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MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES (MREL): GENERAL APPROACH OF THE CZECH NATIONAL BANK

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MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES (MREL): GENERAL APPROACH OF THE CZECH NATIONAL BANK

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The crisis management framework represented in the EU by the Bank Recovery and Resolution Directive (BRRD) introduced a minimum requirement for own funds and eligible liabilities (MREL). This article describes the policy rationale behind the MREL and its nature and purpose in the context of the current legal and regulatory framework. The article also explains in detail the main principles of the CNB's general approach[2] to setting the MREL, putting an emphasis on the factors that need to be taken into account when determining its level and structure. Finally, the article describes the specifics of the domestic banking sector and discusses the aggregate MREL-eligible liabilities shortfall – as estimated using the CNB's general approach – that would need to be gradually filled by banks in the coming years.

1. INTRODUCTION

Financial crises are a cyclical phenomenon which usually entail substantial macroeconomic costs in the form of output losses and public debt increases (Minsky, 1992; Laeven and Valencia, 2012). Studies have shown that these costs are increasing over time, as crises are getting deeper and deeper and recoveries slower and slower (Laeven and Valencia, 2010). The global financial crisis that began in 2007 on the background of the US subprime residential mortgage market turmoil and gained worldwide proportions after the Lehman Brothers collapse in September 2008 led to unprecedented bail-outs in an attempt to restore market confidence and mitigate the negative effects of the shock.

Politicians responded to the crisis with a raft of reforms focused on strengthening the resilience of the financial system as a prerequisite for sustainable economic growth. One of the reform streams was aimed at building an effective resolution framework to deal with unsound and failing institutions and ending the too-big-to-fail problem. At the international level, the *Key Attributes of Effective Resolution Regimes for Financial Institutions*[3] published in 2014 by the Financial Stability Board, followed by the *Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet*,[4] are important milestones in the area of recovery and resolution planning and execution for global systemically important banks (G-SIBs). As described later in the text, the Bank Recovery and Resolution Directive (BRRD),[5] the EU's answer to the crisis, is based on the above principles and has a lot of commonalities with the international framework.

The two aforementioned standards introduce a harmonised set of tools and powers to allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions and minimising the potential negative impact on financial stability. The TLAC requirement, and similarly the minimum requirement for own funds and eligible liabilities (MREL) at European level, are designed to ensure that a bank has sufficient loss-absorbing and recapitalisation capacity.

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2 https://www.cnb.cz/en/resolution/general-approach-of-the-czech-national-bank-to-setting-a-minimum-requirement-for-own-funds-and-eligible-liabilities-mrel/
3 http://www.fsb.org/2014/10/key-attributes-of-effective-resolution-regimes-for-financial-institutions-2/
4 http://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/
5 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0059

This article explains the key features of the MREL and its role in the effective resolution process and specifies the intended local implementation and its potential implications in the form of an estimate of the aggregate MREL-eligible liabilities shortfall[6] at the domestic banking sector level. The article is structured as follows. Section 2 describes the MREL in the context of the current legal and regulatory framework, focusing on the MREL structure. Section 3 presents the main features and discusses the specifics of local implementation and offers a comparison with approaches adopted by other EU resolution authorities. Section 4 outlines the potential impact on the local banking sector. Section 5 concludes.

2. MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES

2.1. Drivers of the MREL

One of the lessons learned from financial crises is that normal insolvency proceedings are not always applicable to banks. This is because insolvency means an abrupt termination of the provision of bank functions often critical to the economy. This may have a significant adverse effect on the financial system or may not otherwise be in the public interest (Article 31 of the BRRD). During the global financial crisis that began in 2007, these negative effects of bank failures were averted by massive bail-outs. The European Commission, for example, reported that EUR 1.6 trillion of crisis-related state aid, representing almost 13% of EU GDP, was used between 2008 and 2011 (European Commission, 2012).[7]

The large amounts of state aid (effectively financed by taxpayers' money) used to save failing banks led the European Commission to issue the *2013 Banking Communication*.[8] This communication postulated the notion of "burden-sharing" and effectively marked the origins of the Bank Recovery and Resolution Directive (2014).

The BRRD responded by introducing a new principle according to which appropriate losses and part of the costs arising from a failure should primarily be covered from the internal resources of the bank, i.e. by its shareholders and creditors in accordance with their position in the insolvency hierarchy. In practice, this is facilitated by a new bail-in tool[9] (Article 46 et seq. of the BRRD). In order to make the bail-in tool effective, designated resolution authorities determine and require banks to meet (at all times) an MREL[10] ensuring they have adequate internal financial resources available to absorb losses and for recapitalisation purposes.

