THE MNB’S PRINCIPLES FOR SETTING MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES (MREL)

The objective of this document entitled ‘The MNB’s principles for setting Minimum Requirement for Own Funds and Eligible Liabilities (MREL)’ is to provide guidance for the public on how the MNB approaches the interpretation of certain regulatory provisions governing the determination of MREL. This document cannot be considered as information covering all of the prevailing legal provisions, and the individual circumstances of institutions may make it necessary for the MNB to apply an approach other than the ones set forth here in the case of a given institution when setting the MREL target or the deadline for compliance. In line with Article 8(3) of Commission Delegated Regulation (EU) 2016/1450, if there is a change in the factors taken as a basis, the MNB may review the content of this document and the MREL requirements set or the transitional period available for the implementation.

Budapest, 14 November 2018

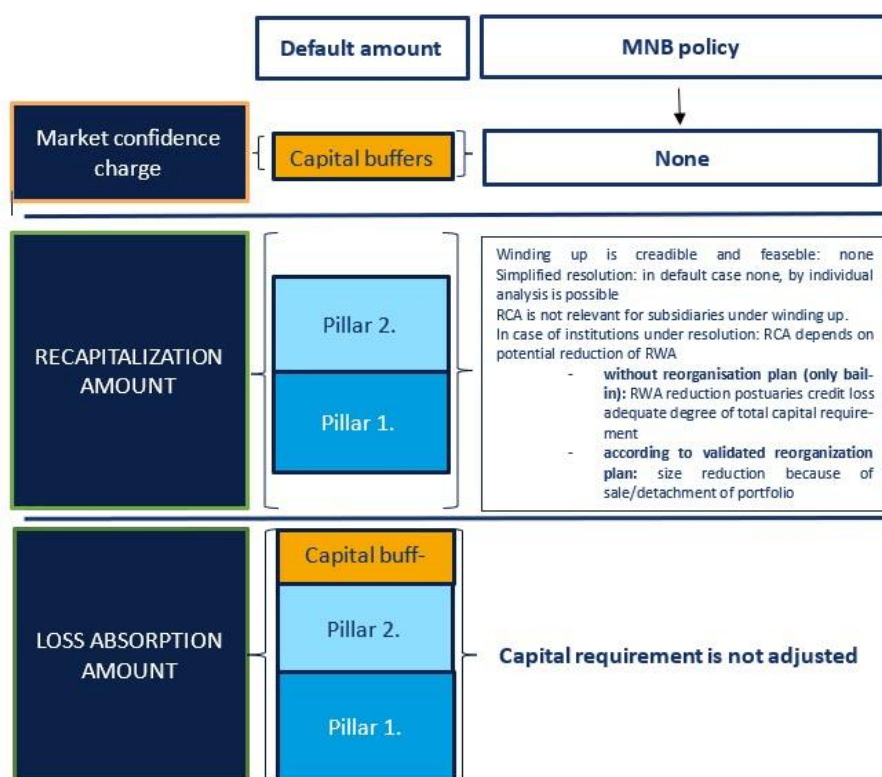
EXECUTIVE SUMMARY

In accordance with the Bank Recovery and Resolution Directive (BRRD) of the European Union, the Act on Resolution requires the MNB as resolution authority to require the domestic credit institutions and investment firms to hold liabilities of adequate quantity and quality, which may partly or completely be written off or converted into capital in the case of a crisis situation. This minimum requirement for own funds and eligible liabilities (MREL) is determined individually, in line with the resolution strategy concerning the given institution, within the framework of the resolution planning, by the resolution authorities independently or within the resolution college in the case of institutions pursuing cross-border activities.

The MNB's policy regarding the framework of imposing the MREL requirement covers three interrelated subjects mentioned below:

1. Size of the MREL requirement

The calibration of the size of the MREL requirement is summarised in the following table:



2. Requirements concerning the quality of the liabilities eligible for meeting MREL

The regulation allows the resolution authorities to determine requirements for the subordination of the MREL eligible liabilities as well. According to the Bank Creditor Hierarchy Directive[1]

[1] Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy

published in December 2017 in order to support compliance with the possible subordination requirements and amending the BRRD concerning the insolvency hierarchy of creditors, within the insolvency proceedings regulated by their national legislation, Member States are required to create a new class of 'non-preferred senior debt'. At present, the MNB does not require a mandatory issue of eligible liabilities for meeting the MREL requirement in this category of liabilities. At the same time, in order to reduce the contagion risk, the MNB's expects credit institutions to refrain from purchasing liabilities in the class of 'non-preferred senior debt'.

3. Deadline for compliance with the MREL requirement

The MNB determines the transitional period available for meeting the MREL requirements in a uniform manner, in order to ensure a level playing field. The transitional period allowed for meeting the requirements is 4 years starting from communicating the requirement to the institution. During the transitional period, the MNB may determine interim objectives individually for each institution as well.

1. INTRODUCTION: LEGAL FRAMEWORK

One of the key principles of the resolution framework is that in case of a crisis situation of credit institutions and investment firms (hereinafter: jointly institutions) **the losses should primarily be borne by the owners of the institutions, then by its creditors**, thus making it possible to avoid or minimise the use of public funds for crisis management.

In order to enforce this principle, the Bank Recovery and Resolution Directive (BRRD)[2] **of the European Union and the Act on Resolution[3] implementing the provisions of the Directive in Hungary introduce strict requirements on the liability structure of the institutions, which are to be met on a continuous basis, similarly to the capital requirements.** Regarding the minimum requirement for own funds and eligible liabilities (MREL), Article 45 of the BRRD (Sections 62–64 of the Act on Resolution) requires the holding of liabilities of adequate quantity and quality to allow their partial or complete write-off or conversion to equity in the case of a situation that makes the resolution action necessary, thus ensuring the bearing of losses by owners and creditors as well as the efficiency of the resolution actions. The MREL requirement serves not only the feasibility of bail-in, but it enables efficient implementation of all resolution tools through the availability of sufficient amount of liabilities with loss-absorbing capacity that can be used for recapitalisation and for ensuring market confidence, which facilitates maintaining of the critical functions while minimising involvement of public funds.

