

EBA Opinion 24/2015: Clarity added to the MDA debate



On 18 December 2015 the EBA issued Opinion 24/2015, which clarifies the interaction among Pillar 1, Pillar 2 and combined buffer requirements (CBR). The opinion adds significant clarity to the capital debate for EU banks, as it is now clear that Pillar 2 requirements have to be complied with at all times and that the Maximum distributable amount (MDA) has to be calculated with respect to the total (Pillar 1 and Pillar 2) requirement, including the CBR.

While the need to comply with CBR is quite clear from CRD IV, there has been some uncertainty in the past as to where Pillar 2 requirements would stack, i.e. whether a breach of Pillar 2 requirements would or would not affect distributions of dividends, bonuses and coupons on Additional Tier 1 (AT1) securities.

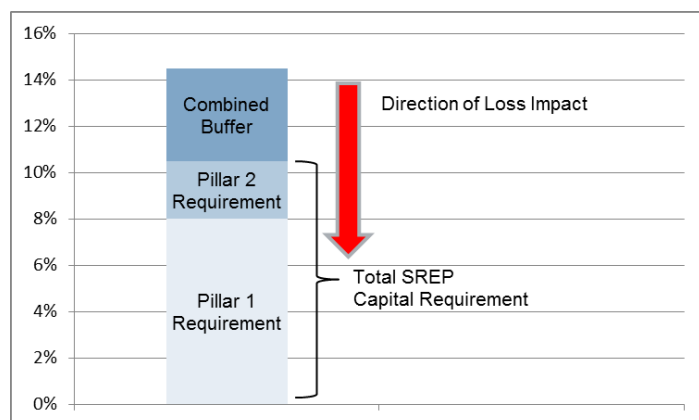
The EBA's opinion states that "Pillar 1 and Pillar 2 capital requirements should be a minimum to be preserved at all times based on an institution-specific assessment of the risks not covered, or fully covered, by Pillar 1 capital requirements." Furthermore, according to the EBA, the MDA should be calculated using CET1 capital held in excess of Pillar 1 and 2 required levels. The opinion also addresses the effects of non-compliance. In the case of a breach of the CET1 requirement (or likelihood of a breach within 12 months), including CBR, the supervisory authority must take early-stage measures.

According to the EBA's opinion, "the failure of an institution to meet its combined buffer requirement has at least the consequence of triggering the mandatory application of the capital conservation measures in Section III of Title VII of the CRD. Competent authorities can take additional supervisory measures where necessary, including before breaching the combined buffers."

Section III of the Title VII includes article 141 (**restrictions on distributions**). Specifically, failure to comply with the requirements can lead to a wide range of actions, from the suspension of dividends, share buybacks, or bonuses to the non-payment of AT1 coupons.

The ECB has confirmed¹ that its approach will follow the EBA opinion.

Figure 1: Stacking order of own funds



Source: EBA, Scope Ratings

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¹ See <https://www.bankingsupervision.europa.eu/banking/html/srep.en.html>

The EBA's remarks on Pillar 2 requirement disclosure needs

Further to the clarification on the stacking order of Pillar 2, the EBA opinion comments on the disclosure requirements. Keeping in mind that institutions may be required by the competent authority to disclose SREP capital requirements, the EBA insists that, given its implication with respect to restrictions on distributions, "it is imperative that the appropriate degree of disclosure of the institutions' own funds requirements is achieved".

In particular, the EBA sees the consistency of disclosure of Pillar 2 requirements as a key factor for bank funding and financial stability, on top of market transparency.

We find this statement especially relevant if we contrast it with the historical practice of not disclosing the Pillar 2 requirements.

In fact, regarding the disclosure of the capital requirements, we believe there is a trade-off between investors' need for market transparency and supervisors' concerns with regards to banks' funding and financial stability. Given the intrinsically volatile nature of bank market funds, a supervisor demanding a sharply increased Pillar 2 requirement could flag serious problems for the respective bank, potentially hindering its market funding ability and even triggering unintended contagion effects. On the other hand, for banks with publicly traded financial instruments, such disclosure is of great importance when market participants make their investment decisions.

