Banks face steep climb in MREL issuance

The upcoming enforcement of the MREL requirement will require European banks to issue a significant amount of subordinated and senior notes. But political instability and differing levels of investor demand could push up pricing and stifle access in some European markets, write **Stuart Willey, Paul Alexander** and **Angelo Messore** of global law firm White & Case.

The Minimum Requirement for Own Funds and Eligible Liabilities (MREL) was introduced in 2016 as part of the bank recovery and resolution directive (BRRD). In the event of a bank failure, the MREL acts as a "buffer" that resolution authorities can use when applying the bail-in tool to absorb losses and provide new regulatory capital to the failing institution.

Although MREL has largely remained a silent issue since then due to the prudent approach followed by regulators in its implementation, the time is now coming for European banks to meet binding MREL targets.

The road to MREL

Resolution authorities have so far adopted a prudent stance in applying the new requirements, which have been phased in gradually. This caution was also due to the timing and complexities surrounding the startup of the Single Resolution Board (SRB) and Single Resolution Mechanism (SRM), the ongoing discussions at the EU level regarding the review of the EU's regulatory framework on prudential requirements and bank resolution (the Banking Reform Package), and around the significant impact that MREL targets will have on the capital structure of EU banks.

In 2016, the SRB started developing its MREL policy together with national resolution authorities in the Banking Union and communicated non-binding MREL targets to banking groups

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under its remit. The purpose was to enable banks to prepare for future binding MREL requirements and at the same time to refine the SRB methodology for MREL calibration.

In 2017, the SRB adopted its first binding decisions on MREL requirements for major banking groups, while the 2018 resolution planning cycle was split in two waves of resolution plans—the second one being based on the updated MREL policy it published on January 16, 2019. In this updated policy, the SRB announced its intention to "raise the bar" on MREL targets to better prepare for the upcoming changes to the regulatory framework deriving from the approval of the Banking Reform Package, on which the European Parliament and the Council reached a political agreement on February 15, 2019.

Bank-specific MREL targets are accordingly in the process of being set

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by resolution authorities in light of the new rules regarding bank capital that will soon be enacted at the EU level. To ensure a smooth transition to full MREL implementation, the SRB has decided to set individual transition periods of up to four years, taking into account bank and market-specific characteristics. But the SRB will also set non-binding interim targets, and banks will be required to submit an implementation and monitoring plan and provide enhanced disclosure on their liability data.

MREL, capital structures and funding strategies

Credit institutions are required to hold a sufficient amount of MREL at all times, consisting of "own funds" instruments and eligible liabilities that can be used by resolution authorities to absorb losses and recapitalize institutions that are failing or likely to fail. The rationale underpinning the MREL requirement is reflected in the default formula for MREL calibration, which is based on two components:

- The loss absorbency amount (LAA), which is the amount of MREL capital that should ensure the full absorption of losses incurred by the bank in case of resolution. The default LAA is equal to the sum of the bank's Pillar 1 and Pillar 2 capital requirements and its fully loaded combined buffer requirement
- The recapitalization amount (RCA), corresponding to the amount of MREL capital that would be used by the resolution authority to restore

the capital position of the credit institution following resolution. The default RCA is equal to the sum of the Pillar 1 and Pillar 2 capital which the bank would need to maintain to hold a banking license, plus an additional buffer to ensure sufficient market confidence after resolution (which according to the SRB methodology is equal to the combined buffer requirement minus 125 basis points).

It is important to note that the RCA does not apply to those credit institutions where the preferred strategy of the resolution authority is the liquidation of the credit institution or banking group. Hence, the quantitative impact of the MREL requirement will be less significant for smaller credit institutions or groups, whose failure should not pose systemic risks.

Resolution authorities may set and adjust the LAA and RCA on a case-by-case basis, considering also the possibility of adopting resolution tools other than the bail-in (i.e., sale of business, establishment of a bridge institution or a "bad bank"/ asset separation vehicle) in case of a resolution. Notwithstanding this bank-specific approach, the SRB confirmed that the benchmark level of MREL should be at least equal to 8 percent of total balance sheet liabilities and own funds. This benchmark level should ensure that in case of a resolution, the bank can access financing arrangements such as the Single Resolution Fund in accordance with BRRD rules.

Credit institutions must use qualifying bail-inable instruments meeting the MREL eligibility criteria set forth in the applicable regulations, which will become more stringent after the enactment of the Banking Reform Package. The question for European banks is accordingly whether they hold a sufficient amount of MREL-eligible instruments to meet their MREL targets, as determined by competent resolution authorities.

This could be a challenge for several banks, in particular because many traditional funding instruments, such as sight deposits, short-term deposits with a maturity of less than one year, and covered bonds do not qualify under the MREL eligibility rules. As a result, any shortfall would need to be filled through the issuance of MREL-eligible instruments, mostly in the form of senior or subordinated notes.

Will supply outstrip demand?

