Enhancing the Capacity to Apply a Bail-in Through the MREL Setting

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Abstract

In the aftermath of the financial crisis, the European Union designed a new legislative and institutional framework to manage banking crises. This new framework is an answer to the situation where the banks could have been perceived as “too big to fail”. It aims to make a bank failure possible without any public bail-out while preserving the critical functions for the economy. To meet this objective, the legislation notably provides the European resolution authorities for a new tool which should be used in most of the resolution schemes in the future: the bail-in.

The principle of the bail-in is to use the banks liabilities to absorb the losses once the equity is exhausted and to recapitalize the banks through the conversion of liabilities into equity. However, if the principle of the bail-in is straightforward, its implementation in practice raises challenges. This is the reason why the resolution authorities will have to analyse through the resolution planning how the bail-in tool could be applied in order to anticipate as much as possible any possible hurdle to implement it in practice. In that regard the setting of a Minimum Requirement of own funds and Eligible Liabilities (MREL) to bail-in is a priority for the resolution authorities in the

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EU in the coming months. However, if the MREL will enhance the banks loss absorbing capacities, it is not in itself the unique answer to crisis times as it is part of the resolution planning and can require time to be properly implemented.

The 2008-2011 financial turmoil highlighted the limitations of the regulatory framework to handle a bank failure without public money. In most of the cases, the size of the banks, the financial situation of the markets and the necessity to react quickly forced the public authorities to inject huge amounts of public money in their banking system[56]. There was no real alternative to public bail-outs given the consequences and the impact of a bank failure on the economy and the complexity to make a bank disappearing in a short timeframe. At the peak of the crisis, most of the banks could be considered as "too big to fail", which clearly raised a moral hazard issue.

Rescuing ailing banks with public money shifted the burden of the failures and of the losses to the taxpayers. The injection of public money in banks put a strong pressure on the national budgets and shifted the crisis from the banks to the States. In several European countries the financial crisis triggered tensions on the sovereign bond markets and more specifically, challenged the coherence and the robustness of the Euro Area. It stressed the need to set a new institutional and legislative framework to answer to banks crises by cutting the link between the banks and the States.

In 2011, the FSB set out the first key principles to handle bank failure[57] and set the basis of a new framework to resolve financial institutions in an orderly manner without taxpayer's exposure to losses while maintaining continuity of their vital economic functions. This initiative paved the way for the development of a European framework on bank crisis management. Two pieces of legislation were designed by the European institutions to incorporate the international principles in European law but also to build a single mechanism to manage the banks failure at the level of the Banking Union:

56. In its 2012 annual report on Competition policy, the European Commission highlighted that approximately EUR 1.6 trillion were transferred to banks between October 2008 and the end of 2011, without taking into account the amount pledged by EU governments. http://ec.europa.eu/competition/publications/annual_report/2012/part1_en.pdf

57. Key attributes of Effective Resolution Regimes for Financial Institutions, FSB, October 2011, http://www.fsb.org/wp-content/uploads/r_111104cc.pdf?page_moved=1

- In April 2014, the Bank Recovery and Resolution Directive[58] (BRRD) set at the European Union level the new legislative framework to handle a bank crisis either in going concern (recovery action) or in gone concern (resolution action).
- In July 2014, the Single Resolution Mechanism Regulation[59] (SRMR) set up the new institutional framework for resolution action at the Banking Union level. The Single Resolution Mechanism is the second pillar of the Banking Union completing the Single Supervision Mechanism.

The mandate of the SRM is not limited to acting in case of a bank failure. Its first objective is to anticipate possible difficulties to handle a bank failure and to restore the viability of the bank after a resolution action to maintain the critical functions. The SRM is primarily focused on preventive and preparatory measures through drawing up resolution plans. The resolution planning aims to design action plans where the costs of resolution – when resolution is preferred to a normal insolvency procedure – would be shouldered by the banks owners and creditors rather than taxpayers. In order to meet this objective, the cornerstone of the resolution plan is, in most of the cases, the bail-in tool.

The BRRD introduced the bail-in in the European legislation and gave new power to the resolution authorities to enforce this tool in case of bank failure. This new tool allows to absorb the losses beyond the own funds through the write-down of certain liabilities. Once the losses are absorbed, the bank's capital could be reconstituted by the conversion of all or part of the remaining eligible liabilities into equity[60]. Once the bail-in decision is implemented, the bank should have a sufficient amount of capital to comply with the prudential requirements and to restore the confidence of the market.

