

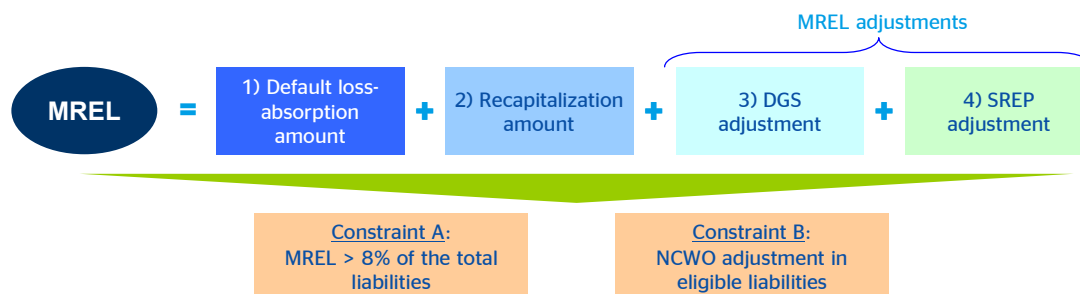
# The European MREL: main characteristics and TLAC similarities and differences

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On 28 November 2014, the EBA released the consultation paper on the criteria for determining the minimum requirement for own funds and eligible liabilities for bail-in – the so-called MREL.<sup>1</sup> With the MREL, European authorities will ensure that banks have enough liabilities to absorb losses in case of failure, and, therefore, shareholders and creditors should shoulder much of the recapitalisation burden, instead of tax-payers.

The MREL could be seen as the transposition of the FSB's TLAC transposition into the European Union.<sup>2</sup> Despite having the same purpose, both ratios have significant divergences. Chief among them are that: the MREL is assessed individually per institution (no common pillar 1 standard), it will take into account the recapitalization needs based on the preferred resolution strategy, it will have a quantitative floor based on total liabilities, and the treatment of senior unsubordinated debt is slightly different. Last but not least, the resolution authorities will have discretionary powers to establish an MREL that considers the individual idiosyncrasies of each institution.

## Minimum Required Eligible Liabilities (MREL) criteria



Source: BBVA Research

The final design of the MREL and TLAC is not yet clear, and nor is it yet consistent between countries. The FSB paper will be under consultation until 2 February 2015 and the MREL's consultation period finalizes on 27 February 2015. Both consultation and calibration periods will be critical in designing the optimal loss-absorbing needs in the banking industry, to ensure resolvability without unduly penalising financial intermediation and financial stability.

<sup>1</sup> See EBA Consultation paper: <http://www.eba.europa.eu/-/eba-consults-on-criteria-for-determining-the-minimum-requirement-for-own-funds-and-eligible-liabilities-mrel->

<sup>2</sup> See the BBVA Research report "Total Loss-Absorbing Capacity (TLAC): making bail-in feasible and credible instead of bail-out" [https://www.bbva.com/wp-content/uploads/2014/11/20141111\\_Regulation-Watch\\_TLAC-V-def1.pdf](https://www.bbva.com/wp-content/uploads/2014/11/20141111_Regulation-Watch_TLAC-V-def1.pdf)

## Bank Recovery and Resolution Directive (BRRD) and MREL

On 15 April 2014 the European Parliament approved the Bank Recovery and Resolution Directive (BRRD), after several months of negotiations between the Commission, the European Council and the European Parliament. The enforcement of BRRD is scheduled to begin on 1 January 2015, and the bail-in regime will be introduced from 2016.<sup>3</sup>

The goal of the Directive is to achieve a **common framework of rules and powers that guide all 28 EU countries’ intervention in banking crises**. National resolution authorities are given some flexibility to resolve distressed institutions through a quick procedure which minimises financial and economic disruption.

The BRRD is based on three main pillars, reflecting the different stages of the recovery and resolution’s planning and execution: i) preparation and prevention, ii) early intervention measures, and iii) resolution powers and tools to tackle failed institutions.

Among the resolution tools, **the bail-in is the cornerstone of the BRRD** and it implies that banks’ creditors will be written down or converted into equity in case of resolution and, thereby, they should shoulder much of the burden to help recapitalize a failed bank instead of the taxpayers. In order for this new banking rescue philosophy to be effective, the **BRRD requires banks to have enough liabilities which could be eligible to bail-in – so-called “Minimum Required Eligible Liabilities (MREL).”**<sup>4</sup> This new concept means that when a bank is unviable, these liabilities will be used to recapitalize the institution and guarantee, in turn, that those critical functions which are inherent to financial activity will be maintained.