2.2. Legal framework and MREL structure

The MREL is embedded in Act No. 374/2015 Coll., on Recovery and Resolution in the Financial Market, the local transposition of the BRRD, and needs to be set in line with Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016[11] (Regulation 2016/1450), which is

6 Own funds and specific eligible liabilities, as defined in Article 45 of the BRRD, can generally be used by banks to satisfy the MREL. The CNB assumes that on an aggregate basis there will be a shortfall between the required capacity and the current stock of MREL-eligible liabilities that banks will need to cover (see section 4).
7 The largest component was guarantees (EUR 1.1 trillion), followed by direct capital injections (EUR 322 billion) and impaired assets purchases (EUR 120 billion).
8 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013XC0730(01)&from=EN
9 Using the bail-in tool, resolution authorities allocate losses and recapitalisation needs to the shareholders and creditors of a failing financial institution. This burden sharing differs from bailout, which usually involves the use of public money.
10 The MREL also plays an important role in conjunction with resolution tools other than bail-in as introduced by the BRRD, such as a sale of business.
11 https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1450&from=EN

directly applicable in all Member States and outlines general rules regarding the structure and calibration of the requirement.

According to Regulation 2016/1450, the MREL has two components – the amount necessary to ensure absorption of losses by the institution[12] or group (the Loss Absorption Amount, LAA) and the amount necessary for recapitalisation purposes, i.e. to continue as a *going concern* complying with conditions for authorisation, carrying out activities and sustaining market confidence (the Recapitalisation Amount, RCA). Both the LAA and the RCA are determined with reference to the prudential requirements applicable to the institution or group. Prudential combined buffer requirements (CBR)[13] are part of both the LAA and the RCA, while in the latter case they are closely linked with market confidence after resolution.

The MREL is determined for each and every institution consistently with the preferred resolution strategy,[14] as defined in the resolution planning process.[15] This means that in some specific cases the institution will only have an MREL equal to the current prudential requirements (i.e. liquidation of the institution under normal insolvency proceedings is deemed credible, so no recapitalisation is anticipated after failure), while in other cases the MREL will consist of both the loss absorption and the recapitalisation parts. Moreover, the MREL is an institution-specific requirement, determined on a case-by-case basis also to reflect the institution's business model, funding model and risk profile.

3. LOCAL IMPLEMENTATION: GENERAL APPROACH AND OTHER CONSIDERATIONS

3.1. The CNB as national resolution authority

The Czech National Bank (CNB) was designated as the national resolution authority for banks, credit unions and large investment firms in the Czech Republic. The main new roles of the CNB in the field of crisis management cover (i) policy making, as the CNB actively participates in the preparation and forming of the regulatory framework, (ii) resolution planning and execution, through drawing up (and potentially using) resolution plans for institutions within its

12 In the text, the terms "institution" and "bank" are used interchangeably. Regulation 2016/1450 states that the MREL applies to all BRRD institutions (i.e. credit institutions and large investment firms) at both the individual and consolidated levels.
13 No part of the applicable combined buffer requirement as defined in Article 128(6) of Directive 2013/36/EU is reflected in either the default loss absorption or the recapitalisation amount (i.e. a "stacking order approach" is applied). The CBR consists of an institution-specific countercyclical capital buffer, a G-SII-buffer (for global systemically important institutions – G-SIIs), an O-SII buffer (for other systemically important institutions – O-SIIs) and a systemic risk buffer.
14 According to the FSB (http://www.fsb.org/wp-content/uploads/r_130716b.pdf?page_moved=1), single point of entry (SPE) involves the application of resolution powers, for example, bail-in and/or transfer tools, at the top parent or holding company level by a single resolution authority – probably in the jurisdiction responsible for the global consolidated supervision of a group. An SPE strategy operates through the absorption of losses incurred within the group by the top parent or holding company through, for example, the write-down and/or mandatory conversion of unsecured debt issued by that top company into equity (bail-in). Provided that sufficient loss absorption capacity is available at the top parent or holding level, operating subsidiaries should be able to continue as a going concern without entering resolution. Multiple point of entry (MPE) involves the application of resolution powers by two or more resolution authorities to different parts of the group, and is likely to result in a break-up of the group into two or more separate parts. The group could be split on a national or regional basis, along business lines, or some combination of each. The resolution powers applied to the separate parts need not be the same and could include resolution options, such as bail-in within resolution, use of a bridge entity, transfer of business or wind-down. MPE strategies nevertheless require actions to be coordinated across jurisdictions so as to avoid conflicts or inconsistencies that undermine the effectiveness of the separate resolution actions, a disorderly run on assets and contagion across the firm.
15 A resolution plan is a comprehensive document outlining the characteristics of a bank or a group and describing the preferred resolution strategy for that bank, including which resolution tools to apply.

