirement to transpose bail-in and MREL provisions into national law by 1 January 2016. Transposition is now complete in 26 out of 28 Member States. As mandated by the BRRD, the EBA adopted draft regulatory technical standards specifying the criteria relating to the methodology for setting the MREL requirement. On 23 May 2016, the Commission adopted a Delegated Regulation<sup>9</sup> endorsing, with limited amendments, the draft regulatory technical standards. This Delegated Regulation (hereafter 'RTS on MREL') is currently subject to the scrutiny of the European Parliament and the Council.

With the BRRD, Single Resolution Mechanism Regulation<sup>10</sup> (SRMR) and the RTS on MREL, resolution authorities now possess a broad set of regulatory provisions to determine MREL for all credit institutions across the internal market on a consistent basis. It is now their responsibility to determine, in the context of resolution colleges and in line with resolvability assessments, the resolution strategy for each firm and the level of MREL sufficient to implement it.

At this stage, resolution planning work for most institutions is still in an early phase. A significant number of resolution colleges are scheduled to take place in the latter part of 2016 and resolution authorities are considering providing indicative MREL requirements in this context. Many institutions are already adjusting their funding structures, and projections show that, depending on the possible calibrations, many would already be in position to meet the indicative requirements.

Given that MREL policy development and the implementation of MREL decisions by resolution authorities are currently at an early stage, with no MREL decisions taken to date by EU resolution authorities<sup>11</sup>, it is expected that further work will be necessary beyond the October 2016 deadline to provide a comprehensive assessment and overview of MREL implementation across the EU.

However, three resolution authorities (the Bank of England (UK)<sup>12</sup>, the SRB (Banking Union)<sup>13</sup>, and the Swedish National Debt Office (SE)<sup>14</sup>) have publicly communicated their policy intentions for setting MREL for institutions in their jurisdictions. These are the three EU resolution authorities responsible for setting MREL for G-SIBs established in the EU. Although final policy decisions have

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<sup>9</sup> Commission Delegated Regulation of 23.5.2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities, C(2016)2976 final, not yet published. Available at [http://ec.europa.eu/finance/bank/docs/crisis-management/160523-delegated-regulation\\_en.pdf](http://ec.europa.eu/finance/bank/docs/crisis-management/160523-delegated-regulation_en.pdf).

<sup>10</sup> Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010

<sup>11</sup> As of July 2016

<sup>12</sup> Cf. <http://www.bankofengland.co.uk/publications/Pages/news/2015/098.aspx>

<sup>13</sup> Cf [http://srb.europa.eu/sites/srbsite/files/2nd\\_industry\\_dialoge\\_12-1-2016\\_-\\_mrel.pdf](http://srb.europa.eu/sites/srbsite/files/2nd_industry_dialoge_12-1-2016_-_mrel.pdf)

<sup>14</sup> [https://www.riksdagen.se/Dokument\\_eng/financial%20stability/mrel-consultation-paper.pdf](https://www.riksdagen.se/Dokument_eng/financial%20stability/mrel-consultation-paper.pdf)

not yet been taken and therefore these approaches remain subject to change, they do allow a comparison of the key features of MREL implementation across resolution authorities.

Annex 2 compares the key features of these approaches.

All three approaches are based on the framework established by the BRRD and RTS on MREL, which links the setting of MREL with an assessment of the amount of liabilities and own funds needed to absorb losses and to recapitalise an institution in implementing the resolution strategy. These assessments should in turn be closely linked to the institution's prudential capital requirements.

Nevertheless a number of differences in approach are worth highlighting:

- **Degree of specificity:** the UK and Swedish consultations set out the treatment of institutions depending on their resolution strategies and provide explicit thresholds serving as indicative proxies for those strategies; the SRB has not done this. This may in part reflect the fact that there is a greater diversity of institutions within the Banking Union than within any one Member State, making the identification of an appropriate classification of institutions challenging.
- **Treatment of capital buffers – stacking:** the UK proposes to introduce a requirement that firms should not count CET1 towards meeting MREL and capital buffers simultaneously, and to reflect this proposes to reduce the calibration of the loss absorption component of MREL. This mirrors the approach taken in the FSB TLAC standard.
- **Treatment of capital buffers – recapitalisation:** the UK proposes that in general it would not include capital buffers in the recapitalisation amount, whereas the Swedish proposal would include capital buffers in the recapitalisation amount. The SRB has not yet specified its approach to this issue.
- **Subordination:** the UK proposes to require subordination of MREL-eligible liabilities for larger banks, and to make a case-by-case decision for smaller banks. The SRB proposes a case-by-case decision for all banks.

In parallel with the development of MREL policy approaches by resolution authorities, as noted above the European Commission has committed to introduce a legislative proposal on the implementation of the FSB TLAC standard for G-SIBs in Europe by the end of 2016<sup>15</sup>. This will be done by amending the MREL framework where necessary, so that banks will face a single loss-absorbing capacity standard. Other G-SIB home jurisdictions (the US<sup>16</sup> and Switzerland<sup>17</sup>) have also consulted on TLAC implementation. Annex 3 compares the key features of the current MREL framework, the FSB TLAC term sheet, and the proposed US and Swiss implementations of the term sheet. Some key points to note from this comparison are:

<sup>15</sup> <http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf>

<sup>16</sup> <https://www.federalreserve.gov/newsevents/press/bcreg/20151030a.htm>

<sup>17</sup> <https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/faktenblaetter/faktenblatt-to-big-to-fail-regime-verstaerkt.pdf?la=en>

- **Scope:** both the TLAC term sheet and the US and Swiss implementations apply only to G-SIBs, whereas the MREL framework applies to a much broader set of institutions<sup>18</sup>.
- **Calibration:** the FSB TLAC term sheet sets a minimum level of TLAC as a percentage of RWAs (18% from 2022), with a leverage ratio requirement (6.75% from 2022) as a backstop, with scope for national authorities to set additional firm-specific requirements on top of this. The US proposals do not include additional firm-specific requirements, but set the leverage ratio requirement at a higher level (9.5%)<sup>19</sup>. The Swiss proposals set both the RWA and leverage ratio requirements at a higher level than the TLAC term sheet.

### Qualitative survey of resolution authorities

To assess the current readiness of European resolution authorities (i.e. the 28 national resolution authorities and the SRB) and to evaluate the potential impact of the implementation of MREL requirements on specific types of institutions<sup>20</sup> in individual Member States, in April 2016 the EBA conducted a qualitative survey addressed to the national resolution authorities and the SRB.

Twenty-six resolution authorities (including the SRB) completed the survey. Resolution authorities indicated that the answers provided were preliminary and may evolve over time. As a result, the findings should be considered as indicative policy considerations rather than reflecting the resolution authorities' final policy stance. As of July 2016, no resolution authority has made a decision setting MREL for any institution.

Where relevant, responses received from resolution authorities in the Member States inside and outside the Banking Union are presented separately. Responses from national resolution authorities inside the Banking Union related to less significant institutions (LSIs) under their remit, and may evolve to take into account guidance provided by the SRB.

The main findings of this qualitative survey on MREL are summarised Table 1 below.

<sup>18</sup> Note that the Canadian law implementing the TLAC standard will be applied to all DSIBs.

<sup>19</sup> However comparability between leverage ratio requirements is limited due to differences in accounting standards (IFRS and US GAAP).

<sup>20</sup> The quality and quantum of MREL-eligible liabilities may be a particular issue for institutions with particular legal forms or governance models, given activity and funding restrictions under national law or ability to access capital markets in general. Specific definitions of types of institutions that may find it difficult to meet the MREL requirement were not pre-defined because the main factors affecting such determination (systemic relevance, materiality criteria, funding model, legal form / governance, etc.) and their thresholds were highly variable across Member States.

Table 1: Results of the quantitative survey on MREL

#	Finding	Description
1	<b>Resolution authorities responsible for most significant institutions in the EU have publicly communicated their proposed policy approach to setting MREL</b>	<p>The SRB and two national resolution authorities in Member States outside the Banking Union – the Bank of England (UK), and the Swedish National Debt Office (SE) – have publicly communicated on their intended policy approach to setting MREL. Together, these authorities are responsible for all G-SIBs established in the EU.</p> <p>Resolution authorities within the Banking Union will implement MREL policy for significant institutions in line with the approach proposed by the SRB. With regards to LSIs, resolution authorities in the Banking Union will define separate MREL policies taking any SRB guidance on how to set MREL for LSIs in the Banking Union into account.</p>
2	<b>MREL to be set based on systemic importance and/or resolution strategy, rather than a business model</b>	<p>When setting MREL, resolution authorities both within and outside the Banking Union indicated their intention to follow the approach laid down in the RTS on MREL. Most resolution authorities that provided preliminary MREL policy stances intended to differentiate MREL targets based on the resolution strategy or systemic importance of an institution. A few resolution authorities considered differentiation of MREL targets based on G-SIB / O-SII<sup>21</sup> classification, type of governance or size. Only three respondents related MREL directly to business models.</p>
3	<b>Resolution authorities intend to adjust loss absorption amount downwards; a few may consider upward adjustment</b>	<p>Resolution authorities outside the Banking Union envisaged downward adjustments to the loss absorption amount, mostly for some parts of combined buffer requirements (capital conservation, countercyclical or systemic risk buffers). Other Pillar 2 capital requirements determined on the basis of the outcome of stress tests or to cover macro-prudential risk were also considered to be excluded. Some resolution authorities considered case-by-case upward adjustments to the loss absorption amount. A few resolution authorities excluded this option in principle or considered it not probable.</p> <p>For resolution authorities in the Banking Union, potential upward or downward adjustments on a case-by-case basis could be made, taking SREP information, barriers or impediments to resolvability and other information into account.</p>

<sup>21</sup> Other systemically important institutions, as identified under the conditions of Article 131(3) of the CRD.

#	Finding	Description
4	<b>Differing approaches to including buffer requirements in the recapitalisation amount</b>	<p>There were split views among resolution authorities outside the Banking Union: some were explicit that the recapitalisation amount should include buffers; one RA held the opposite view; others considered that a case-by-case assessment was needed or had no policy views.</p> <p>Within the Banking Union, the recapitalisation amount is likely to be determined based on the resolution strategy and critical functions that need to be preserved.</p> <p>An adjustment to maintain market confidence following a peer group comparison was supported by two resolution authorities outside the Banking Union and several resolution authorities in the Banking Union, but most resolution authorities do not have final views yet.</p>
5	<b>Resolution authorities have not yet decided on their approach to subordination</b>	<p>A few resolution authorities outside the Banking Union considered that subordination may be required for institutions subject to a bail-in resolution strategy. For others, the policy has not yet been developed or will be made on a case-by-case basis.</p> <p>Resolution authorities within the Banking Union indicated that subordination could be required based on the feasibility and credibility of bailing-in instruments on a case-by-case basis. The preferred form of subordination differed across the Member States. A few resolution authorities referred to changes in the hierarchy of the insolvency regime to mitigate NCWO risk.</p>
6	<b>Deposit-funded banks, cooperative banks or other institutions with limited access to financial markets were most commonly identified as likely to find it difficult to meet MREL requirements</b>	<p>The predominance of covered or preferred retail deposits in the funding structure, and limited or non-existent experience in issuing debt instruments were found to be the main factors affecting institutions' ability to meet MREL. Three resolution authorities in the Banking Union, and one outside the Banking Union, referred to potential use of the DGS. Resolution authorities reported that issuing MREL instruments may raise more acute problems for institutions in Member States with less developed capital markets. Such institutions were likely to rely on CET1 instruments to meet MREL.</p>
7	<b>MREL-eligible debt is usually issued</b>	<p>Most resolution authorities in the Banking Union reported MREL-eligible debt issuances were denominated in EUR. Resolution</p>

#	Finding	Description
	<b>under domestic law and denominated in domestic currency</b>	<p>authorities outside the Banking Union indicated issuances in domestic currency and in EUR. A few resolution authorities mentioned issuance in USD.</p> <p>MREL-eligible debt is usually issued under domestic law, but issuances under (foreign) English law and the law of other Banking Union Member States were frequently reported. Two resolution authorities outside the Banking Union and one national resolution authority within the Banking Union reported issuances under US law.</p>
8	<b>Institutional investors are the main class of investors into MREL-eligible instruments, but in some cases retail investors may be exposed</b>	<p>Most resolution authorities suggested that institutional investors (investment funds, insurance companies, pension funds, other credit institutions, etc.) were the predominant type of investors holding MREL-eligible instruments. However, a few resolution authorities indicated significant exposure of retail investors to MREL instruments – in one instance they were reported to hold almost half of Tier 1 and Tier 2 instruments. A few resolution authorities reported subordinated debt instruments issued to parent institutions.</p>
9	<b>Besides a few established capital markets, most domestic capital markets for MREL instruments are relatively small</b>	<p>Most of the domestic markets were described to be of limited size and liquidity. However, resolution authorities found it difficult to assess potential market capacity. One resolution authority suggested that the largest European financial institutions (e.g. G-SIBs) had access to international markets, but it was a challenge for O-SIBs. A few resolution authorities suggested that there was limited or no access to international financial markets for deposit-funded banks.</p>
10	<b>Split views regarding policy approach to treating deposits as MREL-eligible liabilities</b>	<p>There were split views among resolution authorities on treating non-preferred medium-term deposits as liabilities eligible for MREL. Some preferred to exclude deposits because of their limited loss-absorbing capacity in resolution, and to avoid spill-over effects or unintended systemic consequences. Others suggested that deposit-funded institutions with limited access to capital markets would still have to rely on eligible deposits (beyond CET1 instruments) to meet MREL requirements.</p>

## 3. Quantitative findings

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The EBA has analysed data on a wide sample of banks in order to assess the situation of banks operating in the EU in relation to the MREL requirement, depending on different options for the scope of MREL-eligible instruments and different scenarios for the calibration of the MREL requirements.

### 3.1 The sample

This report draws on data on external MREL issuance collected through the EBA's regular Capital Requirements Directive<sup>22</sup> (CRD) – Capital Requirements Regulation<sup>23</sup> (CRR)/Basel III monitoring exercise as of June 2015.

The sample comprises 114 banks selected by their National Competent Authorities (NCAs) from 18 EU Member States and covers approximately 70% of total EU banking assets.

The sample includes two groups of banks:

- 'Group 1' banks, or very large banks, which have Tier 1 capital in excess of EUR 3 billion and are internationally active;
- All other banks, categorised as 'Group 2' banks and grouped into:
  - large – banks with Tier 1 capital in excess of EUR 3 billion,
  - medium – banks with Tier 1 capital below or equal to EUR 3 billion and above EUR 1.5 billion,
  - small – banks with Tier 1 capital below or equal to EUR 1.5 billion.

In terms of balance sheet size, Group 1 banks range between circa EUR 22 billion and 2,214 billion EUR of total liabilities and own funds, while Group 2 banks range between circa EUR 0.75 billion and EUR 308 billion. This explains why Group 2 banks have been used as the relevant population for the 'smaller bank' scenario described below.

Table 2 presents the sample composition in more detail.

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<sup>22</sup> Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

<sup>23</sup> Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

**Table 2: Number of banks, differentiated by size, systemic importance and international activity, across Member States**

	<b>Total</b>	<i>Of which: O-SIs</i>	<i>Group 1</i>		<i>Group 2</i>		
			<i>G-SIBs</i>	<i>Non-G-SIBs</i>	<i>Small</i>	<i>Medium</i>	<i>Large</i>
Austria	<b>7</b>	5	—	2	2	3	—
Belgium	<b>5</b>	4	—	2	3	—	—
Czech Republic	<b>12</b>	4	—	—	8	3	1
Denmark	<b>4</b>	4	—	1	1	—	2
France	<b>5</b>	1	4	1	—	—	—
Germany	<b>25</b>	10	1	7	7	3	7
Greece	<b>4</b>	4	—	4	—	—	—
Hungary	<b>1</b>	—	—	—	1	—	—
Ireland	<b>4</b>	2	—	3	—	1	—
Italy	<b>15</b>	2	1	1	1	6	6
Luxembourg	<b>1</b>	—	—	—	1	—	—
Malta	<b>3</b>	2	—	—	3	—	—
Netherlands	<b>5</b>	4	1	2	—	2	—
Poland	<b>5</b>	—	—	—	4	—	1
Portugal	<b>3</b>	3	—	2	—	1	—
Spain	<b>7</b>	5	1	1	—	—	5
Sweden	<b>4</b>	3	1	3	—	—	—
United Kingdom <sup>24</sup>	<b>4</b>	—	4	—	—	—	—
<b>Total</b>	<b>114</b>	53	13	29	31	19	22

A wide range of bank business models are present across the Member States. The qualitative survey of resolution authorities referred to above indicated that the setting of MREL for typically small and medium-sized institutions which are predominantly deposit-funded may require particular attention. Given that there is no specific definition of retail-funded banks, two alternative thresholds (30% and 40% of retail deposits to total liabilities and own funds) are used as a proxy for a deposit-funded bank. Table 3 presents the composition of the sample in terms of deposit-funded banks depending on the threshold adopted. The sample includes 41 banks with 40% or higher share of deposits in their liability structure (and 63 banks if using the 30% threshold).

<sup>24</sup> Data as of 31 December 2014.

**Table 3: Number of mainly retail deposit-funded banks and other banks for two alternative thresholds of 30% and 40% in retail deposits relative to total liabilities and own funds**

	<i>Threshold at 30% of total liabilities</i>		<i>Threshold at 40% of total liabilities</i>	
	<i>Mainly retail deposit-funded banks</i>	<i>Other banks</i>	<i>Mainly retail deposit-funded banks</i>	<i>Other banks</i>
Austria	3	4	2	5
Belgium	5	—	3	2
Czech Republic	10	2	9	3
Denmark	—	4	—	4
France	2	3	—	5
Germany	5	20	4	21
Greece	1	3	1	3
Hungary	—	1	—	1
Ireland	3	1	2	2
Italy	13	2	7	8
Luxembourg	—	1	—	1
Malta	3	—	2	1
Netherlands	4	1	2	3
Poland	4	1	4	1
Portugal	3	—	3	—
Spain	7	—	2	5
Sweden	—	4	—	4
United Kingdom	—	4	—	4
Total	63	51	41	73

Source: EBA QIS data (June 2015).

## 3.2 Data limitations and caveats

Resolution authorities have not yet finalised their MREL policies. As a result, assumptions had to be made on MREL calibration scenarios, i.e. what level of loss-absorbing and recapitalisation amounts would be determined by authorities, as well as the scope of MREL-eligible instruments. A limited number of policy options have been considered. Any additional restrictions to the eligibility of MREL instruments (e.g. TLAC/MREL cross-holding deductions) would increase MREL financing needs.

The data limitations and caveats in Table 4 should be taken into account when interpreting the results of the MREL impact assessment.

Table 4: Data limitations and caveats

No	Issue	Explanation
1	<b>Level of consolidation</b>	MREL must apply to institutions on both an individual and consolidated basis (Art. 45(7) and (8) BRRD). However, the QIS exercise provides data mainly at consolidated level <sup>25</sup> .
2	<b>Sample composition (small banks)</b>	Despite a relatively high number of small banks included in the June 2015 sample, the assessed impact may only be seen as a proxy for the real impact on all small banks because of the huge diversity in the sector.
3	<b>Definition of small banks</b>	Small bank are institutions with Tier 1 capital below or equal to EUR 1.5 billion. This threshold may be relatively high in certain Member States and, therefore, the sample may be only a proxy for small banks.
4	<b>MREL calculation methodology</b>	MREL is calculated on a parent level (by excluding issuances from subsidiaries from total MREL amount). However, this affects the MREL numerator only, as subsidiary level information on the denominator is not available.
5	<b>Pillar 2 add-on</b>	Due to data constraints, at this stage the Pillar 2 component of the capital requirement is not bank-specific – it is fixed at 2% across the sample.
6	<b>No finalised MREL policies yet</b>	To date, three resolution authorities have consulted on their MREL policies. In the absence of final MREL policies, a number of assumptions were made on the scope of eligible liabilities to be included in MREL and scenarios to calibrate MREL.

### 3.3 Options on the scope of MREL-eligible instruments and scenarios for calibration

The quantitative findings in this report rely on a number of options for the scope of eligibility of MREL instruments and scenarios regarding the calibration level of the requirement.

#### 1) Scenarios regarding the calibration of MREL

It is not yet possible to determine with certainty the size of institutions' needs both to refinance existing debt in MREL-eligible (or TLAC-eligible) instruments and to issue new MREL-eligible liabilities. This will depend on resolution authorities' MREL implementation policies and bank-specific MREL decisions which have not yet been taken. In this context, at this stage we have considered three scenarios for the calibration of MREL, based on the possibilities for MREL calibration under the BRRD and RTS on MREL as well as the indicative statements of intentions communicated by a few resolution authorities. Nonetheless, the actual MREL set by resolution authorities will be different from the assumptions made and the results should be read against this background.

<sup>25</sup> Most data was reported at consolidated level, except in respect of a few subsidiaries with an EU-parent institution.

