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From:	Commission Services
To:	Delegations
Subject:	Rationale behind MREL requirement and MREL guidance

Delegations will find attached Commission note for the 6/7 February 2017 meeting.

EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Commission Services' note on
Rationale behind MREL requirement and MREL guidance

Generally, the proposed approach on calibrating MREL reflects the fact that it continues to be a bank-specific requirement, determined by resolution authorities on the basis of a case by case analysis. In terms of structure, however, MREL is split in two main parts: MREL requirement (set out in Article 45c(2) of the proposal to amend the BRRD) and MREL guidance (Article 45e(1)).

The distinction between MREL requirement and MREL guidance was created to allow for the development of a mechanism for interventions which ensures that measures taken by the authorities are proportionate and appropriately graduated in view of the financial situation of a bank, i.e. they could become more severe as the financial situation deteriorates.

The role of the combined capital buffer requirement in the revised MREL framework

The proposal includes an important change in terms of eligibility for MREL which is that CET1 capital that is used to meet MREL cannot be used to meet the combined capital buffer requirement (CBR). This was done to ensure that CBR could serve its intended regulatory purpose as a CET1 buffer available in addition to regulatory requirements to be drawn down in stressed periods and, also, to comply with the TLAC term sheet which explicitly sets out such a rule (condition (a), section 6). This means that available CET1 would first be used to extinguish any shortfalls in order to comply with MREL before it would count towards compliance with CBR.

Such a stacking order, however, could imply that a breach of CBR resulting from a "reallocation" of CET1 to ensure compliance with MREL should be accompanied with automatic restrictions to distributions of discretionary payments to the holders of regulatory capital instruments and employees (in CRD referred to as Maximum Distributable Amount, or, MDA). This is also required by the TLAC term sheet (3rd para of section 6). However, MDA restrictions because of a breach of MREL would not constitute a proportionate intervention in cases where the bank is still well capitalised and complies with its regulatory capital requirement under CRR and CRD and the breach originates from a temporary inability of the bank to replace debt instruments that no longer meet MREL eligibility criteria. In such a case, application of restrictions may only aggravate the situation as the bank may find it difficult to issue new MREL eligible debt to restore compliance with MREL.

In this context, dividing MREL into MREL requirement and MREL guidance and stacking CBR on top of the former and below the latter helps to prevent an immediate automatic triggering of MDA restrictions that may lead to disproportionate and unwarranted outcomes (see section on breaches below).

Calibration of MREL requirement and MREL guidance

The underlying purpose of the MREL requirement is to ensure that:

- Losses are fully absorbed (Article 45c(2)(a)). Based on the judgment of the competent authority, such loss absorption amount shall correspond to the sum of Pillar 1 and "hard" Pillar 2 capital requirements under CRR and CRD (Articles 45c(3)(a)(i), 45c(3)(b)(i), 45c(4)(a)(i), 45c(4)(b)(i)), and

- The bank is recapitalised so that following its resolution it meets the CRD requirements for continuing authorisation, which means compliance with Pillar 1 and "hard" Pillar 2 capital requirements, in accordance with resolution actions foreseen in the resolution plan.

  In most cases the recapitalisation amount is likely to be smaller compared to the sum of the bank's existing Pillar 1 and "hard" Pillar 2 requirements because the balance sheet of the bank that is emerging from a resolution and that needs to be recapitalised would normally be smaller compared to its pre-resolution state because of asset write-downs and possible transfers to asset management vehicles, or retaining of assets in the insolvent part of the bank.

  As regards the "hard" Pillar 2 capital requirement one would normally expect a change in its level due to changes to the bank anticipated in its resolution plan (see last sub-paras of Articles 45c(3) and 45c(4)), e.g. discontinuance of certain non-critical but risky business areas. While a resolution should result in a de-risking of the bank with a resultant lowering in its "hard" Pillar 2 capital requirement, recital 9 acknowledges that in duly justified cases, following a resolution, risks addressed under Pillar 2 linked to the bank's business model, funding profile or overall risk profile may increase. In such limited cases the resolution authority should be able to increase the recapitalisation amounts in excess of the recapitalisation amounts referred to in first sub-paras of Articles 45c(3) and 45c(4).[1]

Given the above described assumptions behind the MREL requirement, the proposal gives discretion to the resolution authority to require banks to hold eligible MREL instruments in excess of the MREL requirement. Such MREL guidance, if deemed necessary, may cover two types of "buffers":

- Additional loss absorption needs in cases where such needs have been identified by the competent authorities in the form of prudential capital guidance (Article 45e(1)(a)), and / or

- Additional recapitalisation needs, where this is deemed to be necessary to ensure market confidence (Article 45e(1)(b)). Such needs are generally expected not to exceed the amount of CBR less a countercyclical capital buffer requirement unless the resolution authority assesses that a higher amount is necessary to ensure that

[1] Consultation with the competent authority on taking this decision, as part of a broader determination of MREL in general, is required by virtue of Article 45c(1).

the bank continues to meet the conditions for authorisations (set out in the CRD) for at least one year.

