Financial Regulation, Banks

European banks and the challenge of MREL

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Who will pay for the next banking crisis in Europe, and how? One of the lessons learnt from the last global financial crisis is that there must be an end to public bail-outs of banks. To achieve this, it is necessary to define which creditors and which liabilities absorb losses in the event of an institution's resolution, and in what order of preference. For the legal implementation of this "bail-in" by shareholders and creditors, new regulatory requirements have been developed.

The minimum requirement for own funds and eligible liabilities, or MREL, was introduced for EU banks by means of the Bank Recovery and Resolution Directive (BRRD) in 2014. Its objective is to ensure the effective implementation of the "bail-in". Unlike the international TLAC (Total Loss Absorbing Capacity) standard, which is required only of global systemically important banks (G-Sibs), MREL affects all European banks and represents the cornerstone of the new resolution framework for financial institutions.

MREL has been in existence for only a few years. However, its main aspects are being subjected to review by the EU legislators. The definitive framework is expected to be approved at the end of 2018 or beginning of 2019.

One of the main objectives of this reform is to bring MREL into line with TLAC. The introduction of the subordination requirement as already present in TLAC is one of the most significant changes to be made to the MREL framework. It will establish that part of the MREL requirement must be met with subordinated liabilities such as regulatory capital instruments including the famous "CoCos" or non-preferred senior debt, which in the event of resolution absorb losses before traditional senior debt. So far, the European authorities have reached agreement on the new MREL calculation formula, but still differ on the level of subordination to be required. The significance of the level of subordination required derives from the cost of these issuances for the banks, which is greater than that of traditional senior debt.

With figures at December 2017, we have estimated the MREL shortfall for a sample of 63 European banks in three scenarios with different levels of subordination. The results show that the aggregate MREL shortfall is €195 billion under the subordination recommended by the EBA (soft scenario); €301 billion under the Council's compromise text (medium scenario); and €526 billion in the scenario in which MREL would be met entirely with subordinated liabilities (most demanding scenario). Will the markets be able to absorb such a volume of issuances in a short time? If we take 2022 as the deadline for complying with MREL, this would involve very significant issuances of between €65 billion and €175 billion a year.

The banks of the peripheral countries would present the greatest aggregate MREL shortfall in percentage points (pp) of risk-weighted assets (3.7% in the soft scenario, 4.4% in the medium and 6.4% in the most demanding one). In particular, the nations most affected would be Greece (10%), Portugal (6%-9%) and Ireland (5%-7%).

Core countries' banks would have more manageable MREL shortfalls in terms of risk-weighted assets. However, these shortfalls increase faster in more rigorous subordination scenarios.

The disparity observed in levels of shortfall among banks and countries derives from the fact that some financial systems and some banks within those systems are more dependent on senior debt for their funding, whereas others (mainly peripheral countries and smaller, less diversified banks) tend to rely on issuing subordinated (mainly capital) instruments and deposits as their main source of funding.

In short, the key aspect of the as yet undefined MREL framework will be the level of subordination set by the EU authorities. The impact may end up being very significant, given that subordinated instruments are more expensive to issue, meaning that banks' funding costs will increase, with the consequent negative effects on profitability or the cost of borrowing. With rising interest rates, the cost of issuing increases and meeting the estimated pace of annual issuances poses a challenge for European banks.

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