CENTRAL BANK OF ICELAND

MREL-POLICY

CENTRAL BANK OF ICELAND RESOLUTION AUTHORITY

MREL - POLICY

CENTRAL BANK OF ICELAND RESOLUTION AUTHORITY

December 2021

Table of contents

I Summary 4

II Legal framework 5

2.1 The Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020 5

2.2 Commission Delegated Regulation (EU) 2016/1450 on regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities 6

2.3 BRRD II and further amendments to legislation on resolution 7

III MREL: role and methodology 8

3.1 Relationship between MREL and financial undertakings' resolvability assessment and resolution plans 8

3.2 General information on MREL methodology 8

3.3 Loss absorption amount 9

3.4 Recapitalisation amount and market confidence charge 9

3.5 Other criteria relating to MREL 10

IV Eligible liabilities 12

4.1 Definitions and excluded liabilities 12

4.2 Subordination 13

V The Central Bank of Iceland's MREL requirements 14

5.1 Application of resolution measures and classification of institutions with respect to MREL 14

5.2 Position on the loss absorption amount and recapitalisation amount 15

5.2.1 Loss absorption amount 15

5.2.2 Recapitalisation amount 16

5.2.3 Other adjustments to loss absorption and recapitalisation amounts on the basis of the MREL Regulation 16

5.3 Position on the market confidence charge 17

5.4 Position on subordination and eligible liabilities 17

5.4.1 Subordination 17

5.4.2 MREL at the group level 18

5.4.3 Restrictions on cross-ownership 18

5.4.4 Other points regarding eligible liabilities for MREL 18

5.5 Position on deadline for satisfaction of MREL requirements 19

5.6 Summary of MREL requirements 19

VI Other MREL-related matters 20

6.1 Publication of information on MREL 20

6.2 Final deadline for MREL compliance under BRRD II 20

6.3 Penalties due to MREL 20

6.4 Other MREL-related obligations of financial undertakings 21

I Summary

The Central Bank of Iceland Resolution Authority takes decisions on minimum requirements for own funds and eligible liabilities (MREL)[1] for each credit institution in Iceland, based on a resolvability assessment and the resolution plan for the institution concerned.

The MREL comprises the loss absorption amount (LAA) and the recapitalisation amount (RCA).

The loss absorption amount is equal to minimum required own funds; i.e., the sum of Pillar I and Pillar II-R. The recapitalisation amount must be at least equal to minimum required own funds. It is typically supplemented by a so-called market confidence charge (MCC), which is equal to the combined capital buffer requirement with a haircut based on an assessment carried out by EEA resolution authorities. It is permissible to adjust the recapitalisation amount to accord with the estimated likely size of the balance sheet should the institution be placed in resolution. The recapitalisation amount is zero (0) for financial undertakings that undergo conventional winding-up proceedings and for institutions where the preferred resolution action entails the application of measures other than the bail-in tool.

The aim is to determine financial undertakings' MREL requirements for the first time at the beginning of 2022, and for those requirements to take effect at that time. Institutions that do not satisfy the MREL requirements in full will be granted a reasonable transition period in order to comply with the requirements. The implementation of the second Bank Recovery and Resolution Directive (BRRD II) in Iceland in the coming term will affect the Central Bank of Iceland Resolution Authority's MREL Policy.

Highlights of the Central Bank of Iceland Resolution Authority's MREL requirements

- The loss absorption amount (LAA) will be equivalent to minimum required own funds (Pillar I and Pillar II-R).
- Financial undertakings will be notified of their MREL requirements excluding the combined capital buffer requirement and must satisfy the latter alongside the MREL.
- The recapitalisation amount (RCA) will be equivalent to minimum required own funds.
- The value of the total risk exposure amount (TREA) upon calculation of the proportional recapitalisation amount may be adjusted (reduced) based on the probable balance sheet size position of the financial institution that is failing or likely to fail.
- It will be permissible to satisfy the recapitalisation amount using common equity Tier 1 capital or other capital instruments in excess of total required own funds.
- At the present time, no market confidence charge (MCC) will be levied in Iceland.
- Financial undertakings in Iceland must satisfy requirements concerning eligible liabilities and subordination at any given time, and they must consider the changes that accompany BRRD II.
- The Resolution Authority urges financial undertakings to acquaint themselves with the conditions for the grant of a longer MREL transition period for individual institutions.
- A more detailed summary can be found on pages page 19.

1 MREL stands for *Minimum Requirement for Own Funds and Eligible Liabilities*.

II Legal framework[2]

Chapter IV of the Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020, discusses minimum requirements for own funds and eligible liabilities (MREL or MREL requirements).[3] MREL requirements entail that, in addition to total required own funds[4] (i.e., in addition to the Central Bank's capital buffers and the minimum required own funds), the composition of a financial institution's funding must be sufficient both for loss absorption and for recapitalisation should the institution be failing or likely to fail. The Central Bank of Iceland Resolution Authority determines MREL requirements in accordance with Article 17 of Act no. 70/2020, with reference to the activities and position of each individual financial institution, and with an eye to achieving the objectives of resolution according to Article 1 of the Act.[5] Furthermore, the methodology for MREL calculation has been harmonised within the European Economic Area (EEA) with the adoption of Commission Delegated Regulation (EU) 2016/1450.[6]

2.1 The Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020

Chapter IV of Act no. 70/2020 covers MREL. MREL entail a defined and separate minimum ratio of funds (i.e., own funds and liabilities) that banks must satisfy at all times. By law, MREL are presented as the amount of specified eligible liabilities and own funds as a proportion of total liabilities and own funds. On the other hand, MREL are calculated as a proportion of the total risk exposure amount (TREA) according to Article 84(e) of the Act on Financial Undertakings, no. 161/2002. The Resolution Authority determines the separate proportion in accordance with Article 17, Paragraphs 1-3 of Act no. 70/2020.

In order for liabilities to be considered *qualified* for MREL, they must satisfy certain requirements. They must be considered *eligible liabilities*; i.e., financial instruments or obligations that are not part of own funds and are not excluded from bail-in according to Article 56 of Act no. 70/2020. In addition, they must satisfy six requirements laid down in Article 17, Paragraph 2 of the Act. Among key requirements, the liabilities must be paid in, and they may neither be liabilities owed to the financial institution itself nor be guaranteed by or otherwise the responsibility of the financial institution itself. Furthermore, they must not be funded directly or indirectly by the institution itself. The remaining maturity must be at least one year. Further discussion of eligible liabilities can be found in Section 4 of this Policy.

The Resolution Authority makes the final decision on MREL for each financial institution; cr. Article 17, Paragraph 3 of Act no. 70/2020. The decision must be based on the following points, at a minimum:

1. The institution can be resolved with appropriate resolution actions, including bail-in if appropriate, applied in a manner that achieves the objectives of resolution according to Article 1.
2. The institution's eligible liabilities are sufficient to ensure that, upon application of the bail-in tool, its loss absorbency will be adequate and the CET1 capital ratio can be restored so that the institution satisfies the requirements for an operating licence and retains market confidence.
3. The institution's eligible liabilities, other than those that could fall outside the scope of the bail-in tool according to Article 56, Paragraph 2 or those that could be transferred as a whole according to the institution's resolution plan, are sufficient to ensure

2 All legal authorisations in effect at any given time concerning MREL, the application of resolution measures, and the activities of the Central Bank of Iceland Resolution Authority can be found on the Resolution Authority website.

3 For purposes of simplification, this policy generally uses the acronym MREL instead of the legal term *minimum requirement for own funds and eligible liabilities*. This applies not least to discussions of the minimum requirement as a ratio, or MREL requirements, as regards total requirements relating to MREL; i.e., the ratio together with, for example, conditions pertaining to eligible liabilities.

4 In this MREL Policy, the discussion and use of terminology on financial undertakings' capital requirements is consistent with that in the *Guidelines for common procedures and methodologies for the supervisory review and evaluation process* (SREP Guidelines) issued by the Central Bank of Iceland Financial Supervisory Authority. Further information can be found here.

