# Calibration of Internal MREL remains a high priority for CRR3

## Pre-CRR3 AFME position paper

July 2019

### Introduction

The RRM package represented a very significant step forward in forming a more resilient and resolvable banking sector in the EU, introducing among other things important international standards for liquidity (e.g. NSFR) and resolution (e.g. implementing TLAC through MREL). We have strongly supported the very significant work to put in place credible and effective cross-border resolution plans.

However, we have identified a selected number of areas which we believe should be reviewed and addressed through the proposal for CRR3. In particular, we believe that aspects of the framework for internal MREL need to be reviewed in order to ensure that they support a robust cross-border resolution framework. We identify below a few areas where changes to the legislative framework are necessary to support effective implementation of internal MREL. Similar considerations should also be kept in mind in the context of any future revision of the BRRD2 in order to adjust the framework for internal MREL for all EU credit institutions.

### Internal MREL (iMREL)

A central aspect of the RRM package agreed by legislators was the introduction of Total Loss-Absorbing Capacity (TLAC) in the EU through amending the Minimum Requirement for own funds and Eligible Liabilities (MREL) framework. TLAC, as set out in the Financial Stability Board (FSB) TLAC Principles and Term Sheet (TLAC Standard)[1], is required in the form of external and internal liabilities. We strongly support the objectives of putting in place effective cross-border resolution plans and the implementation of TLAC in the EU.

However, we strongly believe that the CRR2 legislation has a number of deficiencies which, if not addressed in CRR3, will potentially undermine banks' resolution strategies and lead to unjustified fragmentation, as acknowledged by the FSB in their recent report on market fragmentation[2].

The limitations of the MREL framework are particularly prominent in relation to internal MREL, where the calibration and eligibility criteria were not consistent with the FSB TLAC standard and do not reflect the FSB principles on internal TLAC[3]. The topic of internal MREL is a technical one, but it is an important part of the resolution framework with significant implications for banks' funding structures. If these issues are not addressed in the context of CRR3 it is likely to have significant negative impacts on banks operating within the EU; not just on a business level but also with regard to their resilience should the fragmentation and ring-fencing of resources not be avoided.

[1] See FSB – 9 November 2015, http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf

[2] See FSB – 4 June 2019, https://www.fsb.org/wp-content/uploads/P040619-2.pdf

[3] https://www.fsb.org/2017/07/guiding-principles-on-the-internal-total-loss-absorbing-capacity-of-g-sibs-internal-tlac-2/

**Calibration of internal MREL**

Appropriate calibration of internal MREL is very important to ensure effective cross-border resolution plans. As acknowledged by the TLAC Term Sheet and FSB Guiding Principles on internal TLAC, internal loss absorbing capacity should be calibrated within the range of 75-90% of the external TLAC requirement. Excessive internal MREL requirements create fragmentation, reduce the effectiveness of group resolution and lead to unjustified additional external MREL requirements impacting the competitiveness of banks operating in the EU and ultimately the users of their services.

As the recent FSB report on market fragmentation highlights, *"excessive siloing of capital and funding resources within national borders can be to the detriment of the overall resilience of financial institutions".*

The current implementation of internal TLAC in the EU is not in line with the internationally agreed standard and is likely to give rise to excessive ring-fencing of loss absorbing capacity. It is important that this is reviewed and the legislative framework amended to bring it in line with the TLAC Standard and provide for calibration within the full 75-90% range.

This should apply for both the material subsidiaries/sub-groups of third-country GSIBs operating in the EU, and material subsidiaries/sub-groups of EU GSIBs.

Applying the 75-90% range within the European framework would not preclude resolution authorities from calibrating internal MREL requirements at the existing 90% level. It would however provide resolution authorities the ability to set requirements (in consultation with the relevant authorities) at a level that best reflects the risks of the given subsidiary or sub-group, and that would be appropriate and in line with the preferred resolution strategy of the resolution group.

