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SWEDISH NATIONAL DEBT OFFICE

**REPORT**
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Reg. no RG 2016/425

# Decision memorandum
# Application of the minimum requirement for own funds and eligible liabilities

**UNOFFICIAL TRANSLATION**

In the event of discrepancies between the Swedish and English versions of this memorandum, the Swedish version will apply.

**Contents**

# Glossary

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|---|---|
| *The technical standards* | Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities.[1] |
| *Subsidiary* | a subsidiary according to point (16) of Article 4(1) of the Credit Requirements Regulation.[2] |
| *Firm* | credit institutions, investment firms, parent undertakings and other firms required by the SNDO to comply with an MREL under Chapter 4, Section 2 of the Resolution Act. |
| *Own funds instruments* | capital instruments that may be used to meet a firm's total capital requirements. |
| *Eligible liabilities* | debt instruments that meet the criteria in Chapter 2, Section 2 of the Resolution Act. |
| *MREL liabilities* | eligible liabilities that may be used to meet the MREL (see the criteria in Chapter 2, Section 2 of the SNDO's Resolution Regulations (RGKFS 2015:2)). |
| *MREL* | Minimum Requirement for Own Funds and Eligible Liabilities. A requirement, expressed as a percentage, stating how large the firm's MREL liabilities and own funds must be, at least, as a proportion of its total liabilities and own funds. |
| *Parent undertaking* | an EEA parent undertaking required to meet MREL on a consolidated basis under Chapter 4, Section 2 of the Resolution Act. |

[1] https://www.nbb.be/doc/cp/eng/2016/20160903_eu_2016_1450.pdf
[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

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| *MPE strategy* | resolution with multiple points of entry, i.e. a resolution strategy based on some or all of the firms in a group being placed into resolution and dealt with separately from one another. |
| *MREL instruments* | own funds instruments and MREL liabilities. |
| *Resolvability assessment* | the determination under Chapter 3, Sections 10 and 11 of the Resolution Act of whether a firm can be restructured or wound up through bankruptcy, liquidation or resolution in a way that does not lead to a serious disruption in the financial system. |
| *SPE strategy* | resolution with a single point of entry. i.e. a resolution strategy based on only the parent undertaking in a group being placed into resolution. |

<u>Definitions relating to capital requirements</u>

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|---|---|
| *Basel I floor* | the capital requirement under Article 500 of the Credit Requirements Regulation. |
| *Combined buffer requirement* | the combined buffer requirement under Chapter 2 of the Capital Buffers Act (2014:966). |
| *Minimum capital requirements* | the own funds requirements under Articles 92 and 458 of the Credit Requirements Regulation. |
| *Pillar 2 requirements* | capital requirements (over and above the minimum capital requirement and combined buffer requirement) that arise as a result of the comprehensive capital assessment made by the Swedish FSA and, where applicable, a decision on a special own funds requirement under Chapter 2, Section 1 of the Act (2014:968) on Special Supervision of Credit Institutions and Investment Firms. |
| *Total capital requirement* | the sum of minimum capital requirements, pillar 2 requirements and the combined buffer requirement or, if higher, the Basel I floor. |

# Summary

A new framework for crisis management of banks, investment firms and certain other firms came into force in Sweden on 1 February 2016. This means that the government, via the Swedish National Debt Office (SNDO) can take control of and restructure or wind up such firms by means of a process known as 'resolution', if this is required to preserve financial stability.

In resolution, losses and any recapitalisation needs will be covered by the crisis-stricken firm's own shareholders and lenders. For this to be possible, the firms must have sufficient capital and liabilities that can be used for loss coverage and recapitalisation. The resolution rules therefore state that every firm has to meet a special requirement, known as MREL.

MREL is to be determined by the SNDO within the framework set out in Swedish Law and relevant EU rules. This memorandum sets out the policy positions taken by the SNDO in relation to the definition of the requirements.

## The level of MREL

MREL shall comprise the sum of a *loss absorption amount* and a *recapitalisation amount*.

The *loss absorption amount* shall be equivalent to the firm's total capital requirements (without taking account of the Basel I floor), excluding the combined buffer requirement and, where applicable, macro-prudential elements within the pillar 2 requirement.

The *recapitalisation amount* shall be equivalent to a firm's total capital requirements, excluding the combined buffer requirement. The recapitalisation amount shall be zero for firms that are not expected to be placed into resolution, i.e. firms which are deemed capable of being wound up through bankruptcy or liquidation.

Decisions on the amount of MREL in accordance with this model will be taken in conjunction with the decisions on the 2017 resolution plans. The requirement will be applied from 1 January 2018 onwards.

## Compliance with MREL

As part of ensuring that firms are resolvable, the SNDO will evaluate how firms meet MREL. For firms that are planned to be managed by resolution, this evaluation will be carried out on the basis that the following principles are satisfied at the dates specified.

| **Principle** | **Date** |
|---|---|
| *Liabilities proportion:* Firms should have MREL liabilities that are at least equivalent to the recapitalisation amount. | 2018 |
| *MREL liabilities within groups.* For groups where the main resolution strategy is an SPE strategy, the liabilities used to comply with MREL on a group basis should be 1) issued by the firm within the group that are to be placed in resolution, and 2) held by non-group companies. For the group firms that are not themselves to be placed into resolution, the individual MREL should be met with liabilities that are 1) issued to the firm within the group which *is* to be placed into resolution, 2) subordinated to the issuing firm's other liabilities and 3) capable of being bailed-in or converted without the issuing firm being placed into resolution. | No requirement for compliance as yet |
| *Subordination:* MREL should be met with subordinated instruments. | 2022 |
| *Cross-holdings:* Risks related to holdings of other institutions' eligible liabilities and/or MREL liabilities should be limited. | No requirement for compliance as yet |

# 1. Introduction and purpose

In May 2014, the Council of the European Union and the European Parliament adopted the Bank Recovery and Resolution Directive. This Directive establishes harmonised rules in the EU for managing crises in credit institutions, investment firms and certain group firms (collectively referred to as 'firms'). The Directive establishes a process for the reorganisation and winding-up of such firms, which is called resolution. The rules for resolution differ from the rules for reorganisation and winding-up that apply to companies in general. The purpose of the rules is to make it possible to manage crisis-stricken financial firms, especially those of considerable importance for the financial system, without causing contagion that threatens financial stability and without central government being forced to intervene and provide financial support. Many EU countries have not had such rules, and this also applies to some extent to Sweden.

The Directive has mainly been implemented in Swedish law through the Resolution Act (2015:1016), the Resolution Ordinance (2015:1034) and the SNDO's Resolution Regulations (RKGFS 2015:2).

## 1.1 Resolution, bail-in and the need for MREL

A resolution process means that, if it is considered necessary to preserve financial stability, central government takes control of a failing firm through the SNDO and restructures or winds up the operation.

In resolution, any losses and recapitalisation needs must be met by the owners and creditors of the failing firm. In functional terms, this can be done either by applying the bail-in tool or by the SNDO first selling or transferring the bank's critical operations to a new owner and then leaving the remainder of its operations to be wound up through bankruptcy.

Irrespective of which approach is applied, it is only possible to implement resolution effectively if the firm has sufficient capital and liabilities that can be used to meet losses or, in the case of liabilities, converted into share capital.

In contrast to capital, it may sometimes be difficult or inappropriate to bail in (or convert) liabilities. The regulations therefore contain provisions to the effect that some types of liability should always be excluded from bail-in and conversion, such as deposits protected by the deposit guarantee. In exceptional circumstances, the SNDO may also choose on a discretionary basis to exclude other types of liabilities that would otherwise have been eligible for bail-in and conversion.

The existence of these exceptions means that firms could fund themselves in such a way that their capital and bail-inable liabilities might not be sufficient to enable resolution. To prevent this, the Resolution Act provides that firms must meet a special minimum requirement for eligible liabilities (MREL).

## 1.2 Role of the SNDO and purpose of this memorandum

The level of MREL is not directly specified in the Act but has to be set by the SNDO for each individual firm. This is to be done on the basis of a number of criteria set out in the SNDO's Resolution Regulations. These criteria are specified in more detail in the technical standards.

Apart from deciding on the amount of MREL, the SNDO also has some powers to ensure that firms are resolvable, i.e. can be managed through resolution, without serious systemic implications and without the use of public funds. Based on these powers, and where there are significant impediments to resolution, the SNDO may require firms to take certain measures. These could, for example, be measures related to the way in which MREL is met, which thus supplement the requirements set out in the SNDO's regulations on the liabilities that may be used to comply with MREL.

This memorandum sets out how the SNDO intends to exercise these powers to set MREL. The memorandum deals with the level of MREL and with the SNDO's position on certain questions linked to MREL that have bearing on whether firms may be deemed to be resolvable.

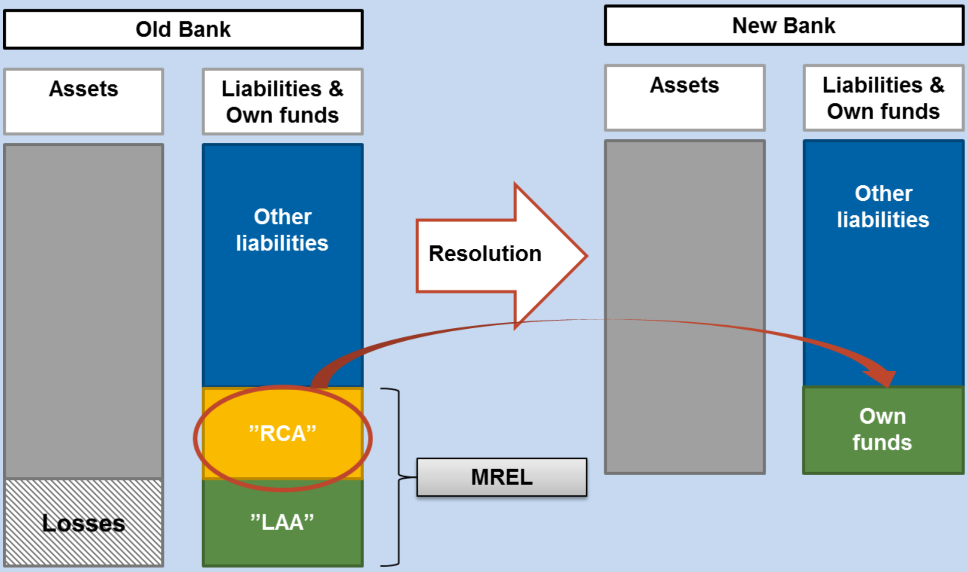
The memorandum contains the SNDO's final position on the matters discussed in the consultation memorandum of 26 April 2016 (reg. no 2016/425). Nine of the 15 consultee bodies responded. The comments received through the consultation procedure are reported under each policy position.

**Box 1 Illustration of the purpose and function of MREL**

Banks and some other financial undertakings have long been required to have sufficient capital (capital requirements) to be able to bear unexpected losses that may be incurred in times of economic stress. MREL introduces a new and complimentary requirement that, in addition to their loss-bearing capital, firms must have sufficient additional capital or debt instruments to be able, when required, to be *recapitalised*. Recapitalisation means that a firm in resolution has its own funds restored to safeguard the continued operation of those parts of its activities that are to continue. This restoration involves writing down some of the firm's liabilities or converting them into shares, a process known as a *bail-in*.

The level of MREL shall reflect the loss absorption or recapitalisation need that is to exist in each firm in the event of a failure. The requirement therefore consists of two components: a loss absorption amount (LAA), corresponding in broad terms to the firm's capital requirement, and a recapitalisation amount (RCA), corresponding to the amount required to restore its capital to the required levels that will apply to the firm after resolution.

The figure below provides an outline illustration of a bail-in and conversion for a firm where *all* its operations are preserved and continue to operate.




In this example the 'old bank' incurs losses corresponding to the whole of its LAA, which means that all of its own funds have been consumed and the bank fails. As the bank is considered to be of material importance for the financial system, it is placed into resolution by the SNDO, which executes a bail-in and conversion in order to restore its own funds in accordance with the resolution plan adopted for the bank. The amount converted corresponds to the RCA, which makes up, after conversion, the capital base of the 'new bank'.

By setting the MREL, the SNDO thus ensures that there is sufficient loss absorption and recapitalisation capacity in firms to be able to manage them through resolution and thereby maintain their critical functions, without using public funds.

# 2. Overall policy position

## 2.1 Alignment with the FSB's TLAC agreement

**The SNDO's policy position:** Pending a decision on the implementation of the TLAC agreement within the EU, the agreement will not be applied to Swedish firms. In order to facilitate adaptation to future rule changes, the SNDO has however decided, where the current rules allow, to take the TLAC agreement and the implementation proposals presented by the European Commission in November 2016 into account in its policy positions on MREL.

**Consultation memorandum**: Contains basically the same policy position.

**Comments from the consultee bodies:** Support the proposal or offer no comments.

**Reasons for the SNDO's policy position:** In parallel to the development of the EU regulations concerning MREL, the Financial Stability Board (FSB), a G20 body, has published an international standard that requires global systemically important banks to maintain a certain minimum loss-absorption capacity *(Total Loss-Absorbing Capacity, or TLAC).*[3] Even though the standard is not identical to the EU rules, both frameworks build on the same conceptual foundation, i.e. that banks and certain other financial firms must have sufficient capital and bail-inable liabilities to enable resolution to be executed without serious systemic consequences and at no cost to the taxpayer.

Since the TLAC requirements only apply to global systemically important banks, the scope of the standard is much narrower than that of the EU rules. Among Swedish firms, only Nordea Bank AB has been assigned the status of a global systemically important bank.

The TLAC standard is not binding. However, the European Commission (the Commission) presented a comprehensive regulatory proposal in November 2016, including the implementation of the standard within the EU.[4] This 'Banking Package' contains several revisions and additions to the existing rules concerning the MREL. The proposal also includes significant reforms to existing capital adequacy rules, some of which will also have a bearing on the setting of MREL.

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[3] *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution – Total Loss-absorbing Capacity (TLAC) Term Sheet*, FSB, 9th November 2015.

[4] http://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-reforms-and-their-progress/progress-financial-reforms_en

**Main components of the Commission proposal**

*Quantitative minimum requirement for global systemically important banks*
For global systemically important banks, a quantitative minimum requirement (minimum TLAC) is proposed, which should be the greater of 18 per cent of risk-weighted assets and 6.75 per cent of non-risk-weighted assets.

*Institution-specific MREL*
The method of determining the individual MREL will be revised and copied over from the technical standards to the Bank Recovery and Resolution Directive. For global systemically important banks, individual requirement will be added to the minimum TLAC. For other firms, the requirement will be solely determined by calculating their individual MREL.

*MREL guidance*
Along with the requirements mentioned here, it is proposed that the resolution authority should also be allowed to decide that firms should hold a certain additional amount of capital and MREL instruments, known as MREL guidance. The intention is to create a certain buffer to cover both the MREL and other regulatory requirements.

*Tighter requirements for MREL liabilities*
Except for 3.5 percentage points, it is proposed that the liabilities that may be used to meet the minimum TLAC should be subordinated liabilities not included in the MREL amount. Similar requirements *may* also be laid down for the institution-specific MREL and MREL guidance.

*Harmonisation of insolvency hierarchy rules*
In order to strengthen the market conditions for subordinated debt instruments and also to facilitate resolution, it is proposed to harmonise Member States' *insolvency hierarchy* rules by establishing in law a category of liabilities that should be ranked lower than non-priority debts but higher than own funds instruments.

*MREL for groups*
For groups, rules will be introduced for the way in which MREL should be met in light of the resolution strategy applicable to the group and the subsidiaries included. For groups planned to be managed wholly or partly on a consolidated basis according to the resolution plan, MREL for those firms in the group that are *not* themselves to be subject to resolution measures may only be met with liabilities issued to the group firm that will be subject to the direct measures.

*Breaches*
Explicit rules for handling breaches of MREL and MREL guidance are proposed. A breach of MREL may be handled in several different ways, including the powers of the resolution authority to remove impediments to resolution.

*Deduction rules*
It is proposed that firms should be required to deduct from their own MREL liabilities any holdings of liabilities issued by global systemically important institutions and used to meet the minimum TLAC. Supplementary rules will be presented at a later date concerning deductions for holdings of 1) MREL-compatible liabilities in excess of the minimum TLAC, and 2) liabilities issued by firms not classified as globally systemically important.

The Commission's proposal has been under negotiation in the Council since the beginning of the year. It is not yet known what the outcome of these negotiations will be. It is therefore unclear when the revised rules will be finalised and how they will be ultimately defined. It is however clear that a number of elements of the proposal will lead to major changes to the existing rules.

In the policy positions set out in this memorandum, the SNDO has chosen, where the current rules allow, to take account of the amendment proposals presented by the European Commission. This is in order to avoid as far as possible any major revisions to the rules in the near future and to facilitate adaptation to future rule changes.

The SNDO does not intend to apply the existing TLAC standard directly to Swedish firms, but considers that the proposal presented by the European Commission essentially satisfies the substance of the standard within the EU. If the negotiations within the EU should result in differences between the EU rules and the standard, whether substantive or in relation to phasing-in, the SDNO will comply with the provisions of the EU regulations as implemented in Swedish law.

## 2.2 Timetable for setting MREL

**The SNDO's policy position**: The level of MREL will be determined according to the model in this memorandum during the last quarter of 2017 and shall be applied from 1 January 2018 onwards.

For firms that 1) have undergone resolution, or 2) are affected by changes in the resolution strategy that cause a significant increase in MREL, the SNDO will decide on a case-by-case basis on the time limit for compliance with MREL.

**Consultation memorandum:** Did not set out any policy position on a transitional period for firms that have undergone resolution or that have been subjected to substantially increased requirements following review of the resolution strategy. Otherwise the policy position is unchanged.

**Comments from the consultee bodies:** The *Swedish Bankers' Association* requests clarification of the transitional process when a firm is subjected to an increased requirement as a result of changes in the resolution strategy. Other consultee bodies support the suggestion or have no objections.

**Reasons for the SNDO's policy position:** According to the technical standards, the resolution authority may determine an appropriate transitional period for firms to meet the MREL requirement from the point at which the requirements are first determined. There is no further detailed guidance on what should be considered an appropriate transitional period.

According to the standard, a similar transitional period may also be applied to firms that have been the object of a bail-in or conversion and then have to comply with MREL once more. On the other hand, it does not state what should happen to firms that are subjected to significantly increased requirements after the resolution authority has decided on revisions to the resolution strategy.

The Commission's proposal for an amended Credit Requirements Regulation states that the transitional period for meeting the minimum TLAC, after the bail-in tool has been used, should be up to two years. The proposal states that the same period should apply after a bail-in or conversion of capital instruments and other liabilities outside resolution.

The Resolution Act does not contain transitional rules regarding MREL. Nor are there any provisions in the Act governing the time frames for meeting the requirement after a bail-in or following a revision of the resolution strategy.

*Initial transitional period*

The need to apply a transitional period from the date on which the MREL is first decided is governed by the extent to which firms need to take measures to adapt to the requirement.

For firms assessed as not needing to be handled through resolution in the event of a failure, no special transitional measures will be necessary, as MREL does not result in any additional requirements over and above the applicable capital requirements.

However, for firms that are to be placed into resolution if they fail, MREL will exceed their capital requirements. If these firms do not have capital and bail-inable liabilities equivalent to the level of MREL, it will be necessary for them to issue MREL instruments that can be counted towards the requirement or to adapt their activities in some other way so as to comply with MREL.

The SNDO has gathered data from a number of firms in order to evaluate the consequences of the policy positions taken in this memorandum. The analysis carried out using this data shows that all firms currently have sufficient MREL instruments to comply with the quantitative level of MREL.

This indicates that there is no need to apply a longer initial transitional period. The SNDO therefore intends to set the requirements according to the model in this memorandum in the last quarter of 2017. The requirements will then take effect from 1 January 2018.

For firms that are part of cross-border groups, any decision on MREL has to be taken jointly with other relevant resolution authorities working within 'resolution colleges'. For this reason, the decision time for these firms may differ from other firms.

*Firms that have undergone resolution or been set increased requirements following review of the resolution strategy*

Until further notice, the SNDO does not intend to apply any fixed time frames for compliance with the requirement 1) after a bail-in, or 2) following a revision of the resolution strategy. Instead, a decision on a suitable transitional period will be made in each case, taking account of the situation prevailing at the time of the decision.

# 3. The level of MREL

## 3.1 Legal basis

### 3.1.2 Swedish law

Chapter 4 of the Resolution Act and the SNDO's Regulations on Resolution contain provisions concerning MREL. Under Chapter 4, Section 3 of the Resolution Act, the SNDO shall set MREL taking into account the circumstances in each individual case, in order to ensure that a firm, if placed into resolution, has eligible liabilities and own funds that together are sufficient to make it possible to take resolution actions that meet the resolution objectives. The requirement should be expressed as a proportion of the firm's capital and total liabilities.

The Resolution Act does not specify any explicit level for the requirement, and this is to be decided by the SNDO, after consulting the Swedish FSA. The decision shall be based on a number of criteria given in the SNDO's Regulations that are specified further in the technical standards (see below). [5]

MREL shall be met both by individual firms and at the group level. For cross-border groups, the consolidated requirement is set by the parent undertaking's resolution authority in consultation with the resolution authorities in the host countries of the subsidiaries according to a process laid down in law.

### 3.1.3 The technical standards

In practice, the technical standards outline a method for deciding the level of MREL. The resolution authority has some scope to make its own assessments and choices, but may only do so within set limits.

According to the standards, MREL should comprise the sum of two components: a loss absorption amount and a recapitalisation amount. Both amounts have to be set on the basis of firms' capital requirements and the resolution authority's assessment of the firm's risk characteristics (size, business model and financing profile).

A number of other factors also have to be taken into account in setting MREL, and this may necessitate adjustments to the level calculated above. According to the technical standards these factors are:

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[5] Chapter 2, Sections 4-7 of the SNDO's Regulations on Resolution (RKGFS 2015:2). These provisions implement the parts of Article 45(6) of the Bank Recovery and Resolution Directive that were not implemented through Chapter 4, Section 3 of the Resolution Act.

- the scope of any exclusions from bail-in and conversion
- the size and systemic importance of the firm
- contributions from the deposit guarantee scheme to the financing of resolution

*The loss absorption amount*

The starting point for the loss absorption amount according to the technical standards is that it has to be equal to the firm's total capital requirement, i.e. it has to be the sum of the firm's minimum capital requirement, pillar 2 requirement and combined buffer requirement or any higher amount that is required to meet the Basel I floor or applicable leverage ratio requirements (default loss absorption amount).[6] However, in certain circumstances the resolution authority may decide that the loss absorption amount should be different from the default amount.

A *higher* loss absorption amount may be set if

- the resolution authority considers, taking account of information from the supervisory authority about the firm's business model, funding model and risk profile[7], that the components included in the default amount do not fully reflect the need for loss absorption in resolution, or
- it is necessary in order to reduce or eliminate an impediment to resolution or to absorb losses on holdings of instruments issued by other entities in the group that may be included in the MREL.

A *lower* loss absorption amount may be set if the resolution authority considers, taking account of the information from the supervisory authority's information about the firm's business model, funding model and risk profile, that

- pillar 2 requirements based on outcomes of stress tests or requirements intended to cover macro-prudential risks are deemed not to be relevant to the need to ensure that losses can be absorbed in resolution, or
- parts of the combined buffer requirement are not relevant to the need to ensure that losses can be absorbed in resolution.

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[6] Called 'default loss absorption amount' in Article 1 of the technical standards.
[7] Article 4 of the technical standards specifies which supervisory information is meant

*The recapitalisation amount*

The starting point for the recapitalisation amount according to the technical standards is that it has to be set on the basis of what is required in order to execute the preferred resolution strategy in the resolution plan. The recapitalisation amount may be set at zero if the resolvability assessment shows that it is feasible and credible to wind up the firm through ordinary insolvency proceedings, i.e. if the firm is *not* expected to be placed into resolution. For these firms, MREL will be equal to the loss absorption amount.

For firms that may be placed into resolution, the recapitalisation amount will consist of two parts:

- The amount necessary for the firm to meet, after execution of the preferred resolution strategy, the capital requirements that apply to its authorisation, including minimum capital requirements, pillar 2 requirements and the Basel I floor and applicable leverage ratio requirements, but not any buffer requirements.
- The additional amount considered necessary by the resolution authority to maintain sufficient market confidence in the firm after resolution. This amount shall correspond to at least the combined buffer requirements that are applicable after application of the resolution tools. The additional amount may however be set lower (but not less than zero) if the resolution authority considers that this is sufficient to maintain market confidence, critical functions and access to funding.

Despite what has been stated above, the resolution authority may disregard all or parts of the pillar 2 requirement or the buffer requirements when it sets the recapitalisation amount. The authority may do so if, after consultation with the supervisory authority, it determines that all or parts of these requirements do not need to be applied after the execution of the resolution strategy.

For a firm that is part of group, the resolution authority shall, when it sets the recapitalisation amount, also take account of capital in other parts of the group that may be available to maintain market confidence in the firm after resolution.

*Other criteria to be taken into account in setting MREL*

The resolution authority may *reduce* the MREL in light of the amount that the deposit guarantee scheme may be expected to contribute under the preferred resolution strategy. That amount shall be set taking account of the limitation rules set by the Bank Recovery and Resolution Directive for the use of the deposit guarantee scheme in resolution, and also the risk of exhausting the financial means available in the deposit guarantee scheme.

The resolution authority must also ensure that MREL is sufficient considering the liabilities that may be excluded when the bail-in tool is applied or be transferred in full when one of the other resolution tools is applied. This will be determined in two ways: first, on the basis that MREL liabilities that may be excluded or transferred and therefore erode the loss absorption and recapitalisation capacity of the firm and, second, considering that the exclusions or transfers, irrespective of whether or not the liabilities are MREL liabilities, may result in a breach of the Directive's safeguard that a creditor of a firm that has been placed under resolution must not be left worse off than if the firm had instead been wound up through normal insolvency procedures.

Finally, when setting MREL for systemically important firms, the resolution authority must also take account of the requirements provided for in Article 44 of the Bank Recovery and Resolution Directive. i.e. the requirements that regulate the option for the resolution authority to exclude liabilities from a bail-in and the circumstances under which such exclusions can be financed from the financing arrangement for resolution (in the case of Sweden, the resolution reserve).[8]

## 3.2 The SNDO's considerations

The technical standards set the framework for decisions by the SNDO on the level of MREL. As shown in section 3.1, the calculation model specified in the standards gives the resolution authority a certain discretion to take its own decision on how to calculate the various MREL components and adjustment amounts. This section sets out how the SNDO intends to apply the provisions of the standards. The starting point regarding MREL is that it has to be high enough to ensure that planned resolution actions can be taken if the firm is placed into resolution.[9]

### 3.2.1 MREL and pillar 2 requirements

**The SNDO's policy position**: The pillar 2 requirements which result from the Swedish FSA's overall capital assessment and are relevant to loss absorption and recapitalisation should be taken into account in MREL

[8] These requirements provide that, before financial means from the resolution reserve may be used, shareholders and holders of capital instruments and eligible debts must have met losses and/or accounted for recapitalisation in an amount corresponding to 8 per cent of total liabilities and capital/own funds, or 20 per cent of the total risk-weighted exposure.

[9] Chapter 4, Section 3 of the Resolution Act and Article 45(6)(a) of the Bank Recovery and Resolution Directive.

calculation as if it had been set in a formal decision.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** The consultee bodies support the suggestion or have no objections.

**Reasons for the SNDO's policy position:** When calculating MREL, the firm's Pillar 2 requirements shall, as a general rule, be included in both the loss absorption amount and the recapitalisation amount according to the technical standards.[10]

However, the Swedish FSA does not normally make any formal decisions on pillar 2 requirements. Instead the FSA notifies each firm of the outcome of the comprehensive capital assessment that it makes regarding the firm. Formal decisions are only made in cases where this is considered necessary.

In view of what is specified in the technical standards and the purpose of setting MREL, the SNDO's assessment is that the pillar 2 requirement which results from the Swedish FSA's comprehensive capital assessment, and which is relevant to loss absorption and recapitalisation, should be taken into account in MREL calculation as if it had been set by a formal decision. Sections 3.2.2 and 3.2.3 set out what parts of the pillar 2 requirement will be taken into account, and how.

### 3.2.2 The loss absorption amount

#### Default loss absorption amount

**The SNDO's policy position**: The loss absorption amount shall be determined without considering the firms' Basel I floor and until further notice without considering firms' leverage ratio.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** The *Riksbank* argues that both the Basel I floor and any leverage ratio requirement should be taken into account in calculating MREL. Other consultee bodies support the suggestion or have no objections.

**Reasons for the SNDO's policy position:** The loss absorption amount shall be set on the basis of the default amount for loss absorption specified in the technical standards. The default amount shall consist of the sum of

[10] Articles 1(2)(b) and 2(6)(b) of the technical standards.

the institution’s minimum capital requirement, pillar 2 requirements and combined buffer requirements or the higher amount required to meet the Basel I floor or applicable leverage ratio requirements.

*Leverage ratio requirements*

Swedish firms are currently covered by requirements to calculate their leverage ratio and report it to the Swedish FSA. But no formal, binding leverage ratio requirement is applied. For the moment, therefore, the SDNO does not intend to take account of any kind of leverage measure when determining the default amount.

However, the Commission’s Banking Package does contain proposals that a binding leverage ratio requirement should be introduced and that MREL should then be determined as a proportion of risk-weighted exposures and of leverage. If the EU adopts the Commission’s proposal, the model for determining MREL will need to be modified.

*Basel I floor*

The Basel I floor is a binding requirement that results in a higher formal capital requirement for certain firms than that calculated using internal models. The requirement follows from the Credit Requirements Regulation and is a transitional rule aimed at setting a floor in the transition from Basel I to Basel II. According to the Credit Requirements Regulation, the Basel I floor will cease to apply from 2018 onwards.[11]

Given that the Basel I floor will cease to apply before the MREL comes into force, the floor will not be considered in determining the default amount.

**Conditions for a *higher* loss absorption amount**

**The SNDO’s policy position**: There is no reason to decide on a higher loss absorption amount than the default amount.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** The consultee bodies have no objections.

**Reasons for the SNDO’s policy position:** The resolution authority can choose to set a higher loss absorption amount than the default amount if

[11] See Article 500 of the Credit Requirements Regulation.

1. the default amount does not fully reflect the loss absorption need in resolution[12], or
2. it is necessary in order to
   - remove or reduce an impediment to resolution, or
   - absorb losses on holdings of capital instruments and eligible liabilities issued by other firms in the group.

As regards the possibility of setting a higher amount on the basis that the default amount does not fully reflect the loss absorption need, it may be noted that the capital requirements decided by the Swedish FSA, which form the basis for the default amount, are set with the specific intention of being sufficient to absorb the losses of each individual firm. The SNDO therefore sees no need to adjust the amount for this reason.

As regards adjustments of the loss absorption amount to remove impediments to resolution, the SNDO has not identified any circumstances over and above those already covered by the standards in which this would be appropriate. The SNDO's assessment is therefore that there will be no need for upward adjustments of MREL on account of this for the time being.

As regards holdings of capital instruments and eligible liabilities issued by other firms in a group, part of the risks associated with such holdings are handled through the rules for deductions for holdings of own funds instruments that follow from the current capital adequacy rules (in functional terms, a deduction from MREL instruments is the same thing as an upward adjustment of MREL). There are at present no equivalent rules for deductions regarding MREL liabilities or eligible liabilities, which could justify an upward adjustment.

However, the need to make such adjustments depends on what general restrictions linked to the firms' cross-ownership of MREL liabilities and/or eligible liabilities that will be applied. As indicated in section 5.2.4, the SNDO intends to return to the question of such restrictions at a later date. Until that time, the SNDO does not intend to apply the possibility of adjusting the loss absorption amount upwards for holdings of liabilities issued by other firms in the same group.

**Conditions for a *lower* loss absorption amount**

**The SNDO's policy position**: In determining the loss absorption amount, the following capital requirement components will be excluded:

- the combined buffer requirement,
- macro-prudential elements within pillar 2 (where applicable)

**Consultation memorandum:** Does not exclude the risk weight floor for mortgages exceeding 15 per cent. Otherwise the same policy position.

**Comments from the consultee bodies:** The *Swedish FSA* and the *Swedish Bankers' Association* consider that the exclusions from the loss absorption amount should also include the risk weight floor for mortgages exceeding 15 per cent. Other consultee bodies support the suggestion or have no comments.

**Reasons for the SNDO's policy position:** The resolution authority is able to set a lower loss absorption amount if parts of the capital requirements used in the calculation of the default amount are judged not to be relevant to covering loss absorption needs in resolution. The capital requirements that can be excluded on these grounds are, first, the pillar 2 requirements based on the outcome of stress tests or intended to cover macro-prudential risks and, second, non-relevant parts of the combined buffer requirement.

Considering how the capital adequacy rules are applied for Swedish firms, the SNDO notes that there are a number of components of the capital requirement that meet the criteria for exclusion from the loss absorption amount.

*The combined buffer requirement*

The main function of the capital buffers is to ensure that firms have a certain capacity to absorb losses without breaching the capital requirements that are a condition of authorisation. In other words, the aim is to ensure that there is a certain amount of capital that can be used *before* any thought of placing the firm into resolution.

If the capital buffers are included in the loss absorption amount, this function will cease, in that the buffers will be locked into MREL in such a way that it may only be possible to use them in resolution. For this reason, no part of the combined buffer requirement should be regarded as relevant to loss absorption in resolution and should therefore not be included as a component in the calculation of the loss absorption amount either.

This approach accords with the proposals in the Commission's Banking Package. In the Commission proposal the combined buffer requirement should not be included in the loss absorption amount.

Excluding the buffers when calculating the loss absorption amount does not mean that the aggregate loss absorption and recapitalisation capacity of the firms is weakened. As indicated in section 5, the SNDO intends to establish certain principles regarding MREL compliance, one of which will be that a certain part of MREL should be met using MREL liabilities. One effect of this principle is that firms will not be able to count all of their capital in order to comply with MREL.

By not allowing firms to double-count parts of their capital in this way, the buffer requirements are in practice placed on top of MREL. One consequence of this is that it will be possible for firms to use this capital without breaching MREL. A design of this kind thus allows the capital buffers to fulfil their intended purpose, i.e. to be an actual buffer against losses without causing a breach of the requirements that apply for the firm's authorisation. Retaining the function of the capital buffers in this way is also in line with the changes proposed in the Banking Package.

*Pillar 2 requirements*

Swedish pillar 2 requirements encompass two components intended to cover macro-prudential risks, a systemic risk add-on applicable only to firms classified as systemically important institutions (G-SIIs or O-SIIs), and the portion of the risk weight floor for mortgages in excess of 15 per cent. [13]

Both of these components constitute what the technical standards call macro-prudential requirements and should therefore be excluded from the calculation of the loss absorption amount.

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[13] Together with the systemic risk buffer, the systemic risk add-on amounts to an extra capital requirement of five percentage points for the four largest Swedish banks. These requirements both have the same purpose: to strengthen the resilience of the financial system to systemic risks. The choice made by the Swedish FSA to divide this extra capital requirement into a buffer requirement (three percentage points) and a pillar 2 requirement (two percentage points) is attributable to the design of the regulatory framework. The risk weight floor for mortgages was originally introduced because the Swedish FSA considered that the expected risk of loss on mortgages was underestimated in the firms' internal models. When the floor was later raised from 15 to 25 per cent, however, this was no longer justified by the firms' individual loss risks but rather by the socio-economic risks arising from the increase in household debt. So this part of the floor does not relate to firm-specific risks but, like the systemic risk add-on, should rather be classed as a macro-prudential requirement. See the Swedish FSA's memorandum 'Capital requirements for Swedish banks' ('Kapitalkrav for svenska banker'), FI reg. no 14-6258.)

### 3.2.3 The recapitalisation amount

The recapitalisation amount should be based on the recapitalisation need implied by the principal resolution strategy. In practice this is a matter of ensuring that MREL is set in such a way that the firm can meet its expected capital requirements after resolution has been executed.

According to the technical standards, to achieve this the amount must be calculated on the basis of the capital required so that, after resolution, the firm:

- complies with the capital requirements that apply to its authorisation, and
- is able to retain sufficient market confidence.

In the same way as for the loss absorption amount, the resolution authority can choose to exclude some of the capital requirement components which, according to the basic rule in the technical standards, should otherwise form the basis for the recapitalisation amount.

As recapitalisation will only need to cover those parts of the firm that, according to the resolution strategy, will survive after execution of the resolution strategy, the recapitalisation amount only needs to reflect the capital requirements in these parts of the firm. For this reason, the recapitalisation amount can be set at zero for the category of firms that are deemed appropriate to be wound up through bankruptcy or liquidation, i.e. outside resolution. Section 3.2.4 describes how firms in this category will be identified.

Another category of firms are those that, according to their resolution plan, will be handled solely by applying the bail-in tool (whole bank bail-in), i.e. where the whole firm is expected to continue. For these firms, the recapitalisation amount will need to reflect the capital needs of the expected size of their operations at the time of resolution.

A third category consists of firms only parts of whose operations are assessed as critical. For these firms, the resolution plan anticipates that it will be possible to separate critical functions from the remainder of the firm by, for example, applying the sale of business tool or the bridge institution tool. Since it is only the operations that are sold or transferred that need to be recapitalised, the capital requirement will be lower than if it had been necessary to continue all of the firm's operations. This means that the recapitalisation amount does not necessarily need to reflect the capital needs of the entire firm. For example, a firm whose resolution plan anticipates that half of its assets will be transferred to a bridge institution while the remaining half will be left to be wound up through bankruptcy could be assigned a recapitalisation amount corresponding to half of the capital requirement for all of its operations (assuming that all of the firm's assets have the same risk-weighting).

The first resolution plans for the four major Swedish banks were adopted in December 2016. Although these plans did not contain any decision on MREL, they did state that the banks concerned, under their chosen resolution strategy, would be assigned a recapitalisation amount equivalent to the whole of their operations.

For other firms expected to be the object of resolution, the SNDO will take a policy position on a resolution strategy and an associated recapitalisation amount when the individual resolution plans are adopted. We cannot rule out the possibility that the recapitalisation amount for these firms will be determined in the same way as for the major banks.

**Calculation basis for the recapitalisation amount**

**The SNDO's policy position**: The recapitalisation amount shall be calculated on the basis of the latest reported total risk exposure amount.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** The *Swedish Bankers' Association* argue that the recapitalisation amount should be calculated on the assumption that the firms' balance-sheets will be 10-15 per cent smaller in the case of resolution.

**Reasons for the SNDO's policy position:** The technical standards state that the calculation of firms' capital needs after execution of their resolution strategy shall be based on the most recent reported values for the total risk exposure amount or, if applicable, the exposure amount used for calculating the leverage ratio.

The resolution authority has the possibility of adjusting these exposure amounts so as to adapt the recapitalisation amount to the chosen resolution strategy. It is through these adjustments that the recapitalisation amount is adapted to the preferred resolution strategy in technical terms. If, for example, the strategy is based on recapitalising only part of the operations, the supporting information for setting the recapitalisation amount only needs to include the amount of exposure attributable to this part of the operations.

With regard to the comment from the *Swedish Bankers' Association* that the recapitalisation amount should be calculated on the assumption of smaller balance-sheet values, the SNDO acknowledges that a firm placed into resolution could have a smaller balance-sheet total than on the date at which the MREL was determined. However, it cannot be taken for granted that this will always be the case, let alone that it can be estimated with reasonable precision. It should also be noted that the recapitalisation amount in resolution will be primarily governed by the extent of the firm's risk-weighted assets and not by the value of the balance-sheet in gross terms. For a crisis-stricken firm, it is not inconceivable that there could have been a certain increase in its risk weights, which would then counteract the effect of any reduction in the balance-sheet.

In view of this, the SNDO believes that it is not possible to make any qualified and generally applicable assumptions about the way the firm will have developed up to the date of resolution. Nor is it then appropriate to base the recapitalisation amount on any other measure than the size of the existing operation, i.e. the capital needs raised by the existing operation after resolution.

This position is also in line with the proposals in the Commission's Banking Package. This states that the recapitalisation amount should be based on the capital needs raised by the existing operation. There is no explicit means for the resolution authority to adjust the amount based on any assumption as to the future nature of the operation.

**Setting of the recapitalisation amount**

**The SNDO's policy position**: The recapitalisation amount shall be equivalent to the firm's total risk-weighted capital requirements, excluding the combined buffer requirement.

**Consultation memorandum:** No capital requirement components have been excluded.

**Comments from the consultee bodies:** The *Swedish FSA* suggests that the combined buffer requirement and the parts of the pillar 2 requirements that relate to systemic and macro-prudential risks should be excluded from the calculation of the recapitalisation amount. The *Swedish Bankers' Association* considers it sufficient for the recapitalisation amount to include the minimum capital requirement, the capital conservation buffer and other pillar 2 own funds requirements. The Bankers' Association also points out that there is a strong probability that the Basel I floor will cease to apply.

**Reasons for the SNDO's policy position:** For firms that may be placed into resolution, the recapitalisation amount will consist of two parts:

- The amount necessary for the firm to meet, after the execution of the preferred resolution strategy, the capital requirements that apply to its authorisation, including minimum capital requirements, pillar 2 requirements and the Basel I floor and applicable leverage ratio requirements, but not any buffer requirements (the default recapitalisation amount).

– The amount considered necessary by the resolution authority to maintain sufficient market confidence in the firm after resolution. This amount must be at least equal to the combined buffer requirements, but it may be lower if the resolution authority deems it sufficient to maintain market confidence (the additional recapitalisation amount).

The assumption is therefore that the recapitalisation amount shall be equivalent to a firm's total capital requirements, including the combined buffer requirement. Exceptions to this general rule may however be made if any part(s) of the total requirement no longer need to be applied after the resolution strategy has been implemented or it is not considered necessary from a market confidence perspective for the firm to meet all or parts of the combined buffer requirement.

*The default recapitalisation amount*

The capital requirements that are conditions for authorisation under current EU regulations and can therefore be considered part of the default amount include minimum capital requirements, Pillar 2 requirements, Basel I floor and applicable leverage ratio requirements.

Of the above requirements, only the minimum capital requirement and the Basel I floor are formally adopted requirements in the Swedish application of the EU capital adequacy rules. No leverage ratio requirement is applied and normally no formal decisions are made about pillar 2 requirements either.

The minimum capital requirement inevitably has to be taken into account when setting the recapitalisation amount, because these apply at all times and cannot ever be altered or reviewed by the Swedish FSA.

With respect to the other requirements, the SNDO takes the following policy position.

<u>Pillar 2 requirements:</u> As noted in section 3.2.1, the SNDO considers that the pillar 2 requirements addressed in calculating the MREL shall be treated as if they had been set by a formal decision. As long as the pillar 2 requirements are deemed applicable after resolution, they will therefore be taken into account in calculating the recapitalisation amount.

Which pillar 2 requirements are applicable at any given time will be determined by the Swedish FSA on the basis of the relevant capital adequacy rules. The FSA states in its response to consultation that some of the risks that the capital requirements are intended to cover have probably already materialised in a crisis in a systemically important bank, so it is reasonable to assume that the capital requirements will be less after resolution, i.e. in the sense that some pillar 2 requirements and buffer requirements will probably no longer apply.

The SNDO nevertheless considers that all pillar 2 components should be taken into account in calculating the recapitalisation amount. The grounds for taking this policy position are that neither the SNDO nor the Swedish FSA can state with certainty what requirements will be applicable at some point in the future. Although it is likely, as the Swedish FSA points out, that capital requirement components intended to cover macro-prudential risks will no longer be applicable after a systemic crisis, situations could arise in which all or parts of these requirements might still continue to apply. This would be the case especially in the event of an ‘idiosyncratic’ crisis, i.e. where an individual firm fails but the financial system as a whole is not affected to any great extent.

The starting point for setting the recapitalisation amount should therefore be that the same requirements that the firm is subject to initially will be applicable after resolution.

<u>Basel I floor:</u> As noted in section 3.2.2 above, the Basel I floor will cease to apply from 2018 onwards. As MREL will not start to apply until after this date, it is not relevant to take account of the floor in calculating the recapitalisation amount.

<u>Leverage ratio requirements:</u> As long as leverage ratio requirements are not a formal capital requirement, the SNDO does not intend to calculate the recapitalisation amount with reference to any form of leverage based measure.

*The additional recapitalisation amount*

The additional recapitalisation amount will generally at least be equal to the combined buffer requirement. But the resolution authority may set a lower amount if

1. all or part of the combined buffer requirement is not deemed to be applicable after resolution, or
2. a lower amount is deemed to be sufficient to sustain market confidence.

The possibility of setting a lower amount because all or part of the buffer requirements are not deemed to be applicable after the execution of the resolution strategy is essentially the same issue as was discussed above concerning the exclusion of the pillar 2 requirement. In the same way as was stated there, the SNDO considers that it is not possible to state with any certainty what requirements will be applicable after the execution of the strategy. It is therefore not appropriate to make a downward adjustment of the amount on these grounds.

A lower amount may however be set if the conditions in the second point are met, i.e. a lower amount is deemed to be sufficient to sustain market confidence. Market confidence means in this context that a firm is able to maintain its critical functions and its access to market financing even though its own funds immediately after the execution of the resolution strategy will potentially not be sufficient to meet the buffer requirements.

The technical standards are based on the assumption that the combined buffer requirement is an appropriate amount. Even if a firm's compliance with the buffer requirements is likely to have a bearing on the willingness of market participants to provide financing, it is not the sole deciding factor. In that sense the amount specified in the standards can, to some extent, be regarded as arbitrary. In practice, the amount required to sustain satisfactory market confidence may be higher or lower than a firm's total applicable capital requirement.

Given the difficulty of assessing the amount needed to preserve market confidence, the SNDO proposed in the consultation memorandum that the recapitalisation amount should include all of the combined buffer requirement because this would provide scope for the SNDO to recapitalise firms up to a level equal to the total capital requirement if this is necessary to maintain market confidence.

However, the Commission's Banking Package sets forth that the recapitalisation amount should be determined without reference to the combined buffer requirement. Assuming that the regulations are drawn up in line with this proposal, no part of the buffer requirements will then be included in the MREL. On the other hand, the same proposal provides for the resolution authority to include the combined buffer requirement in the MREL guidance. This amount will then be in addition to the binding MREL.

Given that the combined buffer requirement will probably not be included in the recapitalisation amount in the future, and pending the adoption and implementation of the new EU rules, the SDNO has decided not to include the combined buffer requirement in the recapitalisation amount.

The fact that the buffer requirement is now excluded does not however mean that the SNDO rules out any future option to include the buffer requirement in the form of MREL guidance. The SNDO's fundamental position as expressed in the consultation memorandum remains, and the application of the MREL guidance will be reviewed when the new EU rules and necessary formal powers are in place.

### 3.2.4 Firms for which the recapitalisation amount can be set at zero

**The SNDO's policy position**: The recapitalisation amount shall be set at zero for those firms that the SNDO has decided shall be subject to simplified planning obligations.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** The *Swedish Bankers' Association* stresses that notice of simplified obligations should be given as soon as possible. Other consultee bodies support the suggestion or have no comments.

**Reasons for the SNDO's policy position:** As described above, the resolution authority may set the recapitalisation amount at zero for firms that the authority deems appropriate to be wound up through bankruptcy or liquidation. This means that MREL for such firms will only consist of the loss absorption amount. As the general rule this amount should be set on the basis of the applicable capital requirements, MREL will, in these cases, never be higher than a firm's capital requirements. So for this category of firms, MREL will not entail any additional requirements over and above the applicable capital requirements.

As part of its work with resolution planning, the SNDO is required under Section 10 of the Resolution Ordinance to determine to what extent resolution planning should be conducted for each individual firm. It should be possible for firms whose failure can be handled through normal insolvency procedures without a significant effect on financial markets, other firms, funding conditions or the wider economy to be subject to simplified obligations and therefore simplified planning requirements. However, firms that are to be managed through resolution will be subject to full planning requirements.[14]

Whether or not a firm is to be covered by full planning requirements will therefore be based on the same considerations that are to determine whether its recapitalisation amount should be greater than zero.

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[14] See SDNO report 'Simplified obligations for resolution planning' ('Förenklade skyldigheter avseende resolutionsplanering') (reg. no RGR 2016/213) for a more detailed description of the method to be used to review simplified obligations.

In this light, the SNDO does not see any reason to carry out a separate assessment of the firms for which the recapitalisation amount can be set at zero. Instead this policy position should be linked to the outcome of the assessment concerning simplified obligations. This means that firms that are subject to full planning requirements will also be assigned a recapitalisation amount in accordance with the model set out above. Firms that are instead subject to simplified obligations will have their recapitalisation amount set at zero.

Where it is considered that a firm can no longer be handled through normal insolvency procedures, and so passes from simplified to full obligations, MREL will have to be adjusted upwards to continue to encompass a recapitalisation amount. For details of how firms should adapt to the new increased requirement, see section 2.2.

#### 3.2.5 Liabilities excluded from a bail-in

**The SNDO's policy position**: MREL should not be adjusted in the case where certain liabilities should or may be excluded from a bail-in.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** Support the proposal or offer no comments.

**Reasons for the SNDO's policy position:** Under the Resolution Act, certain liabilities may not be bailed-in or converted in connection with resolution (mandatory exclusions).[15] Additionally, the Act allows the resolution authority to exclude liabilities that would otherwise be eligible for bail-in and conversion (discretionary exclusion) in extraordinary circumstances at the time of resolution.

The resolution authority is required to ensure that MREL is sufficiently high to avoid the application of these exclusion rules in resolution causing the quantity of bail-inable liabilities that may actually be subject to bail-in to be too low. The technical standards require this to be done by the resolution authority carrying out two types of determination.

First, the authority must ensure that the institution's loss absorption and recapitalisation capacity are sufficient even if the authority has identified a necessity to make full or partial discretionary exclusions of liabilities that are eligible to be included in MREL.

[15] Chapter 21, Section 2 and Chapter 2, Section 2 of the Resolution Act

Second, the authority must analyse to what extent the mandatory and discretionary exclusions identified may lead to a breach of the principle that no creditor should be left worse off in resolution than if the firm had instead been wound up through bankruptcy or liquidation. However, this determination need only be made if the liabilities excluded account for more than 10 per cent of the firm's liabilities of equal rank to the excluded liabilities in insolvency.

These requirements apply not only to the application of the bail-in tool but also in relation to firms whose resolution plan anticipates that resolution will be executed by the resolution authority transferring parts of the firm's operations to a new principal and transferring eligible liabilities in full without any bail-in as part of this.

The technical standards do not specify which measure or measures the resolution authority should take to rectify any deficiencies identified in this process. But a number of alternatives are given in the recitals to the standards. They state that the resolution authority can either 1) set a higher MREL, 2) require that parts of MREL be met by subordinated contractual bail-in instruments or 3) take alternative measures to address impediments to resolution.

The alternative of setting a higher MREL risks being an ineffective measure for the purpose, especially if the need to take the measure stems from the fact that the exclusions are expected to lead to a breach of the principle that no creditor should be left worse off in resolution than if the firm had instead been wound up through bankruptcy or liquidation. Since an increase in MREL would not affect the outcome for the creditors affected, the measure will only have the intended effect if it means that the firm alters the composition of its liabilities, for example by reducing liabilities that may be excluded or by increasing liabilities that will not be excluded. But even in the case where the need for measures stems from an insufficient quantity of bail-inable liabilities on account of anticipated discretionary exclusions, an MREL increase risks being ineffective if the institution chooses to meet the higher requirement by using other liabilities that may also be subject to discretionary exclusions.

In this light, the position of the SNDO is that the alternative of increasing MREL is not an appropriate measure for the purpose.

What is required instead is measures that target characteristics of the bail-inable liabilities used to comply with MREL.

In section 5, the SNDO sets out a number of principles linked to how MREL is met that have a crucial bearing on whether firms are deemed to be resolvable. One of these principles is that the minimum requirement should be met entirely with subordinated instruments, which would in practice eliminate the problem that the quantity of bail-inable instruments could be insufficient due to exclusions from bail-in. As a result, no special measures aimed at handling the consequences of the rules concerning exclusions from bail-in would be necessary.

The proposals presented in the Commission's Banking Package do not give rise to any necessity to review the policy positions taken by the SNDO on how MREL should be defined in terms of possible exceptions from bail-in.

### 3.2.6 Adjustment for contributions from the deposit guarantee scheme

**The SNDO's policy position:** MREL shall not be adjusted for contributions from the deposit guarantee scheme.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** Support the proposal or offer no comments.

**Reasons for the SNDO's policy position:** The technical standards permit deductions from MREL on account of expected contributions from the deposit guarantee scheme to the financing of a resolution process. Such deductions shall be based on an assessment of potential contributions and shall also

- be less than a prudent estimate of the potential losses that the deposit guarantee scheme would have had to bear in normal insolvency proceedings,
- be less than the limit on deposit guarantee scheme contributions to the financing of resolution[16],
- take account of the overall risk of exhausting the available financial means of the deposit guarantee scheme, which needs to be used for multiple cases (resolution or bankruptcy), and
- be consistent with any other national regulations, duties and responsibilities that apply to the deposit guarantee scheme.

The rules of the Bank Recovery and Resolution Directive regarding the contribution of the deposit guarantee to resolution have been implemented in Swedish law through Sections 7 and 7a of the Deposit Guarantee Act (1995:1571). These provisions state that the financial means of the deposit

[16] Section 7b of the Deposit Guarantee Act (1995:1571).

guarantee scheme can be used for both loss absorption and recapitalisation. Concurrently, such deductions can only be considered if the deposit guarantee scheme can actually be expected to be used for loss absorption or recapitalisation, i.e. in cases where the loss absorption and recapitalisation needs are expected to be so great that, without protection, covered deposits would have had to be bailed-in or converted.

As stated above, the position of the SNDO is that the capital requirements set by Swedish FSA should be used, minus the combined buffer requirement, to set the size of the loss absorption amount. Since this means that the whole of the loss absorption amount will be covered by capital, the deposit guarantee scheme will not need to be used for loss absorption. For this reason no deduction can be considered from the loss absorption amount.

As regards the recapitalisation amount, on the other hand, deductions may have to be made if the estimated recapitalisation need is so great that, in the absence of protection, it would have been necessary to use the covered deposits for conversion.[17] However, for such deductions to be permissible, it must be possible to establish in advance that resolution will not leave owners and creditors worse off than they would have been in a bankruptcy. This is because the condition that the contribution of the deposit guarantee scheme has to be less than the amount that would have to paid out in a bankruptcy would otherwise not be met.

Even though the SNDO judges it likely that resolution will preserve value in the great majority of cases, it is not possible to assume that it will always do so. For this reason the SNDO does not intend to grant any deductions from MREL for contributions to the deposit guarantee scheme.

The Commission's Banking Package does not give rise to any need to revisit this conclusion because the proposed rules for adjusting MREL for contributions from the deposit guarantee are basically identical to the provisions in the technical standards.

### 3.2.7 Adjustment on the basis of size and systemic risk

**The SNDO's policy position**: No account will be taken of the possibility of using the resolution reserve for loss absorption or recapitalisation in a resolution process when MREL is set.

**Consultation memorandum:** Contains the same policy position.

[17] Since covered deposits have a right of priority, such deductions can only come into question for firms whose financing (over and above capital) consists largely or wholly of deposits. For other firms there will be other liabilities that cover the recapitalisation needs.

**Comments from the consultee bodies:** The *Riksbank* considers that the method of determining MREL should be such as to ensure that the requirement is set sufficiently high to allow the resolution reserve to be used where necessary to finance a resolution procedure. The *Swedish Bankers' Association* suggests that the comparatively large Swedish resolution reserve (compared to other countries) should be taken into account in setting the level of MREL. The Association also considers that MREL should take account of the options to use precautionary government aid.

**Reasons for the SNDO's policy position:** For firms whose failure may be a threat to financial stability, the resolution authority must take particular account of the rules for executing a bail-in when it sets MREL.[18] These provisions regulate both the mandatory and discretionary exclusions from bail-in and the circumstances under which the resolution authority may use the resolution reserve to cover losses and recapitalisation needs in resolution.

Before the resolution reserve may be used, shareholders and creditors must have contributed an amount to cover losses and recapitalisation that is equivalent to at least 8 per cent of the firm's total liabilities or 20 per cent of its risk-weighted assets. If the MREL set by the resolution authority is insufficient to reach any of these thresholds or if there is a need to exclude certain eligible liabilities which are included in the requirement, situations may potentially arise in which there is not enough loss absorption and recapitalisation capacity in the firm to make an effective resolution process possible. In such a situation, given that it is not possible to use the resolution reserve, the resolution authority may be forced to bail-in or convert liabilities that are deemed, for some reason, to be unsuitable for bail-in or conversion.

However, the technical standards do not set out how the resolution authority is to take the rules concerned into account when it sets the MREL. One interpretation, however, is that the resolution authority should check whether MREL requirements are to be calibrated against the threshold levels for use of the resolution reserve.

A number of other conditions need to be in place for a situation to arise in which there is insufficient loss absorption and recapitalisation capacity at the same time as the resolution reserve cannot be used. The loss levels and

[18] See Chapter 21 of the Resolution Act (Article 44 of the Bank Recovery and Resolution Directive). The firms referred to are firms that 1) the supervisory authority has classified as global systemically important institutions (G-SIIs) or other systemically important institutions (O-SIIs) and 2) other firms that may, in the assessment of the supervisory authority or the resolution authority, constitute a systemic risk, with a reasonable degree of likelihood, if they fail.

recapitalisation needs either have to exceed the estimated loss absorption and recapitalisation amounts or the resolution authority has to be forced to make discretionary exclusions from bail-in that were not anticipated in resolution planning. There must be no other eligible liabilities (apart from those that may be used to meet MREL) or those liabilities must also be excluded from bail-in on a discretionary basis.[19]

However, even if these circumstances should arise simultaneously, calibrating the MREL against the threshold levels does not mean that the resolution reserve can automatically be used.

Firstly, all uses of the resolution reserve are subject to a State aid review by the Commission. Moreover, all discretionary exclusions that may require use of the reserve must be consistent with the Commission's Delegated Regulation on exclusions from bail-in.[20] So the fact that a need to use the reserve arises does not in itself guarantee that it will actually be possible to use it, even if the level of the loss absorption and recapitalisation need is large enough to meet the threshold.

Secondly, contributions by shareholders and creditors to loss absorption and recapitalisation should be measured *at the time of resolution*.[21] Given the very high likelihood that a firm placed into resolution will have made losses before that point in time and thereby consumed all or part of its capital, a requirement of 8 per cent of total liabilities or 20 per cent of risk-weighted assets would be insufficient in the great majority of cases. Therefore, to ensure access to the resolution reserve, this requirement must be supplemented with a component, over and above the threshold amounts, that takes account of the losses that can be expected to be incurred before a resolution process begins. For most firms, this would result in an MREL significantly higher than the requirements calculated on

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[19] It may also be noted in this context that costs can be met from the resolution reserve in cases where the resolution authority has, in its planning, made incorrect estimates of the outcome for non-excluded creditors in bankruptcy and, as a result of this, has not increased MREL or called for other measures to remove the risk that these creditors will be left worse off in resolution than in bankruptcy or liquidation. Even though this is not a desirable situation, it does not present any impediment to the use of the resolution reserve. This is because, under Swedish law, the threshold level for use of the reserve does not apply to the payment of compensation to creditors who have been left worse off in resolution than in bankruptcy or liquidation. (See Government Bill 2015/16:5, p. 655.)

[20] Commission Delegated Regulation (EU) 2016/860 of 4 February 2016 specifying further the circumstances where exclusion from the application of write-down or conversion powers is necessary under Article 44(3) of Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms.

[21] See Government Bill 2015/16:5 pp. 592f and 409ff. See also Chapter 7 of the Resolution Act.

the basis of the other criteria. This is particularly true if MREL is calibrated on the basis of the 8 per cent threshold.[22]

For these reasons, the SNDO's overall position is that MREL should not be calibrated against the threshold values for use of the resolution reserve.

Finally, it should be noted that the regulations do not allow MREL to be determined, as advocated by the *Swedish Bankers' Association*, with reference to the size of the Swedish resolution reserve or the options to use precautionary government aid.

[22] Assuming that MREL is to be designed to allow the use of the resolution reserve, it would be preferable in terms of flexibility to calibrate it on the basis of the 8 per cent threshold. The reason is that, for it to be possible to use the resolution reserve at the threshold of 20 per cent of risk-weighted assets, the balance in the reserve must be at least 3 per cent of the total covered deposits in the bank system. Moreover, the 20 per cent threshold can only be applied when using the bail-in tool. Only the threshold of 8 per cent applies to the use of the government stabilisation tool. To ensure that it will always be possible to also use this tool, MREL must thus be calibrated on the basis of this threshold.

**Box 2 Calculation of MREL**

The table below shows how MREL will be calculated according to the method described in section 3. The calculation uses a hypothetical example (Bank A), but broadly reflects the situation for a major Swedish bank.

| | Calculation of MREL | % Risk weighted exposures |
|---|---|---|
| | Total capital requirements | 20,0% |
| Combined buffer requirement | *minus* systemic risk buffer | -3,0% |
| Combined buffer requirement | *minus* counter cyclical buffer | -0,5% |
| Combined buffer requirement | *minus* capital conservation buffer | -2,5% |
| | *minus* mortgage riskweight floor (15-25%) in Pillar 2 | -1,0% |
| | *minus* systemic risk add-on in Pillar 2 | -2,0% |
| | **Loss absorption amount (LAA)** | **11,0%** |
| | Total capital requirements | 20,0% |
| Combined buffer requirement | *minus* systemic risk buffer | -3,0% |
| Combined buffer requirement | *minus* counter cyclical buffer | -0,5% |
| Combined buffer requirement | *minus* capital conservation buffer | -2,5% |
| | **Recapitalisation amount (RCA)** | **14,0%** |
| | **MREL** | **25,0%** |

The starting point for the calculation of MREL is that both LAA and RCA have to correspond to the capital requirements that apply to the firms (20% for Bank A), i.e. MREL must be twice a firm's capital requirement.

However, as stated in section 3, the SNDO intends to make certain adjustments to MREL, by excluding the combined buffer requirement from the LAA and RCA and also deducting the macro-prudential elements in pillar 2 from the calculation of the LAA.

In all, this means that Bank A's MREL will be 25% (made up of 11% LAA and 14% RCA).

It should be noted that the deductions from the capital requirement in the calculation of the loss absorption amount do not mean that firms need less loss-bearing capital. The capital requirements are still applicable alongside MREL. Box 3 gives a more detailed description of the interaction with the capital requirement.

# 4 Breaches of MREL

The Bank Recovery and Resolution Directive does not contain any specific provisions regarding breaches of MREL. Chapter 4, Section 12 of the Resolution Act states, however, that the SNDO shall monitor that firms comply with MREL. The preparatory work to the Act also states that the Swedish FSA has the task of supervising compliance with MREL and, where relevant, deciding on measures to remedy noncompliance with the rules. According to the preparatory works, what measures are suitable will have to be decided in light of the circumstances in each individual case.[23]

The role of the SNDO is thus limited to monitoring that firms comply with MREL. If a breach is identified, it is the task of the Swedish FSA to decide on measures, based on its powers under the Banking and Financing Business Act and the Securities Market Act. In this respect the handling of MREL does not differ from how other breaches of regulations for credit institutions and investment firms are handled.[24]

Currently, there are therefore no specific provisions on breaches of MREL. However, the Commission's Banking Package proposes that such rules should be introduced and also that resolution authorities should have a clearer role in handling breaches. According to the proposal, breaches could be handled by the resolution authority exercising its powers to remove impediments to resolution. The powers for 'early intervention' could also be applied, along with some other supervisory powers laid down in the Capital Requirements Directive.[25]

It is also proposed to introduce an explicit provision to the effect that breaches arising from an inability to refinance MREL liabilities should not immediately be regarded as a breach of the combined buffer requirement. The purpose of this rule is to prevent the dividend restrictions (which automatically take effect when the combined buffer requirement is breached) being triggered by pure refinancing problems. In this way, the proposal helps to preserve and clarify the loss-absorbing function of the capital buffers – in that they do not need to cover temporary refinancing

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[23] See Govt bill 2015/16:5, p. 256.
[24] The powers of the Swedish FSA to intervene against firms that neglect their obligations under an act of law or other statute regulating the activities of the firms are set out in Chapter 15 of the Banking and Financing Business Act (2004:297) and Chapter 25 of the Securities Market Act (2007:528).
[25] See Chapter 15, Section 1 of the Banking and Financing Business Act, Chapter 25, Section 1 of the Securities Market Act, and Chapter 2, Section 2 of the Act (2014:968) on Special Supervision of Credit Institutions and Investment Firms.

risks.[26] An important effect of this is that the capital buffers will be allowed to retain their intended function.

Among other things, it is to preserve the loss-absorbing function of the capital buffers that the combined buffer requirement is excluded from the calculation of the loss absorption amount (see section 3.2.2). In combination with the liabilities proportion principle set forth in section 5.2.1, this means that the capital buffers can be used without breaching MREL. The design of the liabilities proportion principle also means that breaches of this principle will not be regarded as breaches of MREL or cause any erosion of the buffer capital, resulting in automatic dividend restrictions (see also section 5).

[26] The need for this rule arises from the fact that, under the proposal in the Banking Package, MREL needs to be met *before* the combined buffer requirement, which means that, if a firm does not have the resources to meet both requirements, it is the buffer requirement that will be breached. In the absence of this rule, the effect would be that the capital buffers would be breached if a firm could no longer refinance the liabilities used to comply with MREL. The capital buffers would then indirectly cover refinancing risks, which is not their intended purpose.

# 5 Compliance with MREL

MREL sets a quantitative requirement for the minimum loss absorption and recapitalisation capacity that every individual firm must have. This requirement is a fundamental prerequisite for firms to be 'resolvable', i.e. able to be wound up or reorganised through resolution without this leading to serious disruptions in the financial system and without the need for government support action.

However, MREL is not sufficient by itself to ensure the resolvability of firms. It is equally important that the requirement should be met in such a way that the loss absorption and recapitalisation capacity brought about by MREL can in fact be used in the way assumed by the firm's resolution strategy.

## 5.1 Legal basis

The Resolution Ordinance empowers the SNDO to specify the criteria which MREL liabilities must meet. Based on this authority, the SNDO has issued regulations concerning these characteristics. This is stated in Chapter 2, Section 2 of the SNDO's Resolution Regulations. The regulations do not include any requirements that go beyond those laid down in the provisions of the Bank Recovery and Resolution Directive concerning eligible liabilities which may be used to meet MREL.

Along with the authority to issue regulations on eligible liabilities, the SNDO can also determine, pursuant to the Resolution Act, that individual firms should meet the requirement with 'instruments for contractual bail-in'.[27]

Apart from these two powers which give the SNDO the right to set direct requirements on how firms should meet MREL, the SNDO's resolvability assessment pursuant to Chapter 3, Sections 10 and 11 of the Resolution Act should also include a review of the quantity and type of eligible liabilities in the firms.[28] Pursuant to this assessment the SNDO can, if required, order firms to take measures to remove material impediments to resolution.[29] Regarding compliance with MREL specifically, the resolution authority can deal with impediments by, for example, ordering firms to

[27] See Chapter 4, Section 4 of the Resolution Act and Chapter 2, Section 8 of the SNDO's Resolution Regulations.
[28] Section 9 no 17) of the Resolution Ordinance.

issue eligible liabilities or take other measures to comply with MREL.[30] The resolution authority can also require a firm to set up a holding company that can be used to achieve structural subordination of MREL liabilities.[31] Finally, to counter contagion effects that may arise as a result of holdings of other firms' eligible liabilities, the resolution authority can require a firm to limit its maximum individual and total exposures.[32]

More detailed provisions on what considerations are to be taken into account in the resolvability assessment are set out in Section 9 of the Resolution Ordinance and the technical standards for supervision adopted under Article 15(4) of the Bank Recovery and Resolution Directive.[33] The measures that the SNDO can direct a firm to take to remove material impediments to resolution are set out in Chapter 3, Section 24 of the Resolution Act.

## 5.2 The SNDO's considerations

The SNDO's regulations concerning eligible liabilities help to enhance the resolvability of firms by setting general limits on the types of liabilities that can be included in MREL.

For it to be possible to restructure or wind up a firm through bankruptcy, liquidation or resolution in a way that does not lead to serious disruption in the financial system, there may however be a need for measures that cannot be covered either via regulations or through individual decisions that MREL should be met with a specific type of eligible liabilities.

The SNDO therefore considers that there is a need, over and above the requirements laid down in laws and regulations, to lay down certain general and pre-defined principles against which the firms are assessed within the individual resolvability assessments.

Based on such principles, the SNDO can communicate to the individual firms how they are generally meant to meet the minimum requirement to be considered resolvable. However, if the SNDO determines, after an assessment according to Chapter 3, Sections 10 and 11 of the Resolution Act, that a firm can be restructured or wound up through bankruptcy, liquidation or resolution in a way that does not lead to serious disruption in the financial system, or that this can be achieved by other means, the

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[30] Chapter 3, Section 24, first paragraph no 9) of the Resolution Act.
[31] Chapter 3, Section 24, first paragraph no (8) of the Resolution Act.
[32] Chapter 3, Section 24, first paragraph no (2) of the Resolution Act.
[33] On 23 March 2016, the Commission adopted a delegated regulation containing these technical standards; see http://ec.europa.eu/finance/bank/docs/crisis-management/160323-delegated-regulation_en.pdf

principles do not need to be satisfied. This then creates flexibility for the SNDO, in the specific cases where the firms' activities and resolution strategy allow, to adapt the requirements to any given firm in a way that is not possible with regulations or other applicable powers.

Formulating principles to be applied in the resolvability assessment also provides a greater degree of flexibility when it comes to dealing with breaches. If the principles are not satisfied, this will trigger a more detailed resolvability assessment which may then result (if significant impediments to resolution are found) in a process to eliminate the impediments to resolution. In this case, it will be up to the firms themselves on the one hand to suggest how the identified impediment should be addressed, and up to the SNDO to decide what specific action the firms should take.

The principles that the SNDO intends to apply are set out in the next section.

### 5.2.1 Liabilities proportion

**The SNDO's policy position:** Firms should have MREL liabilities that are at least equivalent to the recapitalisation amount.

The SNDO intends to assess firms' resolvability on the basis of this principle from 1 January 2018.

**Consultation memorandum:** Contains the same policy position.

**Comments from the consultee bodies:** Several consultee bodies have raised objections. The *Swedish FSA* does not consider that the liabilities proportion principle is appropriate, at least not at the high level that has been proposed. The Authority believes that the principle will cause new refinancing risks to arise in the Swedish banking system. The *Riksbank* considers that it should be possible to meet MREL entirely from equity and that the function of the capital buffers should be safeguarded by prohibiting any double-counting of core Tier 1 capital. The *Swedish Bankers' Association* points out that the principle implies a very high level of MREL liabilities, and that is not appropriate for Sweden alone to introduce a requirement that is not present in the EU rules. If the liabilities proportion principle is introduced, the Association feels that Additional Tier 1 and Tier 2 capital should be included. *Kommuninvest i Sverige Aktiebolag* states that it is reasonable to assume that there will be a certain amount of capital left in the firm at the time of resolution and that the liabilities proportion can therefore be set lower.

**Reasons for the SNDO's policy position:** Under the Resolution Act, MREL may be met using both own funds and MREL liabilities. But the Act does not contain any explicit provisions about the mix of own funds and liabilities within MREL. However, the Act does give the resolution authority the power, as part of its resolvability assessment, to evaluate the extent to which the quantity and type of eligible liabilities held by a firm provide satisfactory assurance that a resolution can be executed.[34] Since MREL liabilities consist of certain types of eligible liabilities, this means that the evaluation also covers the quantity and type of MREL liabilities.

The mix of own funds and MREL liabilities may have a bearing on a firm's resolvability. This is because a bail-in can only be applied to achieve the objective of maintaining a firm's operations if, at the time of recapitalisation, the firm still has sufficient own funds and eligible liabilities to restore its own funds to the level necessary to comply, after resolution, with the capital requirement needed for continued authorisation and to retain market confidence.

To ensure that this is possible the firm must either have eligible liabilities equivalent to its RCA or, if all or part of its RCA is met from own funds instruments, still have a sufficient quantity of such instruments at the point of recapitalisation. The second alternative assumes that a resolution decision is taken well before all own funds have been consumed by losses.

Considering that the capital requirements have purposes other than ensuring a firm's recapitalisation capacity in resolution, the SNDO considers that it is inappropriate to require firms to comply with MREL in a way that assumes that there must always still be a certain quantity of own funds instruments at the time of resolution/recapitalisation. Instead it is preferable to ensure a firm's recapitalisation capacity by requiring firms to hold a sufficient quantity of MREL liabilities. This structure clarifies the purposes of MREL's two components: a part consisting of own funds instruments to cover losses and a part consisting of MREL liabilities that can be bailed-in so as to restore own funds.

The fact that the eligible liabilities can only be used in resolution will ensure that there is always a certain quantity of resources available to the firms to use (for recapitalisation) in the event of resolution; see box 3 below. Therefore the SNDO will not be as dependent on how much own funds remain in the firms at the point of resolution.

In light of the above, the SNDO considers that the firms that are expected to be placed into resolution should — in order to be deemed to be resolvable — have MREL liabilities at least equivalent to the size of their RCA.

[34] See Section 9 no 17) of the Resolution Ordinance

The effect of this principle is that firms will not be able to count all of their capital towards compliance with MREL. Not allowing firms to count parts of their capital twice in this way means, in practice, that the combined buffer requirement is placed on top of MREL. One consequence of this is that it will be possible for firms to use this capital without breaching MREL. A design of this kind thus allows the capital buffers to fulfil their intended purpose, i.e. to be an actual buffer against losses without causing a breach of a requirement which is a condition of the firm's authorisation. Equivalent functionality can be provided through the proposals in the Commission's Banking Package which place the capital buffers on top of MREL.

*The liabilities proportion principle in groups*

For groups where the preferred resolution strategy is an SPE strategy, the liabilities proportion principle will only be applied with respect to meeting MREL on a consolidated basis.

*The remaining maturity of MREL liabilities*

Under the SNDO's regulations, MREL liabilities must have a remaining maturity of at least one year.[35] The fact that MREL is allowed to be met with fixed-maturity liabilities means that the regulations as they stand raise a certain inherent refinancing problem, i.e. the risk of a firm breaching the MREL through an inability to refinance eligible liabilities when they fall due. The scale of these refinancing risks is a function of both the size of the requirement and the term to maturity of the firms' eligible liabilities.

The SNDO considers it important to limit these refinancing risks. However, the solution is not to compromise on the amount of MREL, because this would compromise the firms' resolvability. It would also be difficult to require the firms to meet MREL only with instruments with an indefinite term. Rather, a scheme to balance the refinancing risks needs to be established.

The design of the liabilities proportion principle provides a certain flexibility to handle these refinancing risks. This is because the principle is not part of the MREL and the breach mechanisms associated with this, but rather a standalone principle linked to the SNDO's powers to analyse and address impediments to resolution. This means that an inability to refinance eligible liabilities will not initially be treated as a breach of MREL. The flexibility that this provides should make it easier for firms to refinance eligible liabilities.

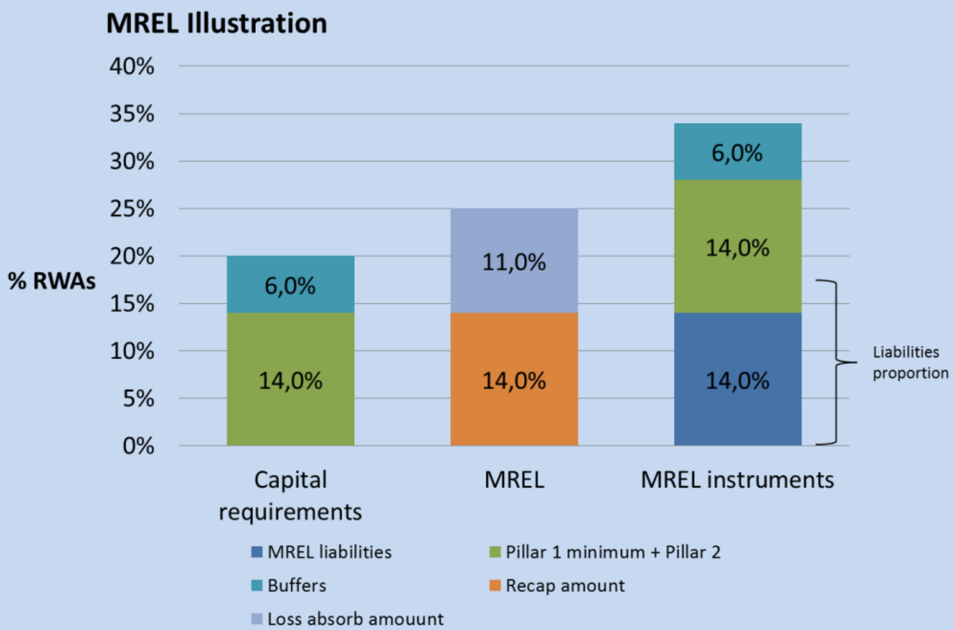
[35] Chapter 2, Section 2, point 5 of the SNDO's Resolution Regulations (RGKFS 2015:2).

However, this scheme may not necessarily be sufficient to handle the refinancing risks. In the consultation memorandum, the SNDO stated that it is important that firms should have a remaining maturity of their MREL liabilities that is longer than the minimum requirement of one year. The SNDO will therefore constantly monitor the maturity profile of firms' eligible liabilities to ensure that they are not carrying excessive refinancing risks.

**Box 3 Compliance with MREL and the operation of the liabilities proportion principle**

Box 2 describes how the SNDO will calculate MREL for a hypothetical major bank (Bank A). This box describes how the bank should *comply with* MREL and, more specifically, what effect the liabilities proportion principle has.

The diagram shows Bank A's capital requirement and MREL. In addition, the 'MREL instruments' column gives a simplified illustration of how the bank can choose to meet MREL.




As stated above, the SNDO intends to apply a principle that firms should meet MREL up to a certain level with MREL liabilities. This level must be equivalent to the size of the RCA, which is equivalent to 14 per cent of risk-weighted assets for Bank A.

The liabilities proportion principle enhances the likelihood of being able to execute a resolution but also means that the combined buffer requirement retains its intended function. This effect is achieved because the liabilities proportion principle means that firms will, on account of their capital requirements, have a certain quantity of capital that cannot be used to meet MREL. So this capital will be in addition to MREL and will therefore also be available for use without the firm breaching MREL.

### 5.2.2 MREL liabilities within groups

**The SNDO's policy position**: For groups where the main resolution strategy is an SPE strategy, the liabilities used to comply with MREL on a group basis should be 1) issued by the firm within the group that is to be placed in resolution, and 2) held by non-group companies. For the group firms (subsidiaries) that are not themselves to be placed into resolution, the individual MREL should be met with liabilities that are 1) issued to the firm within the group which *is* to be placed into resolution, 2) subordinated to the issuing firm's other liabilities and 3) capable of being bailed-in or converted without the issuing firm (subsidiary) being placed into resolution.

Until such time as legal means of bailing in eligible liabilities outside resolution are introduced, the SNDO will not require compliance with this principle.

**Consultation memorandum:** The consultation note suggested that the principle should be applied from 2017 onwards. Otherwise the same policy position.

**Comments from the consultee bodies:** The *Swedish FSA* supports the proposal but considers that a further impact analysis is needed, taking account of the new deduction rules for interest on some subordinated liabilities. The *Swedish Bankers' Association* states that the allocation of liability is confused by the requirement that the liabilities should be bailed in or converted prior to resolution. The Association also finds it unclear how instruments to meet subsidiaries' individual MREL should be defined.

**Reasons for the SNDO's policy position:** Even where several firms are part of one group, resolution measures are always taken against individual legal entities. Which firm(s) within a group are made the object of resolution measures may however vary according to the design of the resolution strategy. Where the resolution measures are applied in turn affects the way in which MREL for the group and for the member firms should be met. The capital and liabilities that may be counted towards compliance with MREL at the group or the individual level must therefore have attributes that are consistent with the resolution strategy. Otherwise, the group cannot be considered resolvable.

For a group whose resolution plan is based on an MPE strategy, i.e. where many or all of the firms within a group are placed into resolution and handled separately from each other, it is not necessary to set any requirements for compliance with MREL over and above those that already follow from the Resolution Act.

On the other hand, for a group where the preferred resolution strategy is based on an SPE strategy, i.e. where the group is to be handled collectively, with only one of the subsidiaries being placed into resolution, the liabilities of the subsidiaries should have certain special characteristics for the group to be deemed to be resolvable.

- The subsidiary to be subject to resolution measures under the resolution strategy should meet both the group's requirements and its own individual requirements with liabilities issued by the firm itself and held by parties other than subsidiaries (i.e. parties that are not part of the group).
- Other firms within the group should comply with their individual MREL with liabilities to the firm within the group which is to be placed into resolution (intra-group liabilities). These liabilities should also be subordinated to the firm's other liabilities and should be capable of being bailed in or converted without the firm itself needing to be placed into resolution.

The Commission's Banking Packages proposes rules to bring about what is described above. There are rules setting out the specific characteristics of the liabilities to be used to comply with MREL in the subsidiaries that will not themselves be subject to resolution measures. For example, there is a requirement for these liabilities to be subordinated to other liabilities and also to be issued to and held by the subsidiary that is to be placed into resolution. These debts must also be bail-inable outside resolution, following a decision by the competent resolution authority. The powers of the resolution authority to bail in liabilities outside resolution should be enshrined in national law.

Swedish law does not currently provide for any powers for the resolution authority to bail in eligible liabilities outside resolution. In the absence of such powers, it is not possible to comply adequately with all of the characteristics that the eligible liabilities must have in a firm that is not itself to be placed into resolution. In view of this, the SNDO does not intend for the present to require firms to comply with this principle in order to be deemed resolvable.

### 5.2.3 Subordination

**The SNDO's policy position**: The SNDO believes that firms should comply with MREL entirely with subordinated instruments no later than 2022. Decisions on subordination can be made on the basis of existing powers or powers in future EU rules.

**Consultation memorandum:** The phasing-in period has now been determined. Otherwise the same policy position.

**Comments from the consultee bodies:** The *Riksbank* supports the principle. The *Swedish FSA* agrees that subordinated liabilities have significant advantages from a resolution standpoint, but notes that the opportunities for Swedish banks to issue subordinated liabilities may be limited, partly because of restrictions in the banks' existing financing programmes which prevent or prohibit issues of some subordinated liabilities. The *Swedish Bankers' Association* points out that the cost of subordinated debt is higher than that of senior debt, and that it is important to have a reasonable phasing-in period for any requirements.

**Reasons for the SNDO's policy position:** Under the Resolution Act, only particular types of liabilities may be included in MREL. More detailed provisions on which liabilities may be used to meet MREL can be found in Chapter 2, Section 2 of the SNDO's Resolution Regulations. Neither the Act nor the regulations set any requirement that MREL liabilities must be subordinated to other eligible liabilities. On the other hand, under the powers granted by the Resolution Act, the SNDO can require MREL to be satisfied wholly or in part by instruments for contractual bail-in (referred to below as 'contractually subordinated liabilities').[36] As part of its powers to address significant impediments to resolution, the SNDO is able to require firms to alter their legal structure by, for instance, setting up a holding company.[37]

Subordinating liabilities used to meet MREL to other liabilities can contribute in various ways to facilitating resolution. Subordination establishes a clear order of priority, meaning that subordinated debts are written down before non-priority debts. Such an arrangement provide greater clarity to firms' investors, depositors and other counterparties, while reducing the risk of some creditors being entitled to compensation where the outcome of the bail-in is worse than would have been the case in a bankruptcy. If the bail-in risk is mainly borne by subordinated

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[36] See Chapter 4, Section 4 of the Resolution Act and Chapter 2, Section 8 of the SNDO's Resolution Regulations.
[37] Chapter 3, Section 24 first paragraph no 8) of the Resolution Act.

liabilities, this will also simplify the practical implementation of resolution because, in most cases, only one kind of debt instrument will be subject to bail-in.

For these reasons, the SNDO's overall position is that firms should generally comply with MREL entirely with instruments subordinated to other liabilities, both in resolution and in bankruptcy/liquidation. However, the SNDO will review the need for subordinated liabilities on a case-by-case basis. For firms where it is clear that subordinated liabilities would not improve resolvability, there may be grounds for not requiring subordination. This could be the case, for example, for firms with a relatively simple debt structure where the class of non-priority debts does not include any significant volumes of liabilities that are or could be excluded from bail-in. More detailed guidance on which firms may be covered by the subordination requirement will be published in 2017 in connection with decisions on firms' resolution plans. It is likely that such requirements will be laid down for firms that are classified as global or other systemically important institutions.

In the Commission's Banking Package, there is a proposal to introduce mandatory requirements on subordination for global systemically important banks for the fixed minimum level of MREL that applies to these banks (the minimum TLAC). It is also proposed that, where necessary, the resolution authority should be able to set requirements for subordination in relation to institution-specific MREL amounts also. The package also contains a proposal to create a class of subordinated instruments for use under insolvency law.

*Forms of subordination*

Subordination may come about in various ways. Capital instruments are by definition always subordinated. With debt instruments, there are three different kinds of subordination:

- *Structural subordination* – achieved by firms organising themselves into a holding company structure in which the liabilities of the holding company consist mainly of MREL liabilities that are sufficient to cover the minimum requirements of the whole group. In this case the holding company is thus obligated to comply with MREL for the group on a consolidated basis.
- *Statutory Subordination*– means that MREL is met with liabilities in a special debt category which by law are subordinated or have a lower priority than ordinary non-prioritised debts (but have a higher priority than own funds instruments and other subordinated liabilities), referred to below as 'statutory subordination'.

- *Contractual subordination* – achieved through contractual conditions in the debt instruments stating that they are subordinated to other liabilities.

The SNDO's position in principle is that structural and insolvency-law subordination are preferable to contractual subordination. This is because the former types have some advantages, both in terms of legal status and in market functionality.

However, there are currently a number of factors that restrict the ability of firms to use the different forms of subordination. Structural subordination cannot be achieved without major reorganisation of the firms, because none of the major Swedish firms is organised into a holding company structure.

Statutory subordination, in the form of a special debt category, is not currently possible under Swedish law. However, this possibility is likely to be introduced in the longer term as the Commission has proposed, as part of the Banking Package, to harmonise Member States' insolvency hierarchy rules by establishing a special category of liabilities that should be ranked lower than ordinary creditors but higher than own funds instruments in the order of precedence.[38] The Commission's intention is that these rules should be introduced earlier than other parts of the Banking Package. As things stand, however, it is unclear when such rules will be introduced.

With regard to contractual subordination, the ability to issue other contractually subordinated liabilities than own funds instruments is currently limited for many Swedish firms. This is because the contractual terms for some of the firms' existing Tier 2 capital instruments prevent them from issuing subordinated liabilities with a higher priority than these Tier 2 instruments.

In view of this, the SNDO considers that it would not be appropriate right now to specify any restrictions on the types of subordination acceptable for compliance with the subordination requirement. In summary, then, we find that subordination of eligible liabilities can be achieved with the following types of instrument:

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[38] The Commission proposal calls the new debt category 'non-preferred' rather than subordinated. Strictly speaking, the Commission proposal also contains elements of contractual subordination in that a condition for an instrument to be included in the new debt category is that the contract documentation should explicitly state that the instrument is non-preferred.

1. non-subordinated eligible liabilities issued by a group holding company (or *holdco senior*), given that the company's debts are made up solely or mainly of such liabilities;
2. subordinated instruments under insolvency law in the form of a special debt category (when the option to issue such debt instruments is introduced in Sweden);
3. contractually subordinated debt instruments.

*Phase-in*

When it comes to the phasing-in period, the SNDO believes that a balance has to be struck between the need to ensure as quickly as possible that firms are resolvable and the need to give the firms sufficient scope to issue new subordinated debt instruments in an orderly fashion. This flexibility is needed because this type of liability is a new phenomenon for Swedish firms and investors. Even at the international level, this category of liability is relatively new, and only a few banks have started to issue such debt instruments.

There is also reason to believe that the banks' issuance capacity will be limited by the fact that it is not possible in Sweden to issue subordinated instruments under insolvency law, and also by the above restrictions in some existing debt contracts on the ability to issue contractually subordinated liabilities. Changes in the international rules also need to be taken into account.

In view of this, the SNDO believes that MREL should be met entirely by subordinated instruments from 2022 onwards. In the period up to this date, firms will be allowed to plan for how the requirement should be met based on their own situation and the prevailing market conditions. However, the SNDO will monitor issue volumes throughout the phasing-in period to ensure that firms adapt at a reasonable pace. If a reasonable adaptation should not take place, the SNDO will examine the need to take individual decisions pursuant to Chapter 4, Section 4 of the Resolution Act at a date earlier than 2022.

### 5.2.4 Limitation of the risks linked to cross-holdings

**The SNDO's assessment:** Risks related to holdings of other firms' eligible and MREL liabilities should be limited. Pending future EU rules, however, the SNDO will not demand compliance with this principle.

**Consultation memorandum:** Same policy position.

**Comments from the consultee bodies:** The *Swedish FSA* and the *Riksbank* support the proposal. The Authority believes that the restrictions should not go beyond those drawn up by the Basel Committee. The

*Swedish Bankers' Association* considers that restrictions on cross-holdings reduce the banks' capacity to be market guarantors, which could aggravate the refinancing problem.

**Reasons for the SNDO's policy position:** The main objective of resolution is to avoid significant adverse impacts on financial stability. This includes preventing contagion in the financial system.[39] The resolution authority has to take account of this in its decisions on resolution actions as well as in the planning phase when setting MREL and in its resolvability assessment.[40]

One of the most obvious channels for contagion from a firm placed into resolution to other firms is when the bail-in tool is applied. Other firms may then incur substantial losses because these firms' exposures to the firm in resolution are written down. This can occur idiosyncratically or in a broader systemic crisis in which a firm incurs large losses on account of the write-down of outstanding exposures to several problem-stricken firms. If the write-downs are large enough, the outcome can be that the infected firm also fails and, depending on its importance for the financial system, may need to be managed through resolution. Even if the losses incurred through write-downs of debt are not large enough to cause the failure of a firm, the risk of contagion can generate uncertainty, leading to a loss of confidence among market participants with potential implications for the firm's access to financing and ability to maintain critical functions.

On account of the size and concentration of the Swedish banking sector such contagion can be viewed as a particular risk to the stability of the financial system. The linkages between firms entail a risk of contagion and, as this can lead to serious disruptions in the financial system, there is a need for regulation to reduce this risk. At present this risk is mainly handled through the regulations for large exposures. [41] In simple terms, these regulations provide that a firm's overall exposure to a customer or group of customers with links to one another must not exceed 25 per cent of the firm's capital. This restriction is intended to enable the capital in a firm to bear, in extreme situations, a total write-down/loss on an exposure to a customer that is at the limit without severely threatening the solidity of the firm.

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[39] See Chapter 1, Section 6, no 2) of the Resolution Act and Article 31(2), first paragraph, point (b) of the Bank Recovery and Resolution Directive.

[40] See Chapter 2, Section 5, first paragraph, point 4 of the SNDO's Resolution Regulations (RGKFS 2015:2) and Article 45(6) of the Bank Recovery and Resolution Directive and, regarding the resolvability assessment, Section 9, nos 26) and 27) of the Resolution Ordinance.

[41] The provisions on large exposures are set out in Articles 4, 387-403, 493, 494 and 517 of the Credit Requirements Regulation.

However, these rules do eliminate the risks of contagion and are chiefly to be seen as an instrument to limit the risk that a failure of a *single* firm results in other firms also failing. The rules can therefore be said to be less effective in countering contagion effects that can arise in a broader systemic crisis in which several, or even most, firms run into problems at the same time. In such a situation, a firm with exposures to several problem-stricken firms could be exposed to aggregate losses that are large enough to result in a failure.

The regulatory framework for resolution therefore contains a number of provisions intended to supplement the provisions on large exposures. Under Chapter 3, Section 24, first paragraph, no 2) of the Resolution Act, the resolution authority can, as part of its resolvability assessment, order a firm to limit its maximum individual or total exposures. This can include setting limits for a firm's largest individual or total exposures to eligible liabilities of other firms.[42] In addition, the resolution authority can, when deciding on MREL, take account of the extent to which the failure of a firm could have an adverse effect on financial stability.[43]

The SNDO considers that the introduction of the regulatory framework for resolution, and particularly the bail-in tool, results in a need to limit the risks linked to a firm holding eligible liabilities or MREL liabilities issued by other firms. The appropriate way to do this depends on what requirements are set for firms regarding subordination of MREL-compatible debt. Given that the SNDO intends as a rule to apply the principle that subordination should apply to the whole MREL, it is sufficient for the restriction rules to cover only those liabilities included in MREL.

In the Commission's Banking Package, it is proposed to introduce explicit rules to handle the risks associated with cross-holdings. However, these rules should only apply to global systemically important banks. There is also a proposal for a review provision which tasks the European Banking Authority (EBA) with drawing up alternative suggestions for how deduction rules should be defined. Based on these suggestions, the Commission will take a position on the need for revised rules.

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[42] See also Article 44(2), last paragraph, of the Bank Recovery and Resolution Directive (which refers to Article 17(5)(b) of the Bank Recovery and Resolution Directive, implemented through Chapter 3, Section 24, no 2) of the Resolution Act).
[43] Chapter 2, section 5, first paragraph, point 4 of the SNDO's Resolution Regulations and Article 45(6)(f) of the Bank Recovery and Resolution Directive.

The EBA has already made a suggestion on how the deduction rules should be defined, in a report from December 2016.[44] This proposes that holdings of other firms' MREL instruments should be deducted from the firm's own MREL instruments. However, this method differs from the recommendations produced by the Basel Committee, under which deductions should be made from Tier 2 capital.

To avoid Sweden introducing a scheme for handling cross-holdings which differs substantially from the rules that may apply within the EU in the future, the SNDO does not intend to define the principle for cross-holdings in more detail for the present, so it will not require firms to comply with this principle either.

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[44] EBA, *Final report on MREL – report on the implementation of and design of the MREL framework*, 14 December 2016

# 6. Other matters

## 6.1 Reporting

**The SNDO's policy position:** The SNDO intends to come back with proposals for regulations on reporting in relation to MREL.

**Consultation memorandum:** Same policy position.

**Comments from the consultee bodies:** Support the proposal or offer no comments.

**Reasons for the SNDO's policy position:** Under Chapter 4, Section 12 of the Resolution Act, the SNDO shall monitor that MREL is met on an individual basis and, where relevant, on a consolidated basis. The SNDO shall coordinate its monitoring activities with the supervision exercised by the Swedish FSA. In addition, Section 22 of the Resolution Ordinance authorises the SNDO to issue regulations about what information about bail-inable liabilities a firm shall provide to the SNDO and when it shall be provided.

In the Commission's Banking Package, it is proposed that firms should report at least annually to the supervisory and resolution authority on the level and composition of their MREL instruments.

The SNDO has not yet issued any such regulations but intends to issue a proposal for consultation in the future. Briefly, the SNDO's intention is for reporting to cover the information needed to monitor compliance with MREL and with the principles set out in section 7. The SNDO intends to gather this information on a quarterly basis, i.e. with the same frequency applicable under the Credit Requirements Regulation to reporting by firms to the Swedish FSA regarding capital adequacy and other matters. The SNDO's preliminary assessment is that firms whose recapitalisation amount has been set at zero (see section 3.5) do not need to be covered by the reporting obligation regarding the minimum requirement.

## 6.2 Disclosure

**The SNDO's policy position:** Pending future EU rules, the SNDO will conduct a thorough investigation, in dialogue with the Swedish FSA, regarding the basis in the existing rules for requiring firms to publish information about MREL.

**Consultation memorandum:** Same policy position.

**Comments from the consultee bodies:** Support the proposal or offer no comments.

**Reasons for the SNDO's policy position:** Access to information for market participants and other stakeholders about, for example, the capital situation and risk profile of firms plays an important role in maintaining market discipline, which is then beneficial for financial stability in general. For this reason the Credit Requirements Regulation makes extensive disclosure requirements for firms. Along with other information submitted according to the Swedish FSA's regulations, these requirements mean that information about, for example, the capital requirements of major Swedish firms, including their pillar 2 requirements and their own funds, has to be published on a quarterly basis.[45]

The SNDO's assessment is that there is an equivalent need for publication of MREL information.

The existing EU rules do not contain any disclosure requirements relating to MREL. The Commission's Banking Package, however, proposes that such rules should be introduced and that firms should be required to disclose, at least once a year, details of the level and composition of their MREL instruments.

Pending future EU rules, the SNDO will conduct a thorough investigation, in dialogue with the Swedish FSA, regarding the basis in the existing rules for requiring firms to publish information about MREL.

[45] The Swedish FSA's Regulations regarding prudential requirements and capital buffers (FFFS 2014:12), Chapter 8.

# 7. Impact analysis

## 7.1 Effects on the firms

The majority of firms covered by the resolution framework will not be subject to MREL levels exceeding their capital requirements. For these firms, MREL will not have ay direct implications at all.

### Issuance needs

The SNDO has estimated the issuance needs arising out of MREL. Given that the SNDO has not yet decided which firms will be subject to an MREL exceeding their capital requirements, the analysis is limited to the four major banks. In terms of size, these banks dominate the Swedish banking system, so the calculations below may be seen as a good approximation of the overall impact.

The analysis assumes the levels of MREL implied by the model, based on today's capital requirements, and full compliance by the firms with the principles governing the liabilities proportion and subordination. On these assumptions, the issuance need totals circa SEK 500 billion for the major Swedish banks.[46] This figure accounts for the fact that firms will both have certain liabilities with less than 1 year remaining until maturity which cannot be counted towards MREL and additionally will choose to hold a buffer above the minimum requirements.

As part of this analysis, the SNDO also examined the maturity structure of the banks' bond holdings. The analysis shows that the cumulative values falling due during the phasing-in period, i.e. up to 2022, are almost twice as much as the issuance needs arising out of MREL. On the assumption that firms can replace maturing bonds with subordinated liabilities that can be included in MREL, the requirement will not give rise to any net issuance need, i.e. the firms will not need to increase their indebtedness as a consequence of MREL. The major banks will not therefore need to expand their balance-sheets to meet the requirements.

The ability of the firms to issue large volumes of subordinated liabilities will depend on the demand from investors in this asset category. The global market for debt instruments issued by financial institutions is estimated at around EUR 32,000 billion.[47] However, the size of the market for subordinated debt issued by Swedish firms is harder to estimate. However, it is reasonable to assume that investors will be prepared to relocate a certain proportion of their existing exposure to Swedish firms'

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[46] The analysis is based on balance-sheet data from 30/06/2016.
[47] FSB et al, *Summary of findings from the TLAC impact assessment studies*, 9 November 2015.

unsecured debt into subordinated liabilities. The major banks' outstanding non-subordinated liabilities amount to SEK 2,500 billion and, in relation to this amount, the issuance need for subordinated liabilities would be 20 per cent.

### Effects on financing costs

The fact that MREL has to be met with a certain quantity of subordinated liabilities means that firms have to change the composition of their financing structure. It is not clear how this affects the firms' financing costs. Because MREL – other things being equal – does not affect the composition or quality of firms' assets, and so does not alter the total risks in the business either, there is little in the strictly theoretical sense to suggest that total financing costs should increase.

In practice, however, it is likely that MREL will give rise to certain effects. As subordinated liabilities carry a higher risk than ordinary non-priority debts, these liabilities will be more costly than the debts that they replace. However, this effect is countered by the fact that non-subordinated liabilities will carry a smaller risk once the MREL is set. All in all, however, it is possible that the net effect will be slightly increased financing costs for the firms. This is because MREL and the principles governing how it should be met increase the probability that resolution can be effected without government support. As discussed in more detail below, this should help to reduce the price effects historically triggered by expectations on the part of market players that tax receipts will be used to rescue crisis-stricken banks.

The costs of the subordinated liabilities can be estimated based on the incremental costs that may be assumed to come from issues of subordinated liabilities compared to the existing financing. The table below shows a number of possible outcomes based on an issuance requirement of SEK 500 billion.[48]

**Table 1:** Added costs of issuing subordinated debt

| Issuance need (BSEK) | Incremental cost (basis points) | Cost (BSEK/year) |
|---:|---:|---:|
| 500 | 50 | 2.5 |
| | 30 | 1.5 |
| | 10 | 0.5 |

[48] In order to illustrate the effect of the higher pricing of subordinated liabilities (the 'added cost'), we have used three scenarios – 10, 30 and 50 basis points. These levels have been chosen on the basis of an analysis of existing pricing of subordinated liabilities issued by a relevant selection of international banks to meet MREL and TLAC requirements.

The most conservative estimate of the incremental costs produces an increase of max. SEK 2.5 billion per year for the major Swedish banks. As discussed above, there are several factors to suggest that the actual costs will be significantly lower than this.

Firstly, the calculations in the table do not take account of the balancing effect that the costs of non-subordinated liabilities will be lower as a consequence of MREL. Secondly, the calculations are based on a static analysis that takes no account of the long-term likelihood that the costs of subordinated liabilities will fall back as the stock of such debt instruments grows, and the fact that non-subordinated liabilities will accordingly become less risky and so logically less costly.

**Refinancing risks**

As noted in the memorandum, MREL is fraught with some inherent refinancing risks. These risks arise from the fact that the requirement has to be partly met with fixed-maturity liabilities that have to be constantly refinanced to ensure that the debt stock is sufficient to meet the requirement. The extent of these risks is mainly a function of the size of the MREL and the term to maturity of the instruments used to meet the requirement.

The objective in defining MREL is to ensure that firms have sufficient loss-absorption and recapitalisation capacity. There is thus no way of handling the refinancing risks by compromising on the amount of the requirement. In some other respects, however, the SNDO has defined the requirements with these risks in mind.

Firstly, the requirement for subordination means that a particular debt category will carry most of the bail-in risk. Of course this does not mean that the refinancing risk for these instruments will decrease. But it does mean that other types of debt instrument (not primarily those that will be bailed-in in the event of resolution) will not be equally exposed to refinancing risks.

Secondly, the liabilities proportion principle is defined in such a way that an inability to refinance maturing eligible liabilities will not initially be treated as a breach of the specified MREL. The flexibility that this proceeding provides should make it easier for firms to refinance eligible liabilities.

## 7.2 Socio-economic impact and effects on financial stability

### Macro-economic costs

The increased financing costs that MREL is likely to bring for firms do not in themselves entail any direct socio-economic cost. Rather, the increased financing costs should be seen as a consequence of lenders continuing to bear the costs previously covered by the State in the absence of any mechanisms to pass on losses to lenders in certain situations. In this sense, the increased costs to firms should be regarded as a desirable transfer of costs from the State to the firms.

On the other hand, macro-economic costs could arise where the increased costs to the firms lead to dearer lending to the real economy (households and non-financial enterprises). This sort of effect will arise if firms' shareholders demand unchanged returns on equity at the same time as the firms transfer the increased costs to their customers. The international studies that have been conducted show that the effects of MREL (and TLAC) on lending and GNP are limited. For example, the Bank of England has estimated that the effect of the MREL to be imposed on British banks is expected to cause an increase in lending rates of 0.06 percentage points, reducing GNP by around 0.04 per cent per year.[49]

Taking the same methodological approach as the Bank of England (2015), the Swedish requirements produce an increase in bank lending rates of around 0.02 percentage points. To make an estimate of the effect on GNP, we have used an econometric model adapted for studies of the Swedish financial transmission mechanism, where the simulation assumes that the actual lending rate rises while interbank interest remains unchanged.[50] On the assumption that all of the change in actual lending rates happens at once, this brings the level of GNP down by 0.01 percentage points in the long term. These estimated effects on Swedish GNP are thus in line with similar assessments by the FSB and the EBA.[51]

### Socio-economic benefits

There are many socio-economic benefits from the resolution framework and MREL. These gains arise partly because MREL helps to reduce the

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[49] Bank of England (2015), *The Bank of England's approach to setting MREL, Consultation on a proposed Statement of Policy*.

[50] Andersson, S., Bjellerup, M., Shahnazarian, H. (2016), *The importance of the financial system for the real economy*, Empirical Economics, doi:10.1007/s00181-016-1175-4.

[51] FSB et al, *Summary of findings from the TLAC impact assessment studies*, 9 November 2015 and EBA, *Final report on MREL – report on the implementation of and design of the MREL framework*, 14 December 2016.

likelihood of crises happening at all and partly because the crises that do occur can be handled more effectively.

*Reduced likelihood of a crisis*

One of the main objectives of resolution is that the costs of a crisis should be borne by firms' financiers. The bail-in tool and MREL are the main tools to ensure that bail-in can be carried out in an adequate and effective manner. The fact that MREL thus ensures that the costs are borne by the firms themselves increases the incentive for lenders to monitor the firms and price their lending on the basis of the underlying risks in the firms' operations. This in turn creates an incentive for the banks to take less risks. Studies that have estimated the effects of introducing MREL (and TLAC) show that the likelihood of failure in systemically important firms decreases by between 26 and 41 per cent.[52]

These market-disciplining effects also eliminate or reduce the element of subsidy that arises from market expectations that the State will take care of some crisis-stricken firms at no cost to lenders (expectations of an implicit State guarantee).[53]

*Effektivare krishantering (The implicit government guarantee to systemically important banks. More effective crisis management)*

When a crisis does occur, the resolution framework contributes to more effective crisis management. This has many different socio-economic benefits.

Firstly, historical experience shows that the State and taxpayers incur significant costs in dealing with crisis-stricken banks. During the crisis in Sweden in the 1990s, the total government support provided came to almost SEK 104 billion. Although the returns on this support were substantial, the investments nevertheless resulted in a net deficit of around SEK 21 billion (equivalent to 1.5 per cent of GNP in 1991).[54] Academic studies of banking crises in a large number of countries show that government expenditure in the form of direct economic aid to banks during a banking crisis averages 13.3 per cent of GNP (before returns).[55]

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[52] See e.g. Bank of England (2015), *The Bank of England's approach to setting MREL, Consultation on a proposed Statement of Policy,* and Bank of International Settlements (2015), *Assessing the economic costs and benefits of TLAC implementation*.

[53] The Swedish FSA has estimated that the subsidy element averaged around SEK 26 billion per year in the period from 1998 to 2014. (Swedish FSA analysis No 1 2015: *Den implicita statliga garantin till systemviktiga banker*.

[54] Barr and Pierrou, *Vad blev notan för 1990-talets bankstöd? (What was the bill for bank bail-outs in the 1990s?)* Ekonomisk debatt, no 5 2015.

[55] Laeven and Valencia (2012), *Systemic Banking Crises Database: an update* (IMF Working Paper)

The intention of the resolution framework is that it should be possible to handle crises without this type of cost. The bail-in tool and MREL, along with resolution planning in general, ensure that these intentions can be realised and that there are no direct costs to the State.

Secondly, more effective crisis management means that disruptions to the basic function of the financial system (provision of credit etc.) are less than they would have been in the absence of a working crisis management system. The negative effects on GNP in a given crisis will also be less. Studies conducted by the Bank of England estimate that the loss of BNP is more than halved as crises can be managed more effectively. According to the study, the costs of a crisis are estimated in the worst case at approximately 122 per cent of GNP compared to a potential cost of around 50 per cent if a crisis should arise after the resolution framework and MREL have been phased in.[56]

Thirdly, and as an indirect effect of more limited negative effects on GNP, the indirect costs to the state of crisis management will also decrease. This is because the tax shortfall and expenditure increases will be less in any given crisis. There is research here to show that government debt rose by an average of 86 per cent in the three years after a crisis occurred.[57] An effective crisis management framework should considerably reduce this type of effect.

*Impact on competition*

The subsidy element that arises out of market expectations that the State will take care of crisis-stricken firms at no cost to lenders has been mainly associated with firms whose size and complexity make them likely candidates for government aid. The fact that the resolution framework and MREL help to reduce this subsidy element produces a more level playing field for both smaller and larger firms.

**Socio-economic net gains**

Based on the analyses presented above, Table 2 shows the overall macro-economic effects of the resolution framework and the introduction of MREL. The macro-economic savings have been calculated based on a estimated of the annual probability of a financial crisis of 2.0 per cent (equivalent to a crisis every fifty years). According to the study by the Bank of England mentioned above this probability can be reduced after implementation of MREL by up to 41 per cent, in other words to circa 1.2

[56] Bank of England (2015), *The Bank of England's approach to setting MREL, Consultation on a proposed Statement of Policy.*
[57] Reinhart and Rogoff (2009), *This time is different: eight centuries of financial folly*

percent per year. In the same study, the costs of a crisis are reduced from circa 122 per cent of GNP for an ineffectively managed crisis to around 50 per cent after the introduction of MREL.

**Table 2:** Overall macro-economic effects of the resolution framework

| **Probability of financial crisis (p.a.)** | **Cost of financial crisis * (SEN bn)** | | **Expected costs (p.a) (SEK bn)** | |
|---|---|---|---|---|
| | Ineffectively managed crisis | After introduction of MREL | Ineffectively managed crisis | After introduction of MREL |
| 2,0% | 5 101 | 2 091 | 102 | 42 |
| 1,2% | 5 101 | 2 091 | 60 | 25 |

The table shows that the introduction of MREL results in a total reduction in the annual expected costs of a financial crisis of SEK 77 bn based on GDP in 2015 (equivalent to circa 2 percent of GDP). These gains comfortably exceed the macro-economic costs, estimated above to SEK 0.4 bn annually (0.01 percent of GNP). None of the scenarios depicted here produce negative macro-economic net effects.