In the proposed MREL framework, G-SIIs will be subject to Pillar 1 MREL requirement (TLAC), which is calibrated in accordance with the TLAC term sheet. The resolution authority will have discretion to supplement the Pillar 1 MREL requirement with Pillar 2 MREL requirement and MREL guidance, as described above, on the basis of bank resolvability analysis.

Despite the proposed division of MREL into the MREL requirement and MREL guidance, generally a similar overall calibration level can be set by the resolution authority when compared to discretion available to it under the existing MREL framework (see the chart in Annex II).[2] The main difference is that the proposed approach is much better articulated in terms of which measures could and should be applied at different levels of breach, the interaction with capital requirements and buffers, whereas the current BRRD does not contain clear rules in this regard. The level of MREL guidance is also not subject to a public disclosure requirement.

Powers to address breaches

The proposal includes a new Article 45k which requires authorities to address a breach of MREL requirement by taking appropriate measures that include at least one of the following:

- Powers to address impediments to resolvability and penalties that can be applied by the resolution authority. As regards powers to remove impediments to resolvability, the current text on the decision making procedure (Article 17) is modified in order to expedite it in cases where an impediment is related to a breach of CBR due to a CET1 "reallocation" towards compliance with MREL (as described above). The list of powers to remove impediments to resolvability is expanded as well, by including powers (i) to require the bank to submit a plan to restore compliance with MREL requirement, CBR and MREL guidance and (ii) to require the bank to change the maturity profile of MREL eligible instruments.

- Early intervention measures that can be taken by the competent authority under CRD or BRRD.

Importantly, as explained above, in case of a breach of the MREL requirement MDA restrictions will also apply where CBR has been breached because of losses incurred by the bank even if it continues to meet its regulatory capital requirements. However, where CBR is breached because of an inability of the bank to issue new debt while it continues to meet its regulatory capital requirements, the bank will be given a fixed six month grace period to address the breach, before MDA restrictions kick in.

As regards breaches of MREL guidance, there is no obligation for the authorities to apply Article 45k, this being without prejudice to authorities' discretion to apply their respective powers if the relevant triggers for such powers are met (e.g. early intervention measures). Such a discretionary approach is warranted given the combined expected levels of MREL

[2] Under both the existing and the proposed MREL frameworks, all discretionary decisions of the resolution authority are expected to be proportionate and duly justified.

guidance and MREL requirement: the banks may be still very well capitalised (in terms of CRR and CRD requirements) at a time of MREL guidance breach and obliging competent or resolution authority to intervene may result in a disproportionate outcome.

However, it is proposed that when the bank breaches its MREL guidance repeatedly, the resolution authority shall have a power to require to accordingly increase the MREL requirement under Article 45c(2). In this regard, recital 17 clarifies that frequency of supervisory reporting on MREL eligible instruments should be consistent with supervisory reporting on own funds eligible instruments, which is quarterly (based on the existing ITS under CRR).

Finally, the proposal requires resolution and competent authorities to consult each other when applying their respective powers to ensure that their intervention measures are not conflicting and overlapping.

Based on the above, the interventions of the authorities are sequenced as follows:

- If the bank breaches its MREL guidance and this is an isolated event, no formal reaction by competent or resolution authorities is expected;

- If the bank breaches MREL guidance consistently and repeatedly (eg for several quarters in a row), the resolution authority may decide to convert MREL guidance into a MREL requirement with the effect that more severe interventions become possible;

- If the bank cannot replace liabilities that cease to meet MREL eligibility criteria, it may breach CBR because its available CET1 will be used to comply with the MREL requirement to extinguish a resultant shortfall in eligible liabilities. If in such a case the bank still complies with it capital requirements it will be given a six months grace period to address the shortfall before MDA restrictions kick in. In parallel, in an expedited procedure to address impediments to resolvability, the resolution authority may require the bank to submit a restoration plan to comply with MREL requirement, CBR and MREL guidance. In addition, other powers of resolution and competent authorities as listed in Article 45k may be exercised under the respective conditions applicable to those powers (early intervention, supervisory measures, administrative penalties etc.);