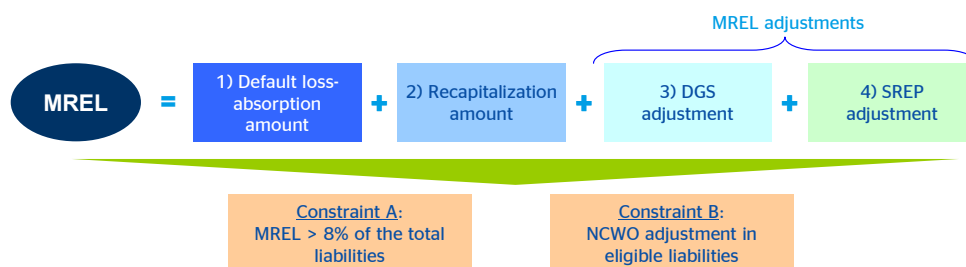
## Determining the MREL: six elements should be taken into account

The MREL will be applied case-by-case in each banking group. Therefore, in order to **ensure a harmonized application in Europe**, the BRRD empowers the **EBA to specify the criteria which resolution authorities are expected to apply when setting the MREL** in each institution. Last Friday, on 28 November 2014, the EBA released the consultation paper on the criteria for determining the MREL.<sup>5</sup>

As shown in Figure 1, the EBA proposes six criteria:

Figure 1

Minimum Required Eligible Liabilities (MREL) criteria



Source: BBVA Research

<sup>3</sup> On 12 June 2014 the BRRD was published in the Official Journal of the European Union

<sup>4</sup> Article 45 of the BRRD

<sup>5</sup> EBA / CP / 2014 / 41

The first key premise that everyone should not forget is that MREL is expressed as a percentage of total liabilities and own funds of each institution. However, the **MREL's quantum will be determined in monetary terms** based on several factors, in which the capital and leverage ratios play a central role. Below, we describe the main MREL determinants.

### 1. The “default loss absorption amount” definition.

The BRRD establishes that the MREL shall be calculated as an amount of own funds and eligible liabilities. As the MREL incorporates the own fund amount, the first criteria should be the minimum capital prudential requirements that the institution must comply with a going-concern basis. Bearing in mind that capital prudential requirements are composed of two standards: the capital and leverage ratios, the **“default loss absorption amount” is the maximum of both:**

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

It is worth highlighting that the capital ratio requirement should **include any Pillar 2, Basel 1 floor, and the so-called combined buffer, which includes the capital conservation, countercyclical, systemic entity (either GSIB or OSIB) and a systemic risk buffer.** As we will describe later, this would be one of the main differences with the FSB's TLAC proposal.

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

### 2. The “recapitalization amount” definition.

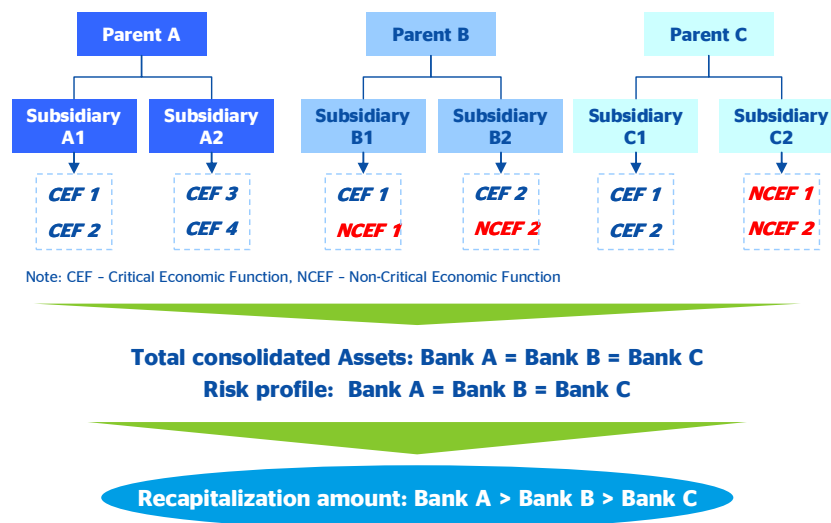
The EBA acknowledges that the resolution plan may not imply that the entire group is recapitalized in the same form as that in which it enters resolution. The preferred resolution strategy in each group may involve discontinuing or winding down some subsidiaries, business lines or activities rather than continuing the entire business. Therefore, **this would require fewer resources for recapitalization, and would not double the pre-resolution minimum prudential requirements.**

One of the main objectives of the bail-in tool is to recapitalize the failed institution at a level that promotes market confidence and meets the going concern regulatory capital requirement. However, which is the optimal level to promote market confidence? Will be the average of the peer group in a concrete moment? Will be the historical average? In this regard, the EBA proposes that the **optimal level should be the median of the CET1 of a peer group.** As we have said before, the post-resolution bank would probably be very different, and its peer group would probably not be the same, especially in a context of an idiosyncratic failure. In any case, the EBA and the industry should carefully analyze it over the following weeks.