5 In the discussion of MREL in this policy, the term "financial institution" is used as a blanket term for entities to which MREL apply, even though MREL could apply to credit institutions, larger investment firms, and certain holding companies or other sub-consolidated entities of these institutions.

6 The Regulation was implemented in Iceland with the adoption of Rules no. 666/2021 on the entry into effect of EU regulations on technical standards for the resolution and recovery of credit institutions and investment firms; cf. Article 1(d) of the Rules.

that its loss absorbency will be adequate and the CET1 capital ratio can be restored so that the institution satisfies the requirements for an operating licence.

4. The institution's size, business model, funding model, and risk profile.
5. The extent to which the Depositors' and Investors' Guarantee Fund (TIF) could participate in financing resolution according to Article 82.
6. The impact of the insolvent institution on financial stability, including the impact due to its interconnectedness with other credit institutions or investment firms, or with other parts of the financial market.

The decision on MREL shall therefore take into account that the requirement is intended to support resolution actions, if applicable. The decision shall also take into account that if bail-in is applied, the financial institution must have sufficient eligible liabilities to ensure that its loss absorbency will be adequate and its own funds can be restored so that the institution satisfies the requirements for an operating licence.

Furthermore, the decision on MREL shall take into account the institution's size, business model, funding model (i.e., how it handles its funding), and its risk profile. Moreover, the decision shall take into account TIF's involvement in financing resolution. Finally, the decision shall take into consideration the impact on financial stability should the institution become insolvent. To this end, consideration shall be given to interconnectedness with other financial undertakings or even with other parts of the financial system, and to potential contagion among institutions.

During the run-up to such a decision, the Central Bank Resolution Authority must consult with the Central Bank Financial Supervisory Authority; cf. Article 4, Paragraph 3 of Act no. 70/2020.

2.2 Commission Delegated Regulation (EU) 2016/1450 on regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities

Harmonised criteria for the calculation of MREL are set forth in Commission Delegated Regulation (EU) 2016/1450 (the MREL Regulation), which was implemented in Iceland with the adoption of Rules no. 666/2021 at the beginning of June 2021. The MREL Regulation presents technical standards laid down by the European Banking Authority (EBA) and used to determine MREL ratios. According to the MREL Regulation, the Resolution Authority has some scope, albeit limited, to conduct its own assessment and take decisions on individual elements of MREL.

The MREL Regulation determines the elements of own funds requirements that must be considered when MREL are set; i.e., the loss absorption amount (Article 1 of the Regulation) and the recapitalisation amount (Article 2). The Regulation also specifies (Articles 3-6) that the Resolution Authority shall assess and determine MREL based on the following:

- Whether any specific liabilities will be explicitly excluded from bail-in on the basis of the authorisation in Article 56, Paragraph 2;
- The institution's risk profile, business model, and funding structure;
- The institution's size and systemic risk; and
- The resolution financing contribution from TIF.

It can be construed from Articles 1 and 2 of the MREL Regulation that the point of departure for the methodology is that the minimum MREL ratio must be equal to double the overall requirement for own funds. The ratio is intended to ensure that if an institution is failing or likely to fail, it can continue to operate following bail-in and will satisfy the same requirements as were made of it before it failed. On the other hand, the Regulation offers options for adjusting amounts, provided that certain conditions are satisfied. This applies to both the loss absorption amount and the recapitalisation amount.

On the basis of Article 1, Paragraph 5 of the MREL Regulation, it is possible, among other things, to adjust the loss absorption amount to a level above or below the total own funds requirement. It is also possible to segregate macroprudential risks from the loss absorption amount if they are Pillar II-R requirements set by the Central Bank Financial Supervisory Authority. And finally, it is possible to segregate capital buffers, partly or in full, from the loss absorption amount.

On the basis of Article 2, Paragraphs 8 and 9 of the MREL Regulation, it is possible to adjust the recapitalisation amount. Thus the market confidence charge, which should generally be equal to the combined capital buffer requirement, may be lower if it is ensured that the institution's critical functions can continue without interruption and that the institution's post-resolution funding will be stable. In addition, the recapitalisation amount may be lower on the grounds that all or some

currently applicable Pillar II-R requirements or capital buffer requirements will no longer apply after resolution. It is also permissible under Article 2 of the Regulation to adjust the value of TREA. Among European countries, the adjustment commonly equals about 10% of TREA.

2.3 BRRD II and further amendments to legislation on resolution

As is mentioned several times in this MREL Policy, it has already become clear that various amendments to MREL requirements and legislation on resolution are in the offing. Directive (EU) 2019/879 on the loss-absorbing and recapitalisation capacity of credit institutions and investment firms, generally referred to as the Bank Recovery and Resolution Directive (BRRD II), has already entered into force within the EU. As the abbreviation suggests, the Directive amends its predecessor, BRRD I, which was implemented in Iceland with the passage of the Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020. In particular, BRRD II harmonises the application of MREL within the EEA as well as empowering resolution authorities to limit firms' maximum distributable amount related to MREL (M-MDA). The implementation and entry into effect of BRRD II goes hand-in-hand with the changes that follow from the Regulation amending Regulation (EU) no. 575/2013 on prudential requirements for credit institutions and investment firms, or the Capital Requirements Regulation (CRR II). CRR II has already taken partial effect in Iceland,[7] but based on Article 1(b) of Regulation no. 749/2021, the parts of CRR II pertaining to eligible liabilities and resolution authorities do not take effect immediately. That will not take place until after BRRD II has been incorporated into the EEA Agreement and into Icelandic law.

Among other changes entailed in BRRD II, capital buffers will not be part of the loss absorption amount in MREL. The capital buffer requirement will be independent and will exist alongside MREL requirements. After BRRD II, it could happen that a financial institution does not satisfy MREL requirements in full, although it does satisfy capital buffer requirements. By the same token, it is possible that an institution satisfies MREL requirements but does not satisfy capital buffer requirements. The methodology regarding the recapitalisation amount in BRRD II is comparable to that provided for in the MREL Regulation, however; cf. Section 2.2 above. The assessment of the adjustment of the amount is based on the same type of criteria. The main difference is that according to BRRD II, the market confidence charge should generally be equal to the combined capital buffer requirement less the countercyclical capital buffer.

7 CRR II took partial effect with the passage of Act no. 44/2021 amending the Act on Financial Undertakings, no. 161/2002, and the adoption of Regulation no. 749/2021 amending the Regulation on Prudential Requirements for Financial undertakings, no. 233/2017.

III MREL: role and methodology

The aim of MREL is to ensure that financial undertakings have sufficient capital to guarantee both loss absorption and recapitalisation should the need arise.8 MREL are therefore intended to ensure that instead of bailing a failed financial institution out using Government funds, it will be possible to bail in and recapitalise it using creditors' funds. A further objective of MREL is to ensure that a financial institution's liabilities are not excluded from bail-in.

The Central Bank Resolution Authority may require that a financial institution's funding – i.e., its own funds and liabilities – equal a specified amount and satisfy specified criteria so as to ensure that the institution can be recapitalised if it fails. MREL requirements thereby have a dual function: they ensure that financial undertakings have adequate loss absorption capacity and that the institutions can be recapitalised. Capital shall be sufficient to respond to the institution's losses and ensure that after the appropriate resolution action is taken, it has enough own funds to retain its operating licence.

3.1 Relationship between MREL and financial undertakings' resolvability assessment and resolution plans

The Resolution Authority determines MREL requirements on an institution-specific basis, and the decision shall ensure that the requirements support the institution's resolution action in accordance with the resolution plan. Although MREL methodology is harmonised within Europe on the basis of the MREL Regulation, decisions are always taken on an institution-specific basis, taking account of the activities and asset portfolio of the institution concerned. Based on the resolution plan for the institution, including the selected resolution strategy, the Resolution Authority takes a decision on that institution's MREL.