Three MREL calibration scenarios were considered:

- **The first scenario** ('No buffers, no Pillar 2') assumes that resolution authorities do not include any Pillar 2 requirement for banks and exclude capital conservation buffer from the recapitalisation amount. This scenario is not assumed to be a likely outcome.
- **The second scenario** ('Twice capital requirements + Buffers') includes a Pillar 2<sup>26</sup> component when determining both loss absorption and recapitalisation amounts and adds a capital conservation and G-SIB buffer<sup>27</sup> to the loss absorption amount.
- **The third scenario** ('Higher of twice capital requirements (incl. buffers) or 8% of total liabilities and own funds') assumes that, when calculating the recapitalisation amount the resolution authority includes all buffers and also assesses, for all banks, the potential impact of the requirement for 8% of an institution's equity and liabilities to be bailed-in before access to resolution financing arrangements is available. As a result this is the most conservative and demanding scenario and it is also not assumed to be a likely outcome for all banks in the sample.

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<sup>26</sup> At this stage a homogeneous 2% Pillar 2 requirement has been assumed.

<sup>27</sup> Institution-specific, in accordance with the FSB's most recent G-SIB list.

Figure 1 describes the three possible scenarios for MREL calibration (from least to most demanding). Please note that no resolution authority has finalised its MREL policies to date; therefore a reference to actual MREL implementation at national level cannot be made at this stage.

Figure 1: Assumptions regarding the calibration of MREL

Scenarios	Threshold denomination	Explanation of threshold
<b>A - No buffers, no Pillar 2</b> <b>(P1 only)</b>	Capital requirements (excluding Pillar 2)	<p><b>Minimum MREL = Loss absorption + Recapitalisation</b></p> <ul style="list-style-type: none"> <li>Loss absorption = Pillar 1 (8%)</li> <li>Recapitalisation = Pillar 1 (8%)</li> </ul> <p>NB: this scenario represents a deliberately low calibration of both loss absorption and recapitalisation amounts and is included purely for illustrative purposes</p>
<b>B - 2 x capital requirements + buffers</b> <b>(LA buffer)</b>	Capital requirements (including Pillar 2) without considering buffers for recapitalisation amount	<p><b>Minimum MREL = Loss absorption + Recapitalisation</b></p> <ul style="list-style-type: none"> <li>Loss absorption = Pillar 1 (8%) + Pillar 2 (2%) + Capital Conservation Buffer (2.5%) + G-SIB buffer add-on (institution-specific)<sup>28</sup></li> <li>Recapitalisation = Pillar 1 (8%) + Pillar 2 (2%)</li> </ul>
<b>C - Higher of 2x capital requirements (incl. buffers) or 8% TLOF</b> <b>(Buffer/8%)</b>	Higher of twice capital requirements or 8 % of total liabilities and own funds	<p><b>Minimum MREL = Max {MREL denominator * 8%; 2*(Pillar 1 (8%) + Pillar 2 (2%) + CCP (2.5%) + G-SIB buffer)}</b></p> <p>[Art. 44(5) BRRD) and Art. 5(1) RTS]</p>

It is important to note that from the data available, Pillar 2 decisions are not known with certainty for all the institutions. In addition, not all the jurisdictions within the sample have defined the specific countercyclical and systemic risk buffers. As a result a fixed Pillar 2 add-on of 2% is used across the sample and the combined buffer requirement includes only capital conservation buffers (2.5%) and specific G-SIB buffers where relevant.

It should also be noted that for the purpose of the analysis, unless stated otherwise, a static balance sheet approach is considered – i.e. it is assumed that the entity after resolution would have the same size and risks as prior to the resolution taking place.

### Additional alternative recapitalisation scenario for ‘smaller’ banks

Depending on the preferred resolution strategy, for some banks, the required MREL recapitalisation amount may be lower. For example, if the resolvability assessment process concludes that it is both feasible and credible to liquidate a bank, the recapitalisation amount

<sup>28</sup> For this interim report, O-SIIs buffers, systemic risk buffers and countercyclical buffers were not included.

should be zero. For other banks where resolution authorities assess that liquidation is not credible and feasible because of critical functions they perform, and where a resolution plan considers some assets and liabilities being transferred, a recapitalisation amount will be required, but at a lower level than a full balance sheet recapitalisation.

To demonstrate the impact of such potentially lower MREL recapitalisation requirements, an additional alternative scenario has been applied as a variant to scenario B (LA buffers). Indeed, for the 72 Group 2 banks a more detailed analysis regarding the determination of the recapitalisation amount has been conducted assuming 50% recapitalisation amounts instead of the full recapitalisation provided for under scenario B. The assumptions underpinning this alternative scenario are summarised in Figure 2. Note that this is an additional scenario, i.e. Group 2 banks remain included in the other three scenarios, even though, as shown below, their impact on aggregate needs is low.

**Figure 2: Assumption regarding the calibration of MREL for Group 2 banks according to Twice capital requirements + Buffers scenario, but with lower recapitalisation amount (50% instead of 100%)**

<b>Partial recapitalisation scenario</b>	Capital requirements (including Pillar 2) without considering buffers for recapitalisation amount with reduced recapitalisation amount	<b>Minimum MREL = Loss absorption + Recapitalisation x 50%</b> <ul style="list-style-type: none"> <li>• Loss absorption = Pillar 1 (8%) + Pillar 2 (2%) + Capital Conservation Buffer (2.5%)</li> <li>• Recapitalisation = Pillar 1 (8%) + Pillar 2 (2%)</li> </ul>
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## 2) Scope of MREL-eligible instruments

Two different options have been considered in terms of the scope of instruments eligible for MREL:

- **Current MREL (MREL)** – all MREL-eligible instruments, including eligible deposits not covered by Deposit Guarantee Schemes (DGS) (i.e. large corporate deposits with a residual maturity of more than 1 year). These deposits might possibly be excluded from MREL if resolution authorities consider this necessary to maintain the critical functions of the resolved institutions or to avoid contagion;
- **Current MREL (excluding deposits) (MREL ex dep)** – excludes all deposits.

Note that the implications of a generalised subordination requirement imposed on all banks are assessed in the subordination section.

Figure 3 summarises the assumptions relating to the options above.

Figure 3: Assumptions regarding the scope of eligible liabilities and the MREL ratio

MREL numerator	MREL definition	MREL ratio (calibration)
<b>Current MREL (excluding deposits)</b> (MREL ex dep)	Regulatory capital + Total unsecured subordinated debt > 1 year + Total senior unsecured debt > 1 year	Current MREL (excluding deposits) / Total liabilities and own funds
<b>Current MREL<sup>29</sup></b> (MREL)	Regulatory capital + Total unsecured subordinated debt > 1 year + Total senior unsecured debt > 1 year + deposits not eligible for DGS coverage > 1 year	Current MREL / Total liabilities and own funds

## 3.4 Key findings on MREL of banks operating in the EU

The objective of this section is to illustrate the key findings from the data analysis on the level, composition and distribution of MREL of EU banks.

### 1) Level of MREL capacity

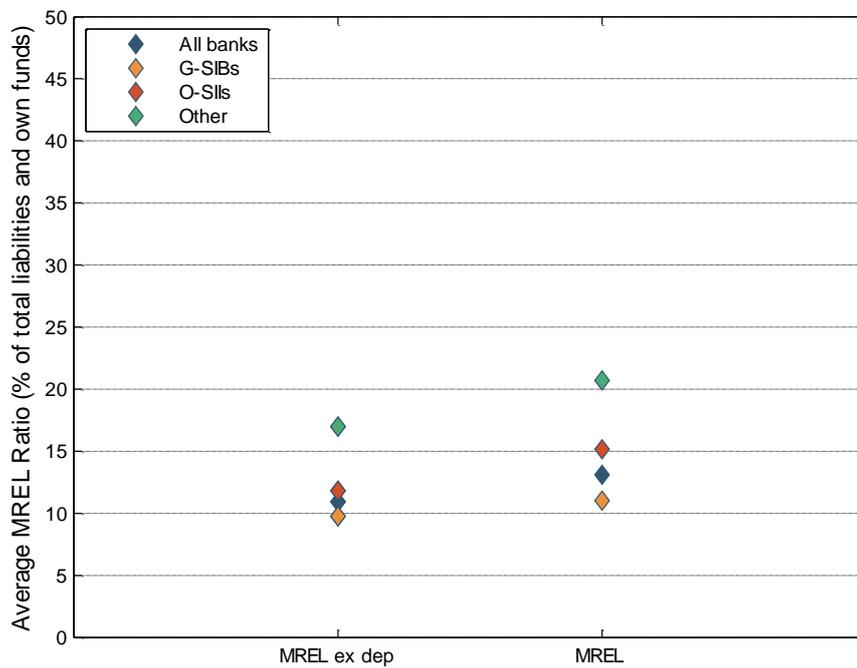
Figure 4 and Figure 5 show average MREL ratios as a percentage of total liabilities and own funds (TLOF), and as a percentage of RWAs.

Based on the current minimum MREL eligibility criteria the current average MREL ratio is 13% of TLOF or 34% of RWAs. MREL ratios tend to be slightly lower than average for G-SIBs, slightly higher for O-SIs and significantly higher for the other (non-systemic) banks in our sample.

Excluding MREL-eligible deposits (large corporate deposits with residual maturity >1 year), the average MREL ratio falls by around 2 percentage points (as a share of TLOF).

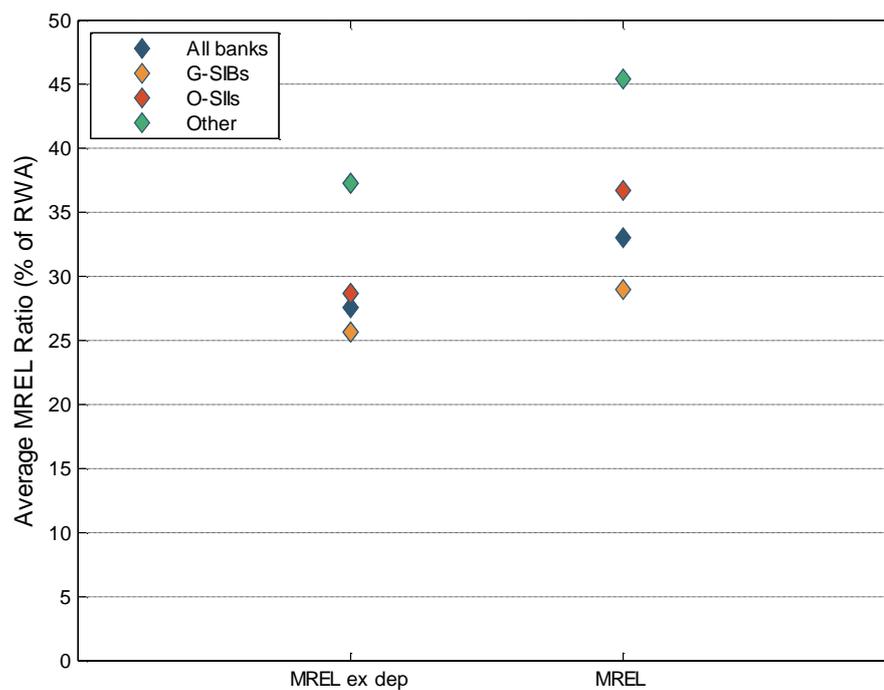
<sup>29</sup> Resolution authorities may ask for additional requirements.

Figure 4: Average MREL ratio (% of total liabilities and own funds)



Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

Figure 5: Average MREL ratio (% of RWA)

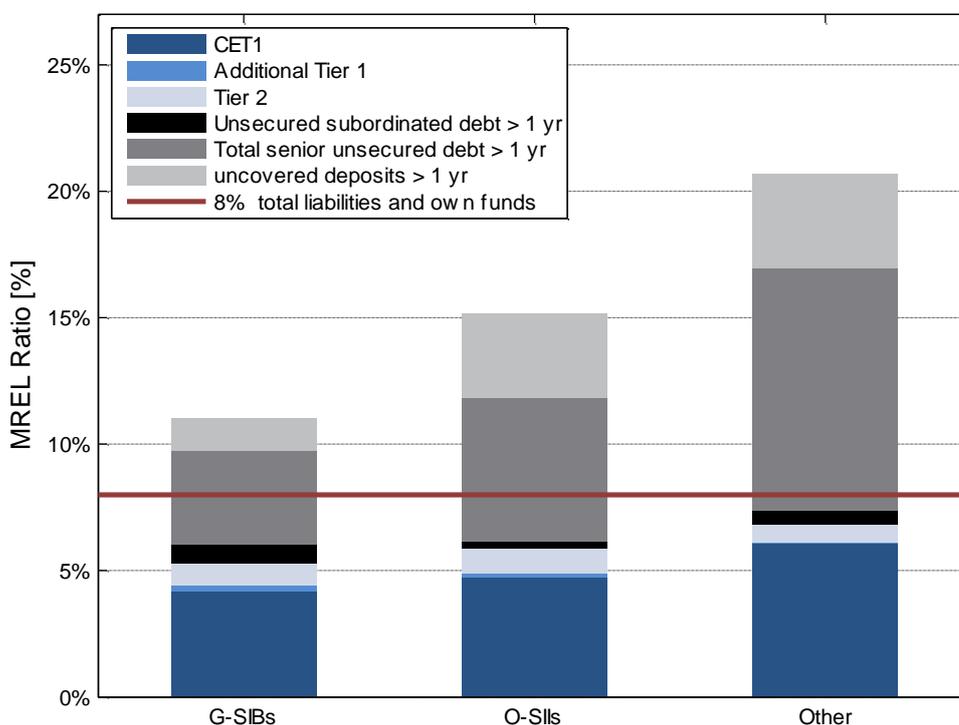


Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

## 2) Composition of MREL

Figure 6 analyses the composition of MREL in terms of type instruments assuming the current definition of the scope of MREL. This composition varies significantly between G-SIBs, O-SIBs, and other banks (Figure 7). For G-SIBs, on average, unsecured debt and uncovered term deposits form a smaller proportion of their balance than for O-SIBs and, especially, other banks. This may in part be because G-SIB balance sheets are likely to include significant derivative portfolios.

Figure 6: Composition of MREL by banks’ systemic importance (% of own funds and total liabilities)



Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

## 3) Financing needs

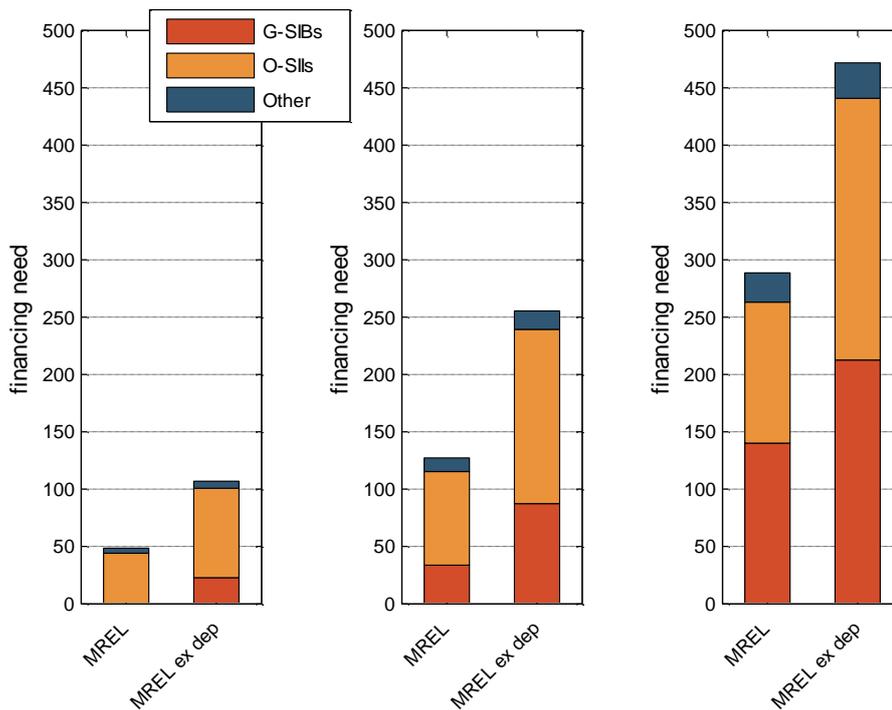
As noted above, it is not yet possible to determine with certainty the size of institutions’ needs both to refinance existing debt in MREL-eligible (or TLAC-eligible) instruments and to issue new MREL-eligible liabilities. This will depend on bank-specific MREL decisions (including resolution strategies) which have not yet been taken. We have consequently estimated banks’ MREL-related financing needs under the illustrative scenarios discussed above (Figure 7).

Based on the current minimum MREL eligibility requirements, and a calibration including capital buffers in only the loss absorption amount (‘LA buffer’ in Figure 7), the financing need of the sample banks is approximately EUR 130 billion. More than half of this is accounted for by O-SIBs,

and more than 90% by G-SIBs and O-SIBs together. Financing needs would increase to approximately EUR 260 billion if term corporate deposits were excluded from MREL.

Applying a higher calibration including buffers in both the recapitalisation and loss absorption amounts and in addition requiring banks to have at least 8% of TLOF in MREL would increase financing needs to approximately EUR 290 billion under the current minimum MREL eligibility requirement, or EUR 470 billion if term corporate deposits were excluded.

Figure 7: Financing needs under scenarios P1 only, LA buffer and Buffer/8% (from left to right) (in EUR billion)



Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

Table 5 shows these financing needs as a percentage of total liabilities and own funds and of risk-weighted assets.

Table 5: Financing need (% of total liabilities and own funds and of % RWA)

	P1 only				LA buffer				Buffer/8%			
	% of Total Liabilities and Own Funds of whole sample	% of Total Liabilities and Own Funds of non-compliant <sup>30</sup> banks	% of RWA of whole sample	% of RWA of non-compliant banks	% of Total Liabilities and Own Funds of whole sample	% of Total Liabilities and Own Funds of non-compliant banks	% of RWA of whole sample	% of RWA of non-compliant banks	% of Total Liabilities and Own Funds of whole sample	% of Total Liabilities and Own Funds of non-compliant banks	% of RWA of whole sample	% of RWA of non-compliant banks
MREL	0.2	3.3	0.5	6.3	0.5	1.7	1.2	3.7	1.1	2.6	2.7	6.1
MREL ex dep	0.4	2.2	1.0	4.9	1.0	2.3	2.4	5.1	1.8	2.9	4.5	6.7

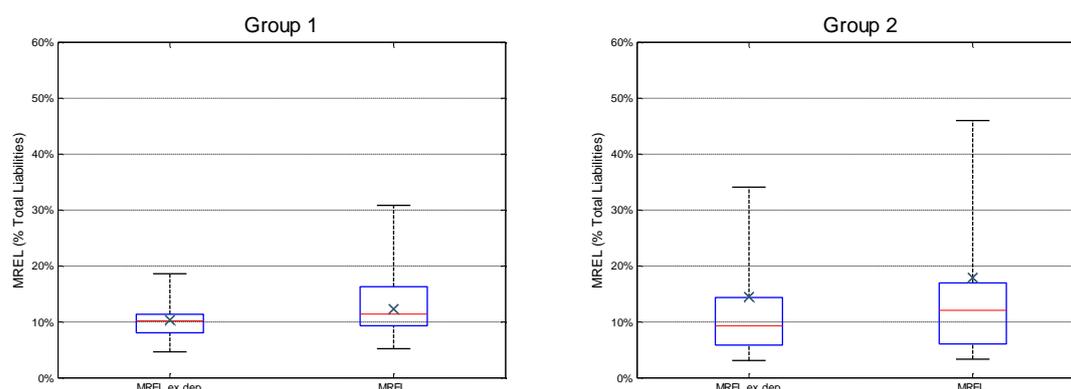
Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

These scenarios are likely to be too conservative for some banks, in particular smaller banks for which full recapitalisation is unlikely to be required in resolution. For this reason a specific assessment of financing need for smaller banks under the additional alternative scenario is included at the end of this section.

### MREL ratios and funding needs for 'smaller' banks under the alternative recapitalisation scenario

Average MREL ratios for Group 2 banks are higher than for the overall sample, at respectively 17.9% of TLOF under the current MREL scope of eligibility and 14.5% if excluding deposits. However, as shown in Figure 8, for these smaller banks there is also a greater dispersion of MREL ratios. As a result, if MREL for smaller banks were calibrated in the same way as for G-SIBs and O-SIBs, a number of them would face significant MREL shortfalls.

<sup>30</sup> Throughout this document, 'compliance' or 'non-compliance' is understood within the strict context of the option and scenarios envisaged.

Figure 8: MREL ratio as a % of TLOF<sup>31</sup>

Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

However, this is unlikely to be an appropriate calibration of MREL for smaller institutions. As explained above, scenarios assuming full recapitalisation in resolution are likely to be ill-suited for the smaller banks in the sample. For that reason, the EBA has estimated the impact of applying to Group 2 banks<sup>32</sup> a variant of the LA buffer scenario assuming a partial recapitalisation amount of 50% rather than 100%.