The detailed criteria of determining the MREL requirement are set out in Commission Delegated Regulation (EU) 2016/1450, which entered into force on 23 September 2016 and is directly applicable in Hungary as well (hereinafter: MREL Regulation). The legislation does not specify a uniform regulatory minimum target for the MREL; the resolution authority sets the MREL requirement for each institution individually, or in a consolidated manner and individually in the case of a group of institutions, in line with the resolution strategy of the institution. The requirement for the institutions and groups of institutions headquartered in Hungary is determined by the Central Bank of Hungary (hereinafter: MNB) as resolution authority, while in the case of cross-border institutions – as a main rule – the MREL requirements at consolidated and individual levels are set by the resolution authorities concerned, within the framework of their cooperation in resolution colleges.

In order to establish a transparent process for setting the MREL requirement in Hungary, during 2018 MNB developed its framework to determine MREL targets. The MNB both sets the requirements applicable to institutions headquartered in Hungary and forms its position

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Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council

[3] Act XXXVII of 2014 on the further development of the system of institutions strengthening the security of the individual players of the financial intermediary system (Act on Resolution)

represented during the decision-making processes in the resolution colleges regarding the individual requirements for local subsidiaries of banking groups with headquarters in the banking union based on these principles. By applying these principles – that are formed to account for the specific features of the institution or group concerned – in a uniform and consistent manner ensures a transparent framework for setting MREL.

The MREL framework presented in this document covers three interrelated topics:

1. the assumptions based on which MNB determines the size of the requirement;
2. the quality of liabilities eligible to meet the requirement;
3. the lengths of the transitional period justified and necessary to comply with the final targets.

The MREL policy presents the MNB's principles concerning the setting of the MREL within the current legislative framework.

The review of the EU regulatory framework regarding the size of the MREL requirement and the quality of eligible liabilities for meeting the requirement is in progress; the Ecofin Council adopted the amendments to the BRRD II on 25 May 2018, the European Parliament's Committee on Economic and Monetary Affairs (ECON) adopted its report regarding the amendments on 19 June 2018, and discussions among EU institutions in order to adopt the final text of the BRRD II started in July. For compliance with the legislation and to provide a level playing field, MNB continuously monitors the changes in international rules and in the practices of other authorities and reviews its framework if necessary. Based on the expected timeline of the review of the BRRD and the prudential regulation relevant for MREL settings, the next review is expected in 2019.

2. MNB'S FRAMEWORK OF CALIBRATING THE MREL REQUIREMENT

In terms of its objectives, the MREL requirement consists of two components: the loss absorption amount (LAA), which ensures that the resources of the institution cover the losses that occur in a potential crisis situation, and the recapitalisation amount (RCA), which is necessary to meet prudential requirements after resolution, and is needed to restore the capital adequacy, i.e. reaching the capital adequacy ratio necessary for the compliance with the conditions for authorisation as well as for the restoration and maintenance of market confidence.

2.1. Loss absorption amount

In accordance with Article 1(4) and (5)a) of the MREL Regulation, the default loss absorption amount is the sum of the institution's supervisory capital requirement and its combined buffer requirement ('default amount'). As that the prevailing prudential regulation does not contain any relevant mandatory rules, upon determining the loss absorption amount, the MNB does not consider the requirements regarding the leverage ratio.

In the cases specified in Article 1(5) b) of the MREL Regulation, the resolution authority may determine a loss absorption amount that is different from the default amount.

The loss absorption amount may be higher than the default amount if the resolution authority identified an impediment to resolvability, and its removal becomes necessary during the resolution, or if, in its opinion, taking into account the institution's business model, funding model and risk profile, the capital requirement does not fully reflect the losses needed to be absorbed during the resolution.

The loss absorption amount may be lower than the default loss absorption amount only if according to the assessment of the resolution authority – also taking into account the information received from the MNB acting within its scope of supervisory powers – the parts of the Pillar 2 capital requirements imposed on the basis of stress tests or in order to cover macroprudential risks, or a part of the combined buffer requirement are not relevant for ensuring the ability to absorb losses during the resolution.

Considering firstly that upon determining the supervisory capital requirement MNB assesses and quantifies the individual risks of the institutions comprehensively and prudently, and monitors the risks and capital adequacy of the institutions within the framework of ongoing supervision as well, and secondly that the supervisory capital requirements cover individual risks and within its macroprudential framework MNB is currently not using its power to set additional capital requirements in Pillar 2, at present we do not deem it justified and necessary to adjust the default amount upon determining the loss absorption amount.

In line with Article 2(2) of the MREL Regulation, if the liquidation as preferred resolution strategy is both feasible and credible, there is no need for the recapitalisation of the institution, only the MREL requirement necessary for the loss absorption has to be set forth.

The **loss absorption amount** (LAA) is for covering the loss that resulted in the institution's being subject to a resolution. Its size– in line with the MREL RTS – is the supervisory capital requirement of the institution, i.e. the higher of the sum of Pillar 1 (P1) and Pillar 2 (P2R) and the combined capital buffer requirement (CBR) or the Basel 1 capital floor.

$$LAA = Max\ (P1 + P2R + CBR\ ;\ Basel\ 1\ floor)$$

In the case of institutions for whom liquidation is deemed credible and feasible to exit from the market in the case of a possible crisis situation according to the assessment by the MNB, and thus no resolution tool is justified in their resolution plan, the amount of the MREL requirement equals the loss absorption amount, and thus the MNB does not set any further requirement in addition to the capital requirement.