MREL are determined with an eye to the preferred resolution action for each institution. The preferred resolution action is selected when the institution's resolvability assessment is prepared, and a decision on it is taken upon approval of the resolution plan. In particular, the preferred resolution action is determined based on which of the institution's critical functions should be protected and an assessment of those functions' substitutability; i.e., whether the functions can be carried out by another financial institution.

Apart from bail-in, it is possible to apply other resolution measures, such as selling part or all of the assets of an institution that is failing or likely to fail. If the institution can be subjected to winding-up proceedings immediately on the basis of the resolvability assessment, or if a decision is made to exclude bail-in as the preferred resolution action according to the resolution plan, this means that the MREL requirements will not exceed the own funds requirements of the institution concerned. Those financial undertakings that do not satisfy the conditions for resolution – for instance, the requirement that resolution be considered necessary in the public interest – are placed in conventional winding-up proceedings pursuant to the Act on Financial Undertakings and will only be required to satisfy general capital requirements; i.e., the total requirement for own funds.

3.2 General information on MREL methodology

If the decision on the preferred resolution action for an institution that is failing or likely to fail entails use of the bail-in tool – i.e., the write-down or conversion of financial instruments – it should be relatively clear what the institution's MREL requirements will be.

The rule of thumb for calculating these requirements without consideration of other resolution actions is that the MREL shall equal at least double the minimum own funds requirement (two times Pillar I and Pillar II). MREL requirements may also equal up to two times the capital buffer requirement.[9] Individual countries within

8 MREL apply to European banks and are based on the Total Loss Absorption Capacity Standard (TLAC Standard), issued by the Financial Stability Board (FSB). Further information on TLAC and minimum loss absorption requirements for global systemically important banks can be found here: FSB website.

9 According to the arrangements provided for in the MREL Regulation, this rule of thumb is relatively clear. It takes a different form in BRRD II. According to BRRD II, own funds that must be held for capital buffers are not included in the calculation of the MREL ratio – the general capital buffer requirement is excluded but is used as a reference in calculating the market confidence charge.

the EEA have used different formulae to determine MREL, however.[10] The double capital buffer requirement takes into account a haircut that differs from one country to another, but because of the requirements laid down in the MREL Regulation on market confidence charges, the haircut cannot be so high that it erodes market confidence or has a negative impact on a financial institution's funding or critical functions. When BRRD I was in effect, the European Single Resolution Board (SRB) set the haircut at 1.25%, but with the entry into effect of BRRD II, the countercyclical capital buffer ratio is excluded from the combined capital buffer requirement.

Other things have changed regarding the double capital buffer requirement in recent years. Under BRRD I, the rule of thumb is that capital buffers are part of the loss absorption amount, which can be raised or lowered; cf. Section 2.2 above. Under BRRD II, however, the rule of thumb is that the combined capital buffer requirement is excluded from MREL; i.e., it is not calculated as part of MREL but is a separate requirement. In essence, then, the combined capital buffer requirement comes on top of MREL under BRRD II, so that it can be used or drawn down. On the other hand, the value of the combined capital buffer requirement is used as a point of departure for determining the market confidence charge and can therefore be part of the recapitalisation amount. As a result, it can generally be said that MREL requirements, whether under BRRD I or BRRD II, depend on the minimum own funds requirement, on the one hand, and how high the capital buffers are, on the other. The total own funds requirement is therefore the main determinant of the final MREL requirement.

3.3 Loss absorption amount

The MREL Regulation assumes that the benchmark for calculating the loss absorption amount shall be presented as the sum of these items:

1. the basic own funds requirement (Pillar I); cf. Article 84 of the Act on Financial Undertakings.
2. the additional own funds requirement set by the financial supervisor (Pillar II); cf. Article 86(g), Paragraph 4 of the Act on Financial Undertakings, and
3. the combined capital buffer requirement pursuant to Chapter X of the Act on Financial Undertakings.

The loss absorption amount may be based on the appropriate requirements for the leverage ratio, however, if they exceed the sum of Items 1-3 above; cf. Article 1, Paragraph 4 of the MREL Regulation. As can be inferred from the items whose sum determines the loss absorption amount, this part of MREL is generally not intended to supersede or affect financial undertakings' own funds requirements. The above-specified items will also be used as a basis for assessing the loss absorption amount after the implementation of BRRD II, with two exceptions. The first exception is that the combined capital buffer requirement is excluded from the assessment of the loss absorption amount and is an independent own funds requirement that actually comes on top of MREL. This is done to ensure loss absorption by ensuring that the institution can draw down its capital buffers in response to losses instead of locking the capital buffers in under MREL requirements. Therefore, financial undertakings will always have to satisfy the combined capital buffer requirement, which will not be part of MREL requirements. The other exception is that after BRRD II, the loss absorption amount will consist of two independent factors, at a minimum: the minimum own funds requirement (Pillar I and Pillar II-R) and the minimum required leverage ratio. Both of these must be satisfied. It could happen, after the implementation of BRRD II, that the Pillar II-G capital buffer will increase the loss absorption amount if the buffer exceeds the total own funds requirement.

3.4 Recapitalisation amount and market confidence charge

It can be inferred from Article 2 of the MREL Regulation that the recapitalisation amount must be able to support the preferred resolution action according to each financial institution's resolution plan. The amount is based on which resolution measures are assumed to be applied in connection with the preferred resolution action. The recapitalisation amount could be zero (0) if the resolvability assessment for the institution suggests that it is both realistic and economical that the institution be placed in conventional winding-up proceedings; i.e., if it is not assumed that the institution will undergo resolution. For such institutions, MREL will be equal to the loss absorption amount. For financial undertakings that undergo resolution, the recapitalisation amount will consist of two factors:

1. The amount that is required, after the implementation of the preferred resolution action, to enable

10 In this context, it is worth noting that under BRRD I, Denmark, Norway, and Sweden have all created their own versions of the MREL formula. Their point of departure was that MREL should be approximately double the total capital base requirement (i.e., Pillar I x 2, Pillar II x 2, and capital buffers x 2).

the institution to satisfy the minimum own funds requirement and the appropriate leverage ratio requirement, without any capital buffer requirement; and

2. an additional amount that the resolution authority considers adequate to maintain market confidence following resolution. This amount shall be equal to the combined capital buffer requirement that will apply following resolution. However, the market confidence charge may be lower than the combined requirement (although not lower than zero) if the resolution considers the amount sufficient to maintain market confidence, support critical functions, and ensure adequate funding for the institution.

The above-specified items will also be used as a basis for assessing the recapitalisation amount after the implementation of BRRD II, with one exception. After BRRD II, the recapitalisation amount will consist, at a minimum, of two independent factors: the minimum own funds requirement (Pillar I and Pillar II-R) and the minimum required leverage ratio. Both of these must be satisfied simultaneously, and in addition to the same requirements for the loss absorption amount. It could transpire, after the implementation of BRRD II, that the Pillar II-G capital buffer will increase the recapitalisation amount if the buffer exceeds the total own funds requirement.

The market confidence charge is the MREL factor that has been the most variable, at least under BRRD I. It is a subjective factor that resolution authorities have been able to determine based on specific ground rules laid down in the MREL Regulation. For instance, in Denmark, the market confidence change has been equal to the combined capital buffer requirement with no haircut, whereas the Single Resolution Board, Norway, and Sweden have applied a haircut. The Single Resolution Board's methodology based on BRRD I assumed that the market confidence charge would be the combined capital buffer requirement, less 1.25% of TREA.[11] In Norway, the corresponding haircut was the countercyclical capital buffer value at any given time.[12] In Sweden, the capital buffers were not included in the market confidence charge portion of the recapitalisation amount, but offsetting this, Swedish banks were prohibited from using retained earnings to satisfy MREL requirements.[13] In the UK, it was decided not to impose a market confidence charge.[14]

Since the entry into force of BRRD II, the market confidence charge has been relatively standardised within the EEA. The general rule is that the market confidence charge is equal to the combined capital buffer requirement, less the countercyclical capital buffer value at any given time. Nevertheless, resolution authorities are still authorised to adjust that amount upwards or downwards, provided that it is ensured that the market confidence charge: i) maintains market confidence; ii) can sustain critical functions; and iii) can guarantee short-term funding; i.e., until access to market funding opens up again (12 months).

