Finance Watch comments on the European Banking Authority's Interim Report on the Implementation and Design of the MREL Framework

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Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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On July 19, the European Banking Authority (EBA) published its interim report on the implementation and design of the minimum requirement for own funds and eligible liabilities (MREL), which contains a number of provisional recommendations to the European Commission regarding a future legislative proposal on the implementation of the Financial Stability Board's "total loss-absorbing capacity" (TLAC) standard in the EU and the review of MREL. Finance Watch is pleased to have the opportunity to share its comments and observations on the report and its recommendations.

1: Reference base for MREL requirement

Finance Watch recognises that there is a desire on the part of legislators to harmonise the reference base for the minimum requirement for own funds and eligible liabilities (MREL) with that for total loss-absorbing capacity (TLAC), which is defined as the higher of a) 16-18% of RWAs or b) 6.0-6.75% of leverage. Whereas we believe that TLAC could, in principle, be incorporated into EU law without necessarily amending the definition of MREL in the Bank Recovery and Resolution Directive (BRRD)[1], we agree that harmonisation could be beneficial in terms of regulatory consistency and transparency. Such benefits should not come at the expense of a weakening of existing BRRD standards, in particular the "burden sharing" threshold as set out in Art. 44/5 BRRD.

We agree that the current definition of "total liabilities and own funds" in Art. 45/1 BRRD does not fully specify the treatment off-balance sheet liabilities, such as derivatives exposures, which can be very substantial in some cases. We would therefore concur with the EBA's view that these exposures should be accounted for in accordance with the same netting approach that is applied for prudential purposes in the context of calculating RWAs or the leverage ratio. The most consistent, and hence our preferred approach therefore would be to adopt the leverage ratio exposure measure as the reference base for calculating MREL.

- Finance Watch believes that a non-risk sensitive measure is generally preferable as a reference base for the purposes of calculating capital requirements as it eschews the known shortcomings of the risk-weighted approach, including complexity and modelling risks, susceptibility to regulatory arbitrage, competitive distortion and pro-cyclicality[2].
- We do not believe that insensitivity to changes in risk is, *per se*, a drawback of using the leverage ratio exposure measure. We note that MREL is, by definition, meant as a backstop which is activated as and when a bank is "failing or likely to fail", at which point its going concern capital is at risk of being depleted. It would be inappropriate and imprudent, in our view, to rely in this situation on the same risk assessment framework and systems which the bank has applied in the run-up to this situation, patently without success, and which will have proven inadequate at this stage.

By replacing "total liabilities and own funds" with the leverage ratio exposure measure the legislator could achieve the necessary clarification of the calculation basis in a relatively straightforward and consistent way and without altering the BRRD's conceptual approach of using a non-risk sensitive reference base.

[1] Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, O.J. L173, 12 June 2014, pg. 190.

[2] Finance Watch, Response to the BCBS consultation on the "Revisions to the Basel III leverage ratio framework", 19 July 2016; (http://www.finance-watch.org/our-work/publications/1271-response-bcbs-leverage-ratio)

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2: Relationship with other regulatory requirements (capital adequacy, buffers)

Buffers are designed to act as safeguards to ensure that banks are, at all times, in a position to comfortably cover their minimum capital requirements. They should be considered as a stand-alone prudential tool, which accounts for risk factors that are not fully captured by the standard capital adequacy regime.

MREL is defined by the Regulatory Technical Standard (RTS) on MREL[3] as the sum of the loss absorption and recapitalisation amounts. Each of the two is designed to meet the regulatory capital requirements of the bank – the loss absorption amount to meet its requirements as a going concern in its current configuration, the recapitalisation amount to restore capital adequacy to a restructured entity post-resolution. As long as the surviving entity is expected to remain of systemic significance, according to the resolution authority's assessment and the resolution plan, the bank should be expected to meet the appropriate combined buffers pre- as well as post-resolution.

Accordingly, the treatment of buffers under MREL should mirror that under TLAC. Common Equity Tier 1 (CET1) capital used to meet regulatory buffer requirements should not be eligible for TLAC/MREL. Buffers should be additive to the other capital requirements, i.e. stacked atop regulatory capital and MREL.

- Double-counting of CET 1 capital for buffers and MREL should be excluded for all banks, both for prudential reasons, as set out above, and to maintain a level playing field between market participants.
- The exclusion of double-counting would also draw a clear line between the domains of the competent and resolution authorities when it comes to intervention. Breaches of the buffer requirement would be sanctioned by the competent authority while the resolution authority would concentrate on monitoring MREL requirements.