2.2. Recapitalisation amount

2.2.1. The factors that determine the necessary degree of recapitalisation

In line with Article 2(2) of the MREL Regulation, if liquidation as preferred resolution strategy is feasible and credible, i.e. there is no need for the recapitalisation of the institution, only the MREL requirement needed for loss absorption needs to be imposed, the recapitalisation amount needs to be determined as 0, unless in the MNB's opinion it is necessary to require a certain amount to achieve the resolution objectives in liquidation at least to the extent that would be possible during resolution.

In line with Article 2 of the MREL Regulation, upon determining the recapitalisation amount, the resolution authority estimates how much of own funds the institution will need following the implementation of the preferred resolution strategy identified in the resolution planning process. In addition, if the resolution strategy assumes the continuous operation of the institution or a part of it, pursuant to Article 2(5)–(6) of the MREL Regulation, following the implementation of the preferred resolution strategy the determined recapitalisation amount may not be lower than the amount necessary for meeting the capital requirements in order to comply with the conditions of authorisation. Moreover, the recapitalisation requirement may also include an additional amount exceeding the capital requirement deemed necessary to maintain market confidence in the given institution after its resolution. Pursuant to Article 2(7)–(8) of the MREL Regulation, the default level of this market confidence charge is the combined buffer requirement. The resolution authority may determine a different level as well, but pursuant to Article 2(8) of the MREL Regulation, upon making its decision it must take into account whether the capital position of the institution after resolution is adequate compared to the capital positions of peer institutions.

Accordingly, the recapitalisation amount is fundamentally affected by the type of resolution tool to be applied in the case of a given institution and by the fact whether the institution or a part of it continues to function after resolution, or the institution is withdrawn from the market by transferring the parts of the portfolio that are to be protected and viable to other institutions. In the latter case it is only necessary to provide for the balance of assets and liabilities to be transferred, no recapitalisation is needed by default. If the institution continues its operation after the resolution or a part of it is transferred to a bridge institution and continues its operations like that it has to comply with the supervisory capital requirement during and after the resolution. Accordingly, a recapitalisation amount needs to be imposed in any case.

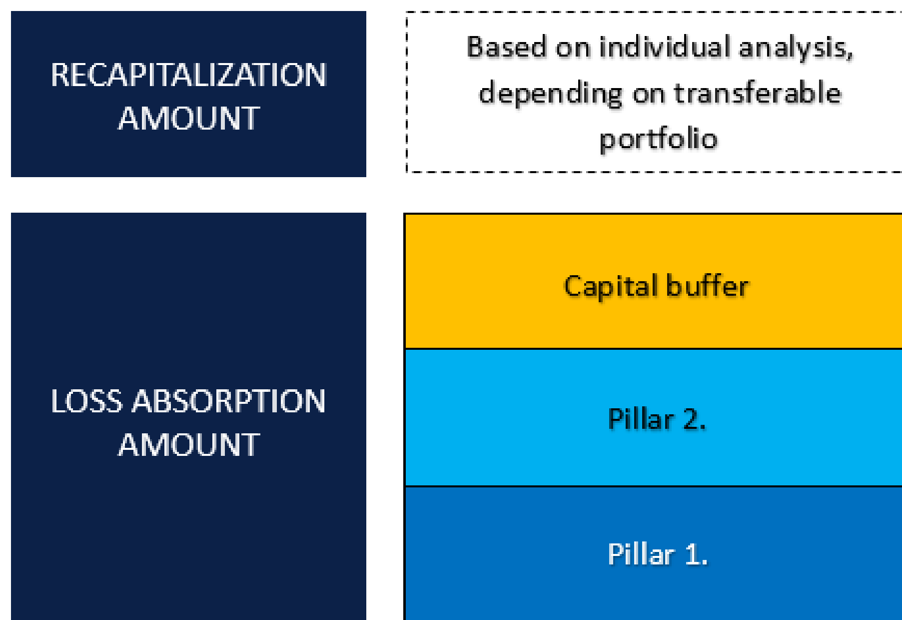
2.2.2. Determining the recapitalisation amount in the case of small and medium-sized institutions

If the resolution strategy does not assume that the institution will continue its operations,[4] and the preferred resolution tool is the sale of business, imposing a recapitalisation amount and a market confidence charge is generally not needed, i.e. the default MREL requirement to be

[4] The institutions concerned learn about it from the summary of their resolution plan communicated to them by the MNB.

imposed equals the loss absorption amount. However, depending on the individual balance sheet structure, the composition of liabilities and the risk profile of assets, to ensure the availability of the assets balancing out the liabilities in the portfolio to be sold may necessitate the imposing of a limited recapitalisation amount in addition to the loss absorption amount. The decision on the adequate recapitalization in these cases is made by the MNB based on an individual analysis in the respective resolution plans of the institutions concerned.

Chart 1: MREL requirement in the case of a resolution plan not assuming further operation of the institution



Source: MNB

2.2.3. Determining the recapitalisation amount in the case of large institutions

If the resolution strategy laid down in the resolution plan of an institution aims at maintaining the operations of the institution as a whole or of a part of it, bail-in is applied as a resolution tool, on its own or combined with other resolution tools (sale of business or asset separation). Therefore, in addition to the loss absorption amount, which equals the capital requirement, it is also necessary to impose a recapitalisation amount. Its size is determined by the institution's expected capital requirement after the implementation of the resolution strategy, which in turn depends on the total risk exposure amount (TREA or total RWA) of the remaining institution or remaining part of the institution.

Pursuant to Article 2(3) of the MREL Regulation, when estimating the regulatory capital needs after implementation of the preferred resolution strategy, the resolution authority needs to use the values for the relevant total risk exposure amount available from the latest supervisory report of the institution. It is possible to deviate from the latest available risk exposure data if the resolution plan identifies, explains and quantifies all the changes that – as a result of the resolution actions – directly lead to a change in regulatory capital requirement, and according to the resolvability assessment this change is both feasible and credible, does not have a negative

impact on the continuity of the institution's critical functions, and does not require any extraordinary financial support other than the contribution of the resolution financing arrangement laid down in Article 101 and Article 44(5) and (8) of the BRRD.

