FINANSTILSYNET

MEMO

Danish Financial Supervisory Authority

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Principles for setting MREL for small banks

The banks' trade associations and the FSA are agreed that the priority for distressed banks is a private solution in the form of a capital injection, sale of assets/branches, merger with a stronger institution, etc. One prerequisite for a private solution is that the bank explores all possibilities well in advance, and that the industry contributes to this.

The FSA's reaction pattern where a bank is in breach of its MREL is described in more detail in Appendix 1. The contents of both this document and the appendix reflect applicable legislation, including EU law, and are subject to review in the event of changes in the legislation.

Following a transfer, Finansiel Stabilitet can be expected to sell the healthy parts of the bank and continue the bad parts in a bridge institution under its control. In line with this model, MREL will be set higher than for bankruptcy and lower than for continuation, which is the resolution strategy applied to SIFIs. MREL also improves the chances of finding a private solution, including a merger with a stronger institution.

Besides the solvency need and capital buffers, the MREL consists of a loss absorption add-on and a recapitalisation amount (with the sum of the last two referred to as the *MREL add-on*).

The calculation of the *loss absorption amount* is based on an 8+ model, where the existing 8+ model for the calculation of the solvency need with regard to the capital required for quality class 1 and 2c exposures is extended to include exposures above ½% of own funds. In the existing model for the calculation of the solvency need, the add-on for credit risks is based primarily on add-ons for exposures above 2% of the institution's own funds in quality classes 1 and 2c, with the full add-on if exposure exceeds the value of impairments, collateral and the 8% requirement. When calculating the additional capital required in the extended 8+ model, the value of the capital deduction for sector shares (shares in the sector's jointly owned financial companies) is made after applying a 10% haircut to the value of these shares. On the basis of their estimated additional capital requirements under this extended 8+ model, banks are divided into

groups with fixed loss absorption add-ons such that the agreed average for the MREL add-on is achieved, see below.

The *recapitalisation amount* is calculated in accordance with the resolution plan drawn up by Finansiel Stabilitet. For banks with assets below EUR 3 billion, the recapitalisation amount will be 8% of the risk exposures amount (REA) on loans and guarantees above DKK 5 million in quality classes 1, 2c and 2b relative to the bank's total REA.

For banks with assets below EUR 3 billion, the level of the MREL add-on will be in the interval of 3½-6% with an average of 4.7% (excluding any add-on for exit fees for data providers, see below).

The FSA has a clear expectation that the data providers will ensure by mid-2018 that exit fees are fully abolished for banks in breach of their MREL or capital buffer requirements. This must not prevent the parties from agreeing on continued membership of a data provider and regular payments in this regard after a bank or parts of a bank are transferred. There are currently agreements in place that require members of a data provider to pay an amount for 3-5 years after terminating their contract with the provider (exit fees). These fees constitute an impediment to resolution, as they could prevent a takeover by another institution and affect resolvability. If these exit fees are not abolished by mid-2018, MREL will be increased by the value of these fees.

As a consequence of the chosen approach, there will be a subordination requirement for the banks concerned, for their senior debt instruments to qualify as MREL eligible liabilities. These instruments should not be sold to retail customers. It should also be ensured that a bank can be resolved without the loss on its MREL issuances bringing other banks down with it. The FSA will also monitor whether refinancing risk is limited, for example by spreading the maturity profile or issuing the debt instruments as soft bullets, where the maturity is extended if refinancing fails.

The resolution strategy described above has been given advance approval by the European Commission for institutions with assets below EUR 3 billion at the time of resolution.

Non-SIFIs with assets above EUR 3 billion will have an MREL add-on that is higher than for other non-SIFIs. For the largest non-SIFI, the preferred resolution strategy is continuation, and the associated MREL is therefore twice the solvency need plus twice the capital buffer requirement, corresponding to the MREL for SIFIs. For the other non-SIFIs with assets above EUR 3 billion, the calculation of the loss absorption add-on will employ the method for non-SIFIs with assets below EUR 3 billion. The recapitalisation amount will have two components. The first will be calculated as 8% of REA on loans and guarantees above DKK 7.5 million in quality classes 1, 2c and 2b relative to the bank's total REA. The sum of this first component of the recapitalisation amount and the loss absorption add-on will be in the interval of 3½-6%. On top of this comes an

add-on to the recapitalisation amount of 1¼% of REA for a bank with assets of EUR 3 billion, rising linearly with assets to give a total MREL add-on for a bank with assets of EUR 10 billon that is 5% of REA higher than for one with assets below EUR 3 billion.

Consequence analysis and phase-in period

Most banks will be able to comply with an add-on of 4.7% after five years (based on projections of their earnings in 2017-2021). These calculations assume an impairment ratio of ½%, a safety margin of 3%, no payment of dividends by limited companies and cooperatives, 3% interest on guarantee capital, and earnings (excluding impairments) on a par with 2016.

The point of departure for the phase-in period is that the requirement should be fully implemented by end-2022. The phase-in period is conditional on the assumptions for impairments and earnings, including fair value adjustments, holding for the relevant banks taken as a whole. If these assumptions do not hold, there is the option of extending the phase-in period by 1-2 years. The phase-in period will be assessed in June each year on the basis of the banks' annual financial statements, starting in June 2018.

MREL will be set in each year of the phase-in period. MREL in the phase-in period will be set such that the sum of the increase in the capital conservation buffer and the MREL add-on is constant each year. The phase-in of MREL will be adjusted if the assumptions do not hold.

Through to the end of 2021, the increase in the capital conservation buffer and the MREL add-on will be a maximum of 1.25 percentage points per year for the individual bank.

Protection

The model chosen for MREL lies somewhere between the model for SIFIs and the requirements for equivalent institutions in other countries. The chosen model reflects the prioritisation of private solutions and an acceptance of a greater risk of loss for senior unsecured creditors if private solutions cannot be found. Senior unsecured creditors and deposits above the limits for the deposit guarantee scheme are exposed in this model. With an orderly wind-down under the control of Finansiel Stabilitet, a substantial bail-in of senior unsecured creditors and deposits above the deposit guarantee scheme limits has to be expected. The strengthening of own funds and eligible liabilities will, however, generally increase protection for ordinary creditors and depositors relative to today.