remit, and (iii) activities linked with the local resolution financing arrangement – the national resolution fund.[16]

3.2. Resolution planning and determination of a resolution strategy

In the area of preparation and prevention, which is one of the key elements of the EU-wide crisis management framework and an essential component of effective resolution, the CNB, usually with other resolution authorities on a resolution college platform, draws up resolution plans on how to deal with situations which might lead to financial stress or the failure of locally supervised institutions and their groups. One of the objectives of the plans is to ensure that any institution can be resolved with the available tools and powers in a way that does not threaten financial stability and does not involve costs to taxpayers, while protecting the vital economic functions of the institution and allowing for orderly closure and wind-down of other/all parts of the institution's business in an organised manner.

In line with the current EU framework, winding up a failing institution through normal insolvency proceedings should always be considered before any resolution tools are applied. However, such a process might not always be appropriate, since it could jeopardise financial stability, interrupt the provision of critical functions to the economy and affect the protection of depositors. In such cases, it is highly likely that there would be a public interest in placing the institution under resolution rather than resorting to normal insolvency proceedings. For these instances, the resolution plan foresees the use of resolution tools and powers as an appropriate response to a potential failure.

In this respect, the CNB communicated in section 5.4.4 of Financial Stability Report 2017/2018[17] indicative conditions used in determining appropriate resolution strategies and tools for institutions and groups under its remit and related implications for the MREL. While it is generally assumed that liquidation under normal insolvency proceedings would be both feasible and credible for small, insignificant institutions or groups with no critical economic function[18] identified, large, complex and systemically important institutions and groups providing more critical economic functions are likely to have an open-bank bail-in resolution strategy (see section 3.3).

3.3. Size of the MREL and the CNB's general approach

The resolution strategy determining the approach to be taken should a bank fail *inter alia* drives the MREL level that the institution or group would have to comply with. Those institutions where a resolution plan assumes liquidation under normal insolvency proceedings to be both feasible and credible would have an MREL equal to the actual prudential requirements as set by the CNB as the supervisor. On the other hand, for complex systemic institutions and groups providing multiple critical economic functions, an open-bank bail-in is the preferred resolution tool. This means, without too much exaggeration, that if bank fails on a Friday afternoon, it should be able to reopen the very next Monday recapitalised, reauthorised and enjoying the necessary market confidence and access to financing. These are

16 For more information, see https://www.cnb.cz/en/resolution/.

17 https://www.cnb.cz/export/sites/cnb/en/financial-stability/.galleries/fs_reports/fsr_2017-2018/fsr_2017-2018.pdf

18 The definition of critical function is based on Article 6 of Commission Delegated Regulation (EU) 2016/778 (available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R0778&from=EN), which stands on the foundations laid by the FSB in its *Guidance on Identification of Critical Functions and Critical Shared Services* (available at http://www.fsb.org/2013/07/r_130716a/). The term "critical (economic) function" is thus often encountered in practice.

the cases for which the general approach communicated by the CNB is mainly designed. According to the general approach, such banks are – in simple terms – expected to have an MREL determined as two times the current Pillar 1 (P1)[19] and Pillar 2 (P2)[20] (pre-resolution) requirements:

Total requirements for own funds and eligible liabilities= MREL + CBR

$$= 2 \times (P1 + P2) + CBR \quad (1)$$

The general approach, however, is based on several important premises. First, upon entry into resolution, the entire capital is wiped out and the bank needs to be recapitalised at least to the level necessary to comply with the conditions for authorisation, i.e. the Pillar 1 and Pillar 2 requirements. The assumption of full capital exhaustion may appear unnecessarily strict, but historical experience suggests it would not be wise to rely on a substantial net asset value in failing institutions after a fair, prudent and realistic valuation performed by the supervisory and resolution authorities.[21] Thus, the default LAA, as outlined in the general approach, exactly mirrors the current prudential requirements applicable to the institution or group, i.e. Pillar 1 and Pillar 2, as set by the CNB as the supervisory authority, and the default RCA is also closely linked with the pre-resolution prudential requirements.

Second, the CBR (i.e. the combined buffer requirements) sit on top of the MREL and are treated separately. The main role of the buffers is to create a "cushion" ensuring institutions do not breach their minimum capital requirements in a period of stress and to cover certain macroprudential risks. Hence, if buffers were included in the MREL, their intended function would be significantly limited (i.e. a breach of the requirements arising from the buffers would simultaneously constitute a breach of the MREL and would also necessitate different, stricter treatment). In line with the aforementioned, any CET1 capital that a bank uses to meet the CBR cannot be double-counted towards the MREL. Such treatment is also compatible with the proposed revisions of the BRRD.

