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MREL for sale-of-business resolution strategies

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MREL for sale-of-business resolution strategies[1]

Highlights

- Making the European bank failure management framework suitable for mid-sized banks requires facilitating sale-of-business transactions by ensuring both adequate financial support from the deposit insurance fund and the availability of sufficient assets that could be transferred to an acquirer.
- Under the current financial cap, support by deposit insurers is limited by the costs (net of recoveries) they would incur if paying out covered deposits in a bank liquidation. That crucially depends on the ranking of deposit insurance fund claims in the creditor hierarchy. The ability to transfer sufficient assets is directly linked to the minimum requirement for eligible liabilities (MREL).
- As a minimum, MREL should aim to help close the expected gap between transferred liabilities and assets, after considering the available support from the deposit insurer.
- Consequently, calibrations should be based on the prevailing status for deposit insurance fund claims in insolvency and on a structured assessment of three key factors: (i) the estimated (franchise) value of banks' assets; (ii) the proportion of transferred liabilities which are not covered by the deposit insurance fund; and (iii) the liquidation procedure's ability to preserve banks' asset values.

1. Introduction

There is by now broad consensus that the most suitable approach for dealing with the failure of most mid-sized banks is through sale-of-business (SoB) strategies that imply market exit after the transfer of the failing bank's sensitive liabilities (such as deposits)[2] to a suitable acquirer. Other resolution strategies are often inappropriate for those banks. In particular, the application of the regular insolvency procedures involving piecemeal liquidation – which are often inefficient – can give rise to significant value destruction and contagion. At the same time, resolution strategies that rely primarily on the writedown or conversion into equity of banks' liabilities (open bank bail-in) is also often inappropriate for mid-sized banks. Those banks' business models cannot easily accommodate the issuance of large amounts of liabilities (other than deposits) that could be loss-absorbing in resolution (Restoy (2018)).

The success of SoB strategies crucially depends on the availability of sufficient funding. In an SoB transaction, acquirers receive a failing bank's assets as compensation for assuming liabilities. Yet, for failing commercial banks with a large deposit base, the value of transferable assets is often lower than the volume of deposits. When this is the case, SoB can only work if there is external financial support. In the United States, that support is regularly provided by the deposit insurance fund (DIF) subject to the (least-cost) condition that this option is less expensive for the DIF than paying out covered deposits if the failing bank is liquidated (FDIC (2017)).

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[2] In this context, "sensitive liabilities" means those that, while in theory capable of being loss-absorbing, may be difficult in practice to write down for social or political reasons, or because a write down would risk contagion.

DIF support for SoB transactions is also available in the European Union.[3] That support is limited to the cost to the DIF of paying out covered deposits if the bank had been liquidated. In practice, that financial cap is substantially more restrictive than the least-cost constraint in the US because of the different ranking of covered deposits in insolvency. In the US, deposits covered by the DIF rank pari passu with uncovered deposits; however, in the EU covered deposits (and, therefore, DIF claims after paying them out) are "super-preferred" over non-covered deposits. Consequently, the DIF claims on the liquidating bank are better protected in the EU, and the DIF would expect to recover more of its costs. As a result, the net cost for the European DIF of paying out deposits would be smaller and the financial cap for any support for SoB transactions will be commensurately lower. That de facto makes the DIF unable to provide meaningful support for SoB transactions in the EU.

Following several contributions made over the last few years,[4] the European Commission (EC) has put forward a legislative proposal to facilitate, among other objectives, the funding of SoB strategies (EC (2023)). This proposal amends the EU crisis management and deposit insurance framework, and is referred to hereafter as the "CMDI proposal". A key element of the proposal is to replace the super-preference of covered deposits with a general depositor preference rule which would give DIF claims and uncovered deposits the same ranking in insolvency procedures.[5]