However, the bail-in of certain liabilities raises practical and legal challenges. The discrepancies between the treatment of certain claims in resolution and in insolvency proceeding could trigger legal actions. Some instruments could be difficult to bail-in, for instance the derivatives or certain

58. Directive 2014/59/EU of the European Parliament and the Council of the 15 April 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

59. Regulation n° 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 (SRMR).

60. Directive 2014/59/EU (BRRD), article 2(57)

structured product where the amount to bail-in at the point of resolution is difficult to determine in advance. Therefore, it is paramount that the resolution authorities anticipate and limit as much as possible the difficulties to apply the bail-in in the resolution plans.

In order to enhance the likelihood to implement a bail-in successfully, the BRRD requests to set a Minimum Requirement of own funds and Eligible Liabilities (MREL) that could be bailed-in at the point of resolution. The objective of MREL is to enhance the banks' loss absorbing capacities by singling out an amount of liabilities easily "bail-inable" (I). However, such an objective needs time to be fully implemented as MREL is the outcome of the resolution planning and the resolvability assessment (II).

1. The need to enhance the banks' Loss Absorbing Capacities to ease the implementation of the bail-in

The BRRD does not foresee a harmonised minimum level of "bail-inable" instruments at the level of individual banks. Instead, it gives the resolution authorities detailed guidance for setting out these requirements for individual banks, while also allowing them discretion on the minimum level on MREL (A) and on the composition and the quality of MREL eligible items (B).

A. Setting a minimum requirement of Loss Absorbing Capacities

The resolution authority should ensure that, in case of application of the bail-in tool, the institution is capable of absorbing an adequate amount of losses and being recapitalised by a sufficient amount. As a matter of fact, after the bail-in, the capital should reach the level necessary to maintain the authorisation and to restore the market confidence.

The credibility and the feasibility of a resolution plan is largely built on the bank's capacities to get sufficient financial resources available to absorb losses and to be recapitalised at the point of resolution. Within the European Union, the loss absorbing capacity is assessed through the MREL. It is a sort of pure "pillar two requirement" for resolution – which should be tailored to the banks' features and adjusted to take into account the resolution strategy.

The BRRD sets the key criteria for MREL[61]. To be eligible to MREL, the instruments should be issued and fully paid up and have a remaining maturity of at least on year. The instrument could not be guaranteed or funded by the institution itself. Derivatives and preferred deposits[62] are not eligible to MREL. However, resolution authorities have the leeway to complete these minimum requirements by their own policy to enforce the legislation and to strengthen the efficiency of the bail-in tool in case of resolution.

Based on the work conducted by the European Banking Authority (EBA), the European Commission endorsed in 2016 a delegated regulation completing the BRRD and clarifying the calculation of the MREL requirements[63]. This regulation harmonises the methodology by providing guidance on the minimum amount of own funds and liabilities to absorb losses (Loss absorption amount) and to recapitalise the bank after resolution (Recapitalisation amount). This calculation is driven by the solvency requirements, taking into account the prudential pillar two, the buffers, the Basel one floor and, when implemented, the leverage ratio. All in all, taking into account the need to compute a specific additional amount to restore confidence, the outcome of the first step of the calculation should lead the resolution authorities to set a level of MREL at least twice the amount of the capital requirements.

This amount could be adjusted by resolution authorities to take into account the features of the banks (e.g. business model, funding model and risk profile) both at the level of the loss absorption amount and the recapitalisation amount. The possibilities for adjusting the loss absorption amount upwards or downwards are closely related to supervisory stress tests and the Supervisory Review and Evaluation Process (SREP). It should be the outcome of a discussion with supervisory authorities. The recapitalisation amount can be adjusted in relation to the resolution strategy.

The confidence layer can be linked to a comparison of the bank with its peers.

For the Global Systemically Important Institutions (G-SIIs), it can be assumed that the FSB Total Loss Absorbing Capacities (TLAC) term sheet will

61. Directive 2014/59/EU (BRRD), article 45

62. According to the article 108(a) of the Directive 2014/59/EU (BRRD), the preferred deposits are the “deposits from natural persons and micro, small and medium-sized enterprises which exceeds the coverage level provided for in Article 6 of Directive 2014/49/EU”.