Calls to relax automatic restrictions on Maximum Distributable Amounts (MDA) should be treated with caution:

- The purpose of MDA is to lend credibility to the fundamental principles of prudent bank management: an institution that does not generate profits should not be distributing capital out of reserves. The tendency of banks, in particular European ones, to carry on paying dividends while reporting losses has already been remarked on critically, e.g. by the BIS, and is seen as one of the primary reasons why many European banks lack appropriate capital reserves to withstand a downturn[4].
- We note that the European Central Bank (ECB) has recently announced its intention to sub-divide its Pillar 2 capital demands into "requirement" and "guidance" components[5]. Finance Watch is skeptical of this approach, which appears to have been prompted by

[3] European Commission, Delegated Regulation of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities; C(2016) 2976 final; (https://ec.europa.eu/transparency/regdoc/rep/3/2016/EN/3-2016-2976-EN-F1-1.PDF)

[4] Shin, Hyung-Song, BIS Head of Research, Bank capital and monetary policy transmission: Panel remarks at the "ECB and its Watchers XVII" conference, Frankfurt, 07 April 2016; (http://www.bis.org/speeches/sp160407.pdf)

[5] European Central Bank, Frequently asked questions on the 2016 EU-wide stress test, July 2016; (https://www.bankingsupervision.europa.eu/about/ssmexplained/html/stress_test_FAQ.en.html)

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market pressure to secure certain discretionary distributions, notably coupon payments on Additional Tier 1 (AT1) capital. We believe that this stance is potentially counter-productive and contrary to the purpose of making AT1 coupon payments discretionary and non-cumulative in the first place, which is to provide strong incentives for AT1 investors to contribute to the scrutiny and governance of the bank and to impose market discipline on management.

3: Consequences of a breach of MREL

In the interest of lending proper credence to MREL as the "gone concern" equivalent of "going concern" regulatory capital it would appear appropriate to treat a breach of MREL in the same manner as breach of minimum capital requirements. Finance Watch shares the EBA's concern that resolution authorities may not have the necessary powers at present to press for swift remedial action in the event of a breach.

At present, the competent authority and the resolution authority are both entitled, subject to consultation with the other, to assess whether an institution is "failing or likely to fail". Art. 32/2 BRRD, in conjunction with the EBA's Guidelines[6], sets out the relevant procedures. Finance Watch believes that responsibilities between these two parties should be more clearly delineated to ensure that they can respond rapidly and effectively in the event of a crisis. In particular, we believe that the resolution authority should have the last word in making a determination of "failing or likely to fail", always subject of course to prior consultation with the competent authority.

Finance Watch would therefore support the concept of enhancing resolution authorities' powers of early intervention. This could be achieved, potentially, in two ways:

- The process to remove impediments to resolvability, as envisaged by Art. 17 BRRD, could be accelerated by enabling the resolution authority to invoke this power not only on the basis of the annual resolvability assessment but equally *ad hoc* in the presence of substantive evidence that a bank is in breach, or in danger of breaching, its MREL requirement. In such a case the timeline could be shortened, e.g. by dispensing with the four-month notification period set out in Art. 17/3 BRRD so that the resolution authority could proceed directly to imposing the measures provided for in Art. 17/5 BRRD, if deemed necessary and appropriate.
- The competent authority should be responsible, primarily for "going concern" supervision including the annual Supervisory Review and Evaluation Process (SREP). This would also include the powers to determine breaches of the buffers and/or MREL and the exercise of supervisory powers under Art. 104 and 141 CRD and early intervention powers in accordance with Art. 27 BRRD and the relevant EBA Guidelines[7]. In the event of the competent authority identifying an (imminent) breach of MREL, specifically, the

[6] European Banking Authority, Guidelines on the interpretation of the different circumstances when an institution shall be considered as failing or likely to fail under Article 32/6 under Directive 2014/59/EU (EBA/GL/2015/07), 26 May 2015; (https://www.eba.europa.eu/documents/10180/1085517/EBA-GL-2015-07+GL+on+failing+or+likely+to+fail.pdf/02539533-27ed-4467-b442-7d2fa6fcb3d3)

[7] European Banking Authority, Guidelines on triggers for the use of early intervention measures pursuant to Article 27/4 of Directive 2014/59/EU (EBA/GL/2015/03), 08 May 2015; (https://www.eba.europa.eu/documents/10180/1067473/EBA-GL-2015-03+Guidelines+on+Early+Intervention+Triggers.pdf/f6234078-a8cb-40a1-88f1-f22d446ca394)

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competent authority should immediately notify and consult with the resolution authority. The resolution authority should be entitled to determine, ultimately, whether a financial institution is “failing or likely to fail” and assume responsibility for triggering resolution.