The additional DIF funding facilitated by this reform aims to make an SoB strategy a realistic alternative to open bank bail-in for banks that cannot issue large amounts of gone-concern capital instruments. However, a key question remaining is how much loss-absorbing capacity should still be required. The Single Resolution Board (SRB), in accordance with the legislative revisions introduced by the 2019 banking package,[6] has introduced some corrective factors for MREL for banks with an SoB strategy. MREL would still have to be calculated as the sum of a loss absorption amount (LAA) and a recapitalisation amount (RCA) as in the case of banks following an open bank bail-in strategy. Yet, as a way to recognise the lower capital needs for failing banks exiting the market, the recapitalisation amount (RCA) component for SoB banks could be adjusted downwards by a minimum of 15% and a maximum of 25%.[7] In selecting the precise adjustment, the SRB uses "criteria that capture the marketability and capital needs of the resolved entity" (SRB (2023)). The EC CMDI proposal also contains general provisions aimed at providing a legal basis for establishing the RCA amount of MREL for banks with an SoB preferred strategy seeking "a proportionate and consistent application".[8]

While those general criteria are certainly all relevant, there is as yet no clear framework to establish the actual MREL for SoB banks. In particular, neither the current nor the proposed provisions on setting MREL take into account the DIF contribution. Moreover, a calibration of MREL on the basis of discounts from what would have been required for an open bank bail-in strategy does not fully capture the specific role that MREL plays in SoB transactions. By definition, MREL instruments should be able to

3 The EU resolution framework requires a DIF contribution to fund certain resolution measures, including SoB transactions (Bank Recovery and Resolution Directive, article 109).

4 See Restoy (2019), Restoy et al (2020), Gelpern and Veron (2020) and Garicano (2020).

5 In addition, the CMDI proposal would reduce the minimum bail-in required (currently 8% of total assets) as a condition for access to the Single Resolution Fund by the amount provided by the DIF.

6 Directive (EU) 2019/879, Regulation (EU) 2019/877, Regulation (EU) 2019/876 and Directive (EU) 2019/879 modifying the Bank Recovery and Resolution Directive, the regulation on the Single Resolution Mechanism (SRMR), the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD).

7 However, even if they exit the market, SoB banks' RCA amount could still be subject to a market confidence charge adjustment (MCC) in order to "ensure that the resolution entity is sufficiently capitalised to sustain market confidence". Moreover, the resolution authority could raise MREL to reach 8% of total liabilities and own funds (TLOF) if so required to "meet resolution objectives" (SRB (2023)).

8 Criteria in SRB (2023) include bank size, the existence of impaired assets, depositor base (covered deposits over total assets and valuation uncertainty. The EC CMDI proposal (EC (2023)) refers to "size, business model, risk profile, transferability analysis, marketability, whether the strategy is asset transfer or share deal and complementary use of an asset management vehicle for assets which cannot be transferred".

absorb losses in resolution. When an SoB is performed, those liabilities are not transferred to the acquirer but rather are written down (in a whole bank transfer) or left behind in a residual entity that will be liquidated (in partial transfers). Therefore, the larger the MREL that can absorb losses, the larger the amount of assets that can be transferred relative to the (sensitive) transferred liabilities. In other words, while less is needed than for an open bank bail-in strategy, MREL still plays a key role – together with the aid provided by the DIF – in ensuring the feasibility of an SoB strategy. Indeed, in the US, where no formal MREL-type obligations currently exist for small and medium-sized banks, there are already plans to introduce (bail-in-able) longer-term debt requirements for banks with more than $100 billion in assets in order to facilitate SoB transactions (Gruenberg (2023)). Moreover, it could be argued that a reasonable volume of bail-in-able liabilities could generally provide incentives for adequate bank management regardless of banks' preferred resolution strategy and reduce the need of any external support when they fail.

Naturally, while an appropriate calibration of MREL might significantly facilitate SoB transactions, it cannot by itself guarantee successful implementation of that resolution strategy. Both external (market) conditions and the specific characteristics of the failing bank would always affect the likelihood of finding a sound buyer and, therefore, the suitability of SoB as a preferred resolution strategy. Beyond MREL, a bank's resolution plan can contain other requirements, such as internal reorganisations or adjustments to its balance sheet structure, to support the feasibility of an SoB strategy when the bank fails. Moreover, when resolution plans contain a combination of different resolution tools, MREL should be adjusted accordingly. In any event, once SoB is identified as the preferred strategy, the calibration of MREL should primarily target the expected gap between the value of the transferred liabilities (eg deposits) and the sum of the value of the transferred assets and the support provided by the DIF. That gap would depend on factors such as the composition of the balance sheet (including the proportion of insured to uninsured deposits), the value of the franchise for the acquirer and elements affecting the efficiency of the liquidation procedures. The latter enter the equation as they have an impact on the cost that the DIF would face in a liquidation counterfactual and, therefore, on the maximum amount it would be able to contribute to support the SoB transaction.

