AT A GLANCE

Risk Weighted Assets versus Total Assets: Does it matter for MREL requirements?

This notes provides a short summary of four external papers commissioned by the ECON Committee to assess the distributional consequences of using a risk-weighted metric or an unweighted one when setting requirement for own funds and eligible liabilities. Those findings were presented to the ECON Committee on Monday 11 July 2016, in advance of the hearing with Mrs König, Chair of the Single Resolution Board, on Wednesday 13 July 2016.

All four experts argued that the choice of metric does actually matter when looking at the distribution of those requirements. Noting that average ratios of RWA / total assets or average exposures to sovereign bonds differ across banks, business model, ownership structures or countries, they conclude that setting a requirement based on a risk-weighted metric rather than on an unweighted metric has indeed a substantial impact on the calculation of requirements.

- **Pr. Martin Hellwig** *(Max Planck Institute for Research on Collective Goods)*

The author underlines the problematic reliance on RWA in banking regulation, since major risks are overlooked, risk-weight calculations can be manipulated and sound statistical basis are lacking. In addition, the author stresses out the conceptual differences between capital requirements and requirements to hold liabilities which should be credibly bailed-in upon failure of an institution. The author argues that for MREL what matter are conditional expectations of losses once the bank has been put into resolution, that is to say once the probabilities of default on the asset side have already materialised. However since the total assets metric also have drawbacks, the author concludes **the dual approach remains the most reasonable way forward**. Based on an analysis of sovereign exposures the authors concludes that calculating an 8% MREL requirements on those exposures would have significant effects for Spain, Italy, Slovenia and Slovakia.

- **Pr. Rym Ayadi** *(HEC Montreal and IRCCF)* **and Pr. Giovanni Ferri** *(LUMSA)*

The authors analyse the impact of both metrics for different business models, systemic profiles, and ownership structures, using the TLAC formula which provides that requirements be set at the highest of 18% RWA or 6.75% of the leverage exposure. They observe that requirements based on RWA are significantly lower for some business models (diversified retail type 2, wholesale), ownership structures (public banks), as well as for domestic systemically important banks (DSIB), with the leverage-based calculation acting as a backstop when the RWA-based requirement falls below 6.75% of total assets. The authors also assess the impact of the 8% floor as per the draft EBA RTS and the impact of extreme shocks on banks' capital positions. In particular, the authors found that the loss absorbing capacity of certain business models could be adjusted to factor in their greater vulnerability to extreme shocks, with requirements of up to 24% for banks with a diversified retail type 2 business model. The authors conclude that **both metrics should be used in line with the TLAC standard**, and that MREL **should be calibrated to the business model and systemic footprint of banks.**

- **Mr. Willem Pieter de Groen** *(Centre for European Policy Studies)*

  The author shows that larger and more systemic, market-oriented and government-oriented banks report lower ratio of RWA / Total assets, due to larger exposures to sovereigns and financial institutions, which bear low risk-weights. While the author acknowledges the need for regulatory requirements to factor-in the risk profile of institutions, he deems the current framework of only limited use to accurately measure the riskiness of a bank. In his view, requirements based on the entire balance sheet may better reflect the risk of "major, but rare, events". He concludes that a **combination of a leverage ratio and a RWA-based ratio is needed for MREL** and calls for further simplification of the framework, for instance by replacing the total liabilities and own funds metric used in the BRRD by the leverage ratio exposure. This would require a thorough assessment of the impact of derivative-netting in the leverage ratio.

- **Mrs. Pia Hüttl, Mr. Bennet Berger and Mrs Silvia Merler** *(Bruegel)*

  The authors find that smaller banks would face higher requirements if those were based on RWA rather than leverage exposures, due to their lower RWA / Total assets ratio. However given the link established in the draft EBA RTS between MREL and going-concern capital, they do not recommend to set requirements on the sole basis of total assets. They rather suggest scaling up the leverage component of the MREL, by **increasing the leverage ratio requirement of 3% in proportion with capital requirements,** depending on which buffers are included. The leverage ratio would therefore no longer act as a static backstop, but as a dynamic secondary metric. The authors also warn against the risks faced by European banks if MREL and TLAC were not aligned, and question to what extent regulatory complexity impedes resolvability.