Scope of institutions taken into account when determining the recapitalisation amount

In setting the consolidated-level requirements, the MNB takes into account the risks of all undertakings subject to prudential consolidation and determines the recapitalisation amount considering the value of the consolidated total risk exposure. It also includes those financial enterprises that are not under the BRRD, but according to the authority's consideration it is necessary to involve them the setting of consolidated-level requirements.

In setting the consolidated requirement as well as the individual requirement for parent companies where the resolution strategy is based on a single point of entry at the level of the parent company, in determining the recapitalisation amount the MNB takes into consideration if the preferred resolution strategy set out in the resolution plan assumes the liquidation of certain subsidiaries. When determining the recapitalisation amount, the MNB adjusts the total risk exposure for the risk exposures of these subsidiaries. When determining the recapitalisation amount, the MNB takes into account the capital requirement contribution of subsidiaries on the basis of the overall capital requirement containing the Pillar 2 add-ons in if individual Pillar 2 capital requirements are available. If not, the MNB takes the respective Pillar 1 capital requirements as a basis.

2.2.3.1. Calibration of recapitalisation amount in the case of a bail-in strategy

If the preferred resolution strategy of the institution is open-bank bail in, in accordance with Article 2(3) of the MREL Regulation the MNB adjusts the value of the total risk exposure amount only for the impact of the loss absorbed in resolution.

The impact of the loss resulting in resolution on the value of the total risk exposure amount and thus on the own fund requirement is quantified by the MNB in the resolution plans based on a common methodology. The starting point of the methodology is that in the case of a potential stress situation leading to resolution – typically assuming a credit risk event – the remaining institution's credit risk exposure and thus its total RWA declines with the extent of the loss suffered in the stress situation.

When developing the methodology for determining the value of the total risk exposure, the MNB considered the practices of other authorities as well. International practice is not uniform in terms of the assumptions concerning the changes in RWA; there are examples for leaving potential changes in RWA completely out of consideration as well as for guidelines allowing for a limited decline in RWA as a result of a loss.

Considering that in the case of institutions belonging to an EU banking group the group-level resolution authority is the SRB or a national resolution authority in the banking union that probably follows the directives of the SRB, for ensuring a level playing field, the practice of the SRB is the most relevant. Based on the SRB's MREL policy document for 2017, when determining

the recapitalisation amount, the loss absorbed in resolution may be considered in the RWA on the basis of individual assessment considering the average risk weight of the institution, but the extent of the potential reduction of the total RWA value is limited in 10 percent.

Taking into consideration the practices of other authorities, the methodology developed by MNB takes credit risk RWA as the basis for quantifying the impact of losses leading to resolution on post-resolution RWA.

Quantifying the impact of the loss leading to resolution

The impact of the loss leading to resolution on the recapitalisation amount is calculated by the MNB assuming losses stemming from credit risk events. In the assumed stress scenario, the decline in overall capital requirement following the loss leading to resolution results from the decrease in the credit risk exposure and thus the capital requirement. Accordingly, the MNB reduces the recapitalisation amount by the credit risk capital requirement of the presumed loan losses equalling to the institution's overall capital requirement that also includes the Pillar 2 add-ons (total loss absorption amount). During this calculation, in the first step the MNB determines the value of the total RWA including Pillar 2 adjustments reduced by the effect of the presumed credit risk loss, then, on the basis of the thus estimated RWA value it determines the post-resolution capital requirement.

By this, the MNB quantifies the change in credit risk RWA using a ***common methodology*** but taking into account the individual portfolio characteristics and risk parameters applied in the ICAAP reviews of each institution. As a result, the determination of the total RWA decline assumed in the MREL setting is based on data consistent with the SREP capital requirements and is ***transparent*** for the institutions.

In determining the total RWA containing Pillar 2 adjustments that is reduced by the effect of the assumed loss, the MNB takes into account the value of the total risk exposure (RWA) indicated in the institution's most recent available COREP report, multiplying it by the percentage decline in RWA determined for the reference date of the ICAAP review.

The recapitalisation amount is determined as shown below:

- Extent of the change in RWA ($dRWA$) considered:

$$dRWA = OCR \times \frac{RWA_{SREP}^{CR}}{EAD^{CR}},$$

where OCR is the value (in HUF) of the institution's overall capital requirement also including Pillar 2 adjustments and the combined buffer requirements; EAD^{CR} indicates the value of the credit risk exposure (Exposure at default), while RWA_{SREP}^{CR} indicates the value of risk weighted assets for credit risk as established during the most recent ICAAP review.

- RWA after resolution ($RWA_{post-resolution}$):

$$RWA_{post-resolution} = \frac{TSCR\%}{8\%} \times RWA - dRWA = \frac{TSCR\%}{8\%} \times RWA - OCR \times \frac{RWA_{SREP}^{CR}}{EAD^{CR}},$$

- Recapitalisation amount (*RCA*):

$$\left(\frac{TSCR\%}{8\%} \times RWA - OCR \times \frac{RWA_{SREP}^{CR}}{EAD^{CR}}\right) \times 8\%$$

Calculation of the recapitalisation amount (RCA) in the case of a bail-in strategy:

$$Max\left\{\left(\frac{TSCR\%}{8\%} \times RWA - OCR \times \frac{RWA_{SREP}^{CR}}{EAD^{CR}}\right) \times 8\%;\ Basel1\ floor\right\}$$

2.2.3.2. Calibration of recapitalisation amount in the case of applying additional resolution tools complementing the bail-in

When determining the recapitalisation amount, it is possible to take into account the decline in risk exposure exceeding the balance sheet depletion as a result of the losses absorbed in resolution if during the implementation of the resolution strategy the resolution authority is planning to apply, in addition to the bail-in tool, another resolution tool as well that significantly reduces the size of the remaining institution (typically a resolution tool entailing transfer of assets).