Following that approach, this paper provides a relatively simple analytical framework that helps to facilitate the calibration of MREL for banks with an SoB resolution strategy. The rest of the paper is organised as follows. Section 2 presents the analytical setup leading to the determination of MREL as a function of bank-specific and more structural characteristics. Section 3 offers some illustrative calibrations. Section 4 concludes.

2. The analytical framework

The problem

The exercise considers a bank for which the competent authority has approved a resolution plan with a preferred SoB resolution strategy. That strategy consists of transferring, when resolution is triggered, all deposits[9] to a suitable acquirer. The acquirer will assume those deposits and in exchange receive the failing bank's assets as well as, if needed and feasible, cash support from the DIF. The transaction would only be feasible if the sum of the expected value of transferred assets and the available DIF support exceeds the volume of assumed deposits.

[9] Throughout the paper, it is assumed that transferred liabilities are just deposits. The analysis could be extended to the transfer of other liabilities or, as has sometimes been advocated, to the consideration that some wholesale deposits should not be transferred and therefore absorb losses. Those cases would nevertheless introduce complexity, as they might imply treating differently (equally) liabilities with the same (different) creditor hierarchy.

The relation between transferable assets and assumed liabilities would be determined by the availability in the failing bank's balance sheet of sufficient loss-absorbing liabilities that would not be transferred to the acquirer. Those liabilities would be directly written down or remain in the residual entity that would be wound up after the execution of the SoB transaction. The maximum support the DIF is allowed to provide is the net cost of paying out covered deposits in a piecemeal liquidation under the applicable insolvency regime (the financial cap). That financial cap will therefore depend on the ranking of DIF claims in the insolvency procedures.

The competent authority should determine, given the available DIF support, the lowest possible level of gone-concern capital that the bank should be required to hold in order to be able to transfer sufficient assets to the acquirer for it to assume all the failing bank's deposits.[10] That amount should depend on the expected value of the assets held by the bank when failing as well as on the composition of liabilities – ie the ratio between covered and uncovered deposits – as the latter affects the financial cap for DIF support, depending on the prevailing hierarchy of DIF claims in insolvency.

Note that the concept of gone-concern capital is not identical to MREL. The former would be composed of those loss-absorbing liabilities that would remain on the balance sheet after the bank is declared failing or likely to fail. The latter also includes going-concern capital able to absorb losses before resolution. Within the current two-component framework for MREL determination, MREL for SoB banks could be approximated by the sum of (going-concern) minimum regulatory capital (the current LAA component) and the gone-concern capital requirements derived from the exercise (a new RCA amount).

The setup

Suppose a failing bank whose assets have an accounting value (net of asset-backed and other preferred claims)[11] of *A*. Those assets are funded by deposits (*D*) and gone-concern capital (*K*).[12] Part of the deposits are covered (*CD*) and the rest (*ND*) are not covered by the DIF. Therefore $\mathrm{A} = \mathrm{CD} + \mathrm{ND} + \mathrm{K}$.

We assume, for simplicity, that all deposits and assets would be transferred to the acquirer under the SoB transaction. The acquirer will also receive cash support from the DIF with a maximum amount of *MS*. When valuing the bank's assets, the acquirer applies a haircut to their accounting value. The acquirer will assume the deposits only if the sum of the value of the transferred assets and the support received from the DIF exceeds the volume of transferred deposits. Thus, the transaction would only be feasible if:

$$hA - D + MS \geq 0,$$

where *h* is the value preservation proportion of the accounting value of the assets for the acquirer (or franchise value).