- If the bank breaches CBR because its available CET1 is used to extinguish a shortfall to comply with the MREL requirement due to incurred losses, automatic MDA restrictions will apply without a grace period. In parallel, as in the above case, the resolution authority may exercise a power to require the bank to submit a restoration plan to comply with MREL requirement, CBR and MREL guidance. In addition, other powers of resolution and competent authorities as listed in Article 45k may be exercised under the respective conditions applicable to those powers (early intervention, supervisory measures, administrative penalties etc.);

- If due to losses incurred all available CET1 that was used to comply with CBR is not sufficient to extinguish a shortfall to comply with the MREL requirement then both CBR and MREL requirements are breached. MDA restrictions and all powers listed

above are applicable, as well as the powers related to the capital conservation plan under Article 142 CRD, and competent and resolution authorities are expected to react proportionally to the financial situation of the bank (including a "failing or likely to fail" assessment, and/or resolution, if the conditions are met).

Annex I: Relevant proposed articles

Recital 9

The MREL should allow institutions to absorb losses expected in resolution and recapitalise the institution post-resolution. The resolution authorities should, on the basis of the resolution strategy chosen by them, duly justify the imposed level of the MREL in particular as regards the need and the level of the requirement referred to in Article 104a of Directive 2013/36/EU in the recapitalisation amount. As such, that level should be composed of the sum of the amount of losses expected in resolution that correspond to the institution's own funds requirements and the recapitalisation amount that allows the institution post-resolution to meet its own funds requirements necessary for being authorised to pursue its activities under the chosen resolution strategy. The MREL should be expressed as a percentage of the total risk exposure and leverage ratio measures, and institutions should meet simultaneously the levels resulting from the two measurements. The resolution authority should be able to adjust the recapitalisation amounts in cases duly justified to adequately reflect also increased risks that affect resolvability arising from the resolution group's business model, funding profile and overall risk profile and therefore in such limited circumstances require that the recapitalisation amounts referred to in the first subparagraph of Article 45c(3) and (4) are exceeded.

Recital 17

To ensure a transparent application of the MREL, institutions should report to their competent and resolution authorities and disclose regularly to the public the levels of eligible liabilities and the composition of those liabilities, including their maturity profile and ranking in normal insolvency proceedings. There should be consistency in the frequency of supervisory reporting on compliance with own funds requirements and with MREL.

Article 45c Determination of the minimum requirement for own funds and eligible liabilities

1. […]

2. Where the resolution plan provides that resolution action is to be taken in accordance with the relevant resolution scenario referred to in Article 10(3), the requirement referred to in Article 45(1) shall equal an amount sufficient to ensure that:

(a) the losses that might expected to be incurred by the entity are fully absorbed ('loss absorption');

(b) the entity or its subsidiaries that are institutions, but not resolution entities are recapitalised to a level necessary to enable them to continue to comply with the conditions for authorisation and to carry out the activities for which they are authorised under Directive 2013/36/EU, Directive 2014/65/EU or equivalent legislation ('recapitalisation');

Where the resolution plan provides that the entity shall be wound up under normal insolvency proceedings, the requirement referred to in Article 45(1) for

that entity shall not exceed an amount sufficient to absorb losses in accordance with point (a) of the first subparagraph.

3. Without prejudice to the last subparagraph, for resolution entities, the amount referred to in paragraph 2 shall not exceed the greater of the following:

(a) the sum of:

(i) the amount of losses to be absorbed in resolution that corresponds to the requirements referred to in Article 92(1)(a),(b) and (c) of Regulation (EU) No 575/2013 and Article 104a of Directive 2013/36/EU of the resolution entity at sub-consolidated resolution group level,

(ii) a recapitalisation amount that allows the resolution group resulting from resolution to restore its total capital ratio referred in Article 92(1)(c) of Regulation (EU) No 575/2013 and its requirement referred to in Article 104a of Directive 2013/36/EU at resolution group sub-consolidated level;

(b) the sum of:

(i) the amount of losses to be absorbed in resolution that corresponds to the resolution entity's leverage ratio requirement referred to in the Regulation (EU) No 575/2013 at resolution group sub-consolidated level; and

(ii) a recapitalisation amount that allows the resolution group resulting from resolution to restore the leverage ratio referred to in Article 92(1)(d) of Regulation (EU) No 575/2013 at resolution group sub-consolidated level.

For the purposes of point (a) of Article 45(2), the requirement referred to in Article 45(1) shall be expressed in percentage terms as the amount calculated in accordance with point (a) of this paragraph divided by the total risk exposure amount.

For the purposes of point (b) of Article 45(2), the requirement referred to in Article 45(1) shall be expressed in percentage terms as the amount calculated in accordance with point (b) of this paragraph divided by the leverage ratio exposure measure.

