Consultation Response

to

The Bank of England's Discussion Paper:

"*The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)*"[1]

from

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[1] BoE Discussion Paper, "*The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)*", December 2020.

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Executive summary

1. We set out suggestions for simplifying the UK's MREL regime as part of the post-Brexit policy shape-up. We focus our attention mainly on the logical construction of MREL, the components of MREL, the thresholds for Bail-in and Partial Transfer resolution strategies (including the definition of transactional accounts) in the context of MREL, the quantum/calibration of the MREL requirement, and the impact of MREL on effective competition in the UK banking sector.

2. Our starting position is that MREL is a critical aspect of the new prudential framework; one that plays a key role in ensuring that firms are regulated not only in the context of prudential resilience but also resolvability. The negative externalities from the disorderly failure of a systemic bank demands that, for those firms, MREL should be significant and impactful.

3. However, we believe that the design and calibration of MREL as a bail-in tool can be improved materially, and the post-Brexit reshaping of the UK's policy framework provides an opportunity to do so. Whereas EU policymakers need to ensure consistency across 27 Member States (which makes sense for the single market), the UK does not have this added pressure and is able to recraft its regime in a manner that better suits its needs as a standalone jurisdiction.

4. In summary, we argue for a simpler regime that defines MREL as the "bail in" element of overall loss absorbing capacity i.e. as the portion required for recapitalisation in the event of resolution. Our view is that the concept of a "loss absorption amount" is unnecessary since it derives from the PRA's capital adequacy regime, not MREL. We submit that having to set the "recapitalisation amount" at zero for Modified Insolvency firms is not meaningful and is proof of the flaw in the logical construction of MREL. We argue further for the recalibration of the thresholds for Bail-in and Partial Transfer resolution strategies, in the specific context of MREL.

5. Most of the comments in this response paper deal with questions 1, 5 and 6 in your list of questions for public consultation.[3]

6. MREL is additional and complementary to the minimum capital adequacy requirements. It is designed to ensure the orderly resolution of those firms that pose a significant risk to the UK financial system.[4] This role should be reflected in the design, scope, and application of MREL.

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[3] Question 1 - "*Are there any issues or evidence that respondents would like to bring to the Bank's attention that would inform its review of the MREL framework, in particular relating to the thresholds for resolution strategies, the calibration of the requirements, the eligibility of instruments or the application of MREL within banking groups?*"

Question 5 - "*What are your views on the Bank's current graduated approach to 'growing into MREL' and in particular, the provision of a transition period of at least three years? The experience of some mid-tier banks in issuing MREL instruments suggests that this period may be insufficient for them to establish themselves as issuers of those instruments. The Bank would particularly welcome public comments on this point*."

Question 6 - "*Should the Bank update its definition of transactional accounts for the purposes of its indicative resolution thresholds, and if so how? The Bank would welcome feedback on whether and how it should be adjusted to take account of changes in market structure and customer behaviour*."

[4] Domestic Systemically Important Banks (D-SIBs) and Global Systemically Important Banks (G-SIBs).

Introduction

7. We welcome the decision by the Bank of England (BoE) to review its approach to setting a minimum requirement for own funds and eligible liabilities (MREL). It is a timely and important exercise. **Midelatory Consulting** is grateful for the opportunity to respond to this public consultation and we stand ready to engage further with policymakers should this be desired.

8. Following the UK's exit from the European Union (EU) on 31 December 2020, the UK regulatory framework for financial services will need to be reformed. The task of "onshoring" EU requirements pursuant to the European Union (Withdrawal) Act 2018, is a substantial one that the PRA and BoE will have to grapple with from 2021 onwards. We are of the view that in addition to transferring pre-existing EU regulatory requirements and expectations into UK law and rules, it is also an opportunity to simplify the UK regime by:

    a) Making the rules more intuitive and easier to understand; and

    b) Ensuring that the rulebook has an enhanced logical underpinning.

9. Making the rules easier to understand should result in increased compliance with regulatory obligations due to a reduction in instances of unintentional misapplication, or breaches, of rules. Subjecting the rulebook to an enhanced logical underpinning may also result in a greater level of "buy-in" from the industry thereby affording it, by definition, greater *legitimacy*.