3.5 Other criteria relating to MREL

The Central Bank Resolution Authority may lower MREL requirements to reflect the amount that TIF could contribute in order to finance resolution based on the preferred resolution action. The amount shall be calculated based on the rules applying to restrictions on payments from deposit insurance schemes pursuant to BRRD; cf. Article 82 of Act no. 70/2020; cf. also Article 6 of the MREL Regulation.

The Resolution Authority is also intended to ensure that MREL are sufficient, given that certain liabilities could be excluded from bail-in on the basis of Article 56, Paragraph 2 of Act no. 70/2020, or that they may be disposed of via other resolution measures (asset sales); cf. Article 3 of the MREL Regulation. The assessment of whether MREL are sufficient is carried out, on the one hand, by determining whether the liabilities in question satisfy the requirements of Article 56, Paragraph 2 of Act no. 70/2020 and therefore cannot support the institution's loss absorption and recapitalisation, and on the other hand, by determining whether excluding or transferring liabilities, irrespective of whether they can be included in MREL, could be in breach of the "no creditor worse off" (NCWO) rule. Under the "no creditor worse off" rule, resolution of a financial institution may not put any creditor in a weaker position than it would have been in had the institution undergone con-

11 Further information on the Single Resolution Board's methodology under BRRD I can be found here: here. Information on the Single Resolution Board's methodology under BRRD II can be found here..

12 Further information on the methodology used by Finanstilsynet in Norway can be found here: here.

13 The methodology used by Riksgälden in Sweden changed in 2021, but the method under BRRD I entailed not applying a market confidence charge; i.e., not including it in the recapitalisation amount. Further information on the methodology used by Riksgälden in Sweden under BRRD II can be found here.

14 Further information on the methodology used by the Bank of England to determine MREL can be found here: here.

ventional winding-up proceedings. In addition, upon determining MREL for systemically important financial undertakings, cf. Article 5 of the MREL Regulation, the Central Bank Resolution Authority will take into account Articles 56-57 of Act no. 70/2020 as a whole, including as regards funding from a resolution fund because of liabilities that are excluded from bail-in.

The Central Bank Resolution Authority is intended to ensure that financial undertakings' MREL are sufficient at all times to allow for the use of the bail-in tool and the preparation of a timetable for the regular update of MREL. The general rule is that at the time MREL are determined, the requirements shall be sufficient for the execution of the preferred resolution action. On the other hand, the Resolution Authority is authorised to grant financial undertakings a transition period to satisfy MREL requirements; cf. Articles 7 and 8 of the MREL Regulation. The transition period shall be as short as possible. If this authorisation is exercised, the Resolution Authority will inform the institution in question what the proposed MREL value will be once the transition deadline has passed, including what requirements must be satisfied within twelve months of the MREL decision.[15]

15 The rules on transition periods changed somewhat with BRRD II; i.e., certain final deadlines for satisfaction of MREL requirements will apply to financial undertakings within the EEA. For further information, see Sections 5.5 and 6.2.

IV Eligible liabilities

MREL entail requirements regarding the amount of own funds and eligible liabilities. This is vital in order for an institution to be considered resolvable, but it does not guarantee resolvability. In order to guarantee resolvability, it must be ensured that own funds and liabilities can be used for loss absorption and recapitalisation in accordance with the preferred resolution strategy selected by the resolution authority. Because of this, MREL requirements lay down conditions that financial undertakings must satisfy as regards liabilities, so that they will be deemed both eligible and qualified. This section of the Central Bank Resolution Authority's MREL Policy focuses on the difference between the requirements for eligible liabilities and qualified eligible liabilities. It also discusses the Resolution Authority's position on issues relating to eligible liabilities, particularly as regards subordination and the possibility of using unsecured (i.e. senior preferred) debt instruments to satisfy MREL requirements, both before and after the implementation of BRRD II in Iceland.

4.1 Definitions and excluded liabilities

The term "eligible liability" is defined in a broad sense in Article 3, Paragraph 1, Item 18 of the Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020. In order for liabilities to be considered eligible, they must satisfy two main conditions:

1. They must be financial instruments that do not comprise the capital base (own funds) as provided for in the Act on Financial Undertakings; and
2. They must not be exempted from bail-in, or the Resolution Authority has not expressly exempted them from bail-in according to Article 56, Paragraph 2 of Act no. 70/2020.

In order for eligible liabilities to be considered *qualified* eligible liabilities and therefore used to satisfy MREL, they must also satisfy the following six conditions; cf. Article 17 of Act no. 70/2020.

1. The financial instrument must be issued and fully paid in.
2. The liability shall not be owed to the financial institution, nor shall it have been guaranteed by the institution.
3. The purchase of the financial instrument may not have been financed directly or indirectly by the institution.
4. The residual maturity of the liability must be at least one year. The residual maturity of a liability that provides for the right to demand reimbursement before the end of the contract period shall be based on the date such a right first becomes exercisable.
5. The liability may not arise from a derivative.
6. The liability may not arise from a deposit balance that enjoys priority in the claim hierarchy pursuant to Article 85(a), Paragraph 1, Item 1(a) or 1(b) of Act no. 70/2020.

The aforementioned conditions relating to eligible liabilities are based on BRRD I. After BRRD II and CRR II take effect in Iceland, the definition of eligible liabilities changes slightly. The term "liabilities eligible for bail-in" is defined in BRRD II but is neither used nor defined in BRRD I, although it is clear that the term covers liabilities that are not excluded on the basis of Article 44 of the Directive. After CRR II takes effect, the conditions for liabilities to be considered qualified and eligible will change significantly, as they will increase in number and be far more detailed. For example, all of the 14 criteria listed in Article 72(b) of CRR II and labelled (a)-(n) must be met in order for liabilities to be considered eligible. Furthermore, more liabilities are excluded from MREL, cf. Article 72(a) of CRR II, than are excluded under Article 45 of BRRD I.

Liabilities that are excluded from bail-in are listed in Article 56, Paragraph 1 of Act no. 70/2020. It is prohibited to apply bail-in to the following liabilities:

1. Guaranteed deposits pursuant to the Act on Deposit Guarantees and an Investor-Compensation Scheme.
2. Collateralised liabilities, including covered bonds, pursuant to the Act on Covered Bonds, and financial instruments that are intended for hedging and included in a collateral portfolio and that enjoy the same legal protections as covered bonds.
3. Liabilities arising from assets that the institution or unit administers on behalf of its customers, including the assets of investment funds and alternative

investment funds – cf. the Act on Investment Funds and the Act on Alternative Investment Fund Management Companies – and are protected pursuant to Article 109 of the Act on Bankruptcy, Etc.

4. Liabilities arising from a custodial relationship between the institution or unit and a rights holder, provided that the rights holder is protected pursuant to Article 109 of the Act on Bankruptcy, Etc., or other legislation.
5. Liabilities falling due within seven days and owed to companies other than those in the same group.
6. Liabilities falling due within seven days and owed to payment and settlement systems (cf. the Act on the Security of Transfer Orders in Payment Systems and Securities Settlement Systems) or to participants in such systems, and deriving from their participation in those systems.
7. Liabilities owed to employees, including accrued unpaid wages, pension fund premiums, accrued vacation pay and other employment-related items, but excluding bonuses unless they are provided for in general wage agreements.
8. Accounts payable due to the purchase of goods and services that are necessary for the institution or unit's day-to-day activities.
9. Liabilities owed to the tax authorities and the social security scheme if they enjoy priority in the insolvency hierarchy.
10. Unpaid contributions to the Depositors' and Investors' Guarantee Fund (TIF); cf. the Act on Deposit Guarantees and an Investor-Compensation Scheme.

