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CENTRAL BANK OF MALTA

MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES

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BOX 1: MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES

During the recent financial crisis, large sums of taxpayers' money were channelled to ailing credit institutions in an effort to prevent them from failing and setting off a chain reaction which could have brought devastating effects on the economies and the well-being of their citizens. However, supporting troubled banks by means of public funds has undesirable consequences on public finances and may lead to moral hazard, providing an incentive to banks for excessive risk taking behaviour. This is particularly the case for systemically important banks, which are considered "too big to fail".

In response to the financial crisis, the G20 mandated the Financial Stability Board (FSB) to draft an international standard for resolution regimes. In 2011, the FSB published the Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes), which should form part of resolution regimes in all jurisdictions. These Key Attributes set out a global standard for Global Systemically Important Institutions (G-SIIs) to hold a minimum requirement for total loss-absorbing capacity (TLAC).

In Europe, these developments brought about Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the Bank Recovery and Resolution Directive, BRRD). The BRRD brought about major changes in the banks' regulatory framework in the ambit of bank recovery and resolution. The Directive provides a common resolution regime in the European Union with the aim of preventing further government bail-outs of failing banks by shifting the cost of bank failures to shareholders and creditors thus internalising such costs. The introduction of the bail-in concept, a tool introduced in the BRRD to seek the orderly resolution of failing banks, revolves around the principle of burden sharing, whereby the private sector shares in the costs arising from a bank failure.[1] Thus, by transferring the risk of bank failure on shareholders and creditors, risks to taxpayers are contained and moral hazard is also minimised. Moreover, such risk transfer also enhances the level playing field between small and large banks, when financing their operations. Banks therefore need to have enough unsecured liabilities on their balance sheet that are credibly, feasibly and quickly bail-inable and can thus be earmarked for recapitalising the ailing bank.

Prior to the BRRD, the supervisory framework included on-going supervision and early intervention measures to deal with bank failure. In case these measures did not suffice, a bank would be placed under normal insolvency proceedings. The nature of the business of banking is, however, deeply intertwined with the real economy as banks perform critical economic functions. Because of such functions, normal insolvency proceedings are not appropriate for banks. Therefore, resolution under the BRRD was introduced to augment the supervisory framework to ensure that banks are able to absorb losses, while at the same time are still able to perform their critical functions. In essence, resolution is not intended to resurrect an ailing bank, but to preserve its critical functions.

Resolution is triggered if (i) the bank is deemed by the Supervisor as failing-or-likely-to-fail (FOLTF); (ii) there is no alternative action by the private sector; and (iii) it is necessary in the public interest. A bank will be FOLTF if (i) it infringes or might infringe minimum capital requirements, (ii) assets are or will likely be less than liabilities, (iii) the bank becomes insolvent or (iv) the bank needs extraordinary public financial support.

1 Bank resolution is the process undertaken by authorities to preserve those critical functions of a bank that have a bearing on the real economy and financial stability, making it a credible alternative to normal insolvency proceedings or government bail-out measures.

Once a bank is deemed FOLTF by the Supervisor, resolution action will be carried out by the Resolution Authority.[2] The resolution authority has at hand an array of resolution tools, comprising (i) the sale of business, (ii) bridge bank institution, (iii) asset separation, and (iv) bail-in.

The Resolution Authority is also bound to establish, for every bank, a Minimum Requirement for Own Funds and Eligible Liabilities (MREL), which is required to ensure an orderly resolution. MREL is the EU equivalent of TLAC for those banks which are not G-SIIs and regardless of which resolution tool (e.g. the bail-in or bridge bank tools) is applied, it must be sufficient to absorb losses related to resolution and ensure that banks still meet minimum capital requirements for continued authorisation and command market confidence even after resolution, without exposing covered depositors to losses.[3]

A sufficient level of MREL would facilitate a resolution action and thus providing added benefits through enhanced depositor protection and the confidence in the banking system. This would, in turn, make the banking system more resilient by reducing contagion risk, thus safeguarding financial stability. The concept of MREL relates to a pre-determined minimum amount of equity and unsecured liabilities allocated to ensure that bail-in can be conducted, effectively. While the bail-in tool and MREL are based on the same concept of write-off/down of debt and equity and/or the conversion of debt into equity, bail-in can be exercised on all the liabilities and equity on the balance sheet (with exceptions such as covered deposits), whereas the scope of MREL is more limited. Liabilities which are excluded both from bail-in (Art. 44(2) of BRRD) and from MREL, include:

(i) covered deposits
(ii) secured liabilities including covered bonds
(iii) any liability that arises by virtue of a fiduciary relationship
(iv) liabilities with a remaining maturity of less than seven days, owed to systems or operators of systems designated according to Directive 98/26/EC
(v) a liability to any one of the following:
    a. an employee, in relation to accrued salary, pension benefits or other fixed remuneration
    b. a commercial or trade creditor arising from the provision to the institution of goods or services that are critical to the daily functioning of its operations, including IT services, utilities and the rental, servicing and upkeep of premises
    c. tax and social security authorities
    d. deposit guarantee schemes.

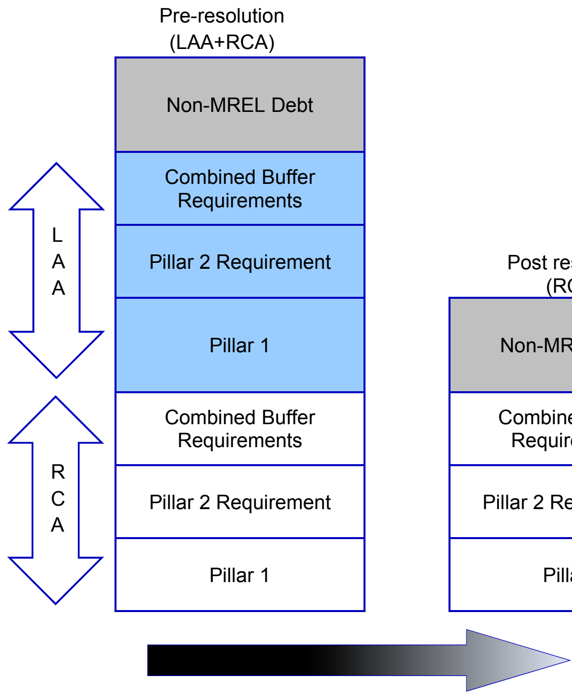
Furthermore, to be eligible for MREL, any liability which is not excluded from bail-in as per above, must satisfy the conditions laid down in Art. 45(4) of BRRD:

(i) the instrument is issued and fully paid-up
(ii) the liability is not owed to, secured by or guaranteed by the institution itself
(iii) the purchase of the instrument was not funded directly or indirectly by the institution
(iv) the liability has a remaining maturity of at least one year
(v) the liability does not arise from a derivative
(vi) the liability does not arise from a deposit which benefits from preference in the national insolvency hierarchy.

[2] Pursuant to Article 7 of Single Resolution Mechanism Regulation, the Single Resolution Board shall be responsible for adopting all decisions relating to resolution of significant institutions supervised by the ECB. For domestic less significant institutions, the Board of Directors of the MFSA shall act as the designated National Resolution Authority in line with Article 7B of the Malta Financial Services Authority Act.

[3] Deposits are covered per depositor per bank, up to a limit of €100,000, which are guaranteed and repayable by the Depositor Compensation Scheme.

Chart 1
BANK LIABILITIES BEFORE AND AFTER RESOLUTION ACTION



MREL = Loss Absorption Amount + Recapitalisation Amount

= (P1+P2R+CBR) + (P1+P2R+CBR) = 2(P1+P2R+CBR)

The ex-ante MREL is composed of a Loss Absorption Amount (LAA), and a Recapitalisation Amount (RCA). Chart 1 provides a visual representation of this concept. The LAA should be sufficient to absorb losses incurred during the resolution process and thus is set equal to the minimum regulatory capital requirements, which aim to cover unexpected losses incurred through on-going business operations.

Since any bank must meet these minimum regulatory capital requirements at all times, to meet the conditions for authorisation, the RCA should ensure that even after resolution, the bank has still enough capital to meet such requirements.

In its public final report on MREL, the European Banking Authority (EBA) has formally interpreted MREL as amounting to 2 x (Pillar 1[4] + Pillar 2 Requirement[5] + Combined Buffer Requirements[6]),

[4] Minimum Capital Requirements under Basel II which must amount to at least 8% to cover market, operational and credit risk.
[5] Institution specific capital add-on according to the supervisory review and evaluation process (SREP), which covers risks over and above Pillar 1.
[6] The total CET 1 capital required to meet the capital conservation, counter cyclical and systemic risk buffers.

based on the Commission's Delegated Regulation.[7] However this can be adjusted both upwards and downwards since the RCA is set at the discretion of the Resolution Authority for each institution to reflect the preferred resolution strategy, the risk over the potential disruption to critical economic functions and the need to apply a proportionate approach.