**Table 6: Financing need (in EUR billion and as % of total liabilities and own funds) and number of non-compliant banks for Group 2 banks under the LA buffer scenario with 50% recapitalisation only**

	Number of banks	MREL ex dep			Current MREL		
		Gross financing need (absolute amount in EUR billion)	Gross financing need (% of TLOF)	Number of non-compliant banks	Gross financing need (absolute amount in EUR billion)	Gross financing need (% of TLOF)	Number of non-compliant banks
All	72	43.3	1.2	33	16.1	0.4	22
Large	22	35.3	1.4	8	11.8	0.5	5
Medium	19	5.6	0.7	8	2.8	0.3	4
Small	31	2.4	0.7	17	1.6	0.5	13

Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

Under this scenario, smaller banks would have a financing need of EUR 16 billion using the current scope of MREL, and EUR 43 billion if excluding deposits. This compares with EUR 47 billion and EUR 90 billion respectively in the full recapitalisation scenario. Table 6 further breaks down these impacts among large, medium-sized, and small members of Group 2<sup>33</sup>. As shown in Table 6, under

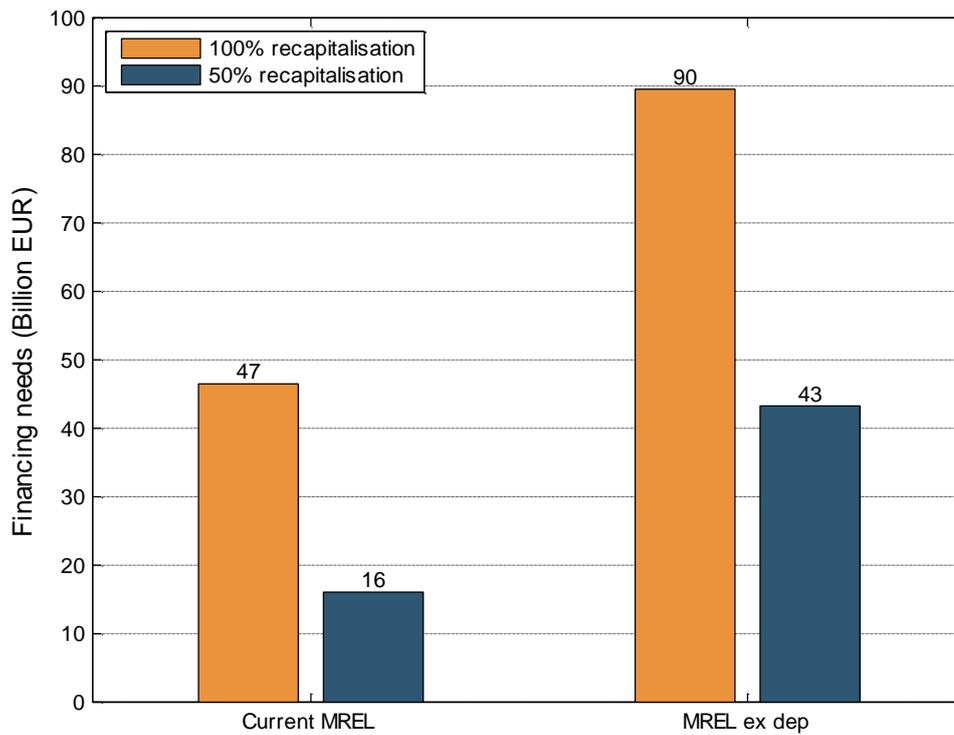
<sup>31</sup> Box plot shows the distribution of MREL ratio across the sample. 50% of banks in the sample have MREL ratios inside the box. 95% and 5% percentiles are shown as the whiskers at the top and the bottom of the plots. The red line indicates the median, and the 'x' the weighted average.

<sup>32</sup> See table 2 and accompanying text for explanation of Group 2 membership criteria.

<sup>33</sup> Note that even the large members of Group 2 are considerably smaller than G-SIBs.

this more realistic calibration, the MREL financing requirements for Group 2 banks are similar as a percentage of total liabilities and own funds to the needs of the whole sample shown in Table 5.

**Figure 9: Financing needs (in EUR billion) for Group 2 banks under two different variants of the LA buffer scenario: with 100% and 50% recapitalisation**



Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

## 4. Options for the reference base (denominator) of MREL

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Article 45(19)(i) of the BRRD requires the EBA to examine *'whether it is appropriate to base the requirement on total liabilities and own funds and in particular whether it is more appropriate to use the institution's risk-weighted assets as a denominator for the requirement'*.

This section aims to assess how well the current reference base serves the purpose of the minimum requirement and identifies a number of limitations affecting its use. It further examines whether risk-weighted assets, complemented by a leverage ratio exposure, could be a more appropriate reference base. Finally it identifies a number of provisions within the BRRD and other regulations which are connected with this reference base and could be impacted by a change.

### 4.1 Current reference base: total liabilities and own funds

The current reference base presents some limitations with regard to achieving the goals of MREL and offering a legally certain backdrop for the requirements.

#### 4.1.1 Achieving the goals of MREL

MREL is meant as a mechanism to prevent bail-in avoidance by banks<sup>34</sup>, to ensure that an institution can be resolved, and to ensure that losses can be absorbed and, in the proportion required to achieve the resolution strategy, capital can be restored<sup>35</sup>. These principles are reflected in the methodology set out by the RTS on MREL, and in particular the criteria for determining the amounts necessary to absorb losses and recapitalise an institution following resolution. On the one hand the regulatory framework<sup>36</sup> and SREP<sup>37</sup> embody a judgment about the amount of capital necessary to absorb losses. On the other, following resolution the resolved firm will need to fulfil the conditions for authorisation by the relevant competent authority to continue any activities as a credit institution, and so will need to meet capital requirements. As a result, resolution authorities who are setting MREL for individual banks need to take into account these judgments. Supervisory capital ratios are therefore expected to be a major determinant of MREL levels both for the loss absorption and recapitalisation amount.

In contrast, setting an MREL requirement based on an assessment of loss absorption and recapitalisation needs as a percentage of TLOF makes it insensitive to changes in risk in the period

<sup>34</sup> Recital 79 of the BRRD *'To avoid institutions structuring their liabilities in a manner that impedes the effectiveness of the bail-in tool it is appropriate to establish that the institutions meet at all times a minimum requirement'*.

<sup>35</sup> Article 45(6)(a) and (b) of the BRRD.

<sup>36</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending previous Regulation and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending and repealing previous Directives.

<sup>37</sup> In accordance with EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP), available under <https://www.eba.europa.eu/documents/10180/935249/EBA-GL-2014-13+%28Guidelines+on+SREP+methodologies+and+processes%29.pdf>

between MREL decisions. The level of eligible liabilities needed to absorb losses and recapitalise will depend not only on the volume of a balance sheet, but also on the average risk-weight of the bank's assets, which may be affected by changing risk appetite, by balance sheet volatility, or by changes in economic conditions in between two annual MREL decisions. An increase in average risk-weights without a corresponding change in the MREL requirement may therefore leave institutions with inadequate loss absorption and recapitalisation capacity.

#### **4.1.2 Defining total liabilities and own funds**

The BRRD defines own funds by reference to the capital framework of the CRD and CRR. It does not, however, provide a clear definition of the total liabilities component. As a result, resolution authorities have to define and measure this component. Differing national approaches to this could stand in the way of a harmonised application of the requirement.

Accounting rules provide a relatively unambiguous framework when defining total liabilities, but also raise several practical challenges which mean this approach is not likely to result in a fully consistent implementation.

First, absent a uniform EU accounting framework for all the institutions subject to MREL, some institutions apply national GAAP rather than IFRS. Although the additional guidance of the legislation on netting of derivative liabilities, discussed below, tries to overcome the difference that is probably most significant, it cannot be excluded that differing accounting treatments might significantly impact the amount of the denominator. This contrasts with the prudential treatment of derivative netting which is harmonised.

Second, there may also be a need to further clarify how accounting liabilities interact with prudential own funds. While accounting identifies subordinated debt as liabilities, some subordinated debt is also included (wholly or in part) in the Tier 2 own funds of an institution. The MREL calculation needs to avoid double-counting the subordinated liabilities or part thereof in the denominator.

The interaction of fair value accounting for liabilities and adjustments to own funds might also give rise to ambiguity. Fair valuation of liabilities may result in decreases in the accounting value of a liability which are not associated with a reduction in the rights of a counterparty in insolvency. This fair value adjustment increases the calculated value of accounting equity, meaning that total balance sheet size is unchanged. However, as prudential own funds are corrected, in particular through the deduction of the own credit risk component and through prudent value adjustments, the value of total liabilities and own funds at the point of resolution might be underestimated.

The supervisory reporting framework (FINREP) is currently not a required reporting format for non-IFRS entities. Competent supervisory authorities may optionally extend FINREP to entities establishing their accounts under national GAAP. However, this would only provide a solution for the lack of uniform accounting basis by requiring these entities to additionally report IFRS concepts through FINREP, which would impose a significant additional reporting burden.

An alternative approach would be to base the valuation of liabilities on an approach other than an accounting basis. However any such alternative basis would face significant practical problems, in particular the need for extensive guidance on how to interpret the concept. One alternative which could be considered would be to base MREL decisions on the estimated value of liabilities in insolvency, rather than on the going concern accounting framework. However national insolvency laws differ significantly and thus create a need for distinct treatment in light of the no creditor worse off principle (NCWO)<sup>38</sup>. An alternative valuation approach is therefore very difficult to envisage.

If the existing reference base were maintained, the definition of total liabilities should therefore be clarified through changes in the Level 1 / 2 text.

#### 4.1.3 Derivative liabilities and netting rights

Article 45(1) of the BRRD specifies that derivative liabilities shall be included in the denominator on the basis that full recognition is given to counterparty netting rights.

However, this provision does not specify the netting principle to be applied. In this regard there are at least three possible options for the calculation of netting:

- Full contractual netting: consider all netting sets on the basis of their contractual netting rights in the event of the institution's default (consistently with the RTS on the valuation of derivatives<sup>39</sup>) to define the resulting asset or liability position. This approach would maximise theoretical consistency with the treatment of derivatives in insolvency or resolution, but would be difficult to calculate without running an actual derivative counterparty default process.
- Accounting netting: under IFRS, derivatives contracts may be netted for accounting purposes when the reporting institution has both the right to net in the event of default *and* the intent to settle payments on a net basis during the contract's life. This has the advantages of consistency with the accounting standards and it is already calculated for accounting purposes. Nevertheless, the requirement for ongoing net settlement means the recognition of netting is more limited than the contractual netting likely to occur in the event of failure, and may not give full recognition to netting rights.
- Prudential netting (as used for calculating RWAs or the leverage ratio exposure measure): this allows a scope of netting which will usually be intermediate between full contractual netting and IFRS accounting netting. For prudential purposes exposures are also calculated including potential future exposure (PFE). This measure is already calculated for prudential purposes (although it is derivative *assets* which are calculated for prudential purposes, this should be based on calculating the value of the same set of derivative contracts, which may take either a positive or negative value). Moving to prudential netting of derivatives would be one consequence of adopting an RWA/leverage exposure based denominator.

<sup>38</sup> The principle whereby shareholders and creditors should not suffer more losses in resolution than in liquidation, cf. Article 74 of the BRRD.

<sup>39</sup> Commission Delegated Regulation with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives, C(2016) 2967 final, 23.5.2016, not yet published. Available at <http://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2967-EN-F1-1.PDF>

This question has recently been addressed by the EBA in the context of its Q&A tool<sup>40</sup>. According to the interpretation given the netting principles applied for derivatives in the BRRD should be consistent with prudential rules as used for calculating RWAs and the leverage ratio exposure measure. Practitioners would benefit from the explicit recognition of this approach in the Level 1 legislation.

## 4.2 Risk-weighted assets with a leverage ratio exposure backstop

This section describes how concretely resolution authorities could set MREL as a percentage of RWAs and the leverage ratio exposure. It further identifies the advantages of such an approach in terms of alignment with the capital framework, and discusses issues related to risk-weight variability and how they can be addressed by the leverage ratio backstop.

Note that for the sample of banks included in the EBA's quantitative analysis, RWAs constitute approximately one third of the exposure amount according to the leverage ratio measure, which is broadly consistent with findings regarding average risk-weights of EU banks' portfolios from previous studies<sup>41</sup>.

### i. Practicalities of determining MREL as a percentage of RWA with leverage ratio backstop

In practice, the change of reference base would imply only a limited change in the methodology used by resolution authorities to set MREL.

As explained above, the current RTS on MREL, in keeping with the principles of the BRRD<sup>42</sup>, set out a methodology for the calibration of MREL based on the determination of two main components<sup>43</sup>:

- a loss absorption amount largely driven by capital requirements (both the minimum requirements and firm-specific add-ons);
- a recapitalisation amount which is largely driven by the choices of the resolution authority since it is meant to implement a particular resolution strategy. Nevertheless it is not disconnected from the capital requirements since the recapitalised institution or receiving entity will need to fulfil minimum capital requirements.

<sup>40</sup> See Q&A 2015-1824, available at <https://www.eba.europa.eu/single-rule-book-ga>.

<sup>41</sup> EBA: CRDIV-CRR/Basel III Monitoring Exercise (March 2016), in particular figure 9 (p. 26), available at <http://www.eba.europa.eu/documents/10180/1360107/CRDIV-CRR+Basel+III+Monitoring+Exercise+Report.pdf>.

<sup>42</sup> Article 45(6) of the BRRD: 'The minimum requirement for own funds and eligible liabilities of each institution pursuant ... shall be determined by the resolution authority... at least on the basis of the following criteria: ... need to ensure, in appropriate cases, that the institution has sufficient eligible liabilities to ensure that, if the bail-in tool were to be applied, losses could be absorbed and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation ... and to sustain sufficient market confidence...'

<sup>43</sup> Adjustments by the resolution authority are provided for under the RTS to these amounts. Cf. RTS on MREL

In both cases, the capital requirements encapsulated in the determination are expressed consistently with the CRD / CRR framework, i.e. capital ratios and buffers expressed as a percentage of ‘total risk exposure amount’ (also known as RWA) and, where applicable (see box below) and exceeding those capital ratios, a leverage ratio requirement expressed as a percentage of the leverage ratio exposure<sup>44</sup>.

On the basis of these elements the resolution authority determines an absolute amount (expressed, for example, in EUR billion), and then translates it, as per the BRRD requirement, into a percentage of total liabilities and own funds.

In practice, if the legislator takes up the option to express MREL as a percentage of risk-weighted assets, with a leverage ratio exposure backstop, most of the methodology in the RTS on MREL would remain applicable. Only the last step, i.e. the conversion into a percentage of TLOF, would be discarded. Instead, the resolution authority would convert the amount into a percentage of the RWAs of the institution, as well as a percentage of its leverage ratio exposure. Note that the latter should not be confused with the leverage ratio, from which it would only borrow the denominator as an additional reference base.

At the moment when the resolution authority sets the MREL requirement, expressing MREL as a percentage of risk-weighted assets and leverage ratio exposure would not change the actual amount of MREL required, in nominal value, compared to the current approach where MREL is expressed in terms of TLOF. However, in between two annual MREL decisions the requirement would evolve with the risk-weighted assets of the institution. If the risk-weighted assets increased, the nominal value of the institution’s MREL would increase. If risk-weighted assets decreased, the nominal value of the institution’s MREL would decrease but not lower than the requirement expressed as a percentage of the leverage ratio exposure (this would act as a backstop).

#### **Box A - Leverage ratio and leverage ratio exposure – state of play**

In December 2010, the Basel Committee on Banking Supervision decided to complement the risk-based capital requirement with a leverage ratio requirement<sup>45</sup>. This requirement acts as a non-risk based measure to i) constrain leverage in the banking sector, thus helping to mitigate the risk of the destabilising deleveraging processes which can damage the financial system and the economy, and ii) introduce additional safeguards against model risk and measurement error by supplementing the risk-based measure with a simple, transparent, measure independent of risk. The BCBS prescribed an observation period from 1 January 2013 until 1 January 2017 during which the leverage ratio, its components and its behaviour relative to the risk-based requirement would be monitored. Based on the results of the observation period, final adjustments to the definition and calibration of the leverage ratio are to be made in the first half of 2017, with a view to migrating to a binding requirement on 1 January 2018.

The leverage ratio requirement has been incorporated into European legislation via the CRR / CRD as a new supervisory measure that can be applied to institutions at the discretion of the

<sup>44</sup> A third floor is also provided for in the RTS: the ‘Basel I floor’ as defined in Article 500 of the CRR.

<sup>45</sup> Basel III framework, <http://www.bis.org/publ/bcbs189.pdf>

supervisory authorities. It has also been included as a specific reporting and disclosure obligations for institutions, pending migration to a binding measure in 2018. Leverage is defined in Article 4 (1) (93) of the CRR as the total on- and off-balance sheet items compared to that institution's own funds. It is expressed as the following percentage:

$$\text{Leverage ratio} = \frac{\text{Capital measure}}{\text{Exposure measure}}$$

Based on an EBA report due by end October 2016, the Commission is required to submit a report to the Parliament and the Council by end 2016 on the impact and effectiveness of the leverage ratio, accompanied, where appropriate with a legislative proposal.

## ii. Alignment with TLAC and risk-sensitive capital ratios

Capital requirements are currently expressed in terms of risk-weighted assets and, where applicable (see Box A) leverage ratio exposure. The FSB TLAC term sheet sets a minimum level of TLAC as a percentage of RWAs (18% from 2022), with a leverage ratio requirement (6.75% from 2022) as a backstop.

A change of the MREL denominator from TLOF to RWAs, with a leverage ratio exposure requirement as a backstop, would therefore be in line with both of these frameworks. This would mean that the number of bases for expressing capital, MREL, and TLAC requirements would be reduced from three – (i) TLOF (MREL), (ii) RWAs (CRR / CRD capital requirements and TLAC), (iii) leverage ratio exposure measure (CRR / CRD capital requirements and TLAC) – to two. This would reduce complexity and would improve comparability among the different ratios and consistency with the current CRR regime, facilitating cooperation and exchange of information between resolution and supervisory authorities.

For some types of institutions and business models whose total balance sheet size is more volatile than their RWAs, using a RWA denominator for the MREL ratio may reduce the possibility of balance sheet volatility leading to an MREL requirement which is unstable, and in particular more unstable than the institution's capital requirements. Applying RWAs as the denominator would mean that changes in the institutions' RWAs affect capital and MREL requirements at the same time; thus changes over time would not have a delayed impact on the MREL ratio (i.e. a 'jump' effect when MREL is next set). Institutions' required MREL resources would therefore be more stable. Responses to the EBA's consultation on its draft technical standards on MREL highlighted the instability of average risk-weights as a particular concern for financial infrastructure firms which are also licensed as credit institutions, but in principle it may also affect other business models – for example, institutions with large, but offsetting, derivatives portfolios.

## iii. Risk-weight variability and the leverage ratio backstop

The use of RWAs as a denominator in the capital framework has raised concerns regarding differences in the calculation of RWAs across institutions and jurisdictions. RWA differences may be caused by differences in business models, asset mixes, risk measurement methodologies, modelling inputs, and supervisory regimes. A series of EBA reports<sup>46</sup> and work by the BCBS<sup>47</sup> have considered the extent to which RWAs might not be calculated consistently and made proposals to mitigate excessive risk-weight variability in the capital framework.

Nevertheless, three observations can be made.

First and foremost, the link between capital requirements and MREL remains relevant and the appropriate place to address differences in RWA calculation is the capital framework. Even using TLOF as a reference base does not alleviate concerns with regard to the determination of RWAs, since capital requirements, expressed using RWAs, are the backdrop for the determination of the MREL loss absorption amount and, in the proportion required by the resolution strategy, the recapitalisation amount.

Second, admittedly the adequacy of institutions' risk modelling approaches may be a concern in the stressed circumstances likely to accompany a bank resolution. For an institution entering resolution, it is likely that many risks will have crystallised and no longer be suitable for statistical risk modelling. However it would be difficult to develop an approach to quantify in advance potential changes in an institution's balance sheet as it approaches resolution for the purpose of setting MREL.

Third, the non-risk sensitive leverage ratio has precisely been developed to serve as a backstop against unduly low risk-adjusted capital levels and to prevent the excessive build-up of leverage, both over the financial cycle and across credit institutions. The leverage ratio serves as an additional safety net independent of the risk-based capital requirements that will help to prevent excessive levels of debt and at the same time protect against the consequences of potential measurement errors and model risks associated with risk-based capital requirements.

If a wholly non-risk sensitive denominator for MREL were still desired, the leverage ratio exposure measure would avoid a number of the disadvantages of the current MREL denominator discussed above. Because it has been developed for the purposes of EU-wide prudential regulation, it has a well-understood and clear definition which can be applied consistently to institutions across the Union and is already calculated for monitoring purposes.

Finally, regardless of whether a new metric is introduced for the denominator of MREL, the impact of introducing a binding leverage ratio on the level of MREL should be assessed. Indeed, a binding leverage ratio requirement, if set at a high level, may become a driving factor for the determination of the MREL requirement.

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<sup>46</sup> See <http://www.eba.europa.eu/risk-analysis-and-data/review-of-consistency-of-risk-weighted-assets>

<sup>47</sup> See two BIS reports analyzing variation in RWAs <http://www.bis.org/publ/bcbs256.htm> and <http://www.bis.org/bcbs/publ/d363.htm>

### 4.3 Connections with other provisions of the BRRD

If changes are made to the denominator's definition, this may impact other articles of the BRRD that refer to related metrics. An overview of the most relevant provisions for resolution purposes is provided below.