Furthermore, the Central Bank Resolution Authority may exclude liabilities other than those listed in the provision on the basis of Article 56, Paragraph 2 of Act no. 70/2020; for instance, if it is not possible to apply the bail-in tool vis-à-vis the liability within a reasonable length of time. In taking such a decision, the Resolution Authority consults the criteria laid down in Commission Delegated Regulation (EU) 2016/860; cf. Regulation no. 95/2021 on the entry into force of EU regulations on resolution procedures for credit institutions and investment firms.

4.2 Subordination

When BRRD II takes effect in Iceland, a certain portion of eligible liabilities will have to be subordinated; i.e., they will have to rank below those liabilities that are excluded from MREL and bail-in. It is worth noting that the current legislative framework provides flexibility concerning how large a portion of liabilities is subordinated, but after BRRD II takes effect, it will be clearer and perhaps narrower. The requirements for subordination pursuant to BRRD II differ according to financial institution type and size. The rule that will probably apply to institutions in Iceland is that subordination due to own funds and liabilities should total a minimum of 13.5% of the total risk exposure amount(TREA), plus the combined capital buffer requirement.

With the passage of Act no. 38/2021, as regards the claim hierarchy during resolution and winding-up, it became clear that deposits take priority over senior preferred debt instruments upon the failure of a financial institution. The passage of Act no. 38/2021 incorporated Directive (EU) 2017/2399 into Icelandic law. The law and the directive provide for the ranking of senior non-preferred debt instruments in the claim hierarchy during resolution and winding-up, as well as setting requirements for their issuance. Senior non-preferred debt instruments must satisfy all of the following conditions:

- The original contractual maturity must be at least one year.
- The instruments in question must not be derivatives or contain embedded derivatives.
- Their ranking in the claim hierarchy must be provided for in the contractual terms and provisions and in the prospectus for the issue, if applicable.

In view of the claim hierarchy provided for in the legislation on resolution of credit institutions and investment firms, senior preferred debt instruments can satisfy the subordination requirement, provided that using them for bail-in will not constitute a breach of the "no creditor worse off" rule laid down in BRRD I. In other words, senior preferred debt instruments are not considered to belong to the portion of MREL requirements entailing subordination under BRRD II, but they can be included with MREL. The ranking of deposits in the claim hierarchy in Icelandic law makes it realistic to include senior preferred debt instruments with MREL requirements in Iceland. In general, the amount of those liabilities that are equal in rank to senior preferred debt instruments in the claim hierarchy is not high among Icelandic financial undertakings. If the amount of liabilities equal in rank to senior preferred debt instruments is less than 5% of own funds and eligible liabilities, it is possible that an institution in Iceland could include such senior preferred debt instruments with MREL. Further information is contained in Section 5.4 of this document.

V The Central Bank of Iceland's MREL requirements

As can be inferred from Sections 2-4, resolution authorities within the EEA are granted some flexibility in determining MREL requirements. To summarise, this flexibility lies mainly in the following:

- Decisions on the application of resolution measures, particularly the determination of whether bail-in is the preferred resolution action.
- The risk profile, funding model, and business model of each institution.
- The loss absorption amount and recapitalisation amount (including the market confidence charge) and their interaction with capital buffer values and additional capital requirements made by the Central Bank Financial Supervisory Authority (Pillar II).
- Subordination and the determination of which liabilities can be included with MREL.
- Deadlines for satisfaction of MREL requirements.

In this section of the MREL Policy, the aim is to present the Central Bank's position on these points, so that financial undertakings will be as well informed as possible of the requirements that will be made of them in the determination of MREL. The point of departure for MREL determination is, and will be, that the ratio must be high enough to ensure that it will be possible to apply the preferred resolution action as presented in each institution's resolution plan.

5.1 Application of resolution measures and classification of institutions with respect to MREL

The Central Bank Resolution Authority is of the view that, in general, bail-in is the resolution action most likely to be applied upon resolution of financial undertakings in Iceland. Applying the bail-in tool serves the general purposes of resolution as laid down in the Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020, more effectively than other resolution measures do; i.e., measures entailing the full or partial distribution of an institution's assets or operations with the participation of an asset management company or the establishment of a bridge bank during resolution. Bail-in can ensure the swift and efficient recapitalisation of an institution that is failing or likely to fail. As a result, it is most realistic and most likely, if an institution in Iceland should be failing or likely to fail, that bail-in will be used to restore the institution's financial position. The Resolution Authority points out, however, that financial undertakings' resolution plans generally include not only the preferred resolution action but also various versions of resolution measures, including the application of other resolution measures under differing scenarios.

The Central Bank Resolution Authority's methodology in applying the bail-in tool entails placing financial undertakings into three broad categories:

- **Category 1** – This category includes institutions whose business model, activities, risk profile, and funding model assume that simple bail-in will be the preferred resolution action. The MREL requirements for these institutions are generally determined on the assumption that bail-in will be the only resolution action taken.
- **Category 2** – This category includes institutions for which a mixed approach to resolution is possible. This implies that it could be considered realistic and economical, in terms of the objectives in the Act on Resolution of Credit Institutions and Investment Firms, to sell operations or dispose of part or all of the institution's assets in addition to using the bail-in tool. One of the main conditions for this classification is that only a portion of the bank's activities – i.e., the part where critical functions take place – will be recapitalised, while other operations will be sold. In general, MREL requirements for these institutions will be lower than for Category 1 institutions.
- **Category 3** – This category includes institutions that do not satisfy the conditions for resolution – i.e., because resolution does not ensure that the objectives of the Act on Resolution of Credit Institutions and Investment Firms will be achieved more effectively than with conventional winding-up proceedings, or because resolution is not