Given a specific amount of deposits (*D*), an estimate of the franchise value parameter (*h*), and the maximum available DIF support (*MS*), the authority could derive the minimum amount of loss-absorbing

[10] For simplicity, the exercise assumes that all available DIF support – ie the maximum volume of funds permitted within the financial cap – will be used before bailing in gone-concern capital. Additional constraints on DIF contributions could, however, be introduced. Likewise, the exercise assumes that the amount of required gone-concern capital is that expected to facilitate the transaction without support from the Single Resolution Fund. That is line with the assumptions made for the calculation of MREL for open bank bail-in strategies. Therefore, the provisions in the EC CMDI proposal reducing bail-in requirements for access to the Single Resolution Fund for failing banks following SoB strategies and receiving DIF support are not relevant for this exercise.

[11] Preferred claims typically include the fees of the liquidator, tax liabilities or liabilities to employees.

[12] As ordinary capital will mostly be exhausted at the point of non-viability, gone-concern capital would mostly be composed of debt instruments that only absorb losses after non-viability is declared.

liabilities (*K*) that would need to be available in order to be able to transfer sufficient assets (*D*+*K*) to the acquirer.

Replacing *A* by its counterparts and rearranging terms permits the required gone-concern capital to be expressed as:

$$K \geq \frac{1-h}{h} D - \frac{MS}{h} \ . \qquad (1)$$

Therefore, quite intuitively, required gone-concern capital would depend positively on the amount of transferred deposits and negatively on the available DIF support and on the acquirer's valuation of the assets.

Maximum DIF support

Following Restoy et al (2020), the financial cap (the maximum net cost for the DIF in liquidation) depends on the hierarchy of liabilities in the applicable liquidation framework. In particular, it depends on whether DIF-covered deposits – and, therefore, DIF claims in liquidation – rank senior to non-covered deposits and thus are super-preferred (SP) or rank pari passu as in a general deposit preference regime (GP). In the SP case, the DIF would be entitled to receive the proceeds of the liquidation of all assets before all other unsecured creditors if needed to compensate for paying out covered deposits. In the GP case, the proceedings of asset liquidation must be shared pro rata between the DIF and holders of non-covered deposits.

Denoting by m ($m < h$) the proportion of the assets' accounting value that would be preserved in piecemeal liquidation, the net cost of paying out deposits in liquidation under super-preference of covered deposits (MS_{SP}) would be:

$$MS_{SP} = \max(0, CD - mA), \qquad (2)$$

since the DIF would only suffer costs if the cash obtained from the liquidation of assets is below the amount required for paying out covered deposits.

In the GP case, the net cost for the DIF in liquidation (MS_{GP}) would be

$$MS_{GP} = \max(0, CD - m'A), \qquad (3)$$

where $m' \equiv m\ CD/(CD + ND)$.

Therefore, as $m' \leq m$, the financial cap for the DIF would be tighter under SP than under GP as long as the failing bank holds non-covered deposits.

Since *A = D + K,* in both regimes the maximum support available correlates negatively with the amount of gone-concern capital. For a given volume of deposits, losses for the DIF in liquidation (the financial cap) will be lower the larger the volume of junior liabilities. In other words, by increasing the required volume of bail-in-able liabilities, the scope for DIF support in SoB transactions would be smaller.

Minimum gone-concern capital

Putting together equations (1), (2) and (3), we can derive expressions for minimum gone-concern capital under the SP and GP regimes.

Under the SP regime, in the absence of DIF support ($MS_{SP} = 0$ in (2)), the ratio of going-concern capital to deposits satisfies:

$$\frac{K}{D} \geq \frac{1-h}{h} .$$

If there is DIF support ($MS_{SP} = CD - mA > 0$ in (2)) minimum *K / D* can be expressed as

$$\frac{K}{D} \geq \frac{1}{h-m}\frac{ND}{D} - 1.$$

As required gone-concern capital would need to be larger when there is no DIF support, minimum requirements under the SP regime (K_{SP}) should satisfy:

$$\frac{K_{SP}}{D} \geq \min\left(\frac{1}{h-m}\frac{ND}{D} - 1, \frac{1-h}{h}\right) . \qquad (4)$$