In addition to that, the general approach is neutral in terms of group structures and works with both the single-point-of-entry and multiple-points-of-entry resolution strategies. This is especially important with regard to maintaining the level playing field on the local market.

3.4. The CNB's general approach in a wider context

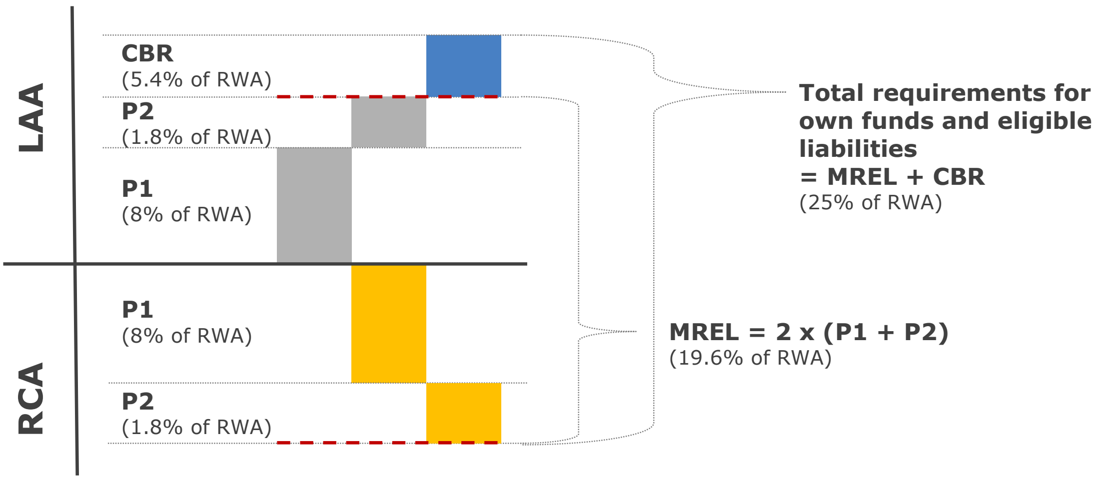
Most of the EU resolution authorities have recently published their approaches to the practical application of the current rules for setting the MREL. This offers an opportunity for a general comparison. From this perspective, it seems interesting to compare the CNB's general approach with that of the Single Resolution Board (SRB),[22] the central resolution authority within the Banking Union. The SRB is the designated group-level resolution authority for the

19 The own funds requirements pursuant to Articles 92 and 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council, which include a CET1 capital ratio of 4.5% of the total risk exposure amount, a Tier 1 capital ratio of 6% of the total risk exposure amount and a total capital ratio of 8% of the total risk exposure amount. The terms total risk exposure amount (TREA) and risk weighted assets (RWA) are used interchangeably in the text, constituting the assets or off-balance-sheet exposures of a bank, weighted according to their risk. RWAs are used in determining the level of capital banks are required to hold from a prudential perspective.
20 Any requirement to hold additional own funds in excess of the Pillar 1 requirements, in particular pursuant to Article 104(1)(a) of Directive 2013/36/EU.
21 https://eur-lex.europa.eu/legal-content/EN/TXT/?toc=OJ%3AL%3A2018%3A067%3ATOC&uri=uriserv%3AOJ.L_.2018.067.01.0008.01.ENG
22 https://srb.europa.eu/

majority of large institutions domiciled in the Czech Republic belonging to wider EU groups with parent companies in the Banking Union, and is hence the main counterparty of the CNB on the resolution college platform.

FIGURE 1

The CNB's general approach



Source: CNB
Notes: (1) Average requirements expressed as % of RWA. (2) The values employed in the rough estimate, representing the banking sector as a whole through average values, are as of December 2017. Since the entities differ, the information content of the results in relation to individual banks may be limited. (3) Data source for the Czech Republic (mainly the average P2 requirement and the CBR): CNB Financial Stability Report 2017/2018, accessible at https://www.cnb.cz/en/financial_stability/fs_reports/fsr_2017-2018/index.html.

In January 2019, the SRB published its updated MREL policy[23] which generally builds on the default setting outlined by Regulation (EU) 2016/1450. The SRB sets a default loss absorption amount equal to the sum of the Pillar 1, Pillar 2 and combined buffer requirements (i.e. LAA=P1+P2+CBR) and a default recapitalisation amount equal to the sum of the Pillar 1 and Pillar 2 requirements and a Market Confidence Charge[24] derived from the pre-resolution CBR (i.e. RCA=P1+P2+(CBR–125 basis points)). The starting MREL, before any institution-specific adjustments, can be expressed as follows: MREL=(P1+P2+CBR) + (P1+P2+(CBR–125 basis points)).

