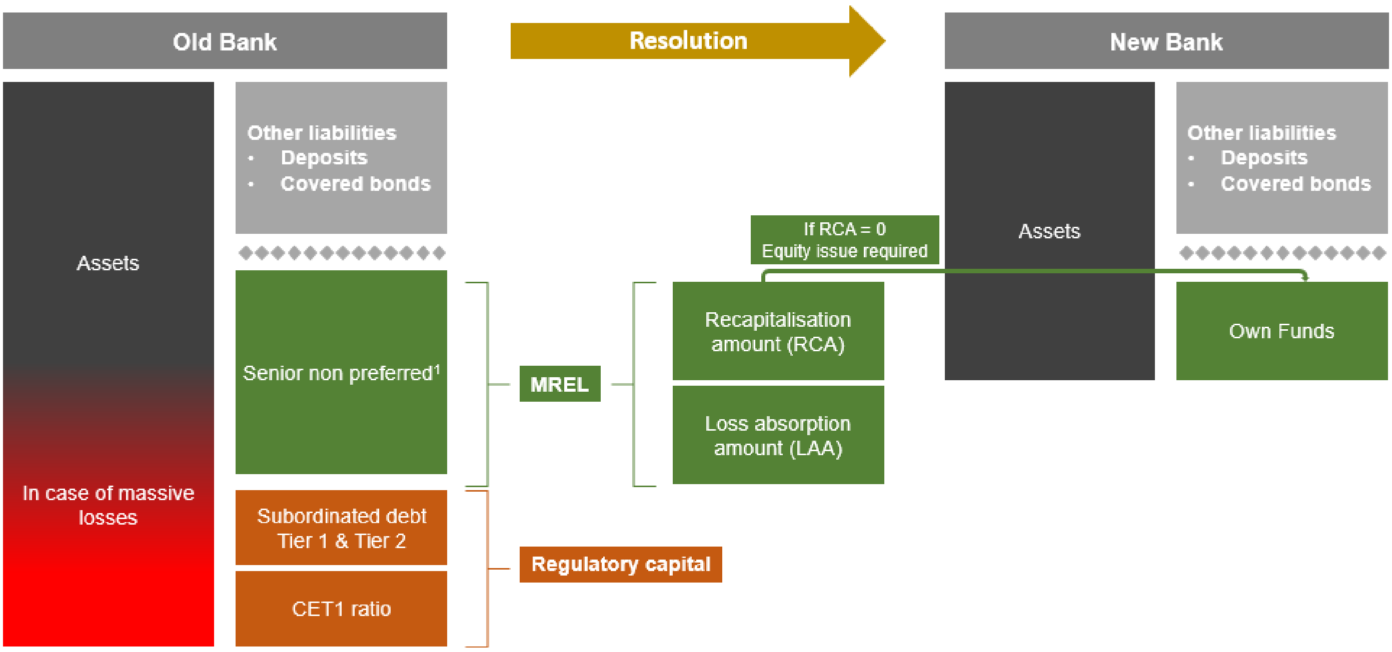
European Banks and MREL shortfalls, a €67.6 bn investment opportunity

In 2015, the Financial Stability Board (FSB) issued the Total Loss-Absorbing Capacity (TLAC) standard for global systemically important banks (i.e., the biggest ones). This standard has been transposed for the European Union into the Bank Recovery and Resolution Directives 1 and 2 (BRRD 1 and BRRD2) which apply to all the banks established in the European Union.

This Directives introduced the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) aiming at protecting clients' deposits in case of massive losses, with the challenge to respect the "pari passu" constraint of a bank capital structure. The solution was the introduction of a loss absorption mechanism to senior creditors via issuance of senior non preferred bonds for the operating company or senior preferred bonds for the holding company of the banks. This layer of capital adds a new subordination cascade enhancing both the resilience and the resolvability of institutions, where resolution would be preferable to a bankruptcy under the principle of "no creditor worse off".



Source: Central Bank of Ireland | [1] Senior preferred in the case the bank is structured under a holding company

MREL ratio is a bank-specific target instituted by the EU authorities, after consultation with prudential supervisors. It is composed of the addition of required institution's loss absorption amount (LAA) and the resolution entity's recapitalisation amount (RCA) and depends on the resolution strategy implemented by each bank.

According to supervisory data, the biggest banks are now almost compliant with MREL requirements. The need to comply is now shifted towards smaller banks, as the European Banking Authority estimates their MREL shortfalls at €67.6bn[1].
As a result, this will govern their senior preferred and senior non-preferred bonds issuance programs, even if they have a comfortable capital ratio and do not need to strengthen their capital structure to finance their activity, especially for low-risk banks. For instance, Crelan, a Belgian cooperative bank, issued for the first time a senior non-preferred bond with a 3-year maturity at an attractive coupon of 5 3/8. The bank is rated A- and has a capital ratio of 20.81%.

The amount to be issued with the relatively small track-record of bond issuance of these non-systemic banks open attractive investment opportunities, in well-capitalised non systemic banks' senior preferred and senior non-preferred bonds. This is particularly true for new issuers which may also offer an inaugural premium.

In the context of a global interest rate rise, these 2 to 5-year maturity instruments are becoming more attractive, thanks to the carry they offer. This is due to their relatively high coupon for their rank of subordination as well as their short duration offering a downside protection.

MREL thematic will probably be one of the hot topics in the fixed income environment for the next two years.

[1] https://www.eba.europa.eu/eba-sees-progress-mrel-shortfall-reduction-largest-institutions-while-smaller-institutions-are

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Adrian Paturle is a graduate of the Lyon School of Actuaries (ISFA) and holds a master's in finance.

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