#### Article 37(10)(a) BRRD

This article provides the possibility to access alternative funding sources by using the government stabilisation tools provided for in Articles 56 to 58 of the BRRD. Such recourse is subject to an extraordinary situation of systemic crisis, complemented by a contribution to loss absorption and recapitalisation by shareholders and creditors of at least 8% of total liabilities including own funds.

#### Article 44(5)(a) and (b) BRRD

Under this article, resolution financing arrangements can make contributions to institutions under resolution. These contributions are however subject to a requirement that shareholders and creditors have made a contribution to loss absorption and recapitalisation of at least 8% of TLOF<sup>48</sup>. Such a contribution from the resolution financing arrangement is also limited to 5% of the TLOF of the institution under resolution.

All three of these ratios have TLOF as their denominator. They do not include the reference made in the MREL denominator to ensuring full recognition of derivative netting rights; however as they would be evaluated at the time of resolution it is possible that derivative netting would in fact have occurred at this point.

The EBA has not considered whether a change in metric can be envisaged in this context too. This issue was considered out of scope.

#### Article 102(4) BRRD

Article 102(4) mandates the EBA to submit a report to the Commission by 31 October 2016 with recommendations on the appropriate reference point for setting the target level for resolution financing arrangements, and in particular whether total liabilities constitute a more appropriate basis than covered deposits. While this definition does not refer to own funds, some of the above considerations with respect to the definition of total liabilities would still be valid.

#### **Provisional recommendation**

The EBA's provisional view is that the preferred option should be changing the reference base of MREL to RWAs. It should be complemented with a leverage ratio exposure backstop in parallel

<sup>48</sup> Or, under certain additional conditions, 20% of RWAs.

with the phase-in of that requirement within the capital framework. This approach achieves alignment with CRR / CRD regulatory requirements and with the FSB's TLAC standard and reduces complexity without major substantive changes to the MREL setting process.

If this change is not made, the EBA recommends changing the reference base of MREL from total liabilities and own funds to the leverage ratio exposure as a more consistently applied non-risk sensitive measure.

If neither of these changes is made, the EBA considers that clarification of the definition of the existing denominator is necessary, either in the Level 1 text or through the introduction of a Level 2 mandate.

## 5. Relationship between MREL and other regulatory requirements

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### 5.1 Stacking of CET1 buffers

#### Existing law and implementation

The current treatment of Common Equity Tier 1 (CET1) buffers in BRRD and CRD / CRR leads to some contradictions:

- On the one hand the CRD / CRR framework provides for the creation of buffers in good times in order to reduce the likelihood of an institution running into trouble during economic downturns. Therefore buffers should be usable without entry into resolution.
- On the other hand, the BRRD provides for MREL as a minimum requirement that must be met at all times and allows resources used to satisfy capital buffers to also satisfy MREL simultaneously.

As a result, the usability of buffers could be affected because using them could lead to a breach of MREL. For example, macro-prudential authorities might require that the countercyclical capital buffers be reduced in view of turns in the credit cycle, where releasing capital would reduce the risk of the supply of credit being constrained by regulatory capital requirements. If the same CET1 capital can count towards MREL and regulatory capital buffers, there is the risk that the countercyclical capital buffers are less effective as macro-prudential tools (or alternatively that MREL is not a genuinely hard minimum).

Under the FSB's TLAC standard, CET1 regulatory capital used to meet minimum TLAC must not be used to also meet regulatory capital buffers<sup>49</sup>. Since regulatory capital buffers are to be met in addition to the TLAC minimum, CET1 capital is first to be used to meet TLAC requirements – i.e. TLAC is stacked below the regulatory capital buffers. A change to the existing treatment of capital buffers in MREL would therefore be necessary to implement the TLAC standard.

In addition, the BRRD and SRMR feature differences which are not supported by any obvious justification. On the one hand, Article 45 of the BRRD is silent on the treatment of buffers. Under the RTS on MREL, the resolution authority can apply a downward adjustment to the loss absorption amount of MREL if part of the capital buffer requirement is assessed not to be relevant to the need to ensure that losses can be absorbed in resolution<sup>50</sup>. In contrast, the SRMR states that MREL must be at least equal to minimum capital including capital buffers<sup>51</sup>. This contradiction may result in inconsistent implementation of the MREL requirement between Member States.

<sup>49</sup> Point 6 of the FSB TLAC term sheet.

<sup>50</sup> Article 1(5)(ii) of the RTS on MREL.

<sup>51</sup> Article 12(6) last paragraph of the SRMR: *'The minimum requirement for own funds and eligible liabilities referred to in paragraph 4 shall not be inferior to the total amount of any own funds requirements and buffer requirements under Regulation (EU) No 575/2013 and Directive 2013/36/EU.'*

The UK Prudential Regulation Authority (PRA) is consulting on a policy whereby, in line with the TLAC standard, firms should not count CET1 for the purposes of meeting MREL and capital buffers simultaneously<sup>52</sup>. This would mean that buffers would need to be met separately from MREL. Depending on their business model and liability structure, firms may need to increase financial resources to avoid the double counting of CET1. The SRB's proposed MREL framework<sup>53</sup> does not include a similar proposal. While this difference need not mean that MREL requirements are more or less strict, as it can be taken into account when setting the requirement, it would reduce comparability of MREL across Member States.

### Policy options

Three options could be considered in respect of clarifying in the relevant EU Level 1 texts the interaction between MREL and the capital buffers:

*a) Removal of double-counting for all banks*

Under this option, no bank would be able to count CET1 capital towards both buffers and MREL at the same time. This would mean that for all banks, the regulatory capital buffers would stack on top of MREL. This would achieve the objective of the TLAC standard (usability of buffers) while extending its application to a broader scope of institutions.

*b) No double-counting, but only for G-SIBs (minimal change needed to implement the TLAC standard)*

Under this option, G-SIBs would not be able to count CET1 capital towards both buffers and MREL at the same time. This means that for G-SIBs, the capital buffers would stack on top of MREL. In contrast, non-G-SIBs would be able to continue to use CET1 capital to meet capital buffers. This option would implement the TLAC standard to the letter.

*c) Double-counting for all banks*

Under this option, the CET1 capital used to meet capital buffers may be used by banks (all banks, including G-SIBs) to meet MREL. The RTS on MREL allows for the resolution authority to make adjustments to MREL, taking into account inter alia the capital buffer requirements. This is currently the status quo in the Banking Union, as provided for in the SRMR and the RTS on MREL. This option would not address the highlighted issue of the usability of buffers.

#### Considerations when choosing the preferred option:

- *Clarity and consistency across Member States*

Regardless of the option for stacking of buffers ultimately adopted, it is important to ensure that the interaction between MREL and the capital buffers is clear in the relevant EU Level 1 texts to avoid ambiguity in interpretation. In particular, any Level 1 difference between Banking Union members and non-participating Member States should be duly justified.

<sup>52</sup> <http://www.bankofengland.co.uk/pr/Pages/publications/cp/2015/cp4415.aspx>. The proposed policy would apply for all banks.

<sup>53</sup> [http://srb.europa.eu/sites/srbsite/files/2nd\\_industry\\_dialogue\\_12-1-2016\\_-\\_mrel.pdf](http://srb.europa.eu/sites/srbsite/files/2nd_industry_dialogue_12-1-2016_-_mrel.pdf)

- *Harmonisation with international standards*

The FSB TLAC standard for G-SIBs allows only CET1 in excess of that required to satisfy the minimum regulatory capital and minimum TLAC requirements to count towards regulatory capital buffers<sup>54</sup>. The European Commission has committed to implementing the TLAC standard in the European Union. In light of this, keeping double-counting for G-SIBs would result in the EU deviating from the internationally agreed standard.

- *Impact on MREL financing needs*

Without offsetting changes in the calibration of MREL requirements, preventing double-counting could increase banks' MREL financing needs. However, this consequence can be avoided by lowering, in the same proportion, the calibration of MREL levels to take into account the elimination of double-counting.

- *Purpose of capital buffers*

There are three main types of capital buffers for banks, which in the CRD methodology are referred to as the Combined Buffer Requirement (CBR)<sup>55</sup>: i) the capital conservation buffer (2.5%), ii) the countercyclical buffer (0-2.5%) and iii) the systemic risk buffer / G-SII buffer or O-SII (0-3%). The CBR must be met with CET1 only. The purpose of the CBR is to allow for it to be drawn on by the bank in a period of stress.

In order to have capital buffers function as intended, authorities could implement alternative methods leading to different national approaches, in particular with respect to intervention regimes. This may affect the EU level playing field as well as lead to unintended cross-border complications (e.g. if an MREL breach is treated differently across EU Member States).

Preventing double-counting would create a clear intervention mechanism for when buffer requirements are breached, which would be separate from any response due to a breach of the MREL requirement.

- *Restrictions on voluntary distributions*

The CBR must be met by a bank if that bank is to be permitted to make discretionary distributions, i.e. the payment of dividends on CET1 instruments, the payment of coupons on AT1 instruments, variable remuneration or discretionary pension benefits. The restriction on the making of distributions when a bank's capital falls within the CBR is not an absolute prohibition on distributions. Instead, a bank will in such instances be required to calculate its Maximum Distributable Amount (MDA). This will be the bank's distributable profits, calculated in accordance with the CRD formula, multiplied by a factor (between 0 and 0.6) depending on how short of CBR the bank's CET1 falls.

Stacking capital buffers on top of MREL (i.e. not counting MREL instruments towards the buffers) could mean that a CBR breach, de facto triggering the application of automatic restrictions on distributions, could in some circumstances happen at high levels of capital. This would be the case

<sup>54</sup> Point 6 of the TLAC term sheet.

<sup>55</sup> Article 128(6) of the CRD.

when banks choose to meet a significant part of their MREL requirements through own funds rather than eligible liabilities. An automatic restriction on distributions could also occur involuntarily if banks are unable to refinance maturing MREL-eligible liabilities due to idiosyncratic or market-wide stresses. The interaction between the stacking of capital buffers and MREL on the one hand, and the rules surrounding MDA restrictions on the other, therefore needs to be carefully considered. In particular, it may be necessary to evaluate, in case capital buffers are stacked on top of MREL, if and under what conditions, it is still appropriate to impose automatic MDA restrictions as soon as a bank breaches its CBR. However the most appropriate context to address concerns with the MDA restrictions is in the existing capital framework.

- *Heterogeneity of EU banking sector*

The EU banking sector is heterogeneous, with many different business models and structures. It may not be appropriate to apply the same requirements to G-SIBs as to all other institutions. Due to the different degrees of access to capital markets, some smaller institutions may find it more difficult to meet any resulting increase in MREL requirements through instruments other than capital. On the other hand, having a separate regime for G-SIBs and other institutions may increase complexity and create confusion.

#### **Provisional recommendation**

The EBA's provisional view is that, in principle, the usability of regulatory capital buffers would be best preserved if they stack on top of MREL – i.e. that banks would not be able to use CET1 capital to meet MREL and also to meet regulatory capital buffers.

However, the implementation of this approach should carefully consider the interaction with automatic MDA restrictions on voluntary distributions and the SREP. This is particularly relevant for banks which rely mainly on capital instruments to meet MREL because of limited access to debt capital markets.

## 5.2 Consequences of breach of MREL

### 5.2.1 Current approach to breach of TLAC and MREL

#### Breach of TLAC

Principle 10 of the FSB TLAC term sheet states that *“a breach or likely breach of Minimum TLAC should be treated as severely as a breach or likely breach of minimum capital requirements and addressed swiftly, to ensure that sufficient loss-absorbing capacity is available in resolution.”*<sup>56</sup>

<sup>56</sup> This prescription has been endorsed by the UK in their MREL consultation which suggests to treat a breach of MREL in the same manner as a breach of minimum capital requirements.

Under the FSB standard, if a firm exhausts its regulatory capital buffers and has breached or is likely to breach its Minimum TLAC requirement, authorities should require the firm to take prompt action to address the breach or likely breach. Authorities must ensure that they intervene and place a firm into resolution sufficiently early if it is deemed to be failing or likely to fail and there is no reasonable prospect of recovery. The rationale for this approach is to ensure that TLAC can achieve its policy objective, i.e. to ensure that a firm has sufficient loss-absorbing and recapitalisation capacity to support effective resolution.

### Breach of MREL

In contrast, while the BRRD is clear that MREL is a minimum requirement that must be met at all times<sup>57</sup>, it does not contain specific provisions covering the implications of an MREL breach.

In this context, at least two courses of action can be envisaged:

- A possible MREL breach could be dealt with by the resolution authority as part of its powers to address or remove impediments to resolvability. The resolution authority has the power to require an institution to either issue eligible liabilities to meet MREL<sup>58</sup> or require an institution to take 'other steps', including in particular to attempt to renegotiate any eligible liability, AT1 or Tier 2 instrument it has issued to meet MREL<sup>59</sup>.

However, these powers do not enable immediate action and there may be a rather lengthy process before the resolution authority is able to make use of them. Indeed, requirements to remove impediments to resolvability can be imposed only on the basis of an assessment of resolvability (usually an annual process), after allowing four months for the institution concerned to make proposals about how to remove the impediment, and for cross-border banks after involving the college. This may not allow a sufficiently prompt response to a breach of a minimum requirement.

Moreover, these powers are linked to 'substantive' impediments without such substantive character being defined in the BRRD, potentially creating an unnecessary legal risk or hurdle for the authorities in using such powers.

Additional powers may be implicitly available to resolution authorities, notably to request institutions to submit a plan to restore compliance with MREL. However, it would provide greater clarity, in particular about how this should interact with the requirement under Article 142 of the CRD to submit a capital restoration plan if they are in breach of their CBR, if this power were specified more explicitly.

As resolution authorities are responsible both for setting MREL and for its use in resolution, they have strong incentives to act in response to a breach of MREL and should take a leading role in responding to such a breach.

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<sup>57</sup> Article 45(1) of the BRRD

<sup>58</sup> Article 17(5)(i) of the BRRD

<sup>59</sup> Article 17(5)(j) of the BRRD

- Action may also be taken by competent authorities. The EBA Guidelines on triggers for the use of early intervention powers by competent authorities<sup>60</sup> identifies a significant deterioration in MREL as a significant event which may trigger consideration of early intervention actions – such measures could include, for example, implementing actions outlined in the institution’s recovery plan or requiring a plan to negotiate restructuring of debt.

In addition, pursuant to Article 110 of the BRRD, Member States are required to attribute to resolution authorities or, depending on the infringement, competent authorities, powers to impose administrative penalties and measures where the national provisions implementing that Directive have not been complied with. Member States may decide not to lay down rules for administrative penalties for infringements which are subject to national criminal law.

In any event, resolution authorities and competent authorities will need to cooperate and coordinate their responses to an MREL breach.

### 5.2.2 Comparison with current approach to breach of minimum capital requirements and buffers

Both the CRD and the BRRD provide the relevant authorities with powers to take measures where an institution fails to maintain capital requirements.

#### CRD / CRR

Article 102 of CRD requires competent authorities to take the necessary measures at an early stage to address problems in cases where:

- i. the institution does not meet the requirements of the CRD / CRR, including own funds requirements and the CBR; and
- ii. there is evidence that the institution is likely to breach those requirements within the following 12 months.

Article 104 of CRD specifies the supervisory measures available in these cases, which include capital add-ons, specific provisioning, reduction of inherent risk, restrictions on business, blocking of dividends, or additional reporting and/or disclosures. Furthermore, Article 18(d) of CRD provides that authorisation may be withdrawn when an institution no longer meets its Pillar 1 or Pillar 2 capital requirements.

A breach of capital buffers results in some specific and automatic consequences. Article 141 of CRD prohibits any institution that meets the CBR from making a distribution of its profit in connection with CET1 capital to an extent that would decrease its CET1 capital to a level where the CBR is no longer met. Institutions that fail to meet the CBR are required to calculate the MDA.

In addition, where an institution fails to meet its CBR, it must prepare a credible capital conservation plan and submit it to the competent authority. The competent authority, if it does

<sup>60</sup> Guidelines on triggers for use of early intervention measures pursuant to Article 27(4) of Directive 2014/59/EU, EBA/GL/2015/03, 28 July 2015, available at [https://www.eba.europa.eu/documents/10180/1151520/EBA-GL-2015-03\\_EN+Guidelines+on+early+intervention+measures.pdf/9d796302-bbea-4869-bd2c-642d3d817966](https://www.eba.europa.eu/documents/10180/1151520/EBA-GL-2015-03_EN+Guidelines+on+early+intervention+measures.pdf/9d796302-bbea-4869-bd2c-642d3d817966).

not approve it, may take other appropriate measures such as requesting an increase in own funds or applying more stringent restrictions on the distribution of profits<sup>61</sup>.

## BRRD

Article 27 of the BRRD establishes early intervention powers that must be available to competent authorities when an institution infringes or is likely in the near future to infringe CRD or CRR requirements. These powers include the ability to dismiss the management and appoint a temporary administrator, as well as to convene a meeting of shareholders to adopt urgent reforms and to require the institution to draw up a plan for the restructuring of debt with its creditors. In addition, Article 32(4)(a) of the BRRD provides that an institution shall be deemed to be failing or likely to fail if it infringes or may in the near future infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority.

### Box B - Proposed UK approach to breach of MREL

In December 2015, the PRA consulted on policy proposals relating to: i) the interaction of MREL with capital buffers; and, ii) the interaction of MREL and PRA Threshold Conditions<sup>62</sup>.

On buffers, the PRA MREL consultation paper (CP) proposes that firms should be prevented from double counting the same CET1 resources to MREL and capital buffers. The result of this policy is that buffers ‘sit on top’ of MREL. This ensures that MREL is a hard minimum requirement and that buffers are usable on a going concern basis.

On a breach of MREL, the PRA MREL CP proposes to treat a breach of MREL in the same way as the PRA treats a breach of minimum capital requirements. The PRA assesses the safety and soundness of firms through its Threshold Conditions framework<sup>63</sup>. The PRA MREL CP proposes that because MREL is a minimum requirement, a breach or likely breach of MREL is relevant to the condition that a firm must conduct its business in a prudent manner (Threshold Condition 5D).

The PRA proposes that, if a firm is in breach of MREL, the firm should expect the PRA to investigate whether the firm is failing, or likely to fail, to satisfy the Threshold Conditions, with a view to taking further action as necessary. However, the relationship would not be automatic. A breach of MREL would not automatically mean that the PRA will consider the firm is failing, or likely to fail, to satisfy Threshold Conditions.

<sup>61</sup> Article 142(4) of the CRD.

<sup>62</sup> For further information see: <http://www.bankofengland.co.uk/pr/Pages/publications/cp/2015/cp4415.aspx>

<sup>63</sup> For further information see ‘The PRA’s approach to banking supervision - March 2016’ page 17-18 available at: <http://www.bankofengland.co.uk/publications/Pages/other/pr/supervisoryapproach.aspx>

### 5.2.3 Options and recommendations

#### Determination of breach of MREL

The point in time when an institution breaches MREL will importantly depend on the relationship between MREL and capital buffers, as discussed in the previous section.

If the MREL framework were amended to implement the TLAC standard so that i) firms are required to meet MREL with separate resources from capital buffers, i.e. the same CET1 cannot count towards meeting buffers and MREL, and ii) MREL ‘takes priority’ as a minimum requirement, so resources are counted towards MREL before capital buffers<sup>64</sup>, then capital buffers will always be breached before MREL. This would mean that the established intervention framework for the competent authorities to deal with breaches of buffers would be engaged ahead of any breach of MREL. This would also need to be reflected in a lower calibration of institutions’ MREL requirements.

Even if, in contrast, the current framework were to remain unchanged, it would still be possible that, at the moment an institution breaches its MREL, it still meets all the CRR minimum capital requirements and buffers. An additional intervention framework would therefore be needed to deal with such case, which could include action by either the competent authority or the resolution authority.

#### Automaticity of consequences of breach

A question arising is whether consequences of MREL breaches should be automatic or on a case-by-case basis. On the one hand, the requirement that MREL be met at all times would support the conclusion that any breach should trigger some consequence. On the other, as for capital requirements, there should be a degree of flexibility and gradation as to the appropriate measures to deal with a breach, as the most intrusive powers should not be applied regardless of the situation and the gravity of the breach.

As a result there could be some measures that are automatic and pre-defined in Level 1/Level 2 provisions, while others would require the judgment of the authorities and depend on the situation. The possibility of a grace period before any automatic consequences apply should also be explored in some circumstances, for example if MREL is breached due to market-wide disturbances preventing the rollover of maturing debt.

Any change in this area should however be balanced against the need to avoid signalling that MREL is a somewhat ‘soft’ requirement that does not need to be met at all times.

#### Powers to respond to breach

Powers to respond to breach should include the resolution authority’s powers to act to address impediments to resolvability, and require appropriate and effective action by the institution to ensure their removal. However, as noted above the current process for use of these powers may not allow a sufficiently prompt response to a breach of MREL, and therefore a simplified or

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<sup>64</sup> The EBA intends to further assess the implications of this solution in the final report on MREL.

accelerated use of these powers should be envisaged. Moreover, additional powers such as the ability to require a credible plan for restoring MREL within a pre-defined timeframe could be considered.

In addition, the competent authority's existing supervisory powers in the CRR / CRD and early intervention powers in the BRRD provide a good basis for a response to a breach of MREL, provided they can be triggered by such a breach.