As shown in Figure 2, three banks with the same balance-sheet and risk profiles but carrying out different critical economic functions or structured them in a different way would not have the same “recapitalization amount. First, the bank which may pose higher systemic risk – let us say with more critical functions (Bank A) - should have more capital after resolution. Second, the bank that organizes their critical and non-critical functions in independent legal entities (bank C) would have fewer impediments to wind down the non-critical function. It is worth remembering that one of the main objectives of the resolution plan and the resolution strategy is to identify which functions are economically critical and should be preserved, and which are not, and should therefore be liquidated.

This approach, opposite to that of the FSB’s TLAC, rightly creates **incentives for banks to reduce barriers or impediments to resolvability**. Resolving a significant bank is a complex task. Authorities have already identified a number of common resolvability barriers (e.g. shared services structure, complex legal structure, interconnections between critical and non-critical functions, etc.). Removing such impediments is a complex task that requires the involvement of the entire organization and invests large amounts of money and resources. Banks may need incentives to invest on resolution, and therefore **discriminate between resolvable and less resolvable banks** through, for example, with lower MRE requirement.

Figure 2  
Critical economic functions and “recapitalization amount”



Source: BBVA Research

**3. The “DGS” criteria.**

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

**4. The “SREP adjustment” criteria.**

The BRRD also requires authorities to determine the **MREL taking into account the idiosyncratic characteristics of each institution** (e.i. business model, risk profile, governance, etc.). In this regard, the resolution authority should use the outcome of the supervisory review and evaluation programme (SREP) that supervisors will carry out for all institutions.

Based on the SREP’s outcome, the MREL could be adjusted if there is any weakness and the resolution authority considers that these risks and vulnerabilities are not adequately reflected in the capital

requirements. Given the discretionary feature of this adjustment, the **dialogue, coordination and information sharing between the resolution authority and the supervisors are critical.**

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

**A) The “Non Creditor Worse off than in Liquidation adjustment” principle (NCWO).**

The EBA is concerned about the legal and operational problems which could arise when senior debt is eligible for bail-in and uncovered corporate deposits are excluded. There is a consensus among authorities that **unsecured debt may pose credible or legal loss-absorbing risks**. In particular, a hotly debated question has been whether or not liabilities that are *pari passu* with normal unsecured creditors, and which cannot effectively be written down or converted into equity (for example those arising from derivatives or corporate deposits), would be excluded from bail-in due to the “non creditors worse off than in liquidation” principle.

In this regard, the **EBA is considering not including in the MREL all the unsecured debt**, when it accounts for less than 90% of the total liabilities in the same rank. This approach is consistent with the BRRD, which states that authorities may force the institution to issue or substitute it with senior debt with subordinated clauses.<sup>6</sup>

The full exclusion of the traditional senior debt is a tougher approach than FSB’s TLAC, which partially recognizes the senior unsubordinated debt in the TLAC (up to 2.5% of RWAs).

**B) The “8% of total liabilities floor” constraint.**

Finally, the EBA seems to introduce the 8% of total liabilities as a MREL floor, recognizing the threshold set by the BRRD before applying any other financial arrangement which may complement the bail-in (i.e., using the resolution fund or public stabilization tools in exceptional circumstances). In this sense, the **EBA ensures that banks**, at least the significant ones (e.i. global SIBs and domestic SIBs), **have enough liabilities before deciding to use other measures.**

As shown in Figure 3, the 8% threshold has different implications depending on the RWA density. The average RWA density among European GSIBs was 35% as of June 2014 which corresponds with an MREL equivalent to 23 % of RWA. Banks with higher RWA density would require a lower MREL floor based on 8% of total liabilities.