In this case, when calculating the recapitalisation amount, the resolution authority may reduce the value of the total risk exposure available from the institution's most recent supervisory report by the extent of the change in exposure directly resulting of the additional resolution tool planned to be applied. Pursuant to the provision of Article 2(3) of the MREL Regulation, a precondition of the above is that the resolution plan identifies, explains and quantifies the changes in regulatory capital needs, and these changes should be considered both feasible and credible in the resolvability assessment, without adversely affecting the provision of critical functions by the institution and without necessitating recourse to extraordinary financial support from the state. Explanation and justification of the feasibility and credibility of the decline in exposure are especially necessary if the application of the resolution tool also depends on the actions of a third person, potential buyer or recipient.

The application of other resolution tools simultaneously with the bail-in can be considered credible if the resolution plan lays down the detailed restructuring plan ensuring the maintenance of critical functions, the achievement of the resolution objectives and ensuring the business viability of the remaining institution. At the same time the restructuring plan shall also present the impact of its implementation on the change in risk exposure amount. For this the institution shall submit its proposed restructuring plan supporting the implementation of additional restructuring tools to the MNB and it is assessed by the MNB, or in the case of decision-making by the resolution college by the resolution authority members of the institution's resolution college. In this case the recapitalisation amount **may be set based on the RWA plan included in the restructuring plan assessed and accepted by the resolution authorities ('validated' by the authorities) and built into the resolution plan.**

Considering that pursuant to the above statutory provision only the change in risk exposure directly resulting of the resolution action can be taken into account, the recapitalisation amount

may only be reduced as a result of the application of resolution tools if the resolution (the application of resolution actions) takes place at the level of the given institution. Therefore, in the case of Hungarian subsidiaries of EU banking groups, where the group-level resolution strategy is based on a single point of entry (SPE strategy), it is not possible to apply a resolution action at the level of the local entity, and recapitalisation is implemented through the resolution actions applied to the parent bank; therefore, the possibility to take into account any decline in the RWA is limited to the absorption of the losses leading to resolution.

2.2.3.3. Calibration of the market confidence charge

Pursuant to Article 2(7) and (8) of the MREL Regulation, the recapitalisation amount should include any additional amount that the resolution authority considers necessary to maintain sufficient market confidence after resolution, with the default amount for this market confidence charge corresponding to the combined buffer requirements applicable after resolution.

Chart 2: Capital buffers

Capital conservation buffer	Additional capital to absorb shocks in a crisis to conserve the capital (max. 2,5% of RWA)
Countercyclical buffer	Capital for covering losses in case of recession (max. 2,5% of RWA)
O-SII buffer	Surpluss reserve for banks which are more risky than average ones (max. 2% of RWA)
Systemic risk buffer	Prevention or decrease of systhemic or prudential risk (1-3% of CET1)

Source: MNB

Article 2(8) of the MREL Regulation allows for the resolution authority to determine the capital necessary for the restoration of market confidence at the individual institutions at a lower level than the default amount if not all the elements of the combined buffer requirement are applicable after the resolution, or the authority considers a lower buffer level sufficient for the restoration of market confidence after resolution, for the provision of the critical functions by the institution and for ensuring access to funding.[5]

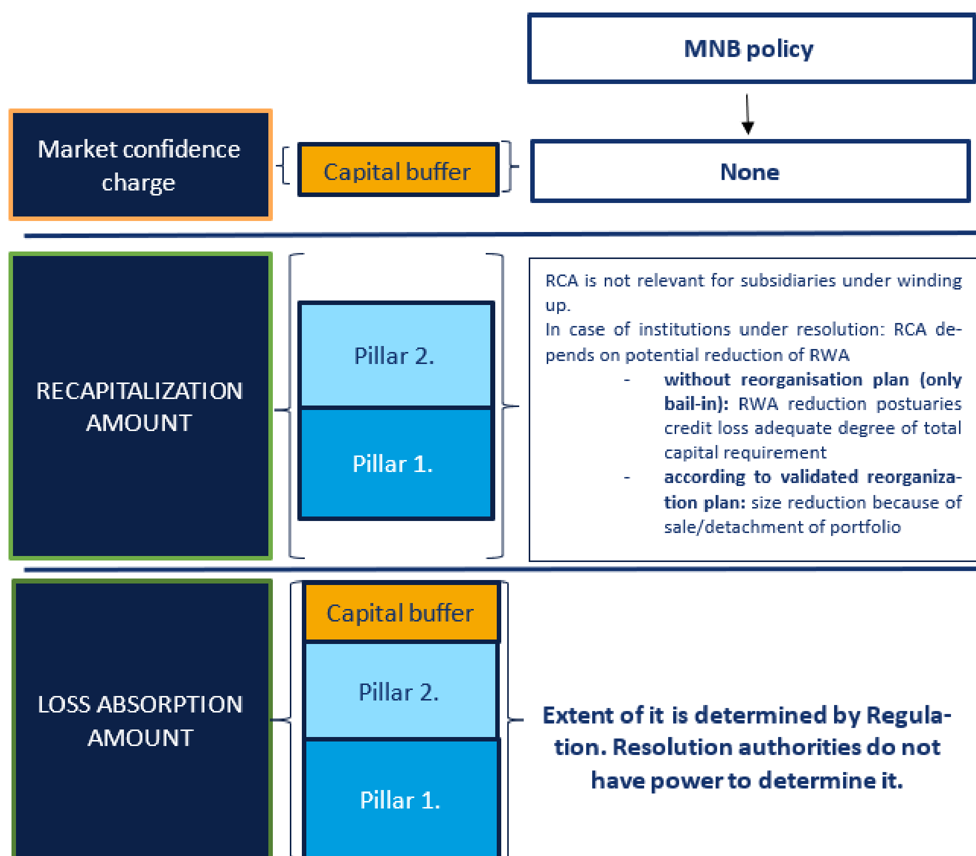
According to the MNB's assessment, in the case of an institution restored after resolution, exemption from meeting the buffer requirements may be granted, considering the double role of the buffer requirements. First, they should strengthen the institution's shock absorbing capacity

