REPLY AVANTAGE

Refining MREL – preparing to fail

The European Banking Authority ("EBA") recently published a *Consultation Paper*[1] (24th July 2020), with the aim of refining the calculation of Minimum Requirements for own funds and Eligible Liabilities ("MREL"). The EBA was mandated[2] to develop the draft Regulatory Technical Standards ("draft RTS") in this Consultation Paper ("CP") as a part of *the Bank Recovery and Resolution Directive* ("BRRD").

In this CP, the EBA proposes a methodology for resolution authorities to refine Pillar 2 Requirements ("P2R") and Combined Buffer Requirements ("CBR") (inputs into the calculation of MREL) for relevant institutions[3] so that a more risk-sensitive approach can be applied.

This CP seeks to address situations where relevant institutions have a resolution group legal entity structure which differs from their banking group ("prudential group") structure. This presents an issue as capital requirements set at prudential group may not capture the risks of the resolution group, leading to inadequate or excessive MREL requirements.

Industry stakeholders are invited to respond to the proposed approach, with three questions called out for an industry public hearing, as below:

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[1] *Draft Regulatory Technical Standards on specifying the methodology to be used by resolution authorities to estimate the requirement referred to in Article 104a of Directive 2013/36/EU and the combined buffer requirement for resolution entities at the resolution group consolidated level for the purpose of setting MREL under BRRD Art. 45c(4)*

[2] Article 45c (4) of Directive 2014/59/EU.

[3] Credit institutions, investment firms and related entities, as per Directive 2014/59/EU (BRRD).

MREL

During the global financial crisis of 2007-08, substantial bail-outs of banks and financial institutions took place, funded by taxpayers. One of the key reasons for this approach was the absence of a credible mechanism for these firms to fail without severely negatively impacting the wider economy. The bail-outs were very unpopular and created a situation of ‘moral hazard’ where bank debt investors were effectively ‘made whole’ by taxpayers, contrary to the principles of capitalism and ‘creative destruction’.

This crisis has informed a great deal of banking regulation since and regulatory changes have been made to allow for banks and other financial institutions to be able to fail in an orderly fashion potentially without the need for bail-outs with public money. Most regulators do not purport to operate a “zero-failure” regime and it is within this context that regulatory tools and requirements such as resolution and MREL have been developed.

MREL is a requirement for banks and other financial institutions to have sufficient[4] and suitable equity and subordinated debt instruments. These allow them to fail and undergo resolution (a form of restructuring in which investors lose money but where critical functions are kept running and the financial stability of the wider system is preserved).

The debt obligations can be ‘bailed-in’ (converted to equity) in the event of a bank’s failure, to the extent that the remaining entities (resolution groups) are sufficiently capitalised to meet regulatory requirements. This avoids disruptive and uncontrolled bank failure to impact the wider financial system and economy, avoids the need for state-backed rescue packages and ensures that it is investors in banks who bear losses related to bank failure. Note that it is the largest and/or most complex firms which have the highest MREL requirements – reflecting the greater disruption that would be caused if they failed in a disorderly manner.

Resolution Groups and Prudential/Banking Groups

A *resolution group* is the level of granularity at which a financial institution is ‘resolved’, as per Directive 2014/59/EU (BRRD). The regulatory requirements for MREL (amongst others) are applied to each resolution group. The division of firms into resolution groups is determined by resolvability criteria.

A *prudential or banking group* is a legal entity structure (“a parent undertaking and its subsidiaries”)[5] and is the level at which capital requirements are set. The perimeter of this group is set by a number of criteria (regulatory, business model, geography, etc.).

Since capital requirements are an input into MREL calculations and given that the legal entities included in resolution groups may differ from those included in the corresponding banking group, there is a risk that the MREL requirements applied to the resolution group may be mis-calibrated (too high or too low).

Figure 1: *Examples of (i) an institution where the resolution group is identical to the prudential group (left) and (ii) an institution where the resolution and prudential groups are different (right). The prudential group on the right is following a ‘multiple point of entry’ resolution strategy (multiple resolution groups). For example, this may be a deposit-taking retail bank*

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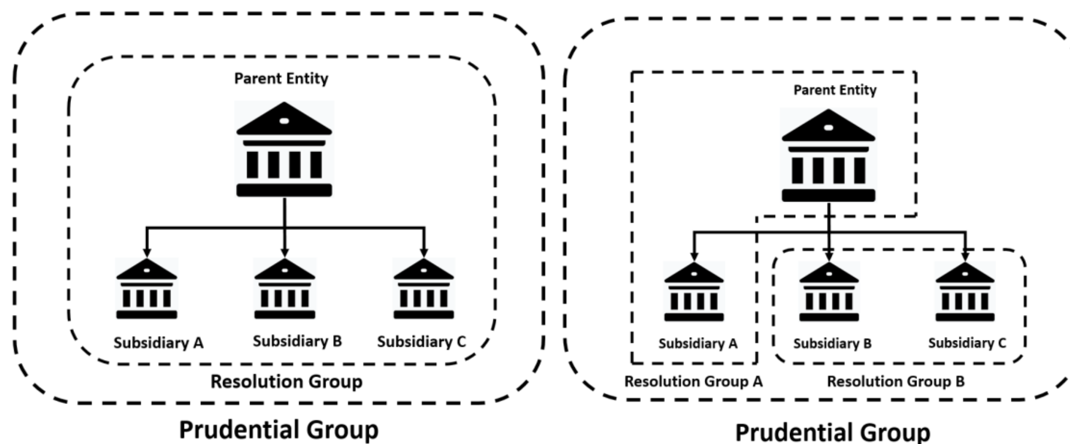
[4] MREL is calculated using the minimum capital requirement and buffers applicable to a banking group / legal entity in order to ensure that this is sufficient.