The approach applied by the CNB differs from the one applied by the SRB mainly in the treatment and positioning of the capital buffers. While the CNB does not include the combined buffer requirements in the MREL to preserve the buffers' intended role of a cushion against potential stress, the SRB embraces (parts of) the CBR in both the loss absorption and recapitalisation amounts. Despite this main difference, a rough comparison using the CNB's general approach and the 2018 SRB policy yields comparable results, with the overall

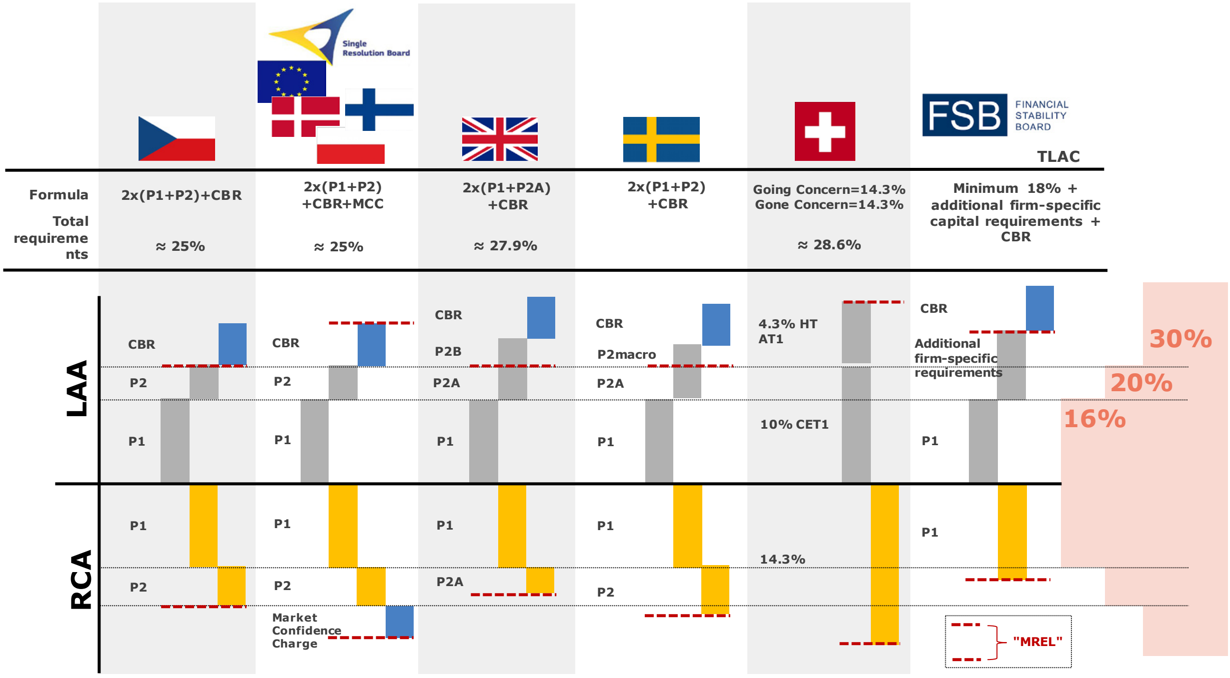
23 https://srb.europa.eu/en/content/mrel
24 Any additional amount that the resolution authority considers necessary to maintain sufficient market confidence after resolution.

requirements for capital and eligible liabilities that institutions or groups must comply with ranging around 25% of RWA.[25]

The requirements determined in line with the CNB's general approach using the available aggregated data for the Czech banking sector are shown in the stylised example in Figure 1. A similar approach as the Czech National Bank was applied, for instance, by the Bank of England, which is the UK resolution authority.[26] A very rough comparison of selected approaches is provided in Figure 2.

FIGURE 2

Loss absorbing capacity: Comparison of communicated approaches



Source: CNB's own analysis of approaches communicated by relevant resolution authorities

Notes: (1) Requirements expressed as % of RWA, designed for bail-in strategies. (2) The SRB uses the Market Confidence Charge (MCC) in the recapitalisation amount determination. MCC=CBR–125bps. (3) The Bank of England (BoE) end-state requirement after a phasing-in period. For the BoE's methodology for setting the P2 requirement, see https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/statement-of-policy/2018/the-pras-methodologies-for-setting-pillar-2a-capital-update-april-2018-effective-january-2019. (4) For the new "too-big-to-fail" capital requirements for global systemically important banks in Switzerland, see https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/faktenblaetter/faktenblatt-to-big-to-fail-regime-verstaerkt.pdf?la=en (5) The Financial Stability Board's approach to setting the TLAC for G-SIBs is available at http://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/. Unlike the MREL, the TLAC is set as a hard-minimum requirement.

