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SAFE Finance Blog

Why MREL Won't Help Much

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Resolution regime does not lead to enhanced market discipline



The architects of the European bank resolution framework seem to be obsessed with the principle of proportionality and a lust for fine-tuning: The highly complex rules of the Bank Recovery and Resolution Directive (BRRD) give a multitude of authorities ample discretion in compelling private sector involvement (PSI) when it comes to bearing losses of failed banks. This is true for the European bail-in regime in general and in particular for the Minimum requirements for own funds and eligible liabilities (MREL).

Uncertainty about the trigger for PSI and the specific application of the bail-in tool make it difficult for investors to assess the risk of their bank assets. Although MREL provides for a prescription of high-quality bail-in capital as non-runnable long-term debt, a lot of discretion remains in determining MREL on a case-

by-case basis for individual banks. Hence, the key policy objective of enhanced market discipline through predictable PSI gets lost in this approach.

The pending European legislation, which aims at implementing the similarly complex specifications of the Financial Stability Board (FSB) for Total Loss Absorbing Capacity (TLAC) by very detailed amendments to the regulatory capital and the resolution regime, will not remedy the situation. On the contrary, it may even increase the complexity of the resolution regime, with regard to both substantive regulation and procedure. The proposal of the European Commission (EC) seeks to amend the current specification of MREL in order to bring it closer to TLAC. However, even for Global systemically important institutions (G-SII) that are subject to TLAC requirements, MREL (as a potential add-on) will continue to be set for individual institutions, as is the case for all other banks. Moreover, the EC intends to provide resolution authorities with powers to request an additional layer of high-quality bail-in capital for exceptional circumstances. Size and quality structure of this buffer is strongly linked to regulatory capital prescriptions supervised by competent authorities. Therefore, the determination of the ultimate amount of MREL for banks, required by the authorities, depends on a highly complicated interplay of agency decisions.

Even if investors are able to correctly gauge the relevant risk of PSI in case of a bank's failure at the time of purchase, subsequent adjustments of MREL prescriptions by competent or resolution authorities potentially change the risk profile of the pertinent instruments. Therefore, original pricing decisions may prove inadequate. Depending on the level of MREL set, the loss participation of an investor changes *ceteris paribus* and so should the risk-adjusted interest rate charged in reaction. However, if adjustments in MREL calibrations are not predictable and therefore will not take place, the original price of bail-in capital is either too low or too high and hence cannot instill adequate market discipline.

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More on this topic: Tobias H. Tröger: Why MREL Won't help much, SAFE Working Paper No. 180 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3023185).

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