10. Our response should be read in the context of this being an opportunity to simplify the UK's MREL framework, rather than simply onshore EU requirements in light of Brexit. More so, simplification whilst maintaining a strong regime would be in keeping with the general aspiration of the BoE.[5]

Background to MREL

11. MREL was introduced as part of the comprehensive regulatory response to the global financial crisis that began in 2007. The rationale for MREL was to ensure that bank investors – both creditors and shareholders – would be subjected to losses in the event of bank failure. That is, the authorities would be able to "bail in" private actors in order to prevent (or reduce) the need for the public sector to "bail out" a failing bank. As the initial global debate developed on the possible introduction of bail-in regimes, the EU introduced MREL, in 2014, via the Bank Recovery and Resolution Directive (BRRD). Although the debate had been mainly about mitigating the financial stability consequences of systemic bank failure, the EU's MREL was designed to apply to all banks irrespective of their relative potential to adversely impact financial stability.

12. However, the structure of that first iteration of MREL was materially flawed and, in some respects, at odds with the structure of the capital regime that it was supposed to supplement. For instance, MREL was expressed as a percentage of banks' total liabilities and own funds whereas the underlying capital regime was expressed as a percentage of risk weighted assets. Therefore, it was a welcome development when the G20-mandated body, the Financial Stability Board (FSB), introduced its own, much better (although not flawless), version of a bail-

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[5] See for instance the Mansion House speech by Sam Woods, Deputy Governor for Prudential Regulation and CEO of the PRA and: *"Strong and Simple"*, 12 November 2020.

in instrument, in 2015, in the form of Total Loss Absorbing Capacity (TLAC). Unlike the EU, the FSB directed the TLAC requirement at Global Systemically Important Banks (G-SIBs) only. It is worth noting that the EU has since greatly improved the design of MREL as part of its Banking Reform package (via BRRD2 and CRR2).

Suggestions for improving the UK's MREL regime post-Brexit

13. Below, we provide suggestions for improving the UK's MREL regime as part of the post-Brexit policy shape-up. We focus our attention mainly on the following areas:

    a) The logical construction of MREL
    b) The components of the MREL requirement
    c) The threshold for Bail-in resolution strategy
    d) The threshold for Partial Transfer resolution strategy
    e) Quantum of MREL requirement
    f) MREL as a potential impediment to effective competition

The logical construction of MREL

14. We are of the opinion that MREL should be defined as the "bail in" element of loss absorbing capacity i.e. as the portion required for recapitalisation in the event of resolution. The BoE should move away from the current all-encompassing construction that incorporates both minimum capital requirements (which the BoE refers to as the "loss absorption amount") and the bail-in element (referred to as the "recapitalisation amount").

15. The concept of a loss absorption amount seems redundant and unnecessary. This is because it is merely a reference to a firm's minimum capital requirements as set by the PRA (i.e. Pillar 1 + Pillar 2A). It is a well-understood concept in the industry (incidentally, the PRA refers to it as "Total Capital Requirement") and giving it an additional name can only confuse. Further, having to set the recapitalisation amount at zero for a Modified Insolvency firm is not meaningful, arguably adds no value to the regime, and perhaps is proof of the flaw in its logical construction. Worse still, it is eminently capable of inducing avoidable confusion in firms.

16. Since the key task of setting MREL is determining the recapitalisation amount, that is where the entire focus of a bail-in requirement should lie. That is, MREL ought to apply only to those firms for which the recapitalisation amount would be set above zero.

17. An all-encompassing loss absorbing capacity number that incorporates the trio of minimum capital requirements (i.e. loss absorption amount), the bail-in element (i.e. recapitalisation amount) and buffers could be referred to with a more fitting terminology that reflects the total loss absorbing capacity for a given firm.

18. Although we acknowledge the origins of the terms MREL (i.e. EU and applicable to all firms) and TLAC (i.e. FSB and applicable to G-SIBs only), we can see no rationale for the UK's future regime continuing to draw a structural distinction between the description and construction of a bail-in requirement for systemic firms and a bail-in requirement for non-systemic firms.