25 For example, UniCredit's consolidated MREL requirement binding from March 2020 received from the SRB is equal to 11.74% of Total Liabilities and Own Funds (TLOF), which is equivalent to 26.03% of RWA (https://www.unicreditgroup.eu/content/dam/unicreditgroup-eu/documents/en/investors/group-results/2018/1Q18/UniCredit_PR_1Q18-ENG_FINAL.pdf). The MREL target for KBC (the Belgium-based group to which Československá obchodní banka belongs) based on the fully loaded capital requirements as at 31 December 2016 was 25.9%, and the SRB requires KBC to achieve this target by 1 May 2019 (https://www.kbc.com/fr/system/files/doc/investor-relations/Results/1Q2018/1Q2018_Debt_Presentation.pdf).

26 https://www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018

3.5. The MREL as an institution-specific requirement

Under the current framework, resolution authorities have some scope to make their own assessments and choices when setting the MREL for institutions and groups within their remit. The MREL is an institution-specific type of requirement, meaning that it should reflect particular features of individual institutions or groups, such as business model, funding model or risk profile, as well as the preferred resolution strategy anticipated by the relevant resolution plans.

Such adjustments may only be considered on a case-by-case basis, so they were not captured or quantified within the CNB's general approach, which serves rather as the starting point for further modification. Since the CNB has not yet communicated any detailed policy regarding the individualisation of the MREL, this section will merely try to outline and identify the main areas that may be affected and related considerations. In general, any individualisation will primarily involve recapitalisation amount alterations (since the loss absorbing amount is in principle a supervisory competence) and will relate mainly to considerations such as the size and structure of the bank's post-resolution balance sheet and the related applicability of pre-resolution prudential requirements.

3.5.1. Adjustments to the RWA basis

In its general approach, the CNB indicates that the default recapitalisation amount will be determined with reference to the latest reported RWA. Resolution authorities, however, have the option of making further adjustments, specifically in order to adapt the recapitalisation amount to the preferred resolution strategy and potential changes resulting from actions foreseen in the resolution plan. The determination of the RWA basis has a relatively substantial impact on the overall MREL, as it represents the resolution authority's notion of the institution or group after the application of resolution measures and hence the future need for recapitalisation – an underestimated MREL may result in a situation where the resolution objectives, such as continuity of critical functions, are not met, while an overestimated MREL could be economically inefficient.

Deliberation about potential changes to the default RWA setting is easier with respect to resolution plans that foresee the use of any of the transfer tools in the event of an institution's failure. In contrast to bail-in, which generally assumes stabilisation of the institution almost as-it-is, transfer tools, such as the sale of business, expect that only part of the institution – delimited mainly by (the range of) critical functions – is subject to the transfer, either to a private purchaser or a bridge institution. It can therefore be assumed that the recapitalisation part of the MREL will be shaped mainly by the need to support the transferred part, which in most cases will be defined by the volume of covered deposits and related payment services, as outlined in the CNB's explanatory memorandum on the approach to developing resolution plans. It is therefore likely that the resulting MREL could be lower than that pertinent to the bail-in tool.

In the case of the bail-in tool, the consideration may not be that straightforward, since the relevant resolution plan itself usually does not foresee any major changes to the structure and operation of the institution or group. However, some resolution authorities, including the SRB, consider several drivers with a potential impact on the recapitalisation needs in such cases. These include balance-sheet depletion, the use of recovery options and the effect of post-resolution restructuring, considerations based on a number of assumptions about the impact of stress on the institution and its balance sheet and recapitalisation needs, and driven by shrinking balance sheets of banks in stress due to potential losses, the application of recovery measures (by institutions themselves or triggered by the authorities) or the application of a business reorganisation plan mandatorily following the application of the bail-in tool. Such impact, though, is extremely difficult to estimate ex ante. For example, the type and nature of the stress can have a significant impact on the development and scale of the losses; under a slow-burn stress it can be assumed that institutions and competent authorities will have more time to take corrective actions, whereas a fast-burn type of stress will probably leave them with insufficient room for manoeuvre. Similarly, under systemic problems the losses will follow a different path than in the case of an idiosyncratic stress, which can take various forms.