[5] Without having recourse to extraordinary financial support other than the contribution of the resolution financing arrangement laid down in Article 44(5) and (8) of the BRRD.

by filling the buffer in 'good times', and then, in a stress situation – for example in one that leads to resolution – the buffer should also be able to absorb losses before breaching the capital requirement. Second, their role is to reduce the building up of excessive risks by internalising the cost of institutions' systemic and procyclical risks in certain periods and regarding certain activities. However, right after the stress situation these risks have already been materialised at the institution, moreover, the limitations on dividend payment entering into force upon breaching the buffer requirements are not relevant for the institution either. Accordingly, if the restructuring plan ensures the building up of the buffers by the end of the restructuring period, it is possible to waive the obligation to immediately meet the market confidence requirement in the form of capital buffers. In addition, the restructuring plan can ensure that even in absence of the incentive induced by the buffer requirements the activity of the institution can be in line with the macroprudential requirements during the restructuring period. Taking that into account, **the MNB generally does not consider it necessary to determine a market confidence charge.**

Based on the above, the proposed MREL requirement is summarized in the chart below:

Chart 3: MREL requirement in the case of large banks



Source: MNB

The **recapitalisation amount** (RCA) is the amount needed for meeting the prudential capital requirement after the write-off of losses, during and after the resolution. If the resolution plan

assumes keeping up the institution's operation after resolution, the institution has to comply with the supervisory capital requirement during and after the resolution as well, i.e. at all times. Accordingly, if in the case of the institution the preferred resolution tool is the open bank bail-in, **the recapitalisation amount equals the higher of the sum of the adjusted Pillar 1 and Pillar 2 capital requirements or the Basel 1 capital floor estimated for a date following the implementation of the resolution action.**

$$RCA = Max\left\{\left(\frac{TSCR\%}{8\%} \times RWA - OCR \times \frac{RWA_{SREP}^{CR}}{EAD^{CR}}\right) \times 8\%;\ Basel1\ floor\right\}$$

Considering that right after the stress situation – at the beginning of the resolution – the institution is able to meet the conditions for authorisation without complying with the buffer requirements, no regulatory requirement is breached if the restructuring plan takes into account the restrictions on distributions entering into force upon breaching the buffer requirements, and provides for the building up of the buffers by the end of the restructuring period. Taking that into account, **the MNB generally does not consider meeting the buffer requirements necessary for maintaining market confidence.**

In the case of institutions having critical functions, the MNB currently does not assume the implementation of additional resolution tools together with the bail-in, and in accordance with that it does not expect any related change in RWA when calculating the recapitalisation amount. If the institution prepares a restructuring plan, and this restructuring plan is validated by the MNB – or in the case of decision-making by a resolution college by the resolution authority members of the institution's resolution college– and is taken into account in the resolution plan, the recapitalisation amount is calculated on the basis of the change in RWA consistent with the joint application of the resolution tools quantified in the restructuring plan.

In absence of a restructuring plan, or if the MNB – or in the case of decision-making by a resolution college the resolution authority members of the institution's resolution college– does not consider it suitable for justifying the changes in the recapitalisation amount, only the risk reducing impact of the assumed credit loss corresponding to the institution's overall capital requirement, including Pillar 2 adjustments and combined buffer requirements, is taken into account when determining the recapitalisation amount.

If the resolution plan does not assume further operation of the institution after resolution, and the MNB is planning to use the sale of business resolution tool concerning certain assets of the institution, imposing a recapitalisation amount and market confidence charge is generally not necessary, i.e. the target level of the MREL corresponds to the loss absorption amount. Depending on the individual balance sheet structure, the composition of liabilities and the risk profile of assets, a limited recapitalisation amount in addition to the loss absorption amount may be required for ensuring the availability of the assets balancing out the liabilities in the portfolio to be sold.

2.3. Ensuring access to the resources of the Resolution Fund

The efficient application of resolution tools and the successful implementation of the resolution is supported, while the necessity of using taxpayers' money is reduced if the resources of the Resolution Fund are available for financing the resolution. Its precondition laid down in Section 60(2) of the Act on Resolution is that at the time of the resolution, it is ensured that based on the independent valuation the institution's shareholders and creditors (involved in the bail-in) bear the losses within the framework of implementing the bail-in at least to an extent corresponding to 8% of the total liabilities and own funds (TLOF) of the institution (bail-in rule). Therefore, in case of institutions for whom MNB considers the application of a resolution tool in their resolution plans justified as according to its assessment liquidation is not a credible or feasible means for the exit from the market in the case of a possible crisis situation, when determining the MREL requirement the MNB also considers ensuring access to the resources of the Resolution Fund.

In case of all institutions where the resolution plan assumes further operation of the institution after resolution, the MREL level consistent with the above bail in rule constitutes the floor for the MREL target. In case of institutions where resolution aims at withdrawing the institution from the market, MNB also takes into account the possible necessity of providing access to the resources of the Resolution Fund in the individual assessment of the need for including a recapitalisation amount in the MREL target.

In case of institutions for whom MNB considers the application of a resolution tool in their resolution plans justified as according to its assessment liquidation is not a credible or feasible means for the exit from the market in the case of a possible crisis situation, when determining the MREL requirement the MNB also considers ensuring access to the resources of the Resolution Fund.

In case of all institutions where the resolution plan assumes further operation of the institution after resolution, the MREL level consistent with the bail in rule constitutes the floor for the MREL target.

$$MREL = Max\ (\ LAA + RCA;\ TLOF * 8\%)$$

In case of institutions where resolution aims at withdrawing the institution from the market, MNB also takes into account the possible necessity of providing access to the resources of the Resolution Fund in the individual assessment of the need for including a recapitalisation amount in the MREL target.