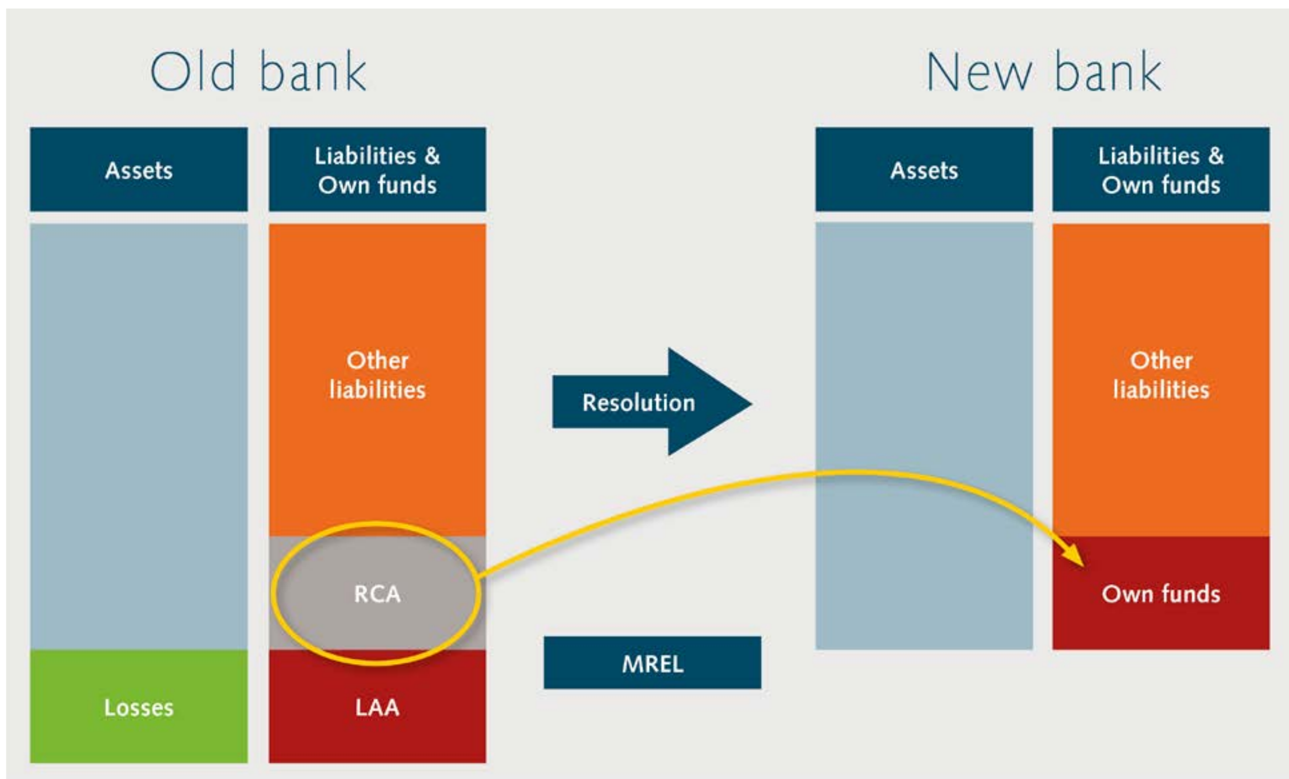

Chart 1. MREL requirements are intended, among other things, to ensure that financial undertakings always have sufficient funds to recapitalise their activities if they are failing or likely to fail. The chart illustrates the relationship between MREL requirements and the application of the bail-in tool.

considered necessary in the public interest. For these institutions, the recapitalisation amount will be zero and there will be no MREL requirements over and above the ordinary own funds requirements for such institutions.

The aforementioned methodology takes into account the execution and policy formulation in neighbouring countries, particularly the Nordic countries and the UK. It can be assumed that institution that satisfy the requirements for submittal of simple recovery plans and for which simple resolution plans are prepared will be placed in Category 3. As regards other institutions, the business plan, activities, risk profile, and funding model will determine in each instance whether the institution is placed in Category 1 or Category 2, provided that critical functions take place in the institution and/or that it could be necessary to take resolution action, cf. Article 35, Paragraph 1 of Act no. 70/2020.

The Central Bank Resolution Authority's MREL Policy and the MREL requirements that will be made of financial undertakings in Iceland entail, all else being equal, that resolution will involve a single point of entry (SPE) approach rather than a multiple point of entry (MPE) approach. This implies that the decision to apply resolution measures at the group level will be taken only by the Resolution Authority in Iceland, without the involvement of resolution authorities elsewhere in the EEA. All else being equal, the activities and structure of Icelandic financial undertakings are such that the Central Bank Resolution Authority alone will prepare a resolution plan and take decisions on the application of resolution measures for Icelandic financial undertakings; no resolution colleges will be involved. If the structure and operating environment should change in this respect, the Central Bank MREL Policy will be reviewed so as to address new issues that could arise.

5.2 Position on the loss absorption amount and recapitalisation amount

5.2.1 Loss absorption amount

The loss absorption amount corresponds to the overall requirement for own funds. The Central Bank Resolution Authority is authorised to raise or lower the default loss absorption amount; cf. Article 1, Paragraph 5 of the MREL Regulation. The Resolution Authority's position is to leave the basic elements of the default amount unchanged; i.e., the minimum own funds requirement (Pillar I and Pillar II-R). This position is consistent with the practice in comparison countries, including that pursued by the Nordic countries and the Single Resolution Board

according to the MREL methodology laid down in BRRD I. It is worth noting that the Resolution Authority's power to adjust the default loss absorption amount will change with BRRD II, whereupon the amount will always be equal to the minimum own funds requirement.

On the other hand, the Resolution Authority considers it appropriate to lower the default loss absorption amount, cf. Article 1, Paragraph 5, Item (b) of the MREL Regulation, because the combined capital buffer requirement is not to be included with MREL in Iceland. This approach is based on the practice pursued in Sweden in connection with MREL methodology under BRRD I. Financial undertakings in Iceland are still required to satisfy the combined capital buffer requirement, and it will not be permitted to include CET1 capital with MREL, even though it is considered part of the combined capital buffer requirement. With this approach, the flexibility provided for in the current MREL methodology under BRRD I is used to lay the foundations for the implementation of MREL methodology under BRRD II. In addition, this approach ensures that own funds accumulated for capital buffers are not locked in with MREL but can be used to cover losses; cf. the discussion in Section 3.3 above. The Central Bank Resolution Authority therefore intends to calculate the loss absorption amount – and therefore the overall MREL requirement – without the combined capital buffer requirement currently in effect. Financial undertakings will be notified of their MREL requirements without the combined capital buffer requirement and must make plans to satisfy the latter alongside the MREL.

5.2.2 Recapitalisation amount

The recapitalisation amount is based on a financial institution's capital requirement after the application of the preferred resolution action. The default recapitalisation amount is the minimum own funds requirement (Pillar I and Pillar II-R). To that amount it is possible to add a market confidence charge that is equivalent to the combined capital buffer requirement. The Central Bank Resolution Authority is authorised to lower the recapitalisation amount, both the default portion and the combined capital buffer requirement; cf. Article 2, Paragraphs 8 and 9 of the MREL Regulation. The Resolution Authority's position is to leave the default amount unchanged; i.e., equal to the minimum own funds requirement. The Resolution Authority's position on the market confidence charge is covered in Section 5.3. It should be noted that the Resolution Authority's power to adjust the default loss absorption amount will change with BRRD II, in that there will be greater flexibility, and it will be possible to raise or lower the default portion of the recapitalisation amount. Until BRRD II takes effect in Iceland, it is not assumed that the Resolution Authority's position on the default portion will change; however, the Authority will review its position after BRRD II takes effect.

In determining MREL requirements, the proportional recapitalisation amount will be set based on the latest data on the institution's TREA. On the other hand, the Resolution Authority will, as applicable, adjust the value of TREA in its determination of the proportional recapitalisation amount, cf. Article 2, Paragraph 9 of the MREL Regulation, so as to reflect the institution's probable balance sheet position when it is failing or likely to fail. When an institution fails, it is likely that measures taken, such as remedial actions and other measures outlined in recovery plans, will have the effect of shrinking the institution's balance sheet. It is also likely that loan losses will affect a financial institution's balance sheet, particularly when credit risk is prominent in its activities. The greater the weight of credit risk in a financial institution's own funds requirements, the greater the likelihood that the recapitalisation amount will be adjusted. Adjustment of TREA is limited to an amount equal to the total own funds requirement, and it should never exceed 10% of total assets. The Resolution Authority determines this adjustment of the recapitalisation amount in each specific instance.

The Central Bank Resolution Authority will not require that the recapitalisation amount be satisfied with specific liabilities other than CET1 or other capital instruments that the financial institution holds in excess of total required own funds. Therefore, institutions can use CET1 or other capital instruments in excess of minimum requirements and capital buffers to satisfy requirements relating to the recapitalisation amount. This position taken by the Resolution Authority is consistent with the strategy followed by most neighbouring countries within the EEA, apart from Sweden. On the other hand, financial undertakings must consider the need to issue new liabilities or take other measures so as to have sufficient eligible liabilities to satisfy MREL requirements, particularly if they draw down their CET1 capital or other capital instruments in excess of the aforementioned requirements.

5.2.3 Other adjustments to loss absorption and recapitalisation amounts on the basis of the MREL Regulation

The Resolution Authority's MREL requirements will take into account that in Iceland, the concepts of eligible liabil-

ities and liabilities suitable for bail-in have yet to be harmonised with the requirements applying under BRRD II. Thus the framework that determines which liabilities can be used for bail-in or included with MREL in Iceland is still broader than it will be in the near future. Particularly applicable in this context are derivatives and debt instruments with embedded derivatives. Adjustments of MREL based on Article 3 of the MREL Regulation – i.e., whether specific liabilities will be explicitly excluded from bail-in (see Section 2.2) – will be made in light of the fact that BRRD II has yet to be implemented in Iceland. The adjustments that are permissible will therefore be calculated with reference to the requirements laid down in BRRD II.