Finally, the competent authority, or the resolution authority under the conditions of Article 32(2) of the BRRD, may at any time make an assessment whether the institution, considering all relevant circumstances, is failing or likely to fail and meets the conditions for resolution. In cases where there is a severe, persistent, and/or worsening breach of MREL, for example where the institution is not able to roll over a substantial part of its MREL-eligible liabilities, while CRR capital requirements are not breached, authorities should be able to take this into account in these assessments. This is consistent with the rationale that MREL is a minimum requirement that must be met at all times. Any such assessment would, as in all cases, need to be done in a proportionate way and take account of the requirement that resolution should be triggered only when there is no reasonable prospect of alternative private sector measures being successful, to ensure that temporary breaches of MREL which can be addressed by the institution do not trigger resolution. In this regard recital 41 of the BRRD provides that *'the fact that an institution does not meet the requirements for authorisation would not justify per-se the entry into resolution if the institution is still or likely to be still viable'*.

**Table 7: Summary of existing powers to respond to breach of MREL**

	<b>Impediments</b>	<b>Early intervention/ supervisory powers</b>	<b>FOLTF/resolution trigger?</b>
<b>Trigger on MREL breach</b>	Probably	Not clear	Not clear
<b>Responsible authority</b>	RA	CA	RA + CA
<b>Range of powers</b>	Broad (e.g. require restructuring) Restoration plan not clear	Less intrusive	Resolution powers
<b>Usability</b>	Low - long process	High	Split views

### Provisional recommendation

The EBA provisionally considers that resolution authorities should have clear responsibility and a leading role in responding to a breach of MREL. Achieving this objective effectively would require additional powers and an accelerated procedure for use of their powers to address impediments to resolvability. This accelerated procedure should allow resolution authorities to act on the basis of a previous assessment of resolvability and to shorten the timeline currently foreseen in Article 17 of the BRRD. An accelerated procedure should be without prejudice to the need for proper consultation and cooperation with the competent authority.

Competent authorities may also respond to breaches of MREL. Where this is the case the EBA's provisional view is that the legal basis for the use of competent authorities' existing powers in response to a breach of MREL should be further strengthened. The existing reference in EBA guidelines on triggers for the use of early intervention measures could be incorporated in the Level 1 legislation and the ability to respond based on a persistently low level of MREL as well as a rapid deterioration clarified.

Resolution and competent authorities should closely cooperate and coordinate, including by notifying and consulting each other in advance, on respective actions taken in response to a breach of MREL.

*The EBA invites stakeholders' comments on whether and in what circumstances a breach of MREL should result in the Competent Authority making an assessment of whether the institution is failing or likely to fail.*

## 5.3 Approval for redemption of MREL-eligible liabilities

The CRR provides for a conditional regime for redeeming own funds, whereby the competent authority shall only grant permission for an institution to reduce, repurchase, call or redeem own funds instruments if either the institution replaces the instruments being redeemed with new instruments, or has demonstrated that it has a sufficient margin over regulatory capital requirements<sup>65</sup>. Under Article 78(1)(b) of the CRR the competent authority may consider that a margin is necessary on top of the minimum requirement for own funds. This permission regime avoids any sudden breach of capital requirements or undesirable deterioration in capital levels above the requirement as a result of redemption.

A similar rationale could be pursued in the resolution area, where resolution authorities may also want to consider the maturity structure of liabilities an institution is using to meet its MREL requirement, to address situations where it may seem unlikely that an institution can issue new MREL-eligible instruments when the maturity of old instruments drops below 1 year and still redeem some of the instruments that have a maturity over 1 year.

To the extent that MREL is met with own funds instruments the competent authority would also exercise this competence with regard to MREL. However, the resolution authority does not play any role in this process. In addition, the conditions for granting or refusing permission are not

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<sup>65</sup> Article 78(1) of the CRR.

linked to MREL eligibility (the institution could replace MREL-eligible own funds with non MREL-eligible own funds) nor with the required level of MREL. However, a competent authority or resolution authority cannot prevent the redemption of MREL-eligible instruments that are not part of own funds. In other words, the current CRR regime is neither meant nor fit for purpose in the resolution area.

A possible option in this regard would be to extend the CRR regime to MREL instruments and requirements. With regards to the conditions for approval, if approval is needed, the resolution strategy (Single Point of Entry (SPE) or Multiple Point of Entry (MPE)), group-level issues, and entity-level and resolution entity-level issues should be considered. As the competent authority granting the approval would not necessarily have all the information on the resolution strategy, consultation with the resolution authority may be needed. Alternatively, redemption could be approved by the resolution authority where eligible liabilities that are not own funds are concerned.

In the TLAC term sheet, approval for redemption is required for external TLAC only in case a breach of minimum requirement would occur, and no margin is considered necessary. If the holder of the instrument has redemption rights the instrument is not eligible for TLAC/MREL unless the redemption right can be exercised at the earliest within 1 year. The maturity of the instrument will be the earliest day when the redemption right arises.

Preliminarily, the following options for change are considered:

- Extending approval for redemption to all external MREL-eligible instruments;
- Further extending approval for redemption to internal TLAC / MREL;
- Powers for resolution authorities to monitor, and potentially enforce, the MREL maturity structure; and
- Requiring approval from competent authority only if a breach of the MREL requirement would occur as a result of the redemption of the instruments (as in TLAC term sheet).

These options should be further assessed, including whether flexibility should be retained with regard to internal MREL instruments, or whether an approval process is realistic in relation to large numbers of cases.

## 5.4 Relationship between MREL and NSFR

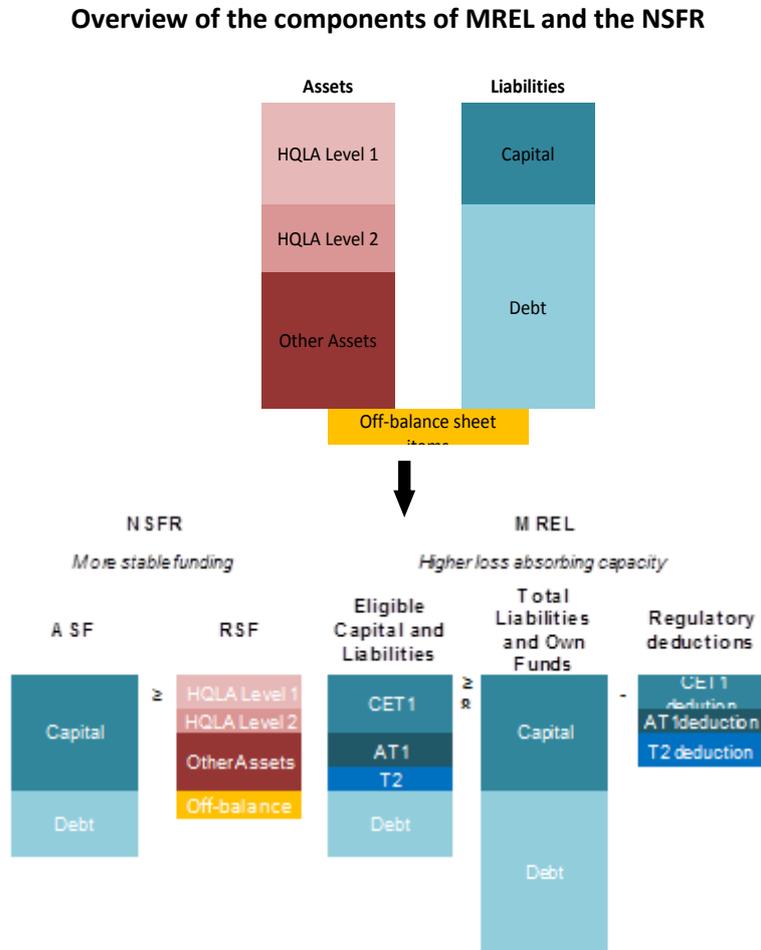
### Composition

The net stable funding ratio (NSFR) requires firms to match long term, illiquid assets with long term stable funding:

- Assets are weighted based on their liquidity to calculate a firm's required stable funding (RSF), and its liabilities are weighted based on their stability to calculate its available stable funding (ASF);
- A firm's NSFR is equal to  $ASF / RSF$ . This should be 100% or more.

The MREL ratio shares similarities with the NSFR numerator. Similar to the NSFR, MREL includes capital and debt in its calculation (see figure below).

Figure 10: Components of MREL and the NSFR



However, the scope of the eligible liabilities to be included in the calculation is stricter for MREL than for the NSFR:

- The ASF includes some liabilities with residual maturity below 1 year and some secured funding, while these types of liabilities are explicitly excluded from the MREL numerator. These instruments with maturity below 1 year are subject to varying weightings within the NSFR calculation depending on the type of instrument and the respective maturity. The MREL framework does not include any liabilities with a maturity less than 1 year and in this regard treats these liabilities equally.
- In addition, term deposits are considered key components of the ASF while they are not included in MREL if covered by the DGS.

## Interaction

MREL and the NSFR are complementary – both encourage firms to use more long-term funding. Liabilities eligible for MREL (equity and debt with > 1 year maturity) all receive a 100% weight under the NSFR.

- In normal times: MREL and NSFR are mutually reinforcing and banks can also issue liabilities which aid in meeting both the NSFR and MREL/TLAC. However, it should be noted that it is possible for a bank to improve its NSFR, while not improving its MREL ratio by increasing the instruments which are non-eligible under MREL but considered as stable funding, e.g. covered term deposits and/or by substituting illiquid assets with liquid assets.
- In financial stress: having MREL liabilities helps to maintain NSFR in financial stress. Nevertheless there are no explicit consequences mentioned in Basel III on what a breach of NSFR implies.
- Once bail-in is implemented: the liabilities that were converted into equity still help to meet the NSFR. As equity also receives a 100% weighting, converting long-term debt to equity in bail-in would not in itself affect a firm's NSFR. Bailing-in short-term liabilities might improve the NSFR although any write-down (to absorb losses) would negatively affect the NSFR.

Both MREL and the NSFR are expected to be met on an ongoing basis (as per recommendation 11 of the EBA report on the NSFR).

Following a resolution there may need to be a period of flexibility in how the NSFR is enforced in order to allow the bank to restore its market access and liquidity position and to rebuild MREL, whilst at the same time ensuring that the conditions for authorisation and market confidence in the firm are maintained.

### **Provisional recommendation**

The EBA's provisional view is that interactions between MREL and the NSFR do not give rise to any need for policy change.

## 6. Eligibility criteria for MREL

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### 6.1 Subordination and compliance with the No Creditor Worse Off (NCWO) safeguard

One of the elements to take into account when revising the MREL framework with a view to implementing the TLAC standard is the requirement that TLAC instruments should be subordinated to operational liabilities. This section discusses the rationale for subordination in support of loss-absorbing capacity, the various approaches available for such subordination, the cost of subordination requirements as well as recommendations.

#### **6.1.1 Rationale for subordination: ensuring continuity in critical functions and avoiding risks of breach of the NCWO principle**

To make resolution credible, it must be ensured that the legal and operational structure of the bank or the banking group continues to support critical functions and critical shared services under the chosen resolution strategy. This objective could be significantly hindered if certain operational liabilities are affected by the resolution action.

In order to avoid this consequence, Article 44(2) and (3) of the BRRD provide for exclusions to bail-in where such exclusions will, inter alia, ensure the continuity of critical functions. Nevertheless these exemptions are not a panacea for at least two reasons.

First, it is essential that there remains sufficient bail-inable resources available to ensure the funding of resolution, and this is why resolution authorities are required, when determining MREL, to factor in any anticipated exclusion from bail-in of certain otherwise eligible liabilities (Article 45(6)(b) of the BRRD).

Second, where bail-in exclusions are applied to certain operational liabilities essential to the continuity of critical functions, those liabilities that are not excluded and which rank *pari passu* with the excluded liabilities are at risk of breaching the NCWO principle. The BRRD and SRMR require that creditors are not treated less favourably in resolution than they would have been in insolvency. They provide creditors with a right to compensation, paid from the resolution fund, if they are treated less favourably. Given the NCWO principle, which derives from the fundamental right to property, if the authorities fully write-down senior bondholders in bank resolution while excluding certain operational liabilities with which they rank *pari passu* in insolvency because of exclusions set out in Article 44(2) and 44 (3) of the BRRD, bondholders may assert that they would have received better treatment in liquidation. In order to avoid this outcome, Article 44(4) of the BRRD provides the possibility for the resolution fund to make a contribution to the institution under resolution in lieu of the losses which should have been borne by creditors who have been excluded from bail-in. However, such a contribution is possible only if the shareholders and creditors of the institution have made a contribution to loss absorbency and recapitalisation of 8% of the TLOF of the institution. Depending on the funding structure of the bank, this may not be

possible without operating liabilities bearing losses, or may not be possible at all if the bank is predominantly funded by liabilities excluded from bail-in (e.g. secured liabilities or covered deposits). Resolution authorities therefore need to consider the risk of breaching the NCWO safeguard in their resolution planning and MREL decisions. Under Article 3(3) of the RTS on MREL, resolution authorities are required to assess the risk of a breach when the resolution plan envisages that a significant part (> 10%) of any insolvency class of creditors would be excluded from bail-in (or loss absorbency under another resolution strategy).

One way to reduce the risk of a breach of NCWO is to ensure that the creditor hierarchy in insolvency is aligned with the likely treatment of creditors in resolution. Concretely, if the liabilities which can most credibly contribute to loss absorbency (term senior unsecured debt) are subordinated to operating liabilities, then the risk of such a breach is likely to be significantly reduced because they would also have borne losses first in liquidation.

Subordination has other benefits. First, the possibility to write-down or convert in full non-operational liabilities first without having to consider exclusion may increase the speed of action of resolution authorities 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 as clearly most loss-absorbing by investors. This is likely to increase market discipline, and incentivise better risk diversification. Clarity over loss absorption should also reduce the risk of market-wide pricing shocks when a resolution actually occurs.

### **6.1.2 Current approach to subordination: TLAC, BRRD and national approaches TLAC rules and exemptions**

In response to the risks described above, a subordination requirement has been included in the TLAC standard for all G-SIBs.

The TLAC standard (applicable to G-SIBs) requires that resources eligible for TLAC be subordinated to liabilities that are specifically excluded from TLAC, such as sight deposits or liabilities arising from derivatives.

The TLAC standard provides for two exemptions to this requirement:

- subordination is not required where the amount of excluded liabilities ranking alongside the TLAC concerned does not exceed a *de minimis* amount of 5% of eligible TLAC resources;
- In addition, in jurisdictions where the resolution authority may under exceptional circumstances, exclude from bail-in liabilities excluded from TLAC as per Section 10 of the term sheet, the resolution authority may opt to allow the equivalent of up to 3.5% of RWA (2.5% of RWA before 2022) resources which rank alongside excluded liabilities to count towards TLAC. This is provided that those resources would otherwise be eligible for TLAC, and would absorb losses prior to excluded liabilities in resolution without giving rise to a material risk of a successful legal challenge or valid compensation claims. Authorities must ensure that this is transparent to creditors.

These exemptions are mutually exclusive – i.e. only one may apply to an institution at any one time. If an institution meets the *de minimis* condition, all of its non-excluded liabilities may qualify for TLAC without being subordinated. If it does not, only a limited portion of its non-excluded liabilities may qualify.

### **BRRD framework**

In contrast to the TLAC standard, pursuant to the BRRD framework resolution authorities are empowered to decide on a case-by-case basis, within the context of their powers to address or remove impediments to resolvability, whether MREL-eligible debt should be subordinated or not, and how this should occur.

Indeed, additional subordination requirements may not be necessary for all firms or resolution strategies. For example, where there is a credible, feasible resolution strategy which involves exposing equally to loss all senior liabilities, including non-preferred deposits, there should be no need for any additional subordination beyond that required by the BRRD depositor preference provisions. An example of such a strategy is where the resolution authority plans to transfer only preferred and covered deposits, leaving behind senior liabilities in insolvency. MREL is still aimed at ensuring that the assets transferred exceed transferred liabilities, but in this scenario MREL-eligible instruments may not need to be further subordinated to other senior liabilities in order for the insolvency creditor hierarchy and resolution creditor hierarchies to be aligned.

### **Member States initiatives on subordination**

Subordination may be implemented through three different legal methods:

- statutory subordination where MREL instruments rank junior to operational liabilities in the statutory creditor hierarchy;
- contractual subordination whereby MREL instruments are subordinated, as a result of their own contractual terms, to operational liabilities in the creditor hierarchy;
- structural subordination whereby MREL is issued by an entity (for example, a holding company) which does not have operational liabilities on its balance sheet that rank *pari passu* or junior to MREL-eligible instruments. Proceeds of those instruments are then down-streamed into a subsidiary as intragroup debt subordinated to operational liabilities in the subsidiary.

Several Member States have taken early policy initiatives on subordination to improve the resolvability of their banks and assist in compliance with the FSB's TLAC standard:

#### **▪ France**

The French approach consists in the creation of a new asset class 'senior un-preferred' debt that French banks may issue to meet TLAC/MREL requirements. These securities will rank between subordinated debt and preferred senior unsecured debt and will need to have a maturity of more than 1 year. When issued, these 'senior un-preferred debt' instruments will need to explicitly refer to the 'un-preferred' ranking in their terms and conditions. The

modification of the ranking of claims is not retroactive; the current stock of senior unsecured debt will not be affected by the changes and will carry 'preferred' status.

- **Germany**

Germany has changed the seniority of debt instruments in insolvency for CRR institutions. As of 1 January 2017, in insolvency as well as in resolution proceedings, shareholders will continue to absorb losses first, followed by existing subordinated creditors (including holders of regulatory capital instruments). However, within the class of ordinary creditors, holders of unsecured debt securities and other plain vanilla debt instruments will absorb losses before other ordinary creditors (such as derivative creditors). The new law therefore creates a new subordinated sub-class within the class of ordinary creditors. The law includes in this new sub-class an exhaustive list of unsecured debt instruments (bearer bonds, registered bonds, and transferable loans) which must meet a number of criteria, and will have retroactive effect.

- **Greece**

Greece has changed the seniority of debt instruments in insolvency for CRR institutions. This changed ranking in insolvency will apply also in resolution. In particular, according to the new law, a) all depositors now have a preferred status with three levels of seniority: covered deposits, eligible deposits of SMEs and physical persons above the coverage limit, and remaining deposits; and b) all senior unsecured debt is now subordinated to all other eligible liabilities.

- **Italy**

The Italian law implementing the BRRD extends depositor preference beyond the categories provided for under Article 108 of the BRRD, layering them through three levels of seniority: covered deposits, eligible deposits (the balance of deposits held by SMEs and natural persons above the EUR 100,000 limit), and all remaining deposits. In contrast to the German approach, uninsured deposits are preferred to senior bonds but senior debt ranks *pari passu* with other residual senior liabilities (e.g. contractual unsecured) loans as well as with derivatives (where these are not fully collateralised) and structured notes.

- **United Kingdom**

For the purposes of enhancing resolvability, the UK has encouraged major banks to issue new senior unsecured debt from non-operating holding companies, rather than from the operating legal entities which are CRR credit institutions. This has the effect of ensuring 'structural subordination' of these liabilities. Indeed their holders only have a direct claim on the value of the assets of the holding company, including its equity holding in the operating entity, which is therefore junior to the claim of direct creditors of the operating entity.

Much market commentary has focused on the difficulty for investors to understand the implications of these differences in approach and the possibility of the fragmentation of the European market for bank senior debt as a result. It is helpful here to distinguish between two aspects of these differences.

First, while subordination may be implemented through a number of different legal methods (statutory, e.g. Germany, Italy, France), contractual<sup>66</sup> or structural (e.g. UK), as long as the choice of legal method does not affect the probability of default or loss given default, in principle it should not affect the pricing of subordinated instruments. Early observations suggest that the impact on pricing of the German bank subordination law and the UK transition from operating to holding company debt have so far been of similar magnitude. The increase in the spread for the senior unsecured bonds of Deutsche Bank after the publication of the German draft law on subordination, and the increase in the spread for senior unsecured debt of the holding company of Barclays and RBS after the publication of the FSB proposal on TLAC, appear to have followed similar patterns in terms of the magnitude of the increase. However, this observation does not take into account other potential factors which might affect pricing, such as the relative size of TLAC issuance needs, or the potential impact on funding costs of a retroactive subordination of the stock of senior debt combined with a prohibition to issue further senior debt. Further monitoring and analysis of market pricing will be needed before drawing any definitive conclusion.

Second, differences in the resulting creditor hierarchy should in principle result in different loss given default expectations for otherwise similar instruments. It is too early to observe whether the impact of the German and Italian subordination laws will have significantly different impacts on pricing but in principle the lack of harmonisation of the creditor hierarchy is more likely to lead to fragmentation than the lack of harmonisation of the legal form of subordination.

However, a lack of understanding may impose its own costs: 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. Following the implementation of the BRRD, rating agencies and investors have an increasing need to analyse the effects of national insolvency law on their loss given default expectations. This adds complexity and uncertainty, given the limited harmonisation of insolvency law within the EU, which could lead to the emergence of a price premium. Further work by national resolution authorities, the EBA or other European authorities to improve standardised information provided on creditors' position in the insolvency hierarchy could help to mitigate this risk. A '*common approach to the bank creditor hierarchy*', as called for by the Council on 17 June 2016<sup>67</sup>, could also bring about improved clarity in this regard.