In its 2017 Quantitative Update of the MREL Report, the European Banking Authority stated that the estimated funding needs of European banks range between €206.8 billion and €284.6 billion. Meanwhile, the SRB said that, based on a sample of 100 banks representing approximately 95 percent of the total assets of SRB banks, the MREL shortfall deriving from the application of its 2018 MREL policy amounted to €171 billion, of which €67 billion would need to be met through subordinated instruments. Some research reports have put the figure as high as €526 billion because they assume that resolution authorities will require MREL targets to be met largely with subordinated issuances.

Although the outcomes of these analyses differ—not least as a consequence of the multiple samples and variables used—the figures give pause for thought. The geographical breakdown of the shortfall across EU Member States may be even more significant. Commentators have expressed concerns that, despite MREL being applied at the EU level, the depth of demand for issuers across the EU may vary significantly, especially between northern and southern Member States of the European Union, which could result in an overall fragmentation of the market for MREL and, for smaller issuers in Southern Europe, a potential barrier in terms of issuance costs.

In a study published in December 2017, the European Central Bank noted that the debt markets of Southern Euro-area countries (i.e., Greece, Spain, Italy and Portugal) are characterized by home bias, with a large portion of bank debt being issued domestically. The market capacity to absorb the issuance required to cover the MREL is accordingly country-specific and depends on the ability and appetite of local investors. This home bias could further hinder the capacity of markets to absorb MREL-eligible securities issued by banks established in Southern Euro-area countries.

Political fears

The investment environment may prove to be challenging in 2019, as a consequence of slower economic growth, tighter monetary policy, weaker earnings and higher volatility. Political instability—with the growth of populist parties, the imminent European elections in May and the approach of Brexit—is also contributing to an unfavorable backdrop for the issuance of new debt instruments, especially in Southern Euro-area countries.

Credit institutions already face higher premiums in issuing new debt compared to previous years, so a further rise in the cost of financing could hit profitability.

Italy has been caught in the cross-hairs of political instability. As the government disputed its deficit plans with the European Commission, yields on Italian sovereign bonds rose, causing Italian banks, which hold a significant portion of the outstanding domestic government debt, to struggle to gain access to bond markets.

Last November, UniCredit, Italy's largest lender, issued €3 billion in senior non-preferred notes, in what has been described as a "one and done" strategy to fulfill their total loss absorbing capacity (TLAC)

€171bn

The total MREL shortfall deriving from the application of 2018 MREL policy

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Meeting MREL targets could be a challenge for several banks, because many traditional funding instruments do not qualify under the MREL eligibility rules

requirements for 2019. The issue was priced at a 7.83% coupon, 420 basis points over the Euro mid-swap rate, which would imply almost unaffordable pricing for other Italian banks—although recent debt issuances made by Italian banks seem to show a more favorable trend.

The bind of Brexit

Banks established in some EU Member States (including Italy and other Southern European countries) have traditionally turned to English law to issue bonds on the international capital markets due to decades of market practice and the confidence investors have in the English legal system. However, in the event of a no-deal "hard" Brexit, or at the end of any transition period agreed between the UK and the EU, bonds governed by English law would thereafter be considered liabilities subject to the laws of a third country for the purposes of the BRRD rules, which may prevent EU banks from counting such instruments towards their MREL capital.

The fact that the draft Withdrawal Agreement negotiated between the UK and the European Union has failed to gain approval from the UK Parliament means the outcome of negotiations remains uncertain. If the Withdrawal Agreement is not signed and no extension is agreed upon by March 29, 2019, the risk of MREL disqualification will become relevant on such date. Conversely, if the Withdrawal Agreement is signed, EU credit institutions will theoretically have an additional period of almost two years to properly adjust their indebtedness, considering the transition period (lasting until December 31, 2020) provided under Article 126 of the Withdrawal Agreement.

EU authorities have already urged EU banks to include clauses on "contractual recognition of bail-in" in their MREL-eligible instruments subject to English law, and to be prepared to demonstrate that any decision of an EU resolution authority would be effective in the UK. However, a large amount of liabilities subject to English law do not contain any such clause (e.g., because they were issued before the Brexit referendum) and could accordingly be subject to disqualification for the purposes of the MREL requirements. To avoid this outcome, EU credit institutions might either amend the terms of existing English law bonds or refinance them via new debt issuances. The costs would, however, be relevant in both cases, and there is no assurance (again) that the market will be willing to refinance the existing stock of English law debt.

The SRB has left open the possibility to provide for an extension of transitional periods for banks that have MREL shortfalls as a consequence of ineligibility of issuances governed by English law. Furthermore, EU banks have been invited to start issuing bonds under the laws of EU Member States rather than English law to avoid MREL eligibility issues. The most recent trend is currently showing top-tier Spanish and Italian banks issuing (or considering the issuance of) MREL-eligible instruments under their own national law—in line with the practice traditionally followed by French and German banks. It remains to be seen whether the same path will be followed by lower-tier banks and the market in general as they navigate political instability amid the new MREL regime.

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