UK Finance response to the Bank of England's consultation on Internal MREL

December 2017

Introduction

UK Finance is pleased to respond to the Bank of England's consultation paper: *'Internal MREL - the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups, and further issues'*[1].

UK Finance is a new trade association which was formed on 1 July 2017 to represent the finance and banking industry operating in the UK. It will represent around 300 firms in the UK providing credit, banking, markets and payment-related services. The new organisation brings together most of the activities previously carried out by the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

General observation

We support harmonised implementation of internationally agreed approaches to banking supervision and resolution so welcome the broad alignment between the Bank's proposals and the *Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC'*[2] issued by the Financial Stability Board (FSB).

Responses to specific questions asked in the consultation

(1) Do you agree with the proposed approach to determining the entities within scope of internal MREL? (chapter 4)

We broadly agree with the proposed criteria for identifying material subsidiaries that are in scope for internal minimum requirement for own funds and eligible liabilities (MREL).

Our overall expectation is that entities that are either immaterial or do not support critical functions should be out of scope.

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[1] https://www.bankofengland.co.uk/-/media/Bank/files/financial-stability/resolution/internal-mrel-consultation-october-2017.pdf?la=en&hash=33594C3FB3C7F1D129033AFE4E3A2BF20A4F9AA8f

[2] http://www.fsb.org/wp-content/uploads/P060717-1.pdf

Paragraph 4.11 – Material subsidiaries with no prudential consolidation

We note that the Bank reserves the right to determine internal MREL requirements for sub-consolidated groups even if they are not subject to prudential regulation, including requiring reporting on such sub-consolidations. This requirement would be burdensome, necessitating a full suite of financial and regulatory reporting mechanisms and adding another level of regulatory monitoring. We suggest that there should be either a limited reporting frequency, or that the Bank considers other alternatives to full blown sub-consolidated balance sheet reporting.

We are also concerned that this may exacerbate the sum of the parts problem and may also cause funding inefficiencies throughout a group.

(2) Do you agree with the proposed approach to calibrating internal MREL and the factors that will be considered? (chapter 5)

Paragraph 5.5 – Calibration range and overseas hosts

We welcome the Bank's attempt to adhere to the FSB principles by anchoring the calibration of internal MREL at 75% of the full MREL amount. This reduces the likelihood of there being a "sum of the parts" problem and also allows resolution entities to have a "surplus" of external MREL which is not prepositioned but can instead be deployed more flexibly, as necessary.

But the consultation paper notes that if other resolution authorities set their calibration at the higher end of the 75%-90% range, the Bank may match this. We understand that this may be a factor in the Bank's assessment, but we would encourage the Bank to resolve these situations in regulatory colleges. The Bank can then defend the FSB principles on internal TLAC and the respective roles of home and host regulators – whereby hosts are required to consider the impact of the Resolution Group on the whole group. It is the role of the consolidated resolution authority to address inconsistencies and to balance the host's concerns in a way that avoids the sum of the parts exceeding the external requirement.

Paragraph 5.8 – Internal MREL for ring-fenced bodies (RFBs)

We are unclear why the Ring-Fenced Banks (RFB) calibration starts at 90%, when all other entities start at 75%. Why are RFB treated differently from other material subsidiaries? There is no additional reliance on other group members, as RFBs will already need issuance from the HoldCo. We also noted during the Bank call on internal MREL, on 19th October 2017, that it plans to reduce this calibration in the future, once resolution frameworks mature. We find this idea very strange, as it is almost a reverse transition mechanism. We would therefore encourage the Bank to start with a lower calibration and then consider moving it at a later date.

Paragraph 5.10 – UK groups with a simple structure

Please clarify what characteristics imply that a bank has a 'simple structure' It would help to provide practical examples of how could be understood. Please also clarify the factors which would determine that internal MREL would be set at 100%. We are concerned that this would be likely to lead to the sum of internal MREL being more than the Resolution Group's external MREL requirement.

Paragraph 5.11 – Internal MREL for UK material subsidiaries of foreign