Expression (4) shows that minimum gone-concern capital requirements depend crucially on three parameters which reflect the valuation of the bank's assets for the acquirer as well as the size of the expected DIF support, if any. Those parameters are the franchise value coefficient in SoB (*h*), the proportion of covered deposits over total deposits, and the value preservation coefficient in liquidation (*m*). The higher the valuation of assets by the acquirer, the less assets required to facilitate the transaction and, therefore, the lower the amount of loss-absorbing liabilities that could be left behind for liquidation that the bank needs to hold. In addition, the larger the proportion of non-covered deposits over total deposits, the lower the support from the DIF as a proportion of transferred liabilities and the larger the need to transfer assets to the acquirer. That can only be achieved by holding more loss-absorbing liabilities. Finally, the larger the value preservation in liquidation, the lower the costs for the DIF in liquidation (thus tightening the financial cap) and, therefore, the higher the need to transfer assets (and therefore the amount of loss-absorbing liabilities required).

Under the GP regime, minimum gone-concern capital requirements could analogously be expressed as:

$$\frac{K_{GP}}{D} \geq \min\left(\frac{1}{h-m'}\frac{ND}{D} - 1, \frac{1-h}{h}\right), \qquad (5)$$

where $m' = m\frac{CD}{D.}$

The difference between K_{SP} and K_{GP} is just that, under the GP regime, the value preservation coefficient in liquidation appears weighted by the proportion of covered deposits over total deposits, since the proceedings from asset sales should be shared by all deposit holders. This makes the costs for the DIF in liquidation larger and, therefore, increases the support that the DIF can provide for SoB. As a consequence, in relation to SP, GP reduces the amount of assets that need to be transferred under SoB and therefore, there is less need for gone-concern capital.

According to (4) and (5), when the ratio of non-covered deposits is low there is no need for gone-concern capital to support the SoB transaction (ie minimum *K / D* becomes zero or negative). The reason is that in such a case, the costs for the acquirer of assuming deposits could be largely offset by the DIF support as its losses for paying out covered deposits in liquidation would be large. In the limit, with zero non-covered deposits, there would be no need to transfer assets (*K* = – *D* and *A* = 0*)*) since, in that case, the DIF would be exposed to a cost for paying out covered deposits in liquidation that would be exactly equal to the liabilities assumed by the acquirer. In that case, the DIF could fully compensate by itself the acquirer's costs of assuming all deposits, thereby making the transaction feasible. In the calibrations below,

whenever (4) and (5) yield a negative value for minimum gone-concern capital we assume $K = 0$. We then adjust DIF support (*MS*) downward accordingly by setting $A = D$ in expressions (2) and (3).

3 Some numerical illustrations

The framework described in this section explains how different characteristics of failing banks and the environment in which they operate could affect the required volume of bail-in-able liabilities that are required to facilitate an SoB transaction in case of failure. That amount, together with the available contribution from the DIF, would help offer sufficient compensation to potential acquirers. Table 1 presents some alternative calibrations of the required gone-concern capital under both the SP and GP regimes as a function of different combinations of the key parameters: (i) the franchise value coefficient of the failing bank (*h*); (ii) the ratio of non-covered deposits over covered deposits (*ND / D*): and (iii) the value preservation coefficient in liquidation (*m*).

REQUIRED GONE-CONCERN RESOURCES FOR MREL CALIBRATION[1] Table 1

SCENARIO 1: Low ratio of non-covered deposits (ND / D = 0.2)

	DIF AID (*MS / D*)		GONE-CONCERN (*K / D*)		
h	SP	GP	NO AID	SP	GP
0.95	0.05	0.05	0.05	–	–
0.9	0.1	0.1	0.11	–	–
0.85	0.15	0.15	0.18	–	–
0.8	–	0.2	0.25	0.25	–
0.75	–	0.25	0.33	0.33	–
0.7	–	0.22	0.43	0.43	0.22

SCENARIO 2: Moderate ratio of non-covered deposits (ND / D = 0.4)