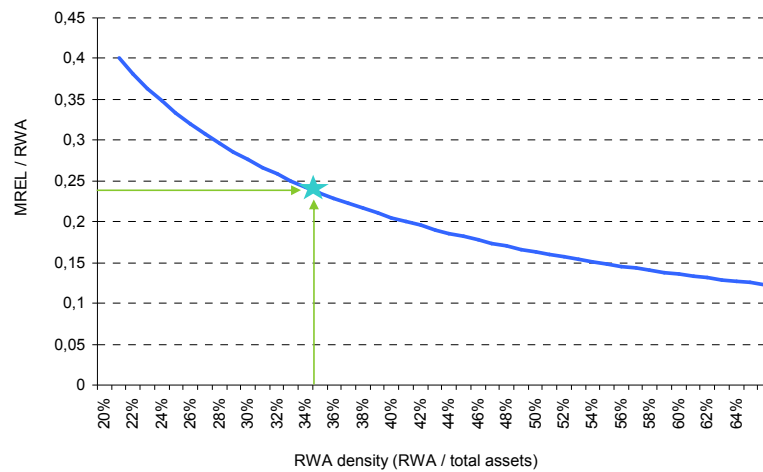
The 8% of total liabilities floor will only apply to significant institutions in Europe, but it may be extended to all institutions, not only the GSIB or OSIBs, with a resolution strategy which does not entail liquidation. Additionally, this constraint would not apply if the resolution authority considers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

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<sup>6</sup> See article 13 and 14 of the BRRD

Figure 3

RWA density and MREL over RWA relation based on the 8% of total liabilities constrain (in %)



Source: BBVA Research

## Determining the MREL: an illustrative example

As an example and based on the previous criteria, suppose that there is a banking institution with the following characteristics:

- a systemic bank with 1% capital buffer,
- the overall SREP score is '1' (no discernible risk) and the partial SREP score in the four subareas is also '1',<sup>7</sup>
- the preferred resolution strategy does not result in any reduction in RWAs,
- and the average CET1 among its peer group is 10%.

Based on the previous characteristics, **the MREL of the institution is 22.5%.**

- Default loss absorption amount = 9% (8% of total capital + 1% of systemic buffer)
- Recapitalization amount = 13.5% (9% + 4.5%, where 4.5% is the increase in CET1 to achieve a 10% taking into account the starting point at 5.5% = 4.5% + 1% of systemic buffer)
- An overall SREP of '2' could be considered as "no risk or vulnerability" in the risk profile and business model.
- If the RWA over total assets ratio is over 35.5%, there will be no need to introduce any add-on. However, if the RWA over total assets ratio is lower than 35.5%, the MREL should increase to comply with the 8% of total liabilities floor.

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

In contrast to the FSB's TLAC, where the minimum would be primarily driven by a common standard, in the European MREL the role of the resolution authority is crucial when determining the specific requirement in

<sup>7</sup> See EBA Consultation paper on Draft Guidelines for common procedures and methodologies for the supervisory review and evaluation process (EBA/CP/2014/14)

each institution. This approach rightly recognizes that not all banks are the same, even among GSIBs, and their resolution strategy, resolvability assessment, size, business model, etc. should be taken into account on a case-by-case basis. Against this backdrop the resolution authorities will have the following **discretionary powers**:

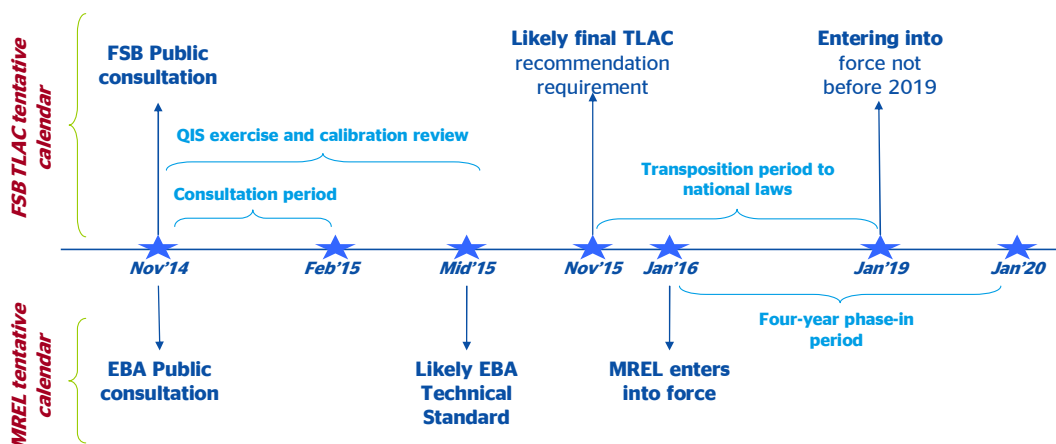
- They may adjust the “**default loss absorption amount**”, if they consider that the minimum capital and leverage requirements do not adequately reflect the institution’s capital needs.
- They will determine an amount of recapitalization which would be necessary to implement the **preferred resolution strategy**.
- They should include any additional amount to **maintain market confidence** after resolution.
- They should assess whether the potential **exclusion from bail-in** may pose any future legal or operational risk due to the NCWO clause.
- They should adjust the MREL, if **the SREP outcome shows any type of risk or vulnerability** not already included.
- Finally, they should assess whether there are no resolvability impediments and the resolution **strategy is credible and feasible**.