The resolution authority shall set the recapitalisation amounts referred to in the previous subparagraphs in accordance with the resolution actions foreseen in the resolution plan and may adjust those recapitalisation amounts to adequately reflect risks that affect resolvability arising from the resolution group's business model, funding profile and overall risk profile.

4. Without prejudice to the last subparagraph, for entities that are not themselves resolution entities, the amount referred to in paragraph 2 shall not exceed the greater of any of the following:

(a) the sum of:

(i) the amount of losses to be absorbed in resolution that corresponds to the requirements referred to in Article 92(1)(a),(b) and (c) of Regulation (EU) No 575/2013 and Article 104a of Directive 2013/36/EU of the entity, and

(ii) a recapitalisation amount that allows the entity to restore its total capital ratio referred in Article 92(1)(c) of Regulation (EU) No 575/2013 and its requirement referred to in Article 104a of Directive 2013/36/EU;

(b) the sum of:

(i) the amount of losses to be absorbed in resolution that corresponds to the entity's leverage ratio requirement referred to in the Article 92(1)(d) of Regulation (EU) No 575/2013, and

(ii) a recapitalisation amount that allows the entity to restore its leverage ratio referred to in the Article 92(1)(d) of Regulation (EU) No 575/2013 ;

For the purposes of point (a) of Article 45(2)(a), the requirement referred to in Article 45(1) shall be expressed in percentage terms as the amount calculated in accordance with point (a) divided by the total risk exposure amount.

For the purposes of point (b) of Article 45(2)(b), the requirement referred to in Article 45(1) shall be expressed in percentage terms as the amount calculated in accordance with point (b) divided by the leverage ratio exposure measure.

The resolution authority shall set the recapitalisation amounts referred to the previous subparagraphs in accordance with the resolution actions foreseen in the resolution plan and may adjust those recapitalisation amounts to adequately reflect risks that affect the recapitalisation needs arising from the entity's business model, funding profile and overall risk profile.

6. […]

Article 45e Guidance for the minimum requirement of own funds and eligible liabilities

1. The resolution authority may give guidance to an entity to have own funds and eligible liabilities that fulfil the conditions of Article 45b or 45g(3) in excess of the levels set out in Article 45c and Article 45d that provides for additional amounts for the following purposes:

(c) to cover potential additional losses of the entity to those covered in Article 45c, and/or

(d) to ensure that, in the event of resolution, a sufficient market confidence in the entity is sustained through capital instruments in addition to the requirement in point (b) of Article 45c(2) ('market confidence buffer').

The guidance shall be only provided and calculated with respect to the requirement referred to in Article 45(1) calculated in accordance with point (a) of Article 45(2).

2. The amount of the guidance given in accordance with of paragraph 1 may be set only where the competent authority has already set its own guidance in accordance with Article 104b of Directive 2013/36/EU and shall not exceed the level of that guidance.

The amount of the guidance given in accordance with point (b) of paragraph 1 shall not exceed the amount of the combined buffer requirement referred to in point (6) of Article 128 of Directive 2013/36/EU, except for the requirement referred to in point (a) of that provision, unless a higher level is necessary to ensure that, following the event of resolution, the entity continues to meet the conditions for its authorisation for an appropriate period of time that is not longer than one year.

The resolution authority shall provide to the entity the reasons and a full assessment for the need and the level of the guidance given in accordance with this Article.

3. Where an entity consistently fails to have additional own funds and eligible liabilities as expected under the guidance referred to in the first paragraph, the resolution authority may require that the amount of the requirement referred to in Article 45c(2) be increased to cover the amount of the guidance given pursuant to this Article.

4. An entity that fails to have additional own funds and eligible liabilities as expected under the guidance referred to in the first paragraph shall not be subject to the restrictions referred to in Article 141 of Directive 2013/36/EU.

Article 45k Breaches of the minimum requirement for own funds and eligible liabilities

1. Any breach of the minimum requirement for own funds and eligible liabilities by an entity shall be addressed by the relevant authorities on the basis of at least one of the following:

    (e) powers to address or remove impediments to resolvability in accordance with Article 17 and Article 18;

    (f) measures referred to in Article 104 of Directive 2013/36/EC;

    (g) early intervention measures in accordance with Article 27;

    (h) administrative penalties and other administrative measures in accordance with Article 110 and Article 111;

2. Resolution and competent authorities shall consult each other when they exercise their respective powers referred to in points (a) to (d) of paragraph 1.

Annex II: Comparison of Proposed and Existing MREL Frameworks