63. Commission Delegated Regulation n° 2016/1450 of the 23 May 2016 based on an EBA draft Regulatory Technical Standard.

be transposed as a binding minimum standard into EU law. For these banks, the MREL policy should start from this document published in November 2015. It requires a minimum amount of Loss absorbing capacities of 16% of the RWA plus the buffers as of 2019[64]. Although TLAC is a pillar 1 like requirement, it shares common objectives with MREL: enhancing the Loss Absorbing Capacities and simplifying the application of the bail-in. In that sense, even if the scope of institutions, the eligibility criteria and the computing methodology are not entirely aligned, it is nevertheless possible to say that MREL and TLAC are "two sides of the same coin".

The TLAC requirements should be introduced in the EU legislation by the European co-legislators in the coming months. It may have an impact on the BRRD and could be the opportunity for the European Commission to suggest improvements to the current provisions on MREL. However, this legislative proposal should not be a pretext to delay the implementation of MREL and the work done so far. Although the legislation could be amended, the substance of the BRRD and the SRMR on MREL should not change. The objective will still be to enhance the loss absorbing capacities. MREL is already a key element for resolution planning and this is why the SRB will keep working on its implementation in the coming months.

B. Enhancing the quality of the Loss Absorbing Capacity

The BRRD sets a wide scope of MREL eligible instruments. Conversely to the FSB TLAC term sheet which allows non-subordinated elements for a small fraction only and subject to stringent conditions, the BRRD is more open regarding senior unsecured liabilities. Nevertheless, resolution authorities have to pay attention on the quality of MREL eligible items to enhance the resolvability of the banks under their responsibility.

The resolvability assessment of loss absorbing capacity will start by a close analysis of the insolvency ranking of the liabilities eligible to bail-in. By principle, the resolution authorities should apply the bail-in tool to all the liabilities respecting a ranking from the more to the less junior instruments

64. FSB, Total Loss-absorbing Capacity (TLAC) Term Sheet, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution, 9th November 2015, http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf

consistently with the order of claims applicable in the insolvency laws (with pari passu treatment within each class)[65]. However, the BRRD allows the exclusion of certain liabilities from the bail-in. These exclusions are justified by different reasons as, for instance, the protection of depositors (covered deposits), the protection of creditors' claims based on a charge, a pledge or collateral arrangements (secured liabilities) or the protection of employee's liabilities[66]. In exceptional circumstances, the resolution authorities could also exclude other liabilities from the scope of the bail-in. These exceptional circumstances could be constituted when there is an impossibility to bail-in certain banks' liabilities in a reasonable time, when there is the need to preserve the continuity of the critical functions, to avoid the risk of contagion or the destruction in value[67]. These exceptions introduce a difference in the treatment between creditors of the same classes, in particular within the senior debt category (i.e. ordinary claim category).

This difference could be justified from a resolution perspective. However, it creates an asymmetry between resolution schemes and the normal insolvency proceeding which could trigger legal actions on the basis of "No Creditor Worse Off" than in liquidation principle (NCWO). According to the BRRD "*no creditor shall incur greater losses than would have been incurred [...] under normal insolvency proceedings*" [68]. In case of breach of the NCWO principle, the creditors have the right to be compensated after the resolution action. It is important to note that there is a right to compensation, but not a possibility to undo what has been done through the resolution scheme. This particular situation reinforces the responsibility of the resolution authorities before taking decisions.

In order to enhance the legal certainty and transparency, the resolution authorities have a strong interest to require the banks to meet all or part of their MREL requirement with debt or equity instruments ranking junior to the other debt instruments.

For the G-SIIs, the core features of the TLAC term sheet can be already taken into account when setting MREL, in particular regarding the subordination

65. Directive 2014/59/EU (BRRD), articles 44.1 and 34(b)
66. Directive 2014/59/EU (BRRD), article 44.2
67. Directive 2014/59/EU (BRRD), article 44.3
68. Directive 2014/59/EU (BRRD), article 34(g)

requirements[69]. For these banks, only a small part of the TLAC requirements could be met with senior unsecured debt, under stringent conditions. For the non-G-SIIs banks, especially the most systematic ones among the Other Systemically Important Institutions (O-SIIs), it will be necessary to set MREL with a minimum amount of subordinated instruments or of instrument ranking junior to the liabilities excluded from bail-in. In that respect, the TLAC principles could be extended to other systemic banks like the biggest O-SIIs.