Providing resolution authorities with the ability to calibrate within this range is vital to ensure consistency with a group's preferred resolution strategy. Lack of sufficient scaling may lead to calibrations that are excessive, and which may (unnecessarily and unjustifiably) increase external MREL (or TLAC) requirements through their sum being greater than the amount of externally issued instruments. Internal MREL (or TLAC) requirements across a resolution group should not exceed this level, as the external requirement will have been set at an amount deemed appropriate to deliver on the group preferred resolution strategy. Crisis Management Groups (CMGs) and resolution colleges should be able to consider this potential impact when calibrating internal MREL and have the ability to avoid such an adverse outcome by being able to scale requirements within the FSB range. Guiding Principle 5 of the FSB's principles on internal TLAC is clear in this respect. However, the current EU legislative framework renders European resolution authorities incapable of making any change in calibrating internal MREL to avoid the risks of creating such situations. This undermines the principles on which CMGs and college are based, i.e. to enhance cross-border collaboration and cooperation, and further propagates fragmentary practices elsewhere as authorities reciprocate in the treatment of European institutions based in host jurisdictions.

As a priority we therefore recommend that the following are reviewed as soon as possible with a view to incorporating necessary changes in CRR3:

- **Scaling within Article 92b:** Article 92b of CRR2 requires material subsidiaries of third country GSIIs (that are not resolution entities themselves) to meet an internal MREL

requirement equal to 90% of the requirement that would have applied had the entity been a resolution entity (i.e. an external MREL requirement).

However, as highlighted above, the TLAC Standard clearly sets out that this requirement be set as a range between 75-90% of the external TLAC requirement, with the specific requirement within this range set according to the resolution strategy and in consultation with the home resolution authority. It is vital that the European legislative framework supports international cooperation on resolution planning, reflecting the FSB principles such as consulting the home resolution authority when calibrating internal TLAC within the 75-90% range.

The agreed range of 75-90% should therefore be reflected in CRR3 to ensure that the requirements for individual material subsidiaries are able to reflect the firm's resolution strategy. The introduction of a range would also facilitate improved cooperation with third country resolution authorities and incentivise other jurisdictions to align their approach with the TLAC standard, supporting the competitiveness of European banks internationally. Other jurisdictions such as the UK[4], Hong Kong[5] and the US[6] have indicated a willingness to apply reduced requirements where this is reciprocated.

- **Introduce scaling of the minimum internal MREL requirement for material subsidiaries of EU GSIIs:** the calibration of internal MREL for subsidiaries of EU resolution entities should also be addressed, introducing at least a similar range as that foreseen for third country firms. We believe that the scaling range between institutions in the EU should be significantly lower than the 75-90% internal TLAC requirement within the FSB's TLAC Standard to reflect the group resolution planning process, close cooperation and information sharing arrangements within resolution colleges, the automatic recognition of resolution actions and the single supervisor and resolution authority within the Banking Union.

  The current framework under the BRRD2 and SRMR2 has a much broader scope in terms of the population of institutions that will have internal MREL requirements placed upon them. However, these requirements are not accompanied by any materiality or scaling conditions. Greater proportionality is therefore also required. Introducing scaling within the FSB range (at a minimum) and applying the same materiality thresholds as per the CRR should be considered here to ensure the risks highlighted above are also addressed within the EU.

### Eligibility criteria for internal MREL

There are some eligibility requirements for internal MREL under the CRR2 which make eligible issuances impracticable, and they are in places inappropriate for the nature of internal MREL. Whilst these are highly technical in nature, they are nevertheless key aspects of the CRR2 that we

[4] The Bank of England in its Statement of Policy, which outlines its approach to setting MREL, makes clear that they will apply a 75%-90% scaler, defaulting to 75% but rising in-line with the Bank of England's considerations as set out in the document on page 9. - https://www.bankofengland.co.uk/-/media/boe/files/paper/2018/statement-of-policy-boes-approach-to-setting-mrel-2018.pdf?la=en&hash=BC4499AF9CF063A3D8024BE5C050CB1F39E2EBC1

[5] Hong Kong Monetary Authority, Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules, December 2018, https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolutions/Financial_Institutions_(Resolution)(Loss-absorbing_Capacity_Requirements-Banking_Sector)_Rules_20181214.pdf

[6] Vice Chairman Randal Quarles of the US Board of Governors of the Federal Reserve System recently expressed openness to calibration of internal TLAC for the US IHCs of non-US G-SIBs at a starting point of 75%, down from the current US calibration. - https://www.federalreserve.gov/newsevents/speech/quarles20180516a.htm

strongly believe need to be addressed, and with some urgency, to ensure that the framework can be implemented effectively. Below we set these out in more detail.