4: Adequacy and calibration of MREL

Compliance with the TLAC Term Sheet published by Financial Stability Board (FSB)[8] requires the adoption of a binding Pillar 1 MREL requirement equivalent to, at least, the higher of 16%/18% of RWAs or 6.0%/6.75% of the leverage exposure measure for all Global Systemically Important Banks (G-SIBs) domiciled in the EU by January 2019 / January 2022, respectively.

Finance Watch believes that the systemic importance of an institution should be regarded as the primary determinant when calibrating its MREL requirements. We would therefore strongly suggest to broaden the scope of binding Pillar 1 MREL requirements to cover all designated systemically important institutions in the EU, including both G-SIBs and Domestic Systemically Important Banks (D-SIBs)[9]. For all other institutions, calibration of the MREL requirement should be predicated primarily on the proposed resolution strategy, i.e. whether a bank could be liquidated under normal insolvency procedures or whether all or some of its operations should be maintained and placed into resolution. Banks business models could serve as a secondary consideration to inform the choice of resolution strategy

Any harmonisation of the TLAC and MREL frameworks should not be allowed to dilute the 8% “burden sharing” threshold set out in Art. 37/10 and 44/5 BRRD, i.e. the need for banks to “bail in” an amount of no less than 8% of total liabilities and own funds (20% of RWAs) before being allowed to access third-party funds in resolution. Systemically important banks are banks that have the potential, due to their size, complexity, interconnectedness and/or critical function within the relevant economy, to trigger contagion and cause severe disruption of the financial system. Such banks are, inherently, in need of an external backstop, i.e. the potential to access third-party resolution funds, in the event of a crisis. It stands to reason therefore that this “bail in” amount should a) be reviewed by the resolution authority *ex ante* to ensure that it is fully funded and available when needed and b) be covered by liabilities which are known, reliably and *a priori,* to be eligible for bail-in, i.e. MREL-eligible liabilities.

- If harmonised on the basis of the leverage exposure measure, as suggested in our response to Q1, the “burden sharing” threshold, and hence MREL for any banks of systemic significance, including G-SIBS and O-SIIs, should not be lower than 8% of the leverage exposure measure (20% of RWAs).
- The decision by the Commission, against the EBA’s recommendation[10], not to mandate the resolution authority to examine systemically important institutions’ compliance with the “burden sharing” requirement of Art. 37/10 and 44/5 BRRD should be revisited in this

[8] Financial Stability Board, Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-Absorbing Capacity (TLAC) Term Sheet, 09 November 2015; (http://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/)

[9] Also know as Other Systemically Important Institutions (O-SIIs)

[10] EBA, Opinion on the Commission’s Intention to Amend the Draft Regulatory Technical Standard Specifying Criteria Relating to the Methodology for Setting Minimum Requirement for Own Funds and Eligible Liabilities According to Article 45(2) of Directive 2014/59/EU (EBA/Op/2016/02), 09 February 2016; (http://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-02+Opinion+on+RTS+on+MREL.pdf)

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context. In the interest of facilitating rapid and reliable resolution the resolution authority should be empowered to apply the "8% test" to all systemically significant institutions.

- Subject to the above Finance Watch agrees, in principle, with the proposed approach of maintaining the current MREL assessment framework for setting Pillar 2 firm-specific MREL requirements.

5: Eligibility of liabilities for MREL

A common approach among EU Member States towards regulating creditor hierarchies in insolvency would resolve many of the current issues with the implementation of MREL and address the problem of diverging national approaches towards subordination of MREL-eligible liabilities. Finance Watch therefore supports the Council's call for harmonisation[11] and would welcome an agreement on this matter.