The resolvability assessment of loss absorbing capacities should also take into account the analysis of the counterparties. The resolution authorities do not have the legal choice not to bail in retail creditors, except under exceptional circumstances[70]. Likewise, resolution authorities should not de-recognise instruments from MREL just because they are held by retail creditors, if they meet the requirements for MREL. There is no legal basis for resolution authorities to ex ante exclude liabilities held by natural persons or SMEs from bail-in or from MREL. However, holdings of senior bonds by the bank's own retail clientele could prove to be an impediment to correctly apply the bail-in tool, and make these banks difficult to be resolved. Resolution authorities would most likely have to bail-in these retail bondholders, which could lead to a loss of customers' base. This could endanger the bank's future viability and the continuation of critical functions, so that the resolution objectives may not be reached entirely. The issue around holding of MREL instruments by retailors is similar to others linked to the poor quality of MREL instruments. In that sense, the resolution authorities are driven by considerations related to the resolvability of the institutions and not by the protection of retailers against mis-selling. There are specific rules on mis-selling, which are of crucial importance, and therefore have to be enforced by designated authorities, different from the resolutions ones. Resolution authorities could address the particular situations based on a case-by-case analysis in the future by means of higher MREL requirements or of subordination requirements. Banks should be encouraged to think of measures to substitute or replace retail bonds with institutional ones.

69. The G-SIIs should meet, at a minimum, an amount equal to 13.5% of group RWA plus the combined buffer requirement with own funds and subordinated instruments. Alternatively, the TLAC requirement could be met by own funds and senior debt only, if the amount of "TLAC excluded liabilities" that rank pari passu or junior to the TLAC eligible liabilities does not exceed 5% of the eligible external TLAC.

70. Directive 2014/59/EU (BRRD), article 44.3

As another example of point of attention, it is worth mentioning that resolution authorities will need to assess the MREL eligibility liabilities subject to the contracts issued under non EU law. When liabilities are not governed by EU law, the resolution authorities run the risk that the courts of the country whose law governs the liabilities do not recognise the bail-in or transfer order of an EU resolution authority. These liabilities may not be "bail-inable" and should not be automatically eligible to MREL although they meet the criteria set by the BRRD. They should be included in MREL only if the bank is able to demonstrate that a bail-in would be effective while governed by foreign law. For that, the introduction of a bail-in clause is definitely necessary but could not be as such sufficient to consider the eligibility of these instrument into MREL. It should be completed by an independent legal opinion to demonstrate its effectiveness.

These examples of resolvability assessment illustrate that setting MREL is not the outcome of an automatic calculation but the result of a detailed analysis done through the resolution planning. In that sense, MREL is tailored to the specificities to each and every institution. The SRB has started this analysis in 2016 but may still need time to adjust it to the preferred resolution strategy for each institution, and to implement it in practice.

2. The need to adapt the Loss Absorbing capacities to the outcome of the resolution planning process

The bank-specific nature of MREL recognises the diversity of business models and resolution strategies among European banks (A). It will require for most of the banks a transitional implementation phase to comply with the MREL requirements (B).

A. Taking into account the resolution strategy and the resolvability assessment in setting MREL

MREL should reflect the strategy developed in the resolution plans. The MREL requirement should be set at the appropriate level to reflect whether the strategy is based on a multiple-point-of-entry (MPE) or a single-point-of-entry

approach (SPE). Given a resolution action would be applied at the legal entity level, the external loss-absorbing capacities should be primarily located in the entity where the losses should occur and where the bail-in would be applied. For the groups following an SPE approach, the external loss absorbing capacities should be located at the parent entity level. In case of MPE, the loss-absorbing capacities should be defined at sub-consolidated level for each point of entry of the MPE. Once the resolution strategy defined, the banks debt issuance policy should be set accordingly to enhance the feasibility of the resolution plans.

Beyond the points of entry, loss absorbing capacities could be allocated internally within the banking groups to cover the losses that could occur in entities bearing critical functions. The resolution authorities will have to ensure that loss-absorbing capacities are distributed properly across the group to upstream to losses to the point of entry if necessary. Internal loss absorbing capacities should be set, at least, between the point of entry and the material entities. Such an allocation of the loss absorbing capacities should rely on a robust analysis of the critical functions and of the risks within the groups.

The resolution strategy should also be reflected in the quantum of the MREL requirements. As a pure pillar two requirement, MREL gives a discretionary power to resolution authorities to adjust upwards or downwards the requirements. The banks' capacities to reduce their risks in case of crisis could be factored in the MREL requirements (e.g. sale of assets, discontinuation of certain activities). Such a reduction of risks would have to be assessed cautiously by the resolution authorities in order to understand the credibility and the feasibility of the measures presented by the banks. The banks have to quantity the impact of their decision (i.e. reduction of Risk Weighted Assets) and to demonstrate that the operationalization of the deleveraging is feasible in stressed conditions (e.g. liquidity of the considered market, appropriate valuation of the assets, ...). The assessment of the risk reduction should be done in cooperation with supervisory authorities.