### 6.1.3 Current additional financing needs of EU banks assuming a subordination requirement

In order to estimate the potential impact of a subordination requirement in relation to MREL, an assumption has been made whereby the scope of instruments eligible for MREL would be limited to capital and subordinated debt only, as described in Figure .

<sup>66</sup> As an example contractual subordination is legally possible in Spain but is not being used, and no explicit decision on subordination has been taken.

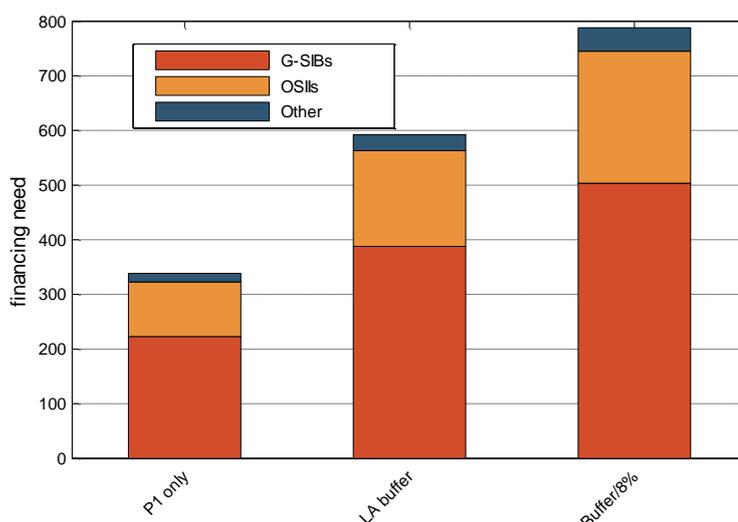
<sup>67</sup> [http://www.consilium.europa.eu/en/meetings/ecofin/2016/06/st10324\\_en16\\_pdf/](http://www.consilium.europa.eu/en/meetings/ecofin/2016/06/st10324_en16_pdf/)

Figure 11: Assumption regarding the scope of eligible liabilities and the MREL ratio

MREL numerator	Scope of MREL-eligible instruments	MREL ratio
Capital and subordinated debt only (OF + sub debt)	Regulatory capital + Total subordinated debt > 1 year	Capital and subordinated debt only / Total liabilities and own funds

Quantitative analysis of June 2015 data<sup>68</sup> suggests that, depending on different hypothetical scenarios described in chapter 3.3 to calibrate the MREL requirement, an additional loss-absorbing capacity in the range of EUR 340 billion to EUR 790 billion could be needed if senior unsecured debt was not included in the scope of MREL and an equivalent increase in junior debt instruments was required (see Figure ).

Figure 12: Additional financing need if senior unsecured debt were excluded from MREL-eligible instruments and had to be rolled-over into junior instruments



Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

However, the impact of this need should be nuanced and further assessed, in particular in relation to banks’ costs of funding and funding strategies. Depending on the form of the subordination requirement some of the additional needs could be met with a transformation of senior unsecured debt into ‘junior senior’ instruments, or with a gradual roll-over of maturing senior instruments into junior instruments over an appropriate transitional period.

As illustrated in Figure , G-SIBs and O-SIIs would account for more than 95% of the additional MREL capacity that would be required by introducing a subordination requirement. On the other hand, they are also currently large holders of the senior unsecured debt that would be rolled over and possibly transformed into subordinated instruments and could be relied on to absorb losses and contribute to recapitalisation, as necessary.

<sup>68</sup> EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

#### 6.1.4 Policy options

At this stage, a number of policy options are available in terms of scope as well as requirement.

In terms of requirement, the framework could:

- a) **Remain unchanged.** The risk of a NCWO challenge would continue to be dealt with by resolution authorities on a case by case basis when setting MREL by requiring action to address impediments to resolvability. As far as G-SIBs are concerned, this would not be consistent with the TLAC standard.
- b) **Specify subordination outcomes.** Legislation would require liabilities to be subordinated to certain other categories of liability in order to count towards MREL, without prescribing a specific subordination form (statutory, contractual or legal). To ensure consistency with the TLAC standard, liabilities would need to be subordinated to, at least, a) insured deposits, b) sight deposits and short term deposits of a maturity of less than 1 year, c) liabilities arising from derivatives, d) debt instruments with derivative linked features, such as structured notes, e) liabilities arising other than through a contract, such as tax liabilities, f) liabilities preferred to senior unsecured creditors, and g) any liabilities that are excluded from bail-in or cannot be written down or converted to equity by the relevant resolution authority without giving rise to material risk of successful legal challenge or valid compensation claims. Consistency with the TLAC standard would also imply implementing the exemptions to subordination as described above.
- c) **Specify a form of subordination.** Legislation would specify the legal form of subordination (statutory, contractual, or structural) as well as specified outcomes.

Under b) or c), the scope of firms to which the subordination requirement applies could be restricted to ensure proportionality. Any such restriction should however be drafted to ensure that resolution authorities retain the ability to ensure that the MREL requirement for any institution is consistent with its resolution strategy. Policy options for restricting the scope of subordination requirements include:

- i. Mandatory subordination for liabilities counted towards any MREL non-firm specific floor requirement (subject to the TLAC term sheet exemptions); resolution authorities may require subordination for liabilities to meet firm-specific MREL requirements;
- ii. Mandatory subordination when the preferred resolution strategy is bail-in; resolution authorities may require subordination in other cases.

In addition, disclosure and/or standardised classification of the creditor hierarchy status of instruments should be considered. Proposals to include additional disclosure on the creditor hierarchy are included in the Basel Committee's current consultation on changes to the Pillar 3 disclosure requirements. Additionally, Member States who participate in the Banking Union are required by the SRMR to report to the SRB their national insolvency creditor hierarchies. This

reporting obligation could form the basis of more standardised descriptions of national creditor hierarchies made available to investors. These issues will be considered in greater depth in the EBA's final report on MREL following the finalisation of the Basel Committee's proposed standards, alongside the related issue of whether additional regulatory reporting requirements for MREL are necessary.

### Provisional recommendation

The EBA's provisional view is that for at least some banks mandatory subordination of MREL-eligible liabilities would improve resolvability and contribute to clarity for investors. Subordination requirements introduced in Level 1 legislation should focus on establishing to which other liabilities MREL-qualifying liabilities need to be subordinated, rather than specifying the legal form (contractual, statutory or structural).

Regardless of whether additional subordination requirements are introduced, the EBA's provisional view is that relevant information should be available to bank creditors on banks' creditor hierarchies and the effects of national insolvency law.

*The EBA invites stakeholders to comment on the appropriate scope of any subordination requirements.*

*In addition, stakeholders are invited to comment on what the highest priority information and disclosure needs are, in the three areas of i) disclosure of bank balance sheet structures; ii) disclosure of banks' MREL requirements; and iii) availability of standardised information on statutory creditor hierarchies.*

## 6.2 Third country recognition of resolution powers

When setting MREL, the resolution authority must consider the risk of liabilities being excluded from bail-in at the point of resolution and, if it anticipates that some liabilities might be excluded, ensure that the institution has sufficient other eligible liabilities to meet loss absorption and recapitalisation needs<sup>69</sup>.

In particular, exclusions could concern certain liabilities governed by third country law for which it would not be possible to effect bail-in decisions and which consequently, as referred to under Article 44(3)(a), it would not be '*possible to bail-in ... within a reasonable time notwithstanding the good faith efforts of the resolution authority*'.

The legislator has aimed to reduce the likelihood of such a situation by requiring credit institutions to include contractual recognition clauses in contracts governed by the law of a third country under the conditions of Article 55 of the BRRD. It has also provided the resolution authority with the power, under Article 45(5) of the BRRD, to require institutions, when setting

<sup>69</sup> Article 45(6)(c) of the BRRD.

MREL, to provide an independent legal opinion demonstrating that any decision of the resolution authority to write-down or convert that liability would be effective under the law of that third country.

However, to date, credit institutions have reported facing many practical difficulties in including contractual recognition clauses. 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. CCP membership agreements). Resolution authorities' approach to addressing these practical difficulties may lead to the inconsistent implementation of Article 55. For example, the UK PRA permits firms to request a disapplication of the requirement for certain classes of liabilities (including trade finance, operational liabilities, and liabilities to financial market infrastructures) when it is impractical to comply<sup>70</sup>.

Therefore, while this issue is not specific to MREL, the MREL framework would benefit from a clarification of the regime under Article 55, which could be achieved by narrowing the scope of the requirement while maintaining the effectiveness of contractual recognition for MREL liabilities. Several policy approaches could be adopted to narrow the scope of the requirement in Article 55 while maintaining the effectiveness of contractual recognition for MREL liabilities:

- i. **Introduce additional exemptions**, in particular for CCP membership agreements, and defined categories of trade creditors.
- ii. **Introduce a power for resolution authorities to grant waivers from Article 55**, where this would not create an impediment to resolvability. This could be limited to liabilities which are either a) not eligible for MREL or b) not eligible for bail-in. Alternatively, clarify that penalties should only be applied by resolution authorities when failure to implement Article 55 constitutes an impediment to resolvability.
- iii. **Limit the scope of Article 55**. Under this option Article 55 would apply only to instruments which are eligible for MREL.

#### Provisional recommendation

The EBA's provisional view is that some reduction of the burden of compliance with third country recognition requirements is necessary. This could be achieved by narrowing the scope of the requirement while maintaining the effectiveness of contractual recognition for MREL liabilities.

*The EBA invites stakeholders to comment on the practical difficulties faced in implementing the recognition clauses, specifically in the field of the MREL, and on alternative approaches to improve the regime without creating incentives to evade the scope of bail-in.*

<sup>70</sup> <http://www.bankofengland.co.uk/pr/Document/authorisations/waiverscrr/modbyconbailin.pdf>

## 7. Calibration of the MREL requirement

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This section discusses essential issues relating to the calibration of the MREL requirement. It explores the option of introducing minimum levels of MREL (floors) as part of the proposal on the harmonised application of MREL and the interaction of such floors with firm-specific MREL requirements (7.1). Additional observations are made regarding the interaction of specific business models (7.2), as well as the ‘8% bail-in rule’ (7.3), with the calibration of MREL.

### 7.1 MREL floors and interaction with firm-specific requirements

The implementation of the TLAC term sheet, which suggests a hard floor for all G-SIBs, raises the issue of whether a minimum non-firm-specific requirement (or Pillar 1 MREL) should or could be introduced in the MREL framework, and if so how it should interact with the current firm-specific requirement.

#### 7.1.1 Calibration of MREL floors and resolution strategies

The MREL determination is closely linked with resolution planning. The resolution authority needs to be sufficiently confident that loss absorbency and recapitalisation needs can be met at the point in time an institution is declared failing or likely to fail. Therefore, ultimately, MREL needs to be sufficient to enable resolution authorities to deliver their responsibility to ensure the resolvability for each bank.

Against that background, options for a minimum MREL requirement are illustrated in the context of 4 specific examples capturing the main possible configurations.

- 1) Case 1: A small bank with no critical functions, for which liquidation under normal insolvency would achieve the resolution objectives.

In such a case, the base loss absorption amount calculated pursuant to the RTS on MREL will be equal to the supervisory capital requirements but may be adjusted upwards/downwards. No recapitalisation is anticipated<sup>71</sup>. As a result the loss absorption amount, based on the minimum capital requirements, acts as an effective “floor” for MREL for such banks and it would be difficult to define an alternative uniform floor above the capital requirements which would suit all such banks and situations.

- 2) Case 2: Less systemic bank, which would be partly resolved or sold with the residual part to be liquidated

In this case, it is assumed that only parts of the institution or certain of its functions are critical, and the resolution plan should determine the parts that are required to be continued. This is likely to mean that the institution’s critical functions at least will be kept running

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<sup>71</sup> Article 2(2) of the RTS on MREL.

(independently, or via sale to an interested purchaser), while other parts of the institution are liquidated.

Two options can be envisaged in terms of introducing an MREL floor in this type of situation:

*Option 1 – no change. No MREL floor (or a floor equal to capital requirement). Recapitalisation amount as needed to recapitalise the parts resolved/sold set by case-by-case determination.*

- Pros: Institutions will not be burdened with fulfilling MREL requirements which are, in the view of the resolution authority, not likely to be necessary. Possible to adapt depending on the specifics of the bank, for example the size or materiality of the critical parts that will be kept running, directly, or indirectly via a sale.
- Cons: Risk of insufficient MREL if separation of critical functions cannot be executed. This may require a wider bail-in, which could be detrimental for financial stability in particular if DGS-eligible non-covered deposits need to bear losses or be converted into equity, or the use of the resolution fund is required.

*Option 2 – floor including a recapitalisation part*

- Pros: Bail-in of non-MREL-eligible liabilities is less likely if the resolution plan needs to be changed to resolve a larger part of the bank than originally planned for.
- Cons: The individual situation of the institution is not taken into account and thus it may be excessively burdened with MREL requirements weighing on its profitability from a going concern perspective. It would be hard to find a floor which would suit all such banks and resolution scenarios.

### 3) Case 3: Systemically important bank that is not a G-SIB

This is the case where the institution is systemic and complex and it is assessed that it should be resolved as an open bank, (i.e., resolution losses are to be recognised and absorbed, and the bank recapitalised) to preserve financial stability, avoid market disruption and enable the bank to continue its provision of critical functions.

Again, in terms of introducing an MREL floor two options can be envisaged:

*Option 1 – no MREL floor (or a floor equal to capital requirement). Recapitalisation amount based on a case-by-case assessment whether the capital requirements have to be adjusted upwards/downwards depending on the resolvability assessment and the resolution planning process*

- Pros: Based on the case-by-case assessment the institution will have sufficient MREL requirements to be fully recapitalised to the extent anticipated in the resolution plan, in case its losses are equal to or less than its capital requirements. MREL can be closely interlinked with resolution planning for each bank.
- Cons: If the institution faces a loss of sufficient magnitude that would result in the existing MREL amounts within the bank not being sufficient, a bail-in of instruments other than MREL-eligible instruments is likely to be required. The availability of such bailed-in instruments outside MREL, as well as the credibility that they can be bailed-in in full or in part, can feed into the MREL determination.

*Option 2 – require an MREL floor for the loss absorption part with a recapitalisation part (e.g. with total calibration equal to the TLAC minimum requirement)*

- Pros: All systemic institutions would be subject to the same minimum MREL floor, ensuring that each institution will have sufficient MREL to be fully recapitalised in case its losses are equal to or less than its capital requirements. The resolution authority can adjust the MREL upwards (but not downwards) based on their case-by-case assessment as in option 1.
- Cons: MREL is less interlinked with the resolution planning for each bank – for example there would be no way to adjust MREL downward if, for example, there are a few non-material subsidiaries. This option may lead to an excessive burden for the individual institution, not justified by its recapitalisation needs in resolution. Additionally, this may be a risk particularly for D-SIBs in smaller Member States, which are considerably smaller and less complex than the G-SIBs for which the TLAC standard has been developed.

#### 4) Case 4 - GSIB bank which would undergo an open-bank resolution

This case is similar to case 3, option 2, with one difference: consistency with the TLAC term sheet implies that such institution should be subject to the TLAC floor.

### **7.1.2 Interaction between MREL floor ('Pillar 1') and firm-specific ('Pillar 2') MREL requirement**

Two lessons can be drawn from experience with Pillar 1 and Pillar 2 capital requirements under the CRR and CRD. First, in order to ensure the consistent implementation of MREL and the development of a stable market for MREL instruments, it is essential to be clear about the stacking order discussed in section 7.1.1 and calibration methodology. Second, it is also essential to be clear about the other interactions between any common floor requirement for MREL and additional firm-specific MREL requirements.

The principles underlying the current assessment methodology set out in the RTS on MREL provide an appropriate basis for calibration of firm-specific Pillar 2 requirements in addition to any Pillar 1 floor based on the resolution strategy. The RTS on MREL set out a methodology based on a two-part determination of a loss absorption amount and a recapitalisation amount, with the possibility for adjustments to be applied to the total amount assessed as necessary. The loss absorption amount determination is largely driven by the capital requirements (both floor and firm-specific) applied by the relevant competent authority. The main choices for the resolution authority therefore relate to the determination of the recapitalisation amount needed to implement the resolution strategy. This methodology has been elaborated based on extended discussion and consultation and therefore maintaining it would have the advantage of ensuring stability of policy.

Applying the RTS on MREL methodology would lead to making an independent assessment of the firm-specific MREL requirement without reference to the floor requirement. The final MREL requirement would then be the higher of the amount determined by this assessment and the

MREL floor. See also the discussion below on options for the simplification of the RTS on MREL if changes are made to the Level 1 framework.

Such an approach would also ensure that a consistent methodology would be applied both to institutions subject to the MREL floor and to those outside its scope, avoiding the introduction of a ‘cliff’ in MREL requirements for institutions which fall just below the level of systemic importance which required to be subject to the MREL floor.

## 7.2 Calibration of MREL for banks by business model

Resolution authorities are responsible for developing resolution plans and setting MREL at a level that enables the credible delivery of the resolution strategy. Therefore, the calibration of MREL must be closely linked to and justified by the resolution strategy while business models should not predetermine mechanically a given MREL calibration which would be inconsistent with the resolution strategy.

This conclusion is consistent with the preliminary views expressed by resolution authorities in the qualitative survey of MREL: they show a preference for MREL calibration focused on resolution strategies and the systemic importance of institutions rather than business models per se.

Nevertheless, pursuant to the relevant RTS, resolution plans will have to contain a preferred resolution strategy ‘capable of best achieving the resolution objectives given the structure and the business model of the institution or group’<sup>72</sup>. Therefore, business models are worth considering when calibrating MREL, to the extent they correspond to differences in resolution strategies and in the cost of complying with a given MREL requirement (most likely associated with particular funding structures). For example, in the UK’s proposed approach to setting MREL<sup>73</sup>, different calibrations are foreseen in relation to different resolution strategies, but those strategies are dictated by indicative thresholds not only in terms of size but also in terms of number of transactional deposit accounts.

The results of the qualitative survey of resolution authorities (see section 2) show particular concern with regard to the setting of MREL for small and medium-sized institutions which are predominantly funded through deposits. For these institutions, the current ratio of MREL-eligible liabilities (see Figure ) is on average slightly lower, and in some cases their access to securities markets, domestically or on a cross-border basis, is perceived as limited (see findings 9 and 10 of qualitative survey results). There is some scepticism that deposits can be relied upon as a source of loss-absorbing capacity, first because the volumes of deposits not covered by a DGS guarantee

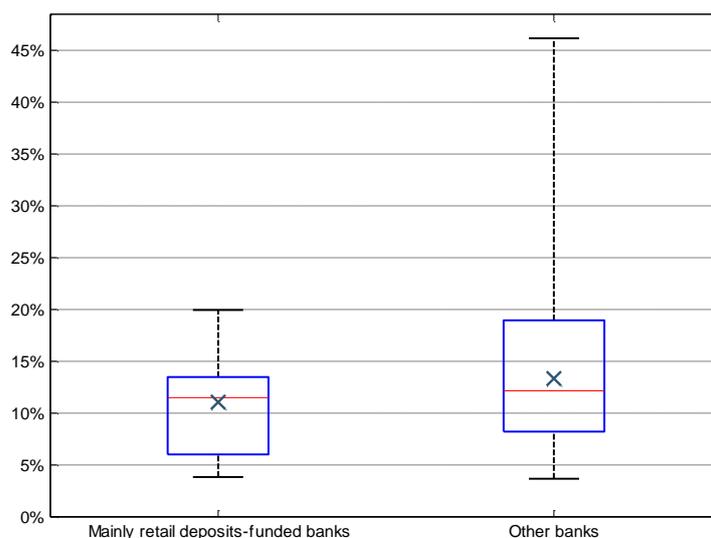
<sup>72</sup> Commission delegated regulation of 23.03.2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the content of recovery plans, resolution plans and group resolution plans, etc., not yet published. Available on the Commission website [http://ec.europa.eu/finance/bank/crisis\\_management/index\\_en.htm](http://ec.europa.eu/finance/bank/crisis_management/index_en.htm)

<sup>73</sup> Bank of England (2015). *The Bank of England’s approach to setting a minimum requirement for own funds and eligible liabilities (MREL)*, available at <http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf>

or creditor preference are limited<sup>74</sup>, and second because of the risks of systemic contagion or bank runs in case of losses to depositors.

At the same time, a high degree of deposit funding, at least for institutions of a certain size, is a factor in determining systemic importance, since the protection of covered deposits is one of the main resolution objectives and a high share of covered deposits, everything else being equal, increases the likelihood of the public interest test being met in case of failure.

**Figure 13: MREL ratio of retail deposit-funded banks vs other banks (threshold at 40% of total liabilities)**



Source: EBA QIS data (June 2015). Cf. definitions of options in section 3.3.

The analysis of the banks in the sample shows that the average and extreme MREL ratios as well as the interquartile range are lower for predominantly retail deposit-funded banks than for others. However, the median MREL ratio of deposit-funded banks is almost equal to that of non-retail deposit-funded banks (12% and 13% respectively).