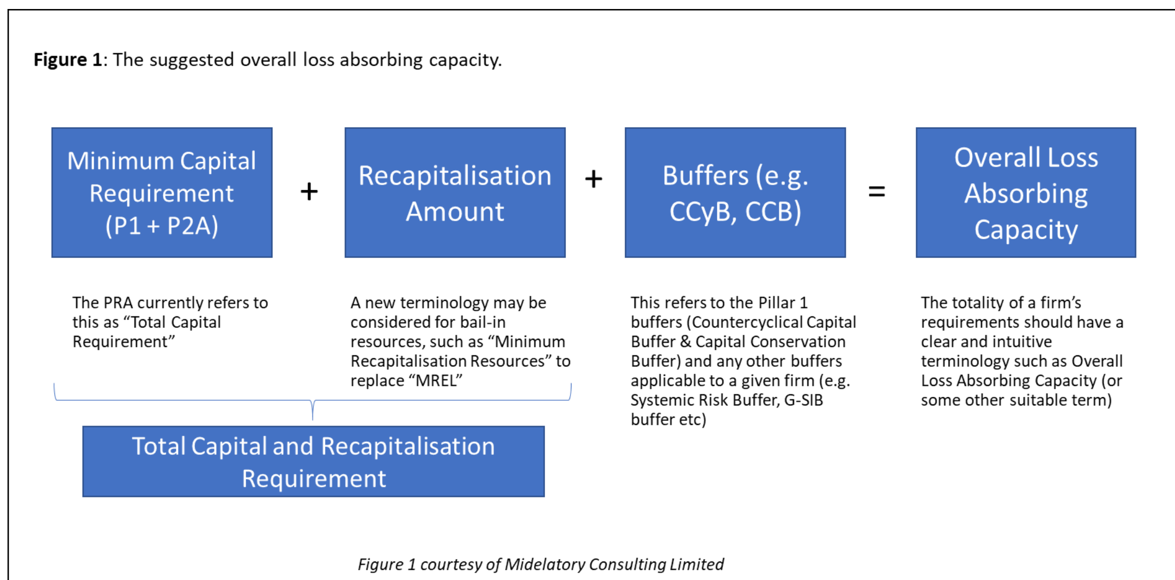

Figure 1: The suggested overall loss absorbing capacity.

Figure 1 courtesy of Midelatory Consulting Limited

The components of the MREL requirement

19. We agree with the BoE's position that an MREL bail-in requirement should not apply to firms for which the BoE has determined a Modified Insolvency resolution strategy, as their failure is unlikely to justify the BoE's use of resolution powers. It would be simpler and easier for firms to understand if it were simply characterised in that manner (i.e. that MREL/bail-in does not apply) rather than suggest that such a bank has an MREL/bail-in requirement which is set at zero. The BoE may have taken this approach previously because of the BRRD which mandated an MREL requirement for all CRR firms. As the BoE no longer has such a constraint, now may be the right time to redress it.

20. In the DP, the BoE states:

> "*The MREL Statement of Policy explains that a bank would be expected to enter insolvency if its failure was unlikely to cause disruption to the UK financial system and it does not provide a significant amount of critical functions. For banks subject to such a strategy, the Bank expects to set the recapitalisation amount of MREL equal to zero, on the assumption that the bank would not need to be recapitalised. This means MREL is set as the loss absorption amount i.e. equal to minimum capital requirements.*"

21. This would appear unnecessarily cumbersome and mostly has the unintended effect of potentially confusing the audience. Two points are worth noting:

    a) The fact that such a bank must meet minimum capital requirements does not arise from the MREL framework, but instead from the underlying capital framework of the PRA (driven by the international standards set by the Basel Committee on Banking Supervision (BCBS) and their EU implementation). Therefore, describing a bank's minimum capital requirements as representing the loss absorption element of MREL is unnecessary at best and confusing at worst.

    b) For a Modified Insolvency firm, the reality is that there is simply no bail-in requirement under the BoE's approach. Therefore, it would be simpler to just say so rather than express it as the BoE *setting the recapitalisation amount at zero*.

22. Notwithstanding our view that whatever term is used to describe an MREL/bail-in requirement should refer only to the recapitalisation element, we will continue to refer to "MREL" in the rest of this response in the context used in the BoE's DP – to avoid any confusion.

The threshold for Bail-in resolution strategy

23. At **Midelatory Consulting**, we are steadfast adherents of the merits of strong prudential regulation and of the need for a workable mechanism for imposing losses on investors (both shareholders and creditors). We consider it wholly inappropriate to call upon public funds without first imposing significant losses on investors. In fact, the ultimate goal should be to achieve a resolution regime that never has to rely on recourse to public funds. It is undesirable and asymmetrical that although bank profits are private, bank losses should be borne by the state. We would like to see a system where banks, of any size, can be allowed to fail.

24. However, the indicative threshold of £15bn - £25bn balance sheet size which may, under the BoE's current approach, necessitate a Bail-in resolution strategy (and therefore the highest possible MREL requirement) seems overly conservative. After all, the rationale for the introduction of a bail-in requirement is causally linked to the financial stability implications of disorderly failure. This, by definition, largely concerns firms considered by regulators to be "systemic" be it domestically (D-SIBs) or globally (G-SIBs). Bail-in requirements should, therefore, ordinarily only apply to systemic firms.

25. If the BoE agrees with this starting point, then it becomes harder to justify the possibility of imposing Bail-in resolution strategy, and the resultant MREL/bail-in requirements on a firm simply because it has a balance sheet of, say, £15bn. This figure is significantly smaller than the £25bn of retail deposits threshold for ring-fencing or the £50bn of retail deposits threshold for the PRA leverage ratio requirement (the UK's *current* leverage ratio regime).

26. In contrast, the FSB's TLAC standard applies only to the largest, most systemic banks in the world, of which there are currently only 30. In the EU's Banking Union, only banks with assets above €100bn are generally required to meet their MREL with subordinated resources. Similarly, in the US, the requirement to have recapitalisation capacity applies only to systemic firms i.e. G-SIBs.

27. Given the above, we would suggest that the indicative threshold be revisited. The BoE should consider a much larger threshold of, say, no less than £50bn if based on retail deposits only. Alternatively, since systemic risk may arise even where a bank's sphere of activity is mainly wholesale, there may well be a case for setting the threshold based on total deposits (both retail and wholesale) in which case the calibration may need to be different e.g. £100bn. The precise calibration should be informed by historical data and current market structure.

28. Further, we are far from convinced of the merits of designing the bail-in threshold as a *range* as opposed to a single figure. At first glance, a range might appear beneficial in theory, however, it is doubtful whether, in reality, the range achieves its probable aims of avoiding cliff edge risk and giving the BoE added flexibility. This is because, it is our experience, from working with clients, that the industry understandably focuses on the lower part of the threshold (i.e. £15bn balance sheet size). Firms are not able to plan on the basis that the BoE might tend towards the upper end of such a range and are in effect compelled to proceed on the basis of the lowest end of the range. It is a range in theory but a single number in reality.

29. Therefore, we believe that a single number would better reflect the practical effect of the threshold on the industry in BAU business planning, capital planning as well as in bank application-related financial projections. Such an approach does not, in any way, fetter the discretion of the BoE in considering if and when a Bail-in resolution strategy is appropriate. In any event, describing the (single) number as "indicative" already mitigates the cliff edge risk (to the limited extent that it can be mitigated). We believe that a single number threshold would be simpler and is not dissimilar to the approaches taken to the current PRA leverage ratio and ring-fencing requirements.

The threshold for Partial Transfer resolution strategy

30. Where the BoE believes that a mid-sized firm should not be subject to a bail-in requirement because it is not deemed to be systemic, then ideally MREL should not apply – reflecting the lower likelihood of its failure impacting financial stability. And yet, the BoE may still be legitimately concerned that the concurrent failures of multiple mid-sized firms may pose significant risks to financial stability. This may be the case where a number of them have similar business models or are susceptible to similar forms of stress (such as reliance on similar liquidity sources). Since avoiding disorderly failure is the key goal, the BoE could choose, in such an instance, to set the recapitalisation amount to reflect the expected wind-down costs for a given firm. This would improve regulatory confidence in the resolvability of a mid-sized, non-systemic firm, without unnecessarily doubling its loss absorbency requirements.

31. Notwithstanding our argument that only systemic banks ought to be subject to the MREL/bail-in requirement, we will now address the threshold for its application to banks for which Partial Transfer is the BoE's preferred resolution strategy.

32. The indicative threshold of 40,000 to 80,000 transactional accounts[6] which may, under the BoE's current approach, necessitate a Partial Transfer resolution strategy seems overly conservative. Even small or new and fast-growing banks will likely exceed this threshold very quickly without there being a corresponding increase in the risk that their failure would pose to UK financial stability. The indicative threshold is really such a small number of accounts that its practical (even if unintended) effect is to serve as a potential barrier to new entrants to the banking sector.

33. It is worth noting that a number of recent entrants into the UK banking sector (e.g. Monzo, Starling etc) have already been set MREL requirements so early on in their journeys despite having relatively small balance sheets. Such banks have attracted millions of current accounts fairly quickly, and despite these being largely "secondary" accounts, many of them qualify as transactional accounts under the BoE's current definition.

34. We would suggest that the indicative threshold be revisited, and that the BoE should consider a much larger threshold. For instance, say the BoE were to consider that a bank with less than 5% of the current account market should not require bail-in, then the threshold could be set at 3.5m of current accounts. Or a smaller number if it continues to be pegged against the subset of current accounts referred to as transactional or primary accounts.

[6] Defined as an account which has been used at least nine times in the last three months to make payments.

35. In line with our earlier point, we are not convinced of the merits of designing the threshold as a range as opposed to a single figure. In our experience, the industry focuses on the lower part of the threshold (40,000 transactional accounts) and ignores the upper end of the threshold (80,000 transaction accounts). This is understandable, as firms cannot predict how the BoE might apply the policy to them. Therefore, a single number, perhaps still described as "indicative" (to give the BoE some flexibility), would be more reflective of the impact of the threshold on business planning, capital raising and authorisation-related financial projections.

Quantum of MREL requirement

36. At present, banks subject to a Bail-in resolution strategy and those subject to a Partial Transfer resolution strategy are subject to a requirement that is two times their minimum capital requirement i.e. 2(P1 + P2A), or 2(leverage ratio) if applicable.

37. The imposition of twice the minimum capital requirements (i.e. Pillar 1 + Pillar 2A) is an incredibly significant requirement to set for any firm whilst still operating a "risk-based" regime. Such quantum should, therefore, be reserved only for those firms whose failure present the greatest threat to the stability of the financial system including the continuity of the provision of critical banking services; that is, G-SIBs and D-SIBs. Given the financial stability goal of fully recapitalising a failing systemic firm, we agree that it is appropriate that such a firm be subject to an amount of bail-in that is twice its minimum capital requirement i.e. a doubling of the sum of its Pillar 1 and Pillar 2A requirements – so that it can be fully recapitalised should its minimum capital requirements be completely depleted.

38. As such, it follows logically that such a highly impactful requirement should not apply to the same extent to firms that are not systemic; otherwise, the requirement is likely to be disproportionate given the lower levels of risk posed by such firms to the stability of the financial system. In our view, the possibility (which does exist in the BoE's approach) of reducing the MREL requirement for a Partial Transfer firm to reflect the fact that less than its entire balance sheet may need to be recapitalised at the point of resolution is not sufficient to address the otherwise disproportionate impact of adopting a doubling of minimum capital requirements as the base case.

39. In any case, such an approach would arguably require unrealistic predictive power on the BoE's part by requiring it to ascertain, *ex ante*, and with a high degree of confidence the parts of a bank's balance sheet that would definitely require recapitalisation – even without necessarily knowing what "type" of stress or crisis might lead the bank toward failure, nor what the wider economic context might be at the time of stress.

40. We would argue that Partial Transfer firms do not require bail-in resources. Put another way, if a firm would require bail-in resources, it should be considered a systemic firm and therefore a Bail-in resolution strategy should apply. However, should the BoE continue to impose MREL on Partial Transfer firms which are not systemic, we would suggest that it considers calibrating the quantum set for these firms at a lower level compared to G-SIBs and D-SIBs. It may, for instance, consider setting the requirement at 1.5 times minimum capital requirement.

MREL as an impediment to effective competition

41. Drawing on our experience of advising various start-ups in the UK banking industry, there is no doubt that prospective firms consider MREL a material barrier to entry into the sector. The

barrier effect seems to be driven by two factors: first, the thresholds mean that virtually any prospective firm that intends to offer current accounts has to immediately contend with MREL in its financial projections. Second, the sheer quantum of MREL is problematic for those firms (non-systemic by definition) i.e. the doubling of minimum capital requirements is a genuine consideration for those firms, casting doubt on their ability to attract sufficient investment.

42. To be clear, the fact that a given requirement is impactful is not on its own a good reason to disagree with it. On the contrary, that could be proof that the requirement is achieving its objectives. So, our reticence in this instance is derived from an inability to identify a corresponding risk to financial stability emanating from such small, early-stage firms to justify the imposition of MREL at that stage of their journey. In any case, it is arguably inconsistent with the PRA's stated intention of applying a graduated approach to "new and growing" banks as set out in a consultation paper published in July 2020.[7]

43. That said, the relatively generous transition timeline given to affected banks to meet the higher MREL requirements (i.e. at least 36 months) may go some way to alleviating some of the barriers to entry. But it is insufficient.

Conclusion

44. To conclude, we fully support the maintenance of strong prudential regulation in the UK in the post-Brexit policy shape-up. We further support a robust bail-in regime as part of that framework. We believe bail-in, in the form of MREL, should ideally only apply to systemic firms (G-SIBS and D-SIBs). In the event that it continues to be applied more widely than that, there should be real proportionality built in.

45. We submit that the MREL regime should be meaningful and clearly indicative of the negative externalities that would emanate from the failure of the affected firms. When imposed on a firm, MREL should be significant and impactful such that it affects the behaviour of the firm in question. Therefore, it should be applied only to those that pose the greatest risk.

46. Finally, the reshaping of regulatory policy following the UK's exit from the EU provides a unique opportunity to simplify the UK approach by making the requirements more intuitive and easier to understand; and ensuring that the regulatory regime has an enhanced logical underpinning.

47. We are grateful for the opportunity to comment. We would be happy to participate in further discussions with the BoE if that would be useful.

Thank you.

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[7] PRA Consultation CP9/20, "*Non-systemic UK banks: The Prudential Regulation Authority's approach to new and growing banks*", July 2020