The Central Bank Resolution Authority is authorised to adjust MREL to reflect estimated contributions from TIF during resolution of a financial institution; cf. Article 6 of the MREL Regulation and Section 3.5 above. The Resolution Authority's position is to refrain from adjusting MREL to reflect this provision. This is because of the ranking of guaranteed deposits in the claim hierarchy and the improbability that a contribution from TIF will be called for during resolution of a financial institution. It is also because such an adjustment is permissible under BRRD I but will no longer be authorised once BRRD II has been implemented in Iceland.

5.3 Position on the market confidence charge

As is provided for in Article 2, Paragraph 7 of the MREL Regulation, a charge to ensure market confidence after resolution shall be part of the recapitalisation amount if the resolution authorities consider it necessary. This amount is generally equivalent to the capital buffers but may be lower, depending on the funding structure and risk profile of the financial institution concerned; cf. Article 17, Paragraph 3, Item 4 of Act no. 70/2020; cf. also Article 2, Paragraph 9 of the MREL Regulation.

The Central Bank Resolution Authority's position is that there is no need at this time to levy a market confidence charge on Icelandic financial undertakings. Icelandic financial undertakings are already bound by stringent own funds requirements, and they all use the standardised approach to calculate TREA. One result of this is that their leverage ratios are high in comparison with peer credit institutions abroad – in the Nordic countries, for instance. Based on Icelandic credit institutions' current funding and position, it is not deemed necessary to levy a market confidence charge.

The Central Bank Resolution Authority will need to update its MREL Policy when BRRD II is implemented in Iceland. When that update is made, the Resolution Authority will review its position on the market confidence charge. The Resolution Authority will also review this position as it deems such review warranted; for instance, in the event of a change in Icelandic financial undertakings' own funds requirements or funding, or in the event of material changes in their business model or risk profile, including increased activity in other EEA member states.

5.4 Position on subordination and eligible liabilities

In general, MREL requirements comprise, on the one hand, the requirement that institutions hold a specified minimum proportion of own funds and eligible liabilities so as to ensure that the preferred resolution action will be successful if resolution takes place, and on the other hand, certain conditions pertaining to eligible liabilities. This section of the MREL Policy focuses on the requirements that will be made of eligible liabilities. In general, it can be said that these requirements will change somewhat in the foreseeable future, as the implementation of BRRD II in Iceland is imminent but not yet complete. In addition to the requirements discussed in Section 4 above, the Central Bank Resolution Authority considers it appropriate to stress the requirements that are forthcoming, so as to prevent Icelandic financial undertakings that already satisfy the requirements under BRRD II from making changes that might result in their no longer satisfying them. Important forthcoming requirements relating to eligible liabilities follow in particular from Articles 72(a) and 72(b) of CRR II.

5.4.1 Subordination

Subordination requirements relating to MREL – i.e., that certain liabilities to be used for bail-in rank below liabilities excluded from MREL and bail-in – were not harmonised under BRRD I. Therefore, according to the current legislation, the Resolution Authority has the latitude to determine subordination requirements on an institution-specific basis. After BRRD II takes effect in Iceland, financial undertakings that undergo resolution must satisfy a specified share of MREL requirements with subordinated instruments, cf. Section 4.2 above, as the objective of such requirements is to ensure that bail-in will proceed smoothly during resolution. Applying bail-in to liabilities could lead to legal action during resolution if it entails discrimination against creditors whose claims rank equally (*pari passu*) vis-à-vis those to which bail-in is applied. As a result, it is vital to ensure that the "no

creditor worse off" rule (Sections 3.5 and 4.2) is applied during the bail-in process. The subordination requirement is intended to place limits on this risk. With the passage of Act no. 38/2021 amending the Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020, the claim hierarchy for resolution and winding-up of financial undertakings and Iceland was clearly stipulated.

The subordination requirements under BRRD II will require that financial undertakings in Iceland decide whether to continue issuing senior preferred securities or shift to senior non-preferred issuance. The Resolution Authority takes the view that senior preferred securities can be used to satisfy MREL requirements at least until 1 January 2024, the deadline for satisfaction of MREL requirements under BRRD II (see also Section 6.2 below). Financial undertakings in Iceland must be prepared for the deadline not to be extended beyond this date, but this will be clarified in the coming term, with the incorporation of BRRD II into the EEA Agreement.

The Resolution Authority therefore stresses that BRRD II and CRR II assume that there will be ways to grant financial undertakings flexibility in satisfying subordination requirements. This flexibility lies both in authorisations to extend deadlines for individual institutions and in provisions allowing for the inclusion of senior preferred securities with MREL.

The former of these points is provided for in Article 45(m) of BRRD II, which authorises resolution authorities to grant individual financial undertakings an extension based on the financial position of the institution concerned, plus a clear and realistic timetable for satisfying MREL requirements within a reasonable time frame and replacing liabilities that do not meet subordination requirements, in addition to other requirements made of eligible liabilities under BRRD II.

The latter points are covered in Article 72(b), Paragraphs 3 and 4 of CRR II. Article 72(b), Paragraph 3 authorises resolution authorities to permit a specified maximum proportion of senior preferred securities (3.5% of TREA) that may be used to satisfy MREL requirements, provided that they meet all of the criteria for eligible liabilities pursuant to Article 72(b), Paragraph 1 of CRR II other than that they be subordinated to liabilities excluded from MREL and bail-in. Article 72(b), Paragraph 4 authorises resolution authorities to permit inclusion of senior preferred securities with MREL, provided that they meet all of the criteria for eligible liabilities pursuant to Article 72(b), Paragraph 1 of CRR II, other than the requirement that they be subordinated to liabilities excluded from MREL and bail-in, insofar as excluded liabilities of equal rank do not constitute more than 5% of the institution's own funds and eligible liabilities. Resolution authorities are only permitted to grant exemptions based on either Article 72(b), Paragraph 3 or Article 72(b), Paragraph 4 of CRR II.

5.4.2 MREL at the group level

The financial instruments of a consolidated financial institution will be used to satisfy group-level MREL; cf. Article 18 of Act no. 70/2020. It should be noted, however, that CET1 capital held for capital buffers cannot be used to satisfy MREL requirements in Iceland, as capital buffers are not part of the loss absorption amount. Because the Resolution Authority's MREL Policy is based on a single point of entry approach, the Authority will only consider as qualified eligible liabilities those financial instruments that are issued by financial undertakings' parent companies, not those issued by subsidiaries. Furthermore, financial undertakings' subsidiaries may not own MREL liabilities issued by the financial institution itself.

5.4.3 Restrictions on cross-ownership

The BRRD framework assumes that risk stemming from cross-ownership of eligible liabilities should be restricted, in part because of the potential for contagion. The Central Bank Resolution Authority is tasked, for instance, with examining the types of owners of liabilities when preparing resolvability assessments, so as to determine whether cross-ownership of eligible liabilities exists. If it is revealed that such cross-ownership impedes resolvability, the Resolution Authority may respond by demanding that the institution sell specified assets or that it limit its portfolio of large exposures, both vis-à-vis specific parties and in the aggregate. This assessment is provided for in the framework under both BRRD I and BRRD II. To a degree, the implementation of BRRD II will entail the harmonisation of provisions on cross-ownership of eligible liabilities within the EEA.

5.4.4 Other points regarding eligible liabilities for MREL

- Financial undertakings should not exercise call options or retire liabilities used for MREL without consulting the Central Bank Resolution Authority if, as a result of such action, the institution concerned would no longer satisfy its MREL requirements. After BRRD II takes effect, financial undertakings will be prohibited from exercising call options or retiring liabilities without Resolution Authority approval.
- If senior preferred securities or other MREL liabilities contain incentives to call in or retire lia-

bilities before maturity (step-up provisions), the assessment of whether the liability is considered qualified and eligible is based on the date such provisions first become exercisable, not the final maturity date; cf. Article 17, Paragraph 2 of Act no. 70/2020.