In this regard, a number of observations can be made.

First, the impact of MREL on predominantly deposit-funded institutions for which the strategy is liquidation will be very limited, since MREL will not be calibrated with a view to recapitalising any part of the business and will in most cases be equal to the own funds requirement.

Second, for some other predominantly deposit-funded institutions for which resolution would be the preferred strategy, if there are genuine difficulties in accessing debt markets this may admittedly create obstacles to the build-up of MREL capacity. For those banks, various options could be considered by resolution authorities and policy makers. For example, a longer

<sup>74</sup> Deposits are eligible for MREL only if they have an outstanding maturity of more than a year, which excludes sight deposits and term deposits with outstanding maturity below 1 year. Additionally, since Article 12(1) excludes preferred liabilities from the scope of MREL, covered deposits up to EUR 100,000, as well as deposits of SMEs and natural persons above EUR 100,000, are excluded. This leaves mainly interbank deposits above 1 year and deposits from large enterprises above 1 year.

transitional period could be explored to phase-in MREL requirements in parallel with policy initiatives to improve access to debt markets provided these are credible, for example in the context of the Capital Markets Union. Cross-border access to debt markets for small to medium-sized banks could thus be added as an indicator of the European Financial Stability and Integration Review.

Third, the potential contribution of DGSs is likely to play a greater role in the analysis with regard to deposit intensive institutions insofar as the DGS would assume losses in lieu of covered depositors. The potential for a DGS contribution should be carefully assessed taking into account the requirements under Article 109 of the BRRD, Article 10 of the DGSD, as well as the actual funding capacity of a DGS at a given point in time. A clarification of the current rules on DGS contributions would be useful, including the modalities and extent to which a DGS making payments in resolution is entitled to recoup its costs (as per Article 9(2) of the DGSD) without raising NCWO concerns for other creditors, and the modalities of funding recapitalisation given that the DGS cannot be required to make any contribution towards recapitalisation costs as per Article 109(1) last indent of the BRRD.

Finally, the application of measures to remove impediments to liquidation, as well as resolution, may allow reduced MREL requirements for some such banks.

#### **Provisional recommendation**

The EBA provisionally recommends 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 they translate into differences in resolution strategies.

The EBA provisionally recommends that the current MREL assessment framework (under Article 45 of the BRRD and the RTS on MREL) 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 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.

### **7.3 Minimum bail-in rule to access resolution funds**

Resolution funds can make a contribution to an institution under resolution only where, among other conditions, shareholders and creditors have made a contribution of at least 8% of TLOF<sup>75</sup> or 20% of RWA<sup>76</sup> to loss absorption and recapitalisation (the 'threshold').

The BRRD does not establish a mandatory relationship between MREL and the threshold. They are separate requirements with different purposes. The threshold will become relevant for the resolution of banks only if the resolution fund is to be used, while MREL should be determined on the basis of *'the need to ensure that the institution can be resolved by the application of the*

<sup>75</sup> Article 44(5) of the BRRD

<sup>76</sup> Under the conditions of Article 44(8) of the BRRD.

*resolution tools, including, where appropriate, the bail-in tool, in a way that meets the resolution objectives*<sup>77</sup>. Both mechanisms also have a different scope, as liabilities eligible for bail-in are more broadly defined than liabilities eligible for MREL

A fair assessment of the criterion for setting MREL relating to *“the need to ensure that an institution can be resolved [...] in a way that meets the resolution objectives”* will require the resolution authority to consider whether the institution’s internal resources may not be sufficient and whether resolution financing arrangements might therefore need to be accessed. This assessment will be part of the determination of MREL but also more generally part of the development of the resolution plan, which must include an explanation of how the resolution options could be financed<sup>78</sup>. The protection of *‘public funds, minimising reliance on extraordinary public financial support’* is one of the resolution objectives set out in Article 31(1)(c) of the BRRD.

In particular the fact that an institution is of systemic significance and its disorderly failure would be likely to have adverse effects on financial stability will support the conclusion that the resolution fund might need to be accessed in order to resolve it. Article 45(6)(f) of the BRRD establishes such adverse effects on financial stability as one of the criteria on which resolution authorities have to base the determination of MREL.

Resolution funds have been established in order to provide financing to resolution in the exceptional circumstances where a resolution scheme cannot be executed using only the financial resources of the failing institution (i.e. MREL and other liabilities that are bail-inable in full or in parts), and failure to execute the scheme would threaten financial stability or other resolution objectives. The burden-sharing requirement that shareholders and creditors should make a contribution to loss absorption and recapitalisation of no less than 8% of TLOF or 20% of RWA before the resolution fund may be used for certain purposes, as established by Article 44(5) of the BRRD, represents an important constraint on the actions of resolution authorities. It is therefore necessary to take account of this constraint when assessing the criteria, laid down in Article 45(6)(a) of the BRRD, relating to the ability to apply the resolution tools in a way that meets the resolution objectives in the case of those systemically important institutions for whom Article 45(6)(f) of the BRRD is relevant. The assessment of the 8% / 20% burden-sharing requirement has to be made taking into account all liabilities eligible (in full or in part) for bail-in, not only MREL-eligible instruments.

In contrast, applying the threshold on an indiscriminate basis as a mandatory floor for MREL for a large set of banks would be costly, and might in some cases impose a higher MREL than the minimum TLAC requirement applicable to the G-SIBs. Therefore the MREL level is to be assessed by the authorities on a case-by-case basis as it is closely interlinked with the resolution strategy for each bank. MREL should be set to what is assessed as needed to achieve the resolution objectives, and the final MREL set may be above or below 8% TLOF or 20% RWA, depending on the circumstances.

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<sup>77</sup> Article 45(6)(a) of the BRRD.

<sup>78</sup> Article 10(7)(i) of the BRRD.

## 7.4 Options for simplification of the RTS on MREL if the Level 1 text is amended

Changes introduced to the Level 1 framework for MREL in the areas covered by this section may require consequential updates to the RTS on MREL.

### Assumptions

This section is based on a number of assumptions that would need to be confirmed before any options for simplification / clarification of the RTS on MREL can be finalised.

This section assumes that the current RTS on MREL framework remains fully applicable to banks that will face neither an MREL floor nor a subordination requirement. These will likely be medium-sized banks (non G-SIBs and potentially non D-SIBs). The RTS on MREL will need to be adapted for G-SIBs and potentially D-SIBs where an MREL floor and/or subordination requirement is applicable.

It also assumes that double-counting of CET1 for both going-concern buffer requirements and gone-concern MREL requirements would be eliminated, as discussed in section 5.1.

### Introduction of a floor for some institutions

The introduction of a floor would impact Articles 1, 2 and 4 of the RTS on MREL:

- Article 1: Determining the amount necessary to ensure loss absorption
- Article 4: Business model, funding model and risk profile

If an MREL floor were to be implemented in the BRRD, the RTS on MREL would need to refer to a floor equal to the higher of 16% RWA or 6% of the leverage ratio denominator as from 1 January 2019 and the higher of 18% RWA or 6.75% of the leverage ratio denominator as from 1 January 2022, for institutions within the scope of these requirements

Article 1 could be amended such that resolution authorities will need to decide whether the going concern requirements (Pillar 1, Pillar 2 and buffers) are sufficient for loss absorption. If they are sufficient, then there should be no adjustment to the loss absorption amount of the floor or firm-specific requirements (this should be the default option). If not, then resolution authorities will need to adjust the loss absorption amount of the floor and firm-specific MREL upwards.

Article 4 could be amended to further specify whether the recapitalisation amount should ensure compliance with only Pillar 1 capital requirements or potentially also Pillar 2 and buffers.

The BRRD and the RTS on MREL require resolution authorities to take into account the risk of exclusions from bail-in and the need for the resolution of the institution to be credible and feasible. The introduction of a subordination requirement for MREL would imply a need to revise Article 3 of the RTS on MREL (Exclusions from bail-in or partial transfer which are an impediment to resolvability), and allow for the simplification of this article.

## 8. Intragroup issues

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A mechanism for loss allocation within banking groups is crucial to facilitate resolution. This chapter provides a preliminary discussion of intragroup and home/host issues which may arise in applying the MREL provisions of the BRRD and the RTS on MREL. The EBA report is required to assess three main areas in relation to intragroup issues: (i) whether the approach of Article 45 of the BRRD to the application of MREL to groups is appropriate, and in particular whether the approach adequately ensures that loss-absorbing capacity in the group is located in, or accessible to entities that need it; (ii) whether the conditions for waivers from the minimum requirements are appropriate, and in particular whether such waivers should be available for subsidiaries on a cross-border basis; and (iii) whether the current EU requirements are consistent with the international standards developed by the FSB. Given that policy approaches to the implementation of intragroup MREL requirements have not yet been developed in depth by resolution authorities, this section does not contain recommendations and a fuller discussion of these issues will be included in the EBA's final report.

This chapter is structured in three parts: after recalling the goal of an internal MREL framework, it analyses the different options in terms of allocation, calibration, and eligibility.

### 8.1 Goals of a framework for setting MREL requirements below consolidated level

**An internal MREL framework aims at ensuring adequate loss allocation within banking groups.** Resolution entities, to which resolution tools are expected to be applied, issue MREL-eligible liabilities to external parties (external MREL). All or part of the proceeds from this issuance is then down-streamed to subsidiaries, matched by equity or debt issued back to the resolution entity as 'internal' MREL resources.

These internal MREL resources provide a mechanism to pass losses from operating subsidiaries (where losses arise and which undertake critical functions) to the resolution entity which facilitates orderly resolution. As a result the resolution entity can be placed into resolution without significant disruption to the critical economic functions located in the subsidiaries.

**This mechanism is important both for banks with single point of entry (SPE) resolution strategies and banks with multiple point of entry (MPE) resolution strategies.** The BRRD provides for both MPE and SPE strategies. However, when choosing either type of strategy, the resolution authority must ensure that a subsidiary can upstream its losses to its resolution entity while the latter can downstream capital to the former to enable recapitalisation.

The BRRD currently leaves it to the resolution authority to decide on the resolution strategy and therefore on which mechanism is the most appropriate to upstream losses, subject to the requirement to set MREL for individual entities. According to recital 80 of the BRRD *'it is imperative that loss-absorbing capacity is located in, or accessible to, the legal person within the group in which losses occur'*. To that end, resolution authorities should ensure that loss-absorbing

capacity within a group is distributed across the group in accordance with the requirements of its different entities and its resolution strategy (see also the RTS on Resolution Planning<sup>79</sup>).

The FSB TLAC standard introduces an explicit requirement of internal loss-absorbing capacity, called internal TLAC, for G-SIBs. In the FSB TLAC term sheet, a significant part of the loss-absorbing capacity issued at the level of the G-SIB's resolution entity in the home jurisdiction must be committed to the G-SIB's material subsidiaries in the host jurisdiction. The resolution entity should generally act as a source of loss-absorbing capacity for its material subgroups that are not resolution entities. Accordingly, the latter are subject to an internal TLAC requirement of 75% to 90% of the external minimum TLAC requirement that would apply to the material subgroup if it were a resolution group.

## 8.2 Allocation and calibration of internal MREL

Additional requirements for the calibration of MREL requirements at levels below the consolidated group would be necessary to transpose the internal TLAC requirements of the FSB TLAC term sheet into EU law. There are at least three options for the extent of the changes required.

- The first, minimal, option is to transpose these requirements only for EU material subgroups from third country G-SIBs. Similar requirements would be expected to apply to material subgroups of EU G-SIB groups that are licensed in third countries, most likely through local requirements<sup>80</sup> (option 1).

In terms of calibration, the FSB TLAC term sheet requires each material subgroup to keep a level of internal TLAC between 75% and 90% of the external TLAC requirement which would have applied if the material subgroup were a resolution group. This means that the hypothetical external TLAC requirement needs to be determined – in principle this may require estimating a hypothetical firm-specific requirement for this entity.

For entities and subgroups within the EU, the existing framework of joint decisions within resolution colleges with the possibility of EBA mediation could be retained. While the BRRD does not explicitly provide for internal arrangements regarding loss-absorbing capacity, it already proposes a similar framework that could be adapted to meet internal MREL objectives. It requires each institution to meet its own MREL at a solo level and consolidated level, regardless of their materiality, such that each entity is able to absorb losses and can be recapitalised. Resolution authorities responsible for the different entities of the group should strive to reach consensus on a joint decision on MREL at both levels within resolution colleges. If consensus is not reached, EBA binding mediation can be activated. Note that in a

<sup>79</sup> Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the content of recovery plans, resolution plans and group resolution plans, the minimum criteria that the competent authority is to assess as regards recovery plans and group recovery plans, the conditions for group financial support, the requirements for independent valuers, the contractual recognition of write-down and conversion powers, the procedures and contents of notification requirements and of notice of suspension and the operational functioning of the resolution colleges. Available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1468851110997&uri=CELEX:32016R1075>.

<sup>80</sup> This is the option contemplated in the US, cf. <https://www.federalregister.gov/articles/2015/11/30/2015-29740/total-loss-absorbing-capacity-long-term-debt-and-clean-holding-company-requirements-for-systemically#h-14>.

similar fashion, the TLAC term sheet allows crisis management groups (CMGs) to agree that a given subsidiary is critical and should have internal TLAC despite it not meeting the quantitative thresholds for materiality.

- The second option is a broader approach which would introduce a regime with mandatory internal MREL calibration requirements for all or some groups subject to MREL, which applies to subgroups both inside and outside the EU.

For G-SIBs the range of calibration (between 75% and 90%) would be determined depending on the importance of the material subgroup for the bank and the jurisdiction and also taking into account the possible risk of breaching the NCWO safeguard. For non-material subsidiaries, resolution authorities should have the discretion to require an appropriate level of internal MREL, both in terms of amount and composition.

- A third, intermediate, option would build on option 1 by further developing the framework for resolution college decision making on internal MREL requirements. Providing more explicit guidance on the factors to consider in calibration decisions and/or on presumptive ranges for internal MREL requirements could facilitate agreement within resolution colleges and EBA binding mediation decisions.

## 8.3 Eligibility requirements for internal MREL

Eligibility requirements for internal MREL resources may need to be different from those for externally issued MREL, because of the different role they play in a resolution. Three specific issues that should be considered are i) subordination to align the creditor hierarchies in insolvency and resolution, ii) intragroup guarantees, with appropriate safeguards, as an alternative to prepositioning for groups operating within the EU, and iii) the triggers for write-down or conversion

### 8.3.1 Subordination

Absent a subordination requirement for internal MREL, internal MREL instrument would absorb losses or be converted at the same time as other similarly ranked operational liabilities. This creates the risk of disrupting the critical economic functions provided by the subsidiary. In addition, the conversion of external instruments at the same time as internal MREL may affect the group structure, which may be problematic where an SPE strategy has been selected.

This need for subordination is recognised in the internal TLAC term sheet. In contrast, the current criteria on MREL eligibility do not systematically require subordination. Pursuant to Article 45(13) of the BRRD, resolution authorities may require that part of the MREL requirement is satisfied with contractually subordinated liabilities. As a result, not all internally issued MREL instruments may be subordinated.

### 8.3.2 Guarantees

The TLAC term sheet foresees that home and host authorities may jointly agree to substitute on-balance sheet internal TLAC with internal TLAC in the form of collateralised guarantees<sup>81</sup>, provided that the guarantee is granted for at least the equivalent amount as the internal TLAC for which it substitutes, and that the entity is able to demonstrate that the guarantee would allow upstreaming of losses efficiently to the resolution entity. Authorities should carefully assess if there is a risk that the collateral may no longer be available to the material subgroup, for instance if the resolution entity is in resolution. Elements that could contribute to decreasing this risk are related to contractual terms and the legal framework (if the guarantee is legally binding in the home authority's jurisdiction), operational execution (e.g. whether the material subgroup should be the one which issues the order of execution) or location of the collateral. Eligible collateral should be of high quality (highly liquid and easily marketable instruments).

In the current BRRD framework, collateralised guarantees would not meet the MREL eligibility criteria specified in Article 45(4) of the BRRD, in particular condition (a) which requires MREL-eligible instruments to be issued and fully paid up. However, the RTS on MREL acknowledges the possibility for resolution authorities to take account of capital resources available in other group entities when calibrating MREL requirements for individual entities or subgroups<sup>82</sup>.

These collateralised guarantees may come on top of pre-funded pre-positioned instruments which are required to support the effective implementation of the preferred resolution strategy and to respect the NCWO safeguard.

### 8.3.3 Triggers for write-down and conversion

Section 19 of the TLAC term sheet provides that internal TLAC instruments must be subject to write-down and/or conversion by the host resolution authority at the point of non-viability of the subsidiary, without the entry of the subsidiary into formal resolution. Write-down or conversion should be subject to the consent of the home authority. This is to ensure orderly resolution by applying resolution tools only to the resolution entity. If instruments are subscribed by the resolution entity and down-streamed as internal MREL this provides a credible mechanism to pass losses to the resolution entity.

Such a statutory mechanism is not currently available under the existing EU legal framework. The powers in Article 59 of the BRRD allow the conversion or write-down, at the subsidiary level, of capital instruments that are recognised for the purposes of meeting own funds requirements on an individual and on a consolidated basis, for entities which are deemed not to be viable but without entering resolution and provided property rights are respected.<sup>83</sup> However Article 59 of

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<sup>81</sup> Point 19 of the term sheet.

<sup>82</sup> Article 2(10) of the RTS on MREL.

<sup>83</sup> According to the BRRD, the authorities have the power to convert/write-down AT1/T2 instruments issued at the level of subsidiaries, without requiring that a resolution action is taken (Article 59.1 BRRD). Such write-down or conversion can be done if those instruments are recognised for the purposes of meeting own funds requirements on an individual and on a consolidated basis.

the BRRD does not apply to eligible liabilities which are not capital instruments, and it can be applied only if the issuing entity<sup>84</sup> is deemed non-viable.

Therefore, either a requirement to include contractual provisions allowing write-down or conversion of internal MREL instruments, or an extension of the scope of the Article 59 power to all internal MREL instruments, should be considered.

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<sup>84</sup> Or, potentially, in limited circumstances the consolidated group.

# Annex 1: BRRD Mandate for a report on MREL

<b>Items to be covered by the EBA MREL Report as per Articles 45(19) and (20) of the BRRD</b>	
BRRD Article	Item
<b>Implementation of MREL, including transitional arrangements, identifying divergences in the levels set for comparable institutions and the use of contractual bail-in instruments</b>	
45(19)(a)	how the minimum requirement for own funds and eligible liabilities has been implemented at national level, and in particular whether there have been divergences in the levels set for comparable institutions across Member States;
45(19)(b)	how the power to require institutions to meet the minimum requirement through contractual bail-in instruments has been applied across Member States and whether there have been divergences in those approaches;
45(20)(vi)	prevalence of contractual bail-in instruments, and the nature and marketability of such instruments;
<b>Impact on different business models, including identification of these models, the impact of MREL on them, and discussion of the appropriate MREL for each</b>	
45(19)(c)	identification of business models that reflect the overall risk profiles of the institution;
45(19)(d)	appropriate level of the minimum requirement for each of the business models identified
45(19)(d)	whether a range for the level of the minimum requirement of each business model should be established
45(20)(a)(i) and (ii)	impact of the minimum requirement, and any proposed harmonised levels of the minimum requirement on: (i) financial markets in general and markets for unsecured debt and derivatives in particular; (ii) business models and balance sheet structures of institutions, in particular the funding profile and funding strategy of institutions, and the legal and operational structure of groups
<b>Impact on markets and institutions, including on profitability, pricing and capacity in debt markets, financial innovation, asset encumbrance, and capacity to raise funding</b>	
45(20)(a)	impact of the minimum requirement, and any proposed harmonised levels of the minimum requirement on financial markets in general and markets for unsecured debt and derivatives in particular, profitability of institutions etc.
45(20)(c)	capacity of institutions to independently raise capital or funding from markets in order to meet any proposed harmonised minimum requirements;
<b>Calculation of MREL and consistency with other regulatory requirements, including the choice of denominator and interaction with own funds, leverage, and liquidity requirements.</b>	
45(19)(h)	whether changes to the calculation methodology provided for in this Article are necessary to ensure that the minimum requirement can be used as an appropriate indicator of an institution's loss-absorbing capacity
45(19)(i)	whether it is appropriate to base the requirement on total liabilities and own funds and in particular whether it is more appropriate to use the institution's risk-weighted assets as a denominator for the requirement

45(20)(b)	interaction of the minimum requirements with the own funds requirements, leverage ratio and the liquidity requirements laid down in Regulation (EU) No 575/2013 and in Directive 2013/36/EU
<b>Consistency with international standards</b>	
45(20)(d)	consistency with the minimum requirements relating to any international standards developed by international fora
<b>Intragroup issues, including the location of loss-absorbing capacity and the conditions for waivers of the MREL for group entities</b>	
45(19)(j)	whether the approach of this Article on the application of the minimum requirement to groups is appropriate, and in particular whether the approach adequately ensures that loss-absorbing capacity in the group is located in, or accessible to, the entities where losses might arise;
45(19)(k)	whether the conditions for waivers from the minimum requirement are appropriate, and in particular whether such waivers should be available for subsidiaries on a cross-border basis;
<b>Adequacy of loss absorbency, including discussion of calibration, eligibility, and the role of DGS contributions</b>	
45(19)(f)	appropriate transitional period for institutions to achieve compliance with any harmonised minimum levels prescribed
45(19)(g)	whether the requirements laid down in Article 45 are sufficient to ensure that each institution has adequate loss-absorbing capacity and, if not, which further enhancements are needed in order to ensure that objective
45(19)(l)	whether it is appropriate that resolution authorities may require that the minimum requirement be met through contractual bail-in instruments, and whether further harmonisation of the approach to contractual bail-in instruments is appropriate
45(19)(m)	whether the requirements for contractual bail-in instruments are appropriate
<b>Disclosure and reporting, including the appropriateness, form, and frequency of MREL disclosure</b>	
45(19)(n)	whether it is appropriate for institutions and groups to be required to disclose their minimum requirement for own funds and eligible liabilities, or their level of own funds and eligible liabilities, and if so the frequency and format of such disclosure

## Annex 2: Policy approach of EU resolution authorities to MREL implementation and calibration

	SRB (SRMR, RTS on MREL) <sup>85</sup>	United Kingdom (11 December consultation) <sup>86</sup>	Sweden (26 <sup>th</sup> April 2016 consultation) <sup>87</sup>
1. Criteria for determination	Case-by-case approach. The RTS on MREL further specify criteria in BRRD Level 1.	<p>MREL will be set on the basis of three broad resolution strategies:</p> <p>Insolvency: no additional MREL beyond current minimum capital requirements.</p> <p>Partial transfer: recapitalisation component of MREL scaled to reflect size of transfer, subordination not required where only preferred deposits are to be transferred.</p> <p>Bail-in: assume recapitalisation of the whole balance sheet, subordination required with a preference for structural subordination.</p> <p><u>Indicative</u> boundaries between strategies: bail-in where balance sheets greater than GBP 15-25 billion (EUR 20-33 billion), insolvency where a firm is not systemically important and provides limited CEFs, in particular fewer than 40,000 transactional deposit accounts. Actual strategies will be set firm-by-firm.</p>	<p>MREL would be set based on resolution strategy:</p> <p><u>Whole bank bail in</u> – MREL would be set according the institution’s current RWA level. This resolution strategy would apply for at least the 4 largest Swedish institutions (i.e. all the Swedish G-SIBs and D-SIBs.)</p> <p><u>Partial transfer</u> – MREL would be set according to the level of RWAs associated with the institution’s critical functions. No decision on how many institutions would be in this category.</p> <p><u>Insolvency</u> – MREL would be equal</p>

<sup>85</sup> The SRB has not yet decided on its position on a number of issues. Therefore the comparison contained in this summary table is subject to change.