In order to ensure a harmonized application of the previous criteria, the **EBA will submit a report** to the European Commission by 21 October 2016 analyzing whether there have been any divergences in the levels set for comparable institutions in Europe.<sup>8</sup> This report will be critical to maintain **the level playing field and enhance transparency among European banks**.

### Last but not least, the phase-in period

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

Figure 4  
FSB’s TLAC and European MREL tentative calendar



Source: BBVA Research

<sup>8</sup> See article 45 (19) of the BRRD

## MREL and TLAC: equivalent concept but not exactly the same

On 10 November 2014, the Financial Stability Board (FSB) released a draft consultation on the principles and characteristics of a minimum TLAC requirement. The FSB paper will be under consultation until 2 February 2015 in parallel with the MREL’s consultation period which finalizes on 27 February 2015.

Although European discussion of the minimum loss-absorbing liabilities is several steps ahead (it started in 2012) and the FSB discussion only began in 2014, there is a broad consensus that both ratios should converge, albeit maintaining the European local features.

As shown in the Table 1, despite having the same concept, **the TLAC and the MREL definitions are not totally consistent** in all their features.

Table 1

### Differences between MREL vs TLAC requirement

	MREL	TLAC	Comparability
<b>Scope of covered firms</b>	<ul style="list-style-type: none"> <li>All credit Institutions and investment firms</li> </ul>	<ul style="list-style-type: none"> <li>Global systemically important banks ( G-SIBS)</li> </ul>	<b>X</b>
<b>Objective</b>	<ul style="list-style-type: none"> <li>To ensure that there is an appropriate level of loss-absorbing and recapitalisation capacity for the relevant group to be resolvable and that the critical functions can be continued without taxpayer (public) funding and avoiding adverse effects on the financial system.</li> </ul>		✓
<b>Eligible Instruments</b>	<ul style="list-style-type: none"> <li>Equity, junior debt, senior debt, and other unsecured liabilities with residual maturity over 1 year.</li> <li>Senior unsubordinated debt may be excluded if it counts less than 90% of the total liabilities in the same rank.</li> </ul>	<ul style="list-style-type: none"> <li>Equity, junior debt, senior subordinated debt and part of the senior unsubordinated debt which is pari-passu with excluded liabilities (limited recognition up to 2.5% of RWA or higher).</li> </ul>	≈
<b>Pillar 1 vs Pillar 2 approach</b>	<ul style="list-style-type: none"> <li>Case-by-case approach (Pillar 2) based on each bank’s characteristics: resolvability assessment; complexity, risk profile, etc.</li> </ul>	<ul style="list-style-type: none"> <li>All banks should have the same Pillar 1 minimum TLAC requirement plus a Pillar 2 firm-specific requirement.</li> </ul>	<b>X</b>
<b>Sizing</b>	<ul style="list-style-type: none"> <li>MREL shall be calculated based on the minimum capital including capital buffers and leverage requirements and the recapitalization needs after resolution.</li> <li>Additionally, some adjustments may be applied based on risk profile, resolution strategy, etc.</li> </ul>	<ul style="list-style-type: none"> <li>Pillar 1 standard minimum: (16-20% of-RWA or 6% of leverage assets) plus Pillar 2 case-by-case requirements.</li> <li>TLAC minimum requirements do not include capital buffers.</li> </ul>	<b>X</b>
<b>Denominator</b>	<ul style="list-style-type: none"> <li>MREL is expressed as a percentage of total liabilities and own funds of each institution.</li> <li>However, the MREL’s quantum will be determined in monetary terms based on several factors where the capital and leverage ratios play a central role.</li> </ul>	<ul style="list-style-type: none"> <li>The TLAC is determined by the capital or leverage ratio</li> </ul>	✓
<b>Come into force</b>	<ul style="list-style-type: none"> <li>MREL requirement is already approved and will come into force in 2016.</li> <li>The EBA proposes a 48 months of phase-in period (4 years)</li> </ul>	<ul style="list-style-type: none"> <li>No earlier than 1 January 2019</li> </ul>	✓



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