- **Clear and appropriate eligibility criteria for Article 92b requirements:** CRR2 internal MREL eligibility criteria should broadly mirror the criteria envisaged by BRRD2 for non-resolution entities subject to article 45f(2). These provisions reference the eligibility requirements of CRR2 but also amend, as necessary, those criteria that are clearly not suitable for an internal issuance. For example, it derogates from Article 72b(2)(b) and (c) (restrictions on issuance within a resolution group), as well as (k), (l) and (m) (restrictions on redemption, acceleration and performance interest). However, as per Article 45d BRRD2, these amended eligibility criteria only apply to the internal MREL required under the BRRD, not Article 92b CRR2. The restrictions that run counter to the very purpose of internal MREL should be removed to ensure that internal MREL can be issued between entities in the resolution group. We therefore recommend replicating the derogations to the above mentioned eligibility criteria made under BRRD2 Article 45f(2) to apply to instruments meeting the Article 92b CRR2 requirement.
- **Structural subordination of internal MREL and the 'de minimis' exemption:** Within Article 45f(2) of the BRRD, Article 72b(3)-(5) is disapplied, however whilst the requirements in article 72b(3) (and by extension (5)) are only relevant to external MREL and should not apply to internal MREL, Article 72b(4) should still be applicable in meeting internal MREL in some circumstances. The 5% 'de minimis' allowance contained within Article 72b(4) should be permitted where a subsidiary (for example an intermediary holding company) is seeking to issue structurally subordinated instruments for the purpose of meeting internal MREL requirements. The FSB make clear in their guiding principles for internal TLAC that such a situation should be permitted[7], yet this has not been fully adopted within the EU under the CRR2, BRRD2 or SRMR2. We therefore recommend Article 72b(4) of the CRR still be applicable for the purpose of meeting internal MREL requirements in this manner (this includes under the BRRD, SRMR and CRR).

  Further to this, a derogation to Article 72b(d)(iii) should be made to make clear that structural subordination is not a feature exclusive to the issuance of external MREL, but that it is also available for the purpose of meeting internal MREL requirements too. Currently the provisions specify the instruments be issued by 'a resolution entity'. We however propose that this is derogated such that it applies to 'an entity' issuing internal MREL. Such a change would provide clarity that structural subordination is available as a route to meeting internal MREL requirements alongside statutory and contractual subordination.

  It is important to ensure that structural subordination is equally permissible to the other routes to subordination in both external and internal MREL requirements. The need to utilise structural subordination is observed within banking groups that utilise intermediary holding companies. This is particularly pertinent given the recent regulatory requirements that have been finalised within the banking package to require certain third country firms to set-up such structures within the EU. It would therefore be advisable for these technical issues to be resolved to assist firms in implementing such structures and fulfilling subordinated internal MREL accordingly.

[7] See FSB – page 15, footnote 14, 4 June 2019, https://www.fsb.org/2017/07/guiding-principles-on-the-internal-total-loss-absorbing-capacity-of-g-sibs-internal-tlac-2/

- **Alternative arrangements to meet internal MREL:** More broadly, we also encourage greater flexibility within the eligibility criteria for internal MREL to be considered. Alternatives to pre-positioned internal MREL such as the use of guarantees and capital contribution arrangements where the host authority is happy with these arrangements should be explored.

### Issuance strategy

Article 92b of CRR2 also includes a requirement that instruments be owned by the ultimate parent undertaking, and have been issued either directly or indirectly through other entities within the same group. This is in line FSB Guiding Principle 10 on Internal TLAC issuance[8] and we support this. However, the provisions within the CRR2 further require that all such entities be established in the same third country as the ultimate parent undertaking or in a Member State. This provision therefore does not permit internal MREL being issued within a resolution group via entities that are based outside the EU, and not in the third country of the ultimate parent undertaking. This may cut across existing ownership and funding structures within these institutions, that are by their very nature large, cross-border banks, active globally in several jurisdictions. We strongly propose that this additional criterion be removed such that the EU's requirements are fully aligned with the FSB's Guiding Principles on this matter and provide sufficient flexibility to resolution authorities to put in place effective structures.

[8] See FSB – 6 July 2017, https://www.fsb.org/wp-content/uploads/P060717-1.pdf