According to the Delegated regulation on MREL, the bank's business model, funding model, and risk profile should also be taken into consideration to set MREL[71]. A bank that is a bigger risk to financial stability will have a higher MREL requirement to ensure that there is sufficient capital in case of

71. Commission Delegated Regulation n° 2016/1450, article 4

resolution, while a bank that has fewer critical functions and a less risky business model, or one that organises its critical functions in a way that they may easily be separated, receive a lower MREL requirement.

The resolution authorities assess the risks of the banks and their importance to the national and international financial markets, setting a level playing field for comparable banks, while still taking proportionality into account. However, MREL should be set at a level sufficiently high to access, if necessary, to the financing arrangements like Single Resolution Fund in the Banking Union. In that regard, the SRB has consistently made reference to minimum threshold of 8% of total own funds and liabilities to be generally considered in the MREL requirement.

Finally, the MREL decisions could be adjusted to reflect the outcomes of the resolvability assessment. In case of material impediments, the MREL requirement should be adjusted upward to ease the success of a resolution action. The MREL decision is not the starting point of resolution planning. It is rather the result of the resolution planning. For this reason, although most of the resolution authorities have started working on MREL and engaged in a discussion with banks, the process to take MREL decisions and to implement these decisions could be spread over the next few years.

B. An implementation to be spread over the next years

The legislation does not provide any guidance for the time period that banks may be given to meet their MREL requirement. The only guidance provided by the Delegated Regulation on MREL is that resolution authorities are required to communicate a "*planned MREL for each 12-month period during the transitional phase*" [72]. Consequently, once the MREL decision is taken, the banks should meet their MREL target as soon as possible but under a path decided by the resolution authorities. There could be practical limitations in terms of the volume of MREL eligible instruments that markets could absorb without significant distortion to the prices at which banks could issue securities. In addition, asking banks to issue as many securities as possible in order to meet their MREL requirement as quickly as possible could force banks to increase their balance sheets and

72. Commission Delegated Regulation n° 2016/1450 of the 23 May 2016, article 8.2

invest the additional funds obtained into risky activities that are not consistent with their existing business models and risk appetite.

In order to find an appropriate balance and in case of a shortfall, a reasonable debt issuing plan should be set by banks and discussed with resolution authorities to reach the MREL requirement as soon as possible.

The MREL requirement will have to be complied with by the deadline defined by the resolution authorities. On a case by case basis, the deadline could be adjusted for each banking group and could be adjusted in the context of the annual review of the MREL requirement. The MREL requirement could be re-set based on a refined resolution strategy and resolvability assessment, as well as due to the outcome of joint decisions by resolution colleges, in coming years. In that sense, MREL is an evolving tool tailored to each bank. Decisions taken by the bank in terms of business model and strategy will have to be assessed in terms of resolvability and translated into a revised MREL target as far as necessary. In all the cases, the G-SIIs will have to comply with the FSB TLAC Term sheet no later than 1 January 2019, which implies that MREL requirement should be defined accordingly.

The disclosure of MREL requirement will have to be considered cautiously by resolution authorities and banks, in particular at the beginning of the process. The figure could be difficult to interpret for the market without a good understanding of resolution planning analysis. Any comparison between two MREL figures would be irrelevant as each MREL figure starts from a common methodology but is tailored to the situation of each bank from a resolvability point of view. The communication to the markets should be conducted in parallel with clear explanation of the objectives and features of MREL setting. For the moment, the SRB is building its dialogue with bank and has not taken yet any binding decision around MREL.

3. Conclusion

MREL is key to increase the loss absorption capacities of European banks, creating real incentives for better resolvability and for ensuring that banks in Europe will never again be 'too big to fail'. Going forward, bail-in rather than bail-out will be the rule of the game.

However, beyond the MREL setting and the implementation of the bail-in tool, the resolution authorities will have to work on other aspects of resolution planning. Although MREL is essential, resolution planning is not limited to the assessment of the loss absorbing capacities. The resolution authorities will have also to take care of the operational continuity of critical services after the resolution. The banks' capacity to raise funding, the access to financial market infrastructures or the restoration of the market confidence are also key elements to take into consideration. The creation of a new institutional and legislative framework on resolution is a major improvement for the financial stability but its full implementation and effectiveness will be achieved only through an on-going discussion between resolutions authorities, between resolutions authorities and supervisory ones, and with banks themselves.

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