	DIF AID (*MS / D*)		GONE-CONCERN (K / D)		
h	SP	GP	NO AID	SP	GP
0.95	–	0.05	0.05	0.05	–
0.9	–	0.1	0.11	0.11	–
0.85	–	0.15	0.18	0.18	–
0.8	–	0.2	0.25	0.25	–
0.75	–	0.17	0.33	0.33	0.11
0.7	–	0.1	0.43	0.43	0.29

SCENARIO 3: High ratio of non-covered deposits (ND / D = 0.6)

	DIF AID (*MS / D*)		GONE-CONCERN (*K / D*)		
h	SP	GP	NO AID	SP	GP
0.95	–	0.05	0.05	0.05	–
0.9	–	0.1	0.11	0.11	–
0.85	–	0.14	0.18	0.18	0.02
0.8	–	0.11	0.25	0.25	0.11
0.75	–	0.08	0.33	0.33	0.22
0.7	–	0.04	0.43	0.43	0.36

[1] SP = deposit super-preference regime; GP = general deposit preference regime. *h* = value preservation coefficient (franchise value) in SoB. Value preservation coefficient in liquidation (*m)* equal to 0.65 in all cases.

Source: Author's calculations.

Table 1 presents calculations in three scenarios that differ according to the assumed proportion of non-covered deposits: low (20%) in scenario 1, moderate (40%) in scenario 2 and high (60%) in scenario 3. The rows for each scenario include combinations of the available DIF support (*MS / D)* and the required gone-concern capital (*C / D*) that would make the SoB transaction feasible for different levels of the franchise value parameter (*h*). Calculations are made for two legal regimes: (i) super-preference of covered deposits (SP); and (ii) a general depositor preference (GP). To facilitate comparison, in all

simulations a value preservation parameter in liquidation (*m*) equal to 65% has been assumed.[13] Required gone-concern capital is presented in proportion to total deposits as this is consistent with the analytical framework presented in Section 2.[14]

The calibrations in Table 1 offer a few general observations.

First, as the ratio of non-covered deposits over total deposits increases, the scope for the DIF to support SoB transactions lowers rapidly. This is a direct consequence of the constraint that caps DIF support for transferring all deposits to the cost in liquidation of paying out only covered deposits.

Second, there is almost no scope for the DIF to support SoB in the SP regime. Except when the ratio of non-covered to covered deposits is small (scenario 1), and the franchise value (*h*) is quite high,[15] the DIF is unable to help fund the transfer strategy. As the financial cap constraint becomes binding, the bank requires gone-concern capital to facilitate the transfer. But when *K* increases, the constraint becomes more binding, as the volume of assets in liquidation becomes larger. The end result is that all support to the acquirer should come from gone-concern capital.

Third, when no DIF aid is available, the required gone-concern capital tends to be very high in all scenarios. Unless the acquirer values banks' assets quite highly in relation to their accounting value (*h* above 90%), the required gone-concern capital is above 10% of transferred liabilities. That would imply large MREL requirements unless the deposit base of the institutions is unrealistically small in relation to total liabilities.[16]

Fourth, under a GP regime there seem to be suitable combinations of DIF support and gone-concern capital that can effectively facilitate SoB transactions. When the ratio of non-covered deposits to total deposits is small (scenario 1), the DIF could effectively support SoB with little gone-concern capital even for franchise values implying significant discounts over accounting values (up to 25%). For higher non-covered deposit ratios (scenarios 2 and 3), those discounts applied by the acquirer would need to be smaller (up to 20% and 15%, respectively.

Importantly, calibrations are subject to significant uncertainty, as they depend on authorities' expectations, at the time of approving resolution plans, on the actual structure of the balance sheet and on acquirers' valuations of the bank when resolution would be effectively triggered. Therefore, in practice, authorities should normally introduce a safety margin when specifying MREL for SoB banks. A simple way to do that within the above framework is by adding a fixed term (*MK)* to the calibrated gone-concern capital as derived from expressions (4) and (5). Within the usual SRB terminology, *MK* would determine a

[13] This parameter can obviously vary across banks and jurisdictions. However, a 65% asset value preservation is roughly consistent with recent available evidence. In particular, in the valuation report used in the resolution case of Banco Popular (Deloitte (2017)) the liquidation value of the banks' assets (net of collateralised obligations and other privileged liabilities) ranges between 59% (worst scenario for a 1.5-year liquidation period) and 71% (best scenario for a seven-year liquidation period). See tables in pp 74–8 of the Deloitte report.

[14] Nevertheless, they can be easily re-escalated to express them in terms of total assets, or even risk-weighted assets. Yet, unlike in the case of open bank bail in, the latter is probably not very informative for determining the amount of resources required to support an SoB transaction.

[15] In the case of Banco Popular, a zero transfer price plus the bail-in of roughly €2 billion of subordinated debt is consistent – using balance-sheet data at the resolution date in Deloitte (2017)) – with a discount over the accounting value of assets (net of collateralised debt) of around 15%. In other words, in this case *h* could be estimated at 0.85.

[16] The average ratio of deposits over total liabilities for Single Supervisory Mechanism-designated significant banks is around 65% (see Table T02.04.1 in ECB Supervisory Banking Statistics). That would imply that, on average, a 0.1 K / D ratio would translate into gone-concern capital requirements of 6.5%. Adding this to going-concern regular capital requirements (eg a 3% leverage ratio) would imply that MREL requirements would reach 9.5% of total liabilities.

minimum RCA that would be applied to all SoB banks[17]. The actual RCA would then be the sum of that common minimum amount and the bank-specific one derived from the relevant calibrations.

Naturally, the calibrations above are illustrations of a simplified framework. The methodology could be extended to incorporate more detailed balance sheet structures and different transfer scenarios. The general criteria used in the current SRB MREL policy approach and the EC CMDI proposal could be relevant for calibrating some of the parameters in the exercise. For example, impaired asset volumes and any source of valuation uncertainty should enter the determination of the franchise value coefficient (*h*). Yet the proposed framework permits a more structured determination of MREL requirements. Thus, it helps to assess how the current general criteria should be weighed in relation to other key variables which are not part of the current SRB framework (eg the ratio of non-covered over total transferred liabilities and the expected size of DIF support) that crucially depend on the expected value preservation in liquidation procedures.

5. Conclusions

The operationalisation of SoB transactions for the resolution of mid-sized banks requires adequate compensation for suitable acquirers which take over a failing bank's sensitive liabilities (mainly deposits). That compensation should primarily be provided by the transfer of sufficient assets and the provision of external support. The former would depend on the availability of sufficient gone-concern capital that would be written down or remain in the residual entity, thereby making it possible to transfer more assets than liabilities. According to CMDI, the latter would primarily be provided by the DIF while satisfying its financial cap.

This paper shows that under a regime such as the current EU one, in which DIF claims are super-preferred over other deposits in insolvency, there is essentially little or no scope for the DIF to support SoB transactions. By contrast, under a general deposit preference rule (like the one prevailing in the US or the one recently included in the EC CMDI proposal) there are suitable combinations of DIF support and gone-concern capital requirements that could effectively facilitate SoB transactions.

Accordingly, MREL requirements for banks with a preferred SoB resolution strategy should be primarily calibrated to make the operation feasible by helping acquirers to obtain sufficient value in the transaction, including the expected DIF support. The framework presented in this paper shows that it is possible to develop a structured methodology to perform that task by combining the assessment of three key factors: (i) the estimated franchise value of the failing bank; (ii) the proportion of covered deposits over all liabilities (eg total deposits) that are planned to be transferred in resolution; and (iii) the prevailing bank liquidation regime's ability to preserve failing banks' asset value.

Naturally, MREL determination is only one aspect of resolution planning. The proposed framework also confirms that, beyond an adequate determination for MREL, the efficacy of SoB resolution strategies would be significantly enhanced by promoting robust franchise values – implying eg accurate accounting – and avoiding excessive reliance by SoB banks on non-covered deposits. In doing that, the SoB transactions would more easily become feasible while respecting the financial cap for DIF support and keeping MREL at affordable levels.

[17] Although, outside the scope of this paper, in practice that minimum RCA for SoB banks could also aim to mitigate potential competitive distortions between SoB banks and other (larger) banks following an open bank bail-in strategy or to further constrain the required DIF support.

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