Historically, financial stability concerns have prevailed, in our view. However, we believe the balance between these two needs may have shifted for several reasons:

1. The financial crisis has shown that a lack of transparency can have great costs because it increases contagion to healthy institutions when investors feel they are in the dark with regards to the true state of banks' solvency.
2. As the market for bank capital securities widens, so do the needs for investor protection. In other words, while non-compliance with Pillar 2 requirements used to be primarily a risk for equity holders facing potential dilution or dividend cuts, supervisory actions can now impact coupon payments on AT1 bonds and, in more extreme circumstances, lead to principal write-downs or conversions.
3. As the regulatory framework evolved to reduce leverage, introduce resolution, and generally strengthen systemic resilience, individual casualties among banks have, in our view, become more acceptable to supervisors. In fact, they may even serve the greater good of disciplining bank managers towards more sustainable business models and risk profiles.

We would expect therefore total SREP capital requirements to eventually enter the public domain for all other banking systems as well, and for market participants to focus less on a headline-ratio comparison and increasingly on the comparison of the buffer over SREP capital requirement.

The table below offers an overview of euro area (EA) banks' SREP capital disclosures so far. Outside the EA, Pillar 2 requirements are disclosed in the UK, Sweden², Denmark and Norway.

² In Sweden the supervisory authority has stated that the capital requirement under Pillar 2 does not affect the level at which the automatic restrictions on distributions linked to the combined buffer requirement come into effect, as long as the supervisory authority does not make a "formal decision" on the requirement.

Figure 2: SREP CET1 requirements in the euro area are clustered around the 10% mark

Spain	Santander	BBVA	Caixabank	Bankia	Sabadell	Popular	Bankinter	Liberbank	Kutxabank
SREP Requirement	9.50%	9.50%	9.25%	10.25%	9.25%	10.25%	8.75%	10.25%	9.05%
ow Pillar 1	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
ow frontloading of CCB in Pillar 2	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
ow Other Pillar 2	2.50%	2.50%	2.25%	3.25%	2.25%	3.25%	1.75%	3.25%	2.05%
Buffers	0.25%	0.25%	0.06%	0.06%	0.00%	0.00%	0.00%	0.00%	0.00%
Countercyclical									
Systemic	0.25%	0.25%	0.06%	0.06%	0.00%	0.00%	0.00%	0.00%	0.00%
Total CET1 Requirement	9.75%	9.75%	9.31%	10.31%	9.25%	10.25%	8.75%	10.25%	9.05%

France/Belgium	BNP	Socgen	CASA (Group)	CASA (Parent)	BPCE	Natixis	KBC
SREP CET1 Requirement	9.50%	9.50%	9.50%	9.50%	9.50%	8.75%	9.75%
ow Pillar 1	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
ow frontloading of CCB in Pillar 2	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
ow Other Pillar 2	2.50%	2.50%	2.50%	2.50%	2.50%	1.75%	2.75%
Buffers	0.50%	0.25%	0.25%	0.00%	0.25%	0.00%	0.50%
Countercyclical	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Systemic	0.50%	0.25%	0.25%	0.00%	0.25%	0.00%	0.50%
Total CET1 Requirement	10.00%	9.75%	9.75%	9.50%	9.75%	8.75%	10.25%

Italy	Intesa	Unicredit	UBI	Mediobanca	BP	BP Milano	MPS
SREP CET1 Requirement	9.50%	9.75%	9.25%	8.75%	9.55%	9.00%	10.20%
ow Pillar 1	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
ow frontloading of CCB in Pillar 2	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
ow Other Pillar 2	2.50%	2.75%	2.25%	1.75%	2.55%	2.00%	3.20%
Buffers	0.00%	0.25%	0.00%	0.00%	0.00%	0.00%	0.00%
Countercyclical	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Systemic	0.00%	0.25%	0.00%	0.00%	0.00%	0.00%	0.00%
Total CET1 Requirement	9.50%	10.00%	9.25%	8.75%	9.55%	9.00%	10.20%

Italy	BP Sondrio	Carige	Pop Vicenza	Veneto banca	BPER	Credem
SREP CET1 Requirement	9.25%	11.25%	10.25%	10.00%	9.25%	7.00%
ow Pillar 1	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
ow frontloading of CCB in Pillar 2	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
ow Other Pillar 2	2.25%	4.25%	3.25%	3.00%	2.25%	0.00%
Buffers	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Countercyclical	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Systemic	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Total CET1 Requirement	9.25%	11.25%	10.25%	10.00%	9.25%	7.00%

Source: Banks disclosures, Scope Ratings



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