[5] Article 2(1) point 26 of Directive 2014/59/EU (BRRD), *inter alia*.

operating in two jurisdictions (with corresponding regulatory requirements to hold capital and liquidity in each country).



EBA's Proposed approach – materiality threshold

In order to identify and apply MREL calculation changes only to resolution groups that materially differ from their prudential groups, the EBA has proposed a ***5% materiality threshold*** between resolution groups and prudential groups. This materiality threshold is calculated by comparing the total risk exposure amount ("TREA") of resolution groups with their corresponding prudential groups (or, where appropriate, the closest entity in size which has its own capital and capital buffer regulatory requirements[6] ("closest entity")).

Where the difference is less than 5%, the existing MREL calculation methodology will hold (i.e. use the inputs from the prudential group for the resolution group MREL calculation)[7]. Alternatively, if the closest entity in size which has its own capital and capital buffer regulatory requirements has a difference of less than 5% from the resolution group TREA, this is used to provide the inputs into the resolution group MREL calculation[8].

NB *The number of firms that will be impacted by the changes proposed in this CP is expected to be very low, although those affected may experience substantial changes in MREL requirements as:*

1) *The pillar 2 survey shows that 93% of in-scope firms (firms with an MREL requirement [9]) have identical resolution group and prudential group perimeters.*
2) *Of the remaining firms, for 36% the difference in TREA is below 5%, meaning that they are out of scope of the proposed changes.*
3) *As per the above, only 4.5% of in-scope firms will potentially need to change their MREL calculation methodology, as below.*

However, a very small number of firms (ca. 0.5%) will potentially need to make significant changes to their MREL calculations (resolution group TREA less than half of banking group TREA).

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[6] The "*entity closest in size for which own funds requirements have been effectively set by the competent authority*".
[7] See Article 1(2) of the RTS on P2R and CBR estimation for resolution groups (draft RTS which forms a part of this CP).
[8] See Article 1(3) of the RTS on P2R and CBR estimation for resolution groups (draft RTS which forms a part of this CP).
[9] "*EU resolution groups earmarked for resolution as opposed to liquidation, and […] thus subject to MREL with a positive recapitalisation amount*".

EBA Public Consultation Question One:
Do you agree with the proposed 5% materiality threshold?

Proposed approach – Pillar 2 top-down approach

The top-down approach involves competent authorities ("CAs") adjusting the Pillar 2 requirements of the banking/prudential group (or closest entity) so that they better approximate the legal entity composition and risks of the resolution group.

In cases where the materiality threshold is exceeded, there should be a calculation of adjustments to the prudential group capital requirements that form inputs into the MREL calculation for the resolution group.

In this case, top-down adjustments to prudential group (or, where appropriate, the closest entity) are made using inputs from the relevant CA. The rationale is that it is the CAs who would need to authorise resolution groups post-resolution and so they should therefore be responsible for setting the capital requirements. This involves altering the pillar 2 requirements on the basis of legal entities and/or risks that are in or out of the perimeter (scope) of the resolution group as opposed to the banking/prudential group.

The CA may elect not to provide inputs (adjustment). In this case the un-adjusted prudential group/closest entity requirements are used to calculate the MREL of the resolution group.

Proposed approach – Pillar 2 bottom-up approach

The bottom up approach is for cases where one or more entities in the resolution group have higher P2R than the banking/prudential group. This indicates potentially idiosyncratic risks within the resolution group that should be captured at resolution group level.

Where the materiality threshold is exceeded and where one (or more) of the entities within the resolution group has P2R greater than the banking group P2R, then the resolution authority should take the greater of:

i) The weighted average of the individual pillar 2 requirements (weighted by TREA); or,
ii) The adjusted group requirement (adjusted by the relevant CA as per the above).

The rationale here is that varying levels of capital requirements may indicate diversity of risks within the resolution group.

EBA Public Consultation Question Two:
Do you agree with the proposed approach to estimating pillar 2?

Proposed approach – combined buffer requirement

The combined buffer requirement ("CBR") is proposed to be managed in different ways, depending on the buffer in question.

Table 1: *Combined buffer requirement and their proposed treatment in the CP*

BUFFER	PROPOSED APPROACH
Globally Systemically Important Institutions ("G-SII") buffer	Keep this as an input to calculating MREL[10].
Other Systemically Important Institutions ("O-SII") buffer	Use as an input to calculate MREL, using the buffer of the prudential/banking group of the largest entity in the resolution group (whichever is closer in size to the resolution group)[11].
Systemic Risk Buffer (SyRB)	Use as an input to calculate MREL, using the buffer of the prudential/banking group of the largest entity in the resolution group (whichever is closer in size to the resolution group).
Capital Conservation Buffer (CCoB)	No changes proposed as the buffer is not bank specific (this is applied at country level).
Countercyclical Buffer (CCyB)	No changes proposed as this does not form an input in the MREL calculation.

EBA Public Consultation Question Three:
Do you agree with the proposed approach to estimating Combined buffer Requirement?

Regarding next steps, there is:

i) **A public hearing scheduled for 29th September 2020;**
ii) **A deadline to submit responses for this consultation paper of 24th October 2020; and**
iii) **A plan to for the EBA to finalise the draft RTS (which forms a part of this CP) and communicate this to the European Commission by December 2020.**

[10] Note that the resolution authorities have the option to adjust the CBR (e.g. by not applying the G-SII buffer) when calibrating based on the resolution plan, as per BRRD article 45c (3), 7 sub-paragraph.
[11] Note that the resolution authorities have the option to adjust the O-SII buffer, as per BRRD article 45c (7), paragraph 6.

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