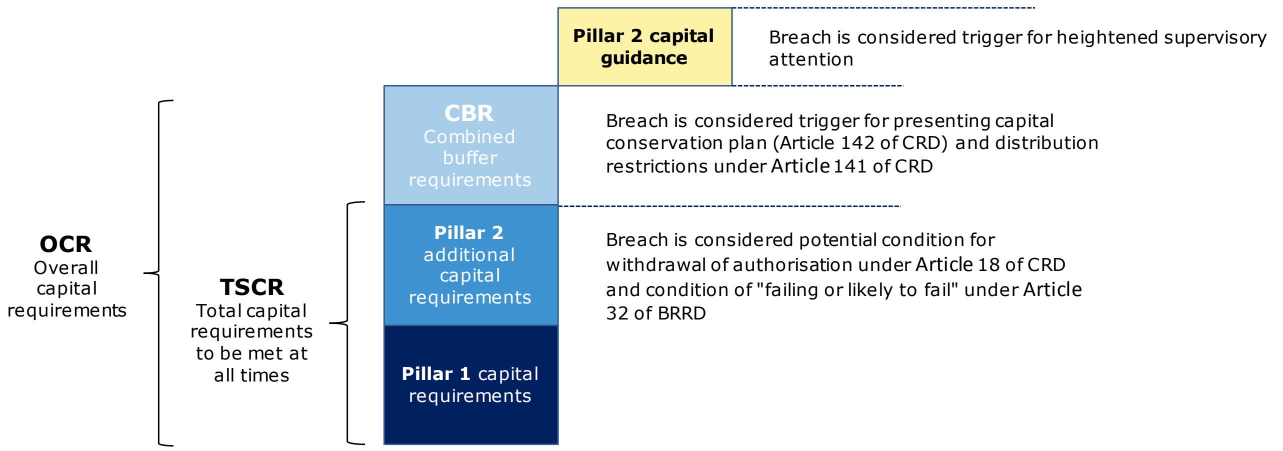
The main driver for the CNB's decision to individualise the recapitalisation amount due to potential changes in the RWA basis, other than those caused by the measures foreseen in the relevant resolution plans (such as the use of transfer tools), should therefore be a high level of probability of such an event occurring with a satisfactorily estimated outcome.

3.5.2. Post-resolution applicability of Pillar 2 prudential requirements

Based on the CNB's general approach, the recapitalisation amount makes use of the pre-existing capital requirements as a reference point. The Pillar 2 capital requirements, which take into account and reflect the specific risk profile of each institution or group as set by the competent authority in the supervisory review and evaluation process (SREP),[27] are generally considered necessary for (keeping) authorisation under the EU capital adequacy rules.

FIGURE 3

EBA Pillar 2 Roadmap



Source: EBA, https://eba.europa.eu/documents/10180/1814098/EBA+Pillar+2+roadmap.pdf

27 The key purpose of the SREP is to ensure that institutions have adequate arrangements, strategies, processes and mechanisms as well as capital and liquidity to ensure sound management and coverage of the risks to which they are or might be exposed, including those revealed by stress testing and those the institution may pose to the financial system. The aim of the Pillar 2 processes is to enhance the link between an institution's risk profile, its risk management and risk mitigation systems and its capital planning.

When considering the potential individualisation of requirements, the CNB will need to form an opinion on whether and what level or parts of the existing Pillar 2 requirements (in terms of % of RWA) would be relevant after resolution. In general, it can be assumed that in the case of institutions and groups where the resolution plan anticipates the use of the bail-in tool, i.e. virtually continuous operation,[28] the risk profile may change, but it will be very difficult to make any qualified assumption ex ante on the resulting appropriate Pillar 2 requirement, especially considering that the SREP is a rather complex process. In such cases, it seems more appropriate and sufficiently prudent to use the original requirement without upward or downward adjustment.

A slightly different consideration has to be made for resolution plans employing transfer strategies, which generally assume that only a part of the "business" defined by the critical function continues and the rest of the former institution undergoes a winding-up process. In this case, the applicability of the original requirement seems to be rather limited. The CNB would need to properly reflect the preferred resolution strategy and its consequences for risks targeted by Pillar 2 outlined in the relevant plans to determine the appropriate post-resolution requirement.

3.5.3. Transitional arrangements for MREL build-up

The introduction of higher requirements, including the MREL, has benefits in the form of an increase in the resilience of the banking sector and a potential reduction in the incidence of highly costly financial crises. However, it can also entail micro- and macro-economic costs in the form of increased bank funding costs, lower availability of bank loans for customers and lower economic growth. This article has no ambition to quantify exactly the costs and benefits of the MREL. However, there are international impact studies that examine this issue and can thus be used to determine the transition period banks should use to meet the new MREL requirements. These studies show, among other things, that most of the negative effects mentioned above are noticeable in building-up phases, when institutions are creating additional capacity in order to comply with the higher requirements, rather than in the longer run (Bank of England, 2015; BCBS, 2010; Dagher et al., 2016; EBA, 2016; FSB, 2015; IIF, 2010).

The current framework allows the CNB to determine an appropriate transition period to reach the final MREL. This transition period should, however, be as short as possible, since the MREL is one of the main prerequisites for effective resolution.[29] The CNB, when introducing its general approach, indicated that banks will be given enough time[30] to meet the new requirements. This approach reflects the prevalence of koruna deposits over debt instruments in the funding model of Czech banks, the different levels of experience and access of particular entities to capital markets for eligible liabilities and reliance on CET1 to meet the MREL. The outlined four-year transition period therefore tries to mitigate as much as possible the potential negative impacts of prompt introduction of the new requirements and at the same

28 This applies similarly to the use of the "write down or conversion powers" independently of resolution action in accordance with Article 59 of the BRRD for institutions that fall under the SPE strategy and are not resolution entities themselves.
29 In accordance with Article 15 of the BRRD, an institution is deemed resolvable if it is feasible and credible for the resolution authority either to liquidate it under normal insolvency proceedings or to resolve it by applying the different resolution tools and powers to it without any significant adverse effect on financial system and with a view to ensuring the continuity of critical functions carried out by the institution.
30 The CNB expects to set a transition period of four years for banks to build the necessary additional loss absorption and recapitalisation capacity of around CZK 120–140 billion.

time takes into account the good shape of the Czech banking sector and the need to gradually enhance the resolvability of banks.[31] In addition to that, this approach gives room to take into account expected changes in the relevant regulatory framework.

4. QUANTIFICATION: ESTIMATION OF THE AGGREGATE SHORTFALL

In its communication concerning the general approach, the CNB in connection with the transition period stated that the estimated aggregate MREL-eligible liabilities shortfall in the Czech banking sector would probably lie in the range of CZK 120–140 billion. Banks would need to cover this shortfall in the future. The estimated shortfall should be interpreted with reference to the specifics of the Czech banking sector. Capital is currently the largest component of the MREL-eligible liabilities of the domestic banking sector. This reflects Czech banks' funding profile, which is based predominantly on koruna deposits. Contrary to the situation in some other EU countries, Czech banks have not made extensive use of the wholesale market and debt issuance for funding purposes in the past. Retail deposits currently have the largest share in koruna deposits at banks. However, they are not generally regarded as MREL-eligible liabilities, unlike bonds, for example, which better satisfy the necessary conditions laid down in Article 45 of the BRRD (such as remaining maturity over one year). So, the relatively well-capitalised Czech banking sector may paradoxically have a somewhat more difficult starting position than banks routinely using wholesale and capital markets as a source of funding.

In December 2018, the capital of most banks sufficiently exceeded the overall capital requirements. The surplus was approximately CZK 66 billion for systemically important banks (3.6 b.b. in relation to RWA) and CZK 48 billion for other banks (6.2 b.b. in relation to RWA). The estimated aggregate shortfall of CZK 120–140 billion[32] communicated alongside the CNB's general approach already takes into account the said capital excess, assuming that banks will tend to reduce their voluntary surplus to partially offset the new requirements. So, if banks wanted to keep a certain level of capital surplus as a management buffer, for example, the total shortfall arising from the need to fulfil the MREL plus the CBR could be higher. These reasons were also considered by the CNB in its statement on the need for a sufficiently long transition period.

5. CONCLUSION

The introduction of the MREL together with the new crisis management framework certainly represents an important milestone on the way to greater bank and financial system resilience. This does not, however, mean that financial crises will no longer occur, but if they do, their effects might be less severe. The process of determination of MREL levels for Czech banks is still in its initial phase. The CNB, in its general approach, outlined the intended local implementation of the requirement. This article, besides describing the policy rationale behind the MREL and its nature and purpose in the context of the current legal and regulatory framework, tried to further specify and describe the various interlinkages and factors that need to be taken into account when deciding on case-by-case adjustments of the requirement to make it institution-specific. With respect to the anticipated general level of the MREL, i.e. two

31 In order to gain sufficient confidence that banks are gradually building up capacity, it may also be appropriate to set intermediate targets before reaching the overall level.
32 According to CNB's Financial Stability Report 2017/2018, the total regulatory capital in the domestic banking sector reached CZK 460.6 billion in December 2017. The estimated aggregate shortfall of CZK 120–140 billion therefore represented around 30% of domestic banking regulatory capital.

times the Pillar 1 and Pillar 2 requirements, the article also underlined the importance of having a sufficiently long transition period. Determination of the appropriate MREL will not be an easy job; however, the CNB together with banks themselves will gradually progress towards greater resolvability and enhanced stability of the Czech banking sector.

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