The EBA has quantified these benefits and presented its findings in a report focussing exclusively on MREL.[8] The EBA estimates that overall, net MREL macroeconomic benefits are positive stemming from a dampened effect of bank failure on the real economy.[9] However, the actual impact of the introduction of MREL depends on the ability of markets to absorb the volumes of debt issuances needed for the build-up of MREL, and the corresponding capacity of banks (especially deposit funded banks) to access markets.

MREL requirements may be difficult to reach due to size and/or the markets' limited capacity to absorb the planned issuances. This could lead to MREL periodic shortages unless sufficient time is allocated for its build-up. The predominance of covered or preferred retail deposits in the funding structure of banks, uncertainties regarding a country's market capacity, and a significant exposure of retail investors to MREL instruments, represent major challenges for the build-up of MREL. In view of this, various policy options are being explored, such as longer transitional periods to phase-in MREL requirements in parallel with policy initiatives to further strengthen the Capital Markets Union to widen banks' access to debt markets.

In the meantime, policy initiatives directed towards a harmonised creditor hierarchy of claims is underway. Indeed, subordination defines the order of wind-down and conversion of debt instruments in resolution and insolvency. Certain senior unsecured debt instruments, which are suitable for bail-in and structurally eligible for MREL, rank *pari-passu* with other debt such as derivatives and corporate deposits; which on their part are more complicated to bail-in due to either their complexity or legal challenges. Such *pari-passu* ranking renders the bail-in of senior unsecured debt more complicated and could give rise to lawsuits, if not respected. The latter arises if the no-creditor-worse-off-principle is not respected.[10]

To this end, several Member States have already taken steps to establish a more effective hierarchy of claims (see Chart 2). Germany implemented a statutory form of subordination, where the senior unsecured class ranks junior to derivatives and corporate deposits on a retroactive basis. Italy has also adopted a statutory form of subordination, whereby a general depositor preference has been introduced, meaning that corporate deposits rank senior to derivatives and other senior debt. In France, a contractual form of subordination has been implemented, where a new debt class of "non-preferred senior debt" has been created, which ranks senior to subordinated debt but junior to senior unsecured. Thus, banks subject to this measure need to issue new debt instruments under this category. All these forms of subordination, whist increasing the efficiency of the bail-in tool, also address the no-creditor-worse-off principle by increasing legal certainty.

At the EU level, on 23 November 2016, the Commission launched a package of reforms to further strengthen the resilience of EU banks. One of the measures includes amendments to the BRRD to harmonise subordination across the SSM through the creation of a new debt class similar to the one adopted in France (and also Spain). Newly-issued debt in this class is also equivalent to the