3. REQUIREMENTS CONCERNING THE ELIGIBLE LIABILITIES FOR MEETING THE MREL REQUIREMENT

3.1. Legal requirements and the eligibility of certain liabilities

In addition to own funds, liabilities that comply with the conditions laid down in Section 63 of the Act on Resolution are eligible for meeting the MREL requirement. Since 2016, MNB assesses yearly the level of potentially MREL eligible liabilities at the institutions falling under the Act on Resolution on the basis of the data reported by the institutions. Based on the results of these analysis and findings of the institutions' resolvability assessments carried out to date, the MNB considers further guiding necessary in two areas regarding assessment of the eligibility of certain liabilities.

As default, irrespective of the contractual maturity of the deposit, liabilities resulting from deposit contracts are not considered MREL eligible by the MNB. Considering that pursuant to Section 6:390(3) of the Civil Code the deposit holder is entitled to request repayment of the funds held on the account even before the expiry of the term specified in the contract, in a general case – if this right is not expressly excluded in the contract – the earliest time when the liability can be repaid is immediately, and thus deposits have to be considered as liabilities past due in line with Section 63(2) of the Act on Resolution. It is possible to assess deposits differently from the default option if the institution justifies that in the case of the deposits concerned the deposit holder is not entitled to request repayment of the deposit within one year, and this justification is accepted by the MNB on the basis of its individual assessment.

Refinancing loans granted by the Hungarian Development Bank (MFB) and Eximbank (EXIM) that have a maturity of over one year and are unsecured at the time of the evaluation are temporarily accepted by the MNB – in line with the practice of the SRB – **as eligible liabilities for meeting the MREL requirement**. The classification of the refinancing loans extended by the MFB and EXIM is not uniform in the institutions' data reporting in terms of MREL eligibility. While the majority of institutions classified them as MREL eligible unsecured loans from credit institutions with a maturity of over one year, in the opinion of some institutions, based on the framework contracts governing the liability they can be terminated or the creditor is entitled to obtain collateral in the case of material adverse changes in the debtor's economic situation, and in this case the requirements concerning residual maturity of more than one year pursuant to Section 63(1c) of the Act on Resolution or the uncovered position pursuant to Section 63(1)e) of the Act on Resolution are not met.

The prevailing Hungarian and EU legislation does not provide any clear guidance concerning the assessment of such liabilities that comply with the MREL requirement in a static approach, but which are based on contracts stipulating reclaiming rights that can be exercised in the case of material adverse changes in the issuer's economic situation (so-called 'material adverse change clause' – MAC). It is important to note, however, that on the basis of the currently known draft texts of the planned amendments to the EU-level legislation defining MREL eligibility, due to the above contract terms, the liabilities stemming from such framework contracts will presumably

not meet the legal conditions of MREL eligibility. At the same time, on the basis of the latest MREL Policy, the SRB temporarily accepts the liabilities stemming from contracts containing such terms as MREL eligible, indicating that their classification may change later.

On the basis of the review and detailed assessment of the framework contracts and the practice of refinancing institutions, for a consistent assessment of the MREL eligibility of individual liabilities within international banking groups and for the equal treatment of the individual institutions' contracts that have similar contents, in accordance with the practice of the SRB the MNB temporarily accepts these liabilities as eligible liabilities for meeting MREL requirement. At the same time, the MNB calls the institutions' attention to the fact that the acknowledgement of the MREL eligibility of these liabilities is granted only for a transitional period, until the current amendment proposals of the BRRD and the CRR/CRDIV enters into force, or until a change in the practice of the SRB takes place, and thus presumably it will not be possible to take them into account for meeting the MREL requirement in the long run.

The MFB/EXIM refinancing loans – in line with the practice of the SRB – **are temporarily accepted by the MNB as eligible liabilities for meeting the MREL requirement**. Nevertheless, the MNB emphasises that the acknowledgement of the MREL eligibility of these liabilities is granted for a transitional period. In the medium term – if the relevant legislation or the practice of the SRB changes – they are not expected to be eligible for meeting the MREL requirement.

3.2. Subordination requirements

By the application of the bail-in tool, if all the conditions of the resolution are jointly fulfilled, the MNB as resolution authority is entitled to involve other resources – in addition to the write-off and conversion of the institution's capital elements – to cover the losses or for recapitalisation, such as writing off liabilities vis-à-vis creditors or their conversion into capital.

The scope of eligible liabilities for bail-in covers all outstanding liabilities of the institution, apart from certain liabilities explicitly excluded from the absorption of losses and bail-in due to the creditor's position protected by law or for the effectiveness of the resolution of the institution, or for the provision of its critical functions or in order to maintain financial stability. The mandatorily applicable exceptions laid down in Section 58(1) of the Act on Resolution include:

- covered deposit parts covered by the reimbursement obligation related to deposits secured by the National Deposit Insurance Fund (OBA), i.e. deposits up to the limit of EUR 100 thousand placed by insured depositors;
- secured liabilities, such as the ones secured with pledge, as their return is ensured by the collateral;
- funds placed by clients and securities purchased on behalf of clients, protected by other legal relationship;
- liabilities with a short maturity (of less than 7 days) vis-à-vis institutions outside of the group in order to eliminate contagion effects.

In addition, pursuant to Section 59 of the Act on Resolution, the liabilities necessary for the provision of the institution's critical functions and the operation of its main business lines, the liabilities whose involvement in bearing the losses would result in contagion in the financial markets and a wider spreading of the problems, or the involvement of which would lead to a significant decline in the value of the institution's assets have to be completely or partially excluded from the bail-in.