<sup>86</sup> <http://www.bankofengland.co.uk/publications/Pages/news/2015/098.aspx>

<sup>87</sup> [https://www.riksdagen.se/Dokument\\_eng/financial%20stability/mrel-consultation-paper.pdf](https://www.riksdagen.se/Dokument_eng/financial%20stability/mrel-consultation-paper.pdf)

	SRB (SRMR, RTS on MREL) <sup>85</sup>	United Kingdom (11 December consultation) <sup>86</sup>	Sweden (26 <sup>th</sup> April 2016 consultation) <sup>87</sup>
			to existing capital requirements. Institutions which are deemed non-systemically significant according to the assessment in Art. 4 BRRD (simplified obligations) are assumed to fall in this category.
<b>2. Interaction with capital buffers</b>	SRMR Art 12(6) states that MREL shall not be inferior to the total amount of any own funds requirements and buffer requirements under CRR.	The PRA is consulting on a related policy that firms should not count CET1 towards meeting MREL and capital buffers simultaneously. This would mean that buffers would need to be met separately from MREL. Depending on their business model and liability structure, firms may need to increase financial resources to avoid double counting of CET1.	The SNDO's MREL model enables the buffers to maintain their function and "sit on top" of the MREL requirement.
<b>3a. Calibration: loss absorption</b>	According to the RTS on MREL, the starting point for the loss absorption amount (LAA) is the minimum prudential requirement, including buffers, required on a going-concern basis. In line with EBA RTS on MREL, the SRB may make potential upward or downward adjustments on a case-by-case basis per group, taking into account inter alia SREP information, barriers or impediments to resolvability and other information.	In line with the PRA's proposed policy on the interaction between buffers and MREL, buffers will not be included in the loss absorption component (they will sit on top of and be met separately from MREL).  The same approach will be adopted for all firms entering insolvency (including FCA sole-regulated investment firms) to align MREL with minimum capital requirements.	The SNDO proposes that the going concern buffers and the macro-prudential risks component of Pillar 2 should be excluded from the loss absorption amount.
<b>3b. Calibration: recapitalisation</b>	The RTS on MREL set out an approach to setting the recapitalisation amount (RCA). The RTS on MREL provide limited	Insolvency: no recapitalisation component.  Partial transfer: recapitalisation component scaled down to match expected size of transfer. Anticipate that retail preferred and covered deposits will be	For bail-in and partial transfer strategies the SNDO assumes that all currently applicable capital requirements, including buffers,

	SRB (SRMR, RTS on MREL) <sup>85</sup>	United Kingdom (11 December consultation) <sup>86</sup>	Sweden (26 <sup>th</sup> April 2016 consultation) <sup>87</sup>
	flexibility to set a higher or lower recapitalisation amount. The SRB may likely need to perform a case by case analysis based on the resolution strategy and critical functions that need to be preserved.	<p>transferred and not other deposits nor any senior non-preferred liabilities.</p> <p>Bail-in: full balance sheet assumed for recapitalisation.</p> <p>For both partial transfer and bail-in:</p> <ul style="list-style-type: none"> <li>- Adjustments to the discretionary requirements applicable after resolution (Pillar 2A) will be considered on a case-by-case basis.</li> <li>- Buffers will generally not be included in recapitalisation amount. This preserves the buffers' purpose of providing going concern loss absorbency.</li> </ul>	<p>would still be applicable after resolution. The recapitalisation amount would be calibrated to ensure that the full capital requirements, including buffers, can be met after resolution (i.e. no deductions).</p> <p>Insolvency – no recapitalisation amount required.</p>
4a. Eligibility: subordination	No general subordination requirement for MREL. However, the SRB may review feasibility and credibility of bailing-in instruments on a case-by-case basis.	Subordination of MREL required for all firms with a bail-in strategy. Structural subordination of MREL via holding company issuance which is downstreamed to operating bank companies in the form of capital or subordinated debt liabilities will generally be required, except for mutually-owned firms which cannot operate with holding companies (UK building societies). Such firms which have a bail-in strategy will be required contractually to subordinate their MREL.	The SNDO has yet to decide how much of institutions' total MREL requirements need to be met with subordinated instruments. However the consultation document sets a strong preference that MREL be met to a certain level with subordinated instruments. The proposed calibration of this level will be consulted on in Q1 2017.
4b. Eligibility: maturity	> 1yr remaining maturity.	No additional hard maturity requirements beyond the minimum 1 year residual maturity requirement in the BRRD, but an expectation that firms will monitor their overall MREL maturity profile and be resilient to temporary market access issues.	The SNDO has indicated that it is considering whether the average maturity of MREL instruments should be subject to certain minimum requirements. No decisions have been made at this

	SRB (SRMR, RTS on MREL) <sup>85</sup>	United Kingdom (11 December consultation) <sup>86</sup>	Sweden (26 <sup>th</sup> April 2016 consultation) <sup>87</sup>
			stage.
4c. Eligibility: other issues	SRMR Art 12(16) specifies the conditions that eligible liabilities must satisfy in order to be included in MREL. All third country liabilities must include contractual recognition of bail-in tools.	Liabilities with significant embedded derivative components, including structured notes, will not count towards MREL.	At this stage, no additional requirements beyond the BRRD minimum criteria have been set.
5a. Location: consolidated	Parent undertakings will need to comply with MREL on a consolidated basis. The SRB's intention is to provide indicative MREL requirements for all banking groups under its remit before the end of 2016, but only on consolidated level.	Consolidated MREL will be set in line with the RTS on MREL framework and the Bank's calibration proposals.	During 2016 the SNDO will prioritise MREL decisions at the consolidated level.
5b. Location: solo entities within groups	MREL will be applied to a group's subsidiaries on an individual basis. The SRB does not intend to set MREL decisions for subsidiaries in 2016 but at a later stage. SRB intends to base the MREL decision for subsidiaries on their individual characteristics and the consolidated level which has been set for the group (SRMR Art 12(9)) and considering the possibility of waivers (SRMR Art 12(10)).	Individual entity MREL will be set later in the transitional period.  For firms subject to structural subordination, individual operating entities will be required to issue subordinated liabilities to the group resolution entity to meet their individual MREL.  In line with the TLAC term sheet, for material subsidiaries (including domestic subsidiaries) of G-SIBs the Bank will endeavour to set the requirement at 75-90% of what the requirement would have been had they been resolution entities. The Bank is considering an exception to this by requiring 100% for domestic "ring-fenced bank" entities / subgroups.	For groups with SPE strategies, subsidiaries' MREL should be met with internal instruments. The SNDO will communicate at a later date what characteristics such internal instruments should have (i.e. should be subordinated, trigger mechanism, etc.).
5c. Location: holding companies	Not specified in SRMR / RTS on MREL.	Firms subject to structural subordination will be set an individual MREL at the holding company level, to ensure sufficient external MREL resources are issued	Not applicable in Swedish context.

	SRB (SRMR, RTS on MREL) <sup>85</sup>	United Kingdom (11 December consultation) <sup>86</sup>	Sweden (26 <sup>th</sup> April 2016 consultation) <sup>87</sup>
		by the resolution entity. A consolidated requirement would not necessarily be sufficient to achieve this.	
6. Transitional arrangements	Not specified	<p>Final transitional deadline of 1 January 2020. Generally will not set escalating requirement over the transitional period, although the Bank may do so in individual cases.</p> <p>G-SIBs are also expected to meet the 1 January 2019 TLAC deadline, with the common floor of 16% RWA / 6% LRE applying to UK G-SIBs during 2019.</p>	<p>The MREL requirement should be met by Q4 2017 on the basis of debt instruments which meet the minimum BRRD eligibility criteria (i.e. senior unsecured may be included).</p> <p>Once a decision has been taken on the level of MREL which should be met with subordinated instruments, a separate transitional period will be set for compliance with that requirement.</p>

## Annex 3: Comparison between MREL, TLAC term sheet and US/Swiss planned implementation of TLAC

	TLAC Term Sheet	USA/Swiss proposals	MREL
Scope	<p>G-SIBs and their material subsidiaries.</p> <p>External TLAC requirement set for each resolution entity; internal TLAC requirement set for each material subgroup.</p>	<p><u>USA</u>: US G-SIBs and intermediate holding companies of foreign G-SIBs;</p> <p><u>CH</u>: G-SIBs</p>	<ol style="list-style-type: none"> <li>1. Credit institutions and investment firms on a consolidated and solo basis.</li> <li>2. Holding companies and other affiliated financial institutions (optional).</li> </ol>
Calibration - minimum	<p>From 1 Jan 2019: at least 16% of RWAs (plus buffers) and &gt; 6% of leverage exposure</p> <p>From 1 Jan 2022: at least 18% of RWAs (plus buffers) and &gt; 6.75% of leverage exposure</p> <p>See also section below on firm-specific requirements</p>	<p><u>USA</u>: TLAC &gt;18% of RWAs and &gt;9.5% of leverage exposure (from 2022).</p> <p>Long-term debt &gt; 6% + G-SIB surcharge of RWAs; 4.5% of total leverage.</p> <p>For foreign G-SIB subs TLAC &gt; 16% of RWAs, 6% of leverage exposure, and 8% of total assets; LTD &gt;7% of RWAs, 3% of leverage, 4% of assets</p> <p><u>CH</u>: &gt; 28.6% of RWAs (o/w 10% CET1, 4.3% T1, 14.3% other); &gt;10% of leverage exposure (o/w 3.5% CET1, 1.5% T1, 5% other)</p>	<p>No harmonised minimum requirement; six firm-specific criteria set out in the BRRD relating to the resolution strategy.</p> <p>RTS on MREL - resolution authorities to determine an appropriate transitional period which is “as short as possible”.</p> <p>SRB: Generally expect most institutions under SRB remit to have MREL of at least 8% of own funds + total liabilities</p>

<p>Calibration - firm-specific requirements</p>	<p>Additional firm-specific requirements if necessary and appropriate to implement resolution, minimise impact on financial stability, ensure continuity of critical functions, or avoid exposing public funds to loss</p>	<p>None discussed</p>	<p>MREL is a firm-specific requirement, based on ensuring that firms have sufficient loss-absorbing capacity to implement the preferred resolution strategy, size and risks, DGS contribution, and impact on financial stability</p> <p>RTS on MREL - Must assess:</p> <ul style="list-style-type: none"> <li>a) loss absorption amount (starting from own funds requirements)</li> <li>b) recapitalisation amount (starting from own funds requirements)</li> <li>c) adjustments for DGS contributions and excluded liabilities</li> </ul> <p>Denominator of MREL is total own funds and liabilities, but MREL requirement should be set as an amount.</p> <p>SRM Regulation: At least equal to own funds (buffers included) (see SRM Regulation art 12.6)</p> <p>SRB currently expect most SRB institutions to have MREL of at least 8% of own funds + total liabilities (still under discussion)</p>
<p>Denominator</p>	<p>RWA/leverage ratio denominator of the resolution group</p>		<p>Total liabilities and own funds at individual and</p>

			consolidated level
<p>Arrangements for groups, including internal requirements</p>	<p>External TLAC requirement for the resolution entity to be set in relation to the consolidated balance sheet of each resolution group</p> <p>Internal TLAC must be set for each material subgroup at 75-90% of the external TLAC requirement that would apply if that material subsidiary were the resolution entity.</p> <p>The calibration within the 75-90% range is decided in discussions within the CMG.</p> <p>Internal TLAC can be in the form of collateralised guarantees subject to conditions. TLAC that is not pre-positioned should be readily available to recapitalise any direct or indirect subsidiary as necessary to support the execution of the resolution strategy.</p> <p>No mandatory requirement for domestic internal TLAC, but can be imposed by authorities on discretionary basis.</p> <p>The resolution entity should issue and maintain at least as much external TLAC as the sum of internal TLAC, which it has provided or committed to provide, and any</p>	<p>USA: the Fed LTDR proposes that US IHC of foreign G-SIBS will have to meet an 89% internal TLAC requirement. Seeking comment on domestic internal TLAC.</p> <p>CH: no announcement in October 2015 implementation of TLAC. Seeking comment on domestic internal TLAC.</p>	<p>MREL for the group on a consolidated basis.</p> <p>MREL must be set for all credit institutions and investment firms within groups on an individual entity basis, set having regard to consolidated MREL and the group resolution strategy. Limited possibility of waivers when institution and parent are in the same Member State.</p> <p>There is no requirement to issue at least as much external MREL as the sum of internal MREL.</p>

	<p>TLAC needed to cover material risks on the resolution entity’s own balance sheet. However, external TLAC may be lower if and to the extent this is due to consolidation effects only.</p>		
Relationship with capital buffer requirements	<p>CET1 capital cannot count simultaneously towards both TLAC RWA minimum and regulatory capital buffers</p>	<p><u>USA and CH:</u> CET1 capital cannot count simultaneously towards both TLAC and regulatory capital buffers</p>	<p>Capital instruments count towards MREL</p> <p>Relationship between MREL and buffers not specified in BRRD. MREL is a minimum requirement that “must be met at all time”.</p>
Penalties for breach	<p>Restrictions for breach due to maturing instruments mirroring restrictions for breach of buffer requirements due to maturing Tier 2 instrument</p> <p>Breach should be treated as seriously as a breach of minimum regulatory capital requirements</p>	<p>Not specified</p>	<p>Not specified in BRRD.</p> <p>Options available include:</p> <ul style="list-style-type: none"> <li>• triggering powers to remove impediments to resolvability</li> <li>• triggering early intervention powers</li> <li>• administrative penalties under Article 110 BRRD</li> <li>• general supervisory powers and penalties for any associated breach of capital requirements</li> </ul>
Eligibility – remaining maturity	<p>&gt; 1yr. Maturity profile should be adequate in case access to capital markets is impaired.</p>	<p><u>USA:</u> &gt;1 yr; possible 50% haircut on &lt; 2yr (it is proposed that this will only be applied for the long-term debt requirement not the TLAC requirement)</p>	<p>&gt; 1yr</p>

		<u>CH</u> : TBC	
Eligibility - subordination	<p>External TLAC must be subject to contractual, statutory, or structural subordination (relative to excluded liabilities on the balance sheet of the resolution entity).</p> <p>Exemptions may apply if they would not result in material risk of successful legal challenge or compensation claims:</p> <ul style="list-style-type: none"> <li>a) if excluded liabilities pari passu or junior to TLAC liabilities &lt; 5% of external TLAC (and exclusion is possible and would not affect resolvability).</li> <li>b) if all liabilities excluded from TLAC are statutorily excluded from the scope of bail-in.</li> <li>c) (up to 2.5% of RWAs, rising to 3.5% in 2022) if resolution authority has discretion to exclude from a bail-in all the liabilities excluded from TLAC.</li> </ul>	<p>USA: Issuing holding company must meet ‘clean holding company’ requirements.</p> <p>Debt instruments must be:</p> <ul style="list-style-type: none"> <li>a) unsecured</li> <li>b) not self-guaranteed</li> <li>c) not subject to other enhancement of seniority</li> </ul> <p><u>CH</u>: TBC</p>	<p>No requirement in Level 1, but resolution authority may require part of MREL to be met by subordinated bail-in instruments. The resolution authority may also require establishment of holding company under Article 17 BRRD.</p> <p>RTS on MREL: must assess whether resolution would breach NCWO (due to too much excluded liabilities versus MREL-eligible liabilities within or junior to a certain class) and recalibrate MREL accordingly or require alternative measures, unless below de minimis threshold (10% of a given class).</p>
Eligibility – other instrument characteristics	<p>Following are excluded from TLAC:</p> <ul style="list-style-type: none"> <li>a) insured deposits</li> <li>b) deposits w &lt; 1yr maturity</li> <li>c) derivatives</li> <li>d) structured notes</li> </ul>	<p>USA: Debt instruments subject to ‘plain vanilla’ requirements, excluding:</p> <ul style="list-style-type: none"> <li>a) structured notes</li> <li>b) credit-sensitive features</li> <li>c) convertibles</li> </ul>	<p>Resolution authorities may require contractual bail-in instruments.</p> <p>Following liabilities are excluded on a mandatory basis:</p>

	<ul style="list-style-type: none"> <li>e) non-contractual liabilities</li> <li>f) preferred liabilities</li> <li>g) liabilities exempt from bail-in</li> </ul> <p>Liabilities must be paid-in, unsecured, not subject to contractual set-off or netting, not redeemable, not self-funded.</p>	<ul style="list-style-type: none"> <li>d) acceleration clauses</li> </ul>	<ul style="list-style-type: none"> <li>a) liabilities arising from derivatives</li> <li>b) liabilities must be paid up, unsecured, not self-funded – issued or guaranteed</li> <li>c) preferred deposits</li> <li>d) liabilities excluded from bail-in:                             <ul style="list-style-type: none"> <li>a. covered deposits</li> <li>b. secured</li> <li>c. client money/asset</li> <li>d. fiduciary liability</li> <li>e. inter-bank &amp; &lt; 7days</li> <li>f. arising from recognised payment/settlement system participation and &lt;7 days</li> <li>g. to employees (except variable compensation), commercial or trade creditors in critical services, tax authorities, or DGSS.</li> </ul> </li> </ul>
Eligibility – contractual triggers	External TLAC must contain – absent any statutory mechanism - contractual trigger allowing resolution authority to write-down or convert in resolution	No mandatory contractual triggers	No mandatory contractual triggers, except for third country law governed liabilities.
Eligibility - jurisdiction	Must generally be subject to governing law of jurisdiction of resolution entity. If issued under the law of another jurisdiction, must ensure the application of resolution tools is effective and enforceable		All third country liabilities must include contractual recognition of bail-in tools.

Eligibility - issuer	TLAC must be directly issued by resolution entity except CET1 recognised in consolidated capital and regulatory capital instruments issued by cooperative banks within an IPS. Minority interest other than CET1 allowed until 31 December 2021. Exception for wholly owned funding vehicles on a temporary basis (until 2022).	USA: Issued directly by holding company.	Individual level MREL requirements apply. Those requirements would need to be met by issuance by the entity to which they apply.
Other restrictions on composition	Expectation that one third of TLAC is non-equity.	USA: LTD debt requirement applies in parallel. TLAC issued by foreign G-SIB IHCs must be issued to parent.	None.
Other features – exposures to TLAC/MREL instruments	BCBS proposal on deductions from capital under consultation.		Not harmonised.
Other features – disclosure and reporting	BCBS disclosure template.		Not harmonised, but national/Banking Union requirements may apply.
Conformance period	1 January 2019 – first phase. 1 January 2022 – second phase.		Resolution authorities shall determine an appropriate transitional period which is as short as possible.



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