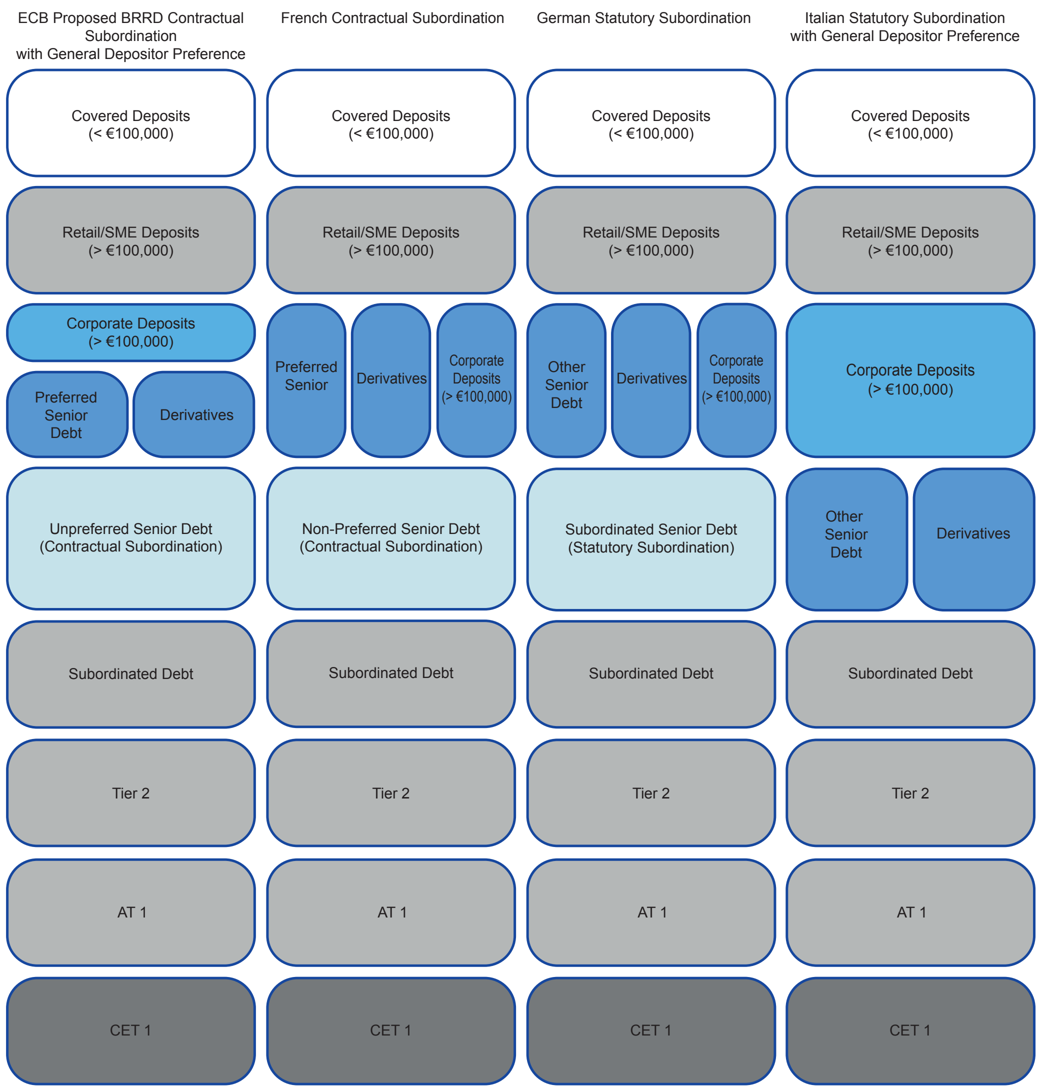
7 Commission Delegated Regulation (EU) 2016/1450 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities.

8 EBA Final Report on MREL (EBA-Op-2016-21).

9 It is important to highlight that the approach followed provides aggregate results and, to this end, the benefits may vary across Member States.

10 In resolution creditors should not incur greater losses than if the institution had been wound up under normal insolvency proceedings.

Chart 2
DIFFERENT APPROACHES TOWARDS SUBORDINATION ACROSS THE EU



retroactive German subordinated debt. In its proposal, the ECB has gone a step further by suggesting the addition of a General (Tiered) Depositor Preference, akin to that adopted in Italy, which is to be coupled with the introduction of the new non-preferred senior debt class.[11]

The introduction of MREL is expected to further build the resilience of the banking industry, by facilitating the application of bail-in. This new requirement also brings along new challenges, most notably shortfalls in meeting immediate MREL targets, particularly for deposit-funded institutions, as well as an increase in the bank's cost of funding. Talks and discussions are still on-going to decide on the optimal calibration of MREL which ensures the further strengthening of financial stability, while at the same time, limit or reduce MREL shortfalls and give sufficient time for banks to build MREL. Current

[11] Opinion of the ECB of 8 March 2017 on a proposal for a directive of the European Parliament and of the Council on amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy (CON/2017/6).

revisions and amendments to the BRRD will help achieve a more effective implementation of both MREL and the bail-in tool.

Resolution authorities will play a key role in planning resolution strategies with banks to ensure that the most efficient MREL requirement is in place. A careful assessment of an appropriate transitional period and further strengthening of the Capital Markets Union to facilitate new issuances of MREL debt are considered important for the successful implementation of MREL. Furthermore, a functioning resolution mechanism is an important step towards shifting the risk and the associated costs of default from sovereigns to the private sector. Ultimately, the resolution regime can be more credible if it is harmonised and applied in a consistent manner across the European Union.