In the absence of a harmonisation of insolvency law (creditor hierarchies) it is indispensable to ensure that bail-in liabilities are clearly separated from other senior liabilities to provide legal certainty for investors and regulators and to address the "No Creditor Worse Off Than In Liquidation" (NCWO) problem. Therefore all MREL-eligible liabilities need to be subordinated, in line with the TLAC Term Sheet. In order to maintain a level playing field, subordination of MREL-eligible liabilities is not just needed for some banks, e.g. G-SIBs. MREL-eligible liabilities must be subordinated for all banks.

- We recognise the need for banks to have access to a deep and liquid market for MREL-eligible securities. It is of paramount importance that these securities are held by investors capable of absorbing potential losses in the event of a "bail in" and that any concentration of holdings in the hands of a few investors, which could again trigger systemic contagion, should be prevented.
- We are therefore in favour of limiting MREL-eligibility to a number of well-understood, transparent and marketable instruments which are standardised and can be traded on the European and international markets. They should be placed preferably with large institutional investors. Whereas we do not propose a wholesale ban on selling MREL-eligible securities to private investors, they need to be informed extensively, proactively and in understandable terms about the riskiness of their investment.
- In particular, all investors should be provided with ready access to standardised information on a) the respective bank's capital position and MREL requirements (including, potentially, relevant SREP scores) and b) the ranking of the relevant security within the statutory creditor hierarchy.
- Deposits should for a number of reasons, not be considered for the purposes of MREL. Apart from the fact that depositors, unlike holders of equity or debt securities, are, first and foremost, customers, not investors of the bank, "bailing in" depositors is a highly disruptive measure with a high risk of triggering a bank run and, consequently, contagion.
- Going forward, all eligible liabilities should be Tier 1 or Tier 2 capital as defined under CRR/CRD IV, i.e. ordinary or preferred equity or subordinated debt with an original term of at least five years and a residual maturity of at least one year. For the purposes of

[11] Council of the European Union; Minutes of the 3475th Council meeting (Economic and Financial Affairs), (PR 10324/16), 17 June 2016, pg. 7; (http://www.consilium.europa.eu/en/meetings/ecofin/2016/06/st10324_en16_pdf/)

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MREL, subordinated term debt with an original maturity of at least three years should also be considered. Unlike senior unsecured debt, in particular, these instruments are designed specifically to absorb potential losses and are therefore best suited to cover the exigencies of MREL. AT1 capital, in particular contingent convertible (CoCo) bonds, by contrast, should be discouraged: these instruments have already proven to be flawed and are likely to introduce more volatility than stability.

- Whereas contractual subordination, by way of issuing Tier 1 and 2 capital instruments, appears to be the most appropriate way forward, transitional measures need to be taken to address concerns that a) existing debtholders are downgraded without warning or compensation and b) vulnerable banks may be forced to refinance large portions of their balance sheet under pressure at an unfavourable point in the macroeconomic cycle. Appropriate transition periods should therefore be put into place to allow banks to replace outstanding debt with MREL-eligible instruments as it falls due. For the duration of the transition period, statutory subordination of existing senior unsecured bonds could be implemented as a transitional measure. Since this approach is susceptible to challenges on the grounds of NCWO it should not be regarded as more than a stopgap measure.
- Where private investors were mis-sold subordinated bank debt in the past without proper information about the attendant risks they should be entitled to compensation if they suffer losses in the event of a "bail in".
- We note that the TLAC Term Sheet requires G-SIBs to introduce structural subordination by means of creating a "clean holding company". Regardless of the approach chosen towards the subordination of MREL liabilities Finance Watch believes that this model should be encouraged, not only for G-SIIs but for all "systemically significant" banks in the EU. In the event of a crisis, capital and bail-in liabilities could be downstreamed where needed with a minimum of impediments[12]. A "clean holding company" structure would also provide an incentive for diversified financial groups to adopt separation of banking and trading activities which, in turn, could materially improve their robustness in the case of crisis and the effectiveness of supervision.

6: Third-country recognition

Finance Watch recognises the issues related to the recognition of bail-in decisions by third countries. We believe that the proposed approach to MREL eligibility set out above, i.e. standardisation of MREL-eligible instruments in the form of Tier 1 and 2 capital instruments would go some way to simplifying the process of achieving legal recognition of resolution authorities' "bail in" or "write down" decisions in third-party jurisdictions. We believe, accordingly, that Article 55 BRRD could be limited to MREL-eligible instruments.

[12] e.g. Ringe, Wolf-Georg, Bail-In between Liquidity and Solvency, Oxford Legal Studies Research Paper No. 33/2016; (http://ssrn.com/abstract=2782457)

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