The most important principle of the resolution framework serving the protection of creditors is that the losses of creditors suffered during the resolution cannot exceed the loss that they would have suffered during liquidation ('no creditors worse off', NCWO principle). For the enforcement of this, during the resolution, even if the bail-in exceptions determined by law are applied, the principle of equal treatment of creditors with the same ranking, i.e. liabilities with the same ranking according to the insolvency hierarchy (not affected by exclusion), shall not be violated, liabilities with the same ranking according to the insolvency hierarchy have to bear the loss without discrimination, in a pro rata manner.

In order to make the violation of the NCWO principle as a result of the exclusions from the bail-in and the related compensation claims as avoidable as possible, Article 3 of the MREL Regulation provides that the resolution authority should evaluate the ratio of liabilities excluded from the bail-in in the case of each category in the insolvency hierarchy. An adequate amount of liabilities available for the bail-in should be ensured even taking into account possible exclusions from bail-in. Considering this, if the risk of violating the NCWO principle is high, in order to ensure resolvability, it may be justified for the resolution authority to determine further requirements also concerning the subordination of the MREL eligible liabilities not only their amount. This may be done by requiring inclusion of contract terms ensuring subordination or by regulating the ranking of MREL eligible liabilities in the insolvency hierarchy.

Analysing the structure of MREL eligible liabilities of institutions incorporated in Hungary, in the current phase of the resolution planning the MNB did not identify any potential impediments to resolvability resulting from the violation of the NCWO principle that would necessitate the imposition of subordination requirements. Nevertheless, the MNB continuously monitors the composition of institutions' MREL eligible liabilities, and if NCWO aspects or amendments to the BRRD justify, it will revise the framework of determining the MREL requirements and might formulate new qualitative requirements.

3.3. Requirements concerning the ownership of MREL eligible liabilities

Based on the provisions concerning the bail-in and the exclusion of liabilities from the bail-in, the MNB does not see any legal possibility to limit in general, as a principle, the MREL eligibility of liabilities that are held by natural persons, micro, small and medium-sized enterprises and meet the conditions determined in Section 63 of the Act on Resolution. In view of that, and also taking into account that within the framework of the existing investor protection and consumer protection rules, the MNB, in its consumer protection role, may ensure that potential investors have adequate information about the risks of these assets when making their investment

decisions, thus the MNB does not consider the exclusion of natural persons, micro, small and medium-sized enterprises from holding MREL eligible liabilities reasonable.

At the same time, in the MNB's opinion, credit institutions' investments in MREL eligible liabilities of other institutions not subject to the same consolidated supervision constitute a major source of contagion risk. If there is high probability that these MREL eligible instruments held by other institutions will be involved in loss absorption or bail-in, it may jeopardise financial stability through the spreading of the losses. Therefore, **during the resolvability assessment, direct investments classified into the new class of 'non-preferred senior debt' created within the insolvency hierarchy of the insolvency proceedings pursuant to the Bank Creditor Hierarchy Directive[6], are treated by the MNB as potential impediments to resolvability that justifies the imposition of additional MREL requirement**.

At present, the MNB does not impose any additional requirement concerning the quality of MREL eligible liabilities compared to what is specified in the relevant legislation, but it calls the attention of institutions that it continuously monitors the changes in the structure of MREL eligible liabilities, and if in connection with that it identifies impediments to resolvability, or changes in legislation necessitates, additional qualitative requirements may be imposed either on the level of individual institutions or at the level of general principles.

4. TRANSITIONAL PERIOD FOR MEETING THE MREL REQUIREMENT

4.1. Time of setting the requirements

The objective of the MREL requirement is to support the efficient application of resolution tools. Accordingly, in terms of the **preparations** for crisis management and **strengthening** the credibility of the resolution plans, it is an advantage in setting the requirement as soon as possible. However, meeting the requirement requires the institutions to adapt, while the issuance of MREL eligible liabilities necessary to meet the requirements **means additional costs**, and thus it has a negative impact on bank profitability. Consequently, the institutions for which MREL requirement is set would have a competitive disadvantage vis-à-vis other Member State institutions that do not yet have to meet this requirement because the amount to be met has not been determined yet.

In the case of banking groups led by a parent company that is incorporated in an EU Member State within the banking union, in the 2018 resolution planning cycle the SRB intends to make a proposal for determining MREL requirements for all individual institutions belonging to the group. Taking into account the expected schedule of the resolution college planning, binding MREL targets for individual institutions, including subsidiaries in Hungary, may be accepted in 2019 H1. Therefore, **also to ensure a level playing field, the MNB expects to determine the**

[6] Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy

requirements for the institutions falling within its remit simultaneously with the imposition of binding individual level target requirements for the subsidiaries of the banking groups falling within the remit of the SRB incorporated in Hungary, i.e. in 2019 H1.

4.2. Transitional period

Article 8 of the MREL Regulation allows a transitional period for meeting the requirements; pursuant to paragraph 2, this period should be as short as possible.

The transitional period for meeting the requirements and the interim requirements for the transitional period, if any, are determined by the MNB on the basis of the assessment of the preparedness of the institutions and the capacity of the local capital markets to absorb MREL eligible liabilities, also taking account the need for a level playing field.

The deadline determined by the MNB for meeting the MREL requirements is 4 years from communicating the MREL requirement. The MNB monitors and assesses the progress of institutions in meeting the MREL requirement during the transition period at least once a year. In order to promote a smooth and gradual adjustment process, and not to relay excessively on adjustment at the end of the transitional period , in line with Article 8(2) of the MREL Regulation, in the case of institutions that do not yet meet the MREL requirement at the time when it is set, the MNB sets interim targets as well for each of the 12 months of the transitional period.

The MNB sets a uniform deadline for meeting the MREL requirements. The length of the transitional period provided is 4 years.

The MNB monitors and assesses the progress of institutions in meeting the MREL requirement during the transition period at least once a year. If a given institution does not yet meet the MREL requirement at the time it is set, the MNB sets interim targets as well for each of the 12 months of the transitional period.