- The Central Bank Resolution Authority cannot authorise the inclusion of liabilities with MREL if they contain embedded derivatives. If such liabilities only contain call and/or put options, this does not prevent them from inclusion with MREL.
- Liabilities with set-off or netting provisions cannot be included with MREL if such provisions would prevent the financial institution from absorbing losses during resolution.
- When liabilities are issued outside the EEA, the financial institution must ensure that the terms and conditions of the issue include the counterparty's acknowledgement that the liability could be subject to bail-in and could therefore be used for recapitalisation during resolution, in accordance with Article 23 of Act no. 70/2020 and the provisions of BRRD I and BRRD II.
- The Resolution Authority stresses that it is the responsibility of the financial institution to ensure that liabilities and equity instruments included with MREL satisfy all of the conditions necessary for consideration as eligible liabilities. The Resolution Authority also emphasises that financial undertakings in Iceland should prepare themselves for the changes in requirements for classification as eligible liabilities that will accompany BRRD II.

5.5 Position on deadline for satisfaction of MREL requirements

It is intended that MREL requirements will take effect in full in Iceland from the beginning of 2022, with the Central Bank's approval of resolution plans. At this time, the Resolution Authority sees no reason to grant financial undertakings a separate transition period to satisfy MREL requirements; cf. Articles 7 and 8 of the MREL Regulation. Financial undertakings must be aware that after the implementation of BRRD II, a specific deadline for satisfaction of MREL requirements, most likely 1 January 2024, will take effect (see Section 6.2). In the interim, financial undertakings should not make major changes in their funding composition that would result in their being unable to satisfy the MREL requirements laid down in this MREL Policy.

5.6 Summary of MREL requirements

The Central Bank of Iceland Resolution Authority's MREL requirements are summarised below:

- The Resolution Authority will not adjust the default loss absorption amount. Therefore, the loss absorption amount will be equivalent to minimum required own funds (Pillar I and Pillar II-R).
- The Central Bank Resolution Authority will calculate the loss absorption amount – and therefore the overall MREL requirement – excluding the combined capital buffer requirement currently in effect. Financial undertakings will be notified of their MREL requirements excluding the combined capital buffer requirement and must satisfy the latter alongside the MREL.
- At the present time, the Resolution Authority will not adjust the default recapitalisation amount, which will be equivalent to the minimum own funds requirement.
- The value of the total risk exposure amount (TREA) upon calculation of the proportional recapitalisation amount may be adjusted (reduced) based on the probable balance sheet position of the financial institution when it is failing or likely to fail.
- It is permissible to satisfy the recapitalisation amount using common equity Tier 1 capital or other capital instruments in excess of total required own funds.
- At the present time, no market confidence charge (MCC) will be levied in Iceland.
- The Resolution Authority will not adjust MREL to reflect estimated contributions from TIF during resolution of financial undertakings; cf. Article 6 of the MREL Regulation.
- Financial undertakings in Iceland must satisfy requirements concerning eligible liabilities, and they must consider the changes that accompany BRRD II.
- The Resolution Authority is of the view that financial undertakings in Iceland should not rely on receiving an extension of time beyond 1 January 2024 to satisfy MREL requirements under BRRD II.
- Financial undertakings are urged to acquaint themselves with the conditions for the grant of a longer MREL transition period for individual financial undertakings on the basis of exemption provisions in BRRD II and comparable provisions in Articles 7 and 8 of the MREL Regulation.

VI Other MREL-related matters

Since the Act on Resolution of Credit Institutions and Investment Firms, no. 70/2020, entered into force, the Resolution Authority has received a number of queries regarding MREL and has provided information in response to them. The Central Bank Resolution Authority's MREL Policy contains information relating to those queries that are deemed to have general significance and applicability to financial undertakings in Iceland. In addition to the topics discussed in Sections 2-5 above, the Authority has received queries regarding the publication of information on MREL, final deadlines for MREL compliance under BRRD II, and transition periods and penalties.

6.1 Publication of information on MREL

The Resolution Authority intends to disclose MREL-related decisions and requirements only to the financial undertakings affected by them. Financial undertakings are free to disclose MREL-related information if they so choose. The regulatory framework on transparency in connection with MREL will change somewhat with the implementation of BRRD II in Iceland, however, and financial undertakings will then be required to publish information on MREL requirements.[16] The Resolution Authority urges financial undertakings to acquaint themselves with the forthcoming changes in a timely manner.

6.2 Final deadline for MREL compliance under BRRD II

In the current statutory environment – i.e., until BRRD II is incorporated into Icelandic law – there is flexibility to grant financial undertakings extensions of time to satisfy MREL requirements. According to current legislation, no final deadline for MREL compliance has been specified for Iceland, but once BRRD II has been implemented, the final MREL compliance deadline will take effect in Iceland. The deadline specified in the directive is 1 January 2024.

As long as BRRD II has not been incorporated into the EEA Agreement, the deadline applies only to banks within the European Union. Furthermore, it is uncertain whether the MREL compliance deadline will be extended beyond 1 January 2024; for instance, whether a longer transition period will be set when BRRD II is incorporated into the EEA Agreement. While this uncertainty exists, the Central Bank Resolution Authority assumes that Icelandic financial undertakings will have to satisfy MREL requirements in stages until 1 January 2024, unless the conditions for an extended transition period apply; cf. Article 45(m) of BRRD II.[17] This position will be reviewed when it becomes clear whether or not the general deadline for MREL compliance will be extended.

The Resolution Authority encourages Icelandic financial undertakings to give timely consideration to whether issuance of senior non-preferred securities is favourable and compatible with their institution's funding composition, in view of the forthcoming deadlines under BRRD II. Furthermore, the Resolution Authority points out the exemptions provided for in Article 72(b), Paragraphs 3 and 4 of CRR II, which permit the inclusion of senior preferred securities with MREL after BRRD II takes effect; cf. Section 5.4.1 above. It should be noted that the Resolution Authority will only be able to grant an exemption based on one of the two provisions.

6.3 Penalties due to MREL

Neither the Act on Resolution of Credit Institutions and Investment Firms nor BRRD I contains provisions for penalties in the event that a financial institution does not satisfy its MREL requirements. On the other hand, the Resolution Authority may demand that a financial institution issue eligible liabilities or take other action, such as renegotiating the terms and conditions of eligible liabilities so as to satisfy MREL requirements; cf. Article 15, Paragraph 3, Items 10 and 11 of Act no. 70/2020. Furthermore, under the MREL maximum distributable amount (M-MDA) rules provided for in BRRD II, a

16 After BRRD II is implemented, financial undertakings will be required to publish, on a regular basis, information according to Annexes V and VI of Commission Implementing Regulation (EU) 2021/763, which can be found here.

17 Extensions of time to satisfy MREL requirements will be granted only on an institution-specific basis, and not as a general rule.

financial institution's distributions can be restricted if it does not satisfy its MREL requirements.[18] Under these rules, an institution is only authorised to make distributions – i.e., pay dividends, buy back its own shares, or pay bonuses – if it satisfies the proportional MREL requirement set by the Resolution Authority. If it does not, the institution's authorisation to make distributions is reduced commensurably, in a manner comparable to that provided for in Articles 5-6 of Rules no. 1270/2015 on the maximum distributable amount and restrictions on financial undertakings' distributions in connection with capital buffers.

6.4 Other MREL-related obligations of financial undertakings

The Central Bank Resolution Authority reiterates that financial undertakings are responsible for ensuring that contractual terms and conditions satisfy the requirements laid down in Article 23 of Act no. 70/2020.

Furthermore, they must assess whether their contractual agreements are resolution-proof (i.e., whether they will retain their validity after resolution) and must update this assessment annually in the reports filed in connection with the preparation of resolution plans.

18 For further information, see Section 8 of the Single Resolution Board's MREL Policy, based on BRRD II, which can be found here: here.

SEÐLABANKI
ÍSLANDS