FI Analysis No 39

Are the capital buffers fulfilling their purpose?

– Relationship between MREL and the capital requirements

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Summary

A bank must hold sufficient capital to cover the risks to which it is exposed. Banks are therefore subject to capital requirements, which include both minimum requirements and buffer requirements. The buffers provide some distance from the minimum requirement, allowing banks more capacity for continuing to issue loans and thus supporting the economy. This also allows the banks to carry losses and gives them time to take measures to restore their capital, which reduces the risk that the banks will be placed into default and resolution.

In order to manage banks that despite this still fail and are placed in resolution, there are rules that apply to systemically important banks to also meet a parallel requirement: the minimum requirement for own funds and eligible liabilities (MREL). MREL aims to ensure that a bank can be reconstructed without having to use public funds. The capital requirements and MREL may be met partly by using the same resources – the bank's own funds.

Because the regulations are designed in such a manner that a bank can breach the resolution requirements before it breaches the capital requirements, MREL can become the bank's most restrictive requirement. This means that the bank will be controlled by how much own funds and liabilities it is required to hold for resolution management. The capital buffers' aim to absorb losses and reduce the risk of the bank being placed in resolution becomes subordinate to the bank meeting the resolution requirements. This means that the bank may be forced to reduce its activity and shrink its balance sheet and in the long run the risk of becoming subject to dividend restrictions or an intervention, even though it still meets its capital requirements. The impact is not as significant for a bank that meets MREL with a larger surplus of liabilities. A higher percentage of debt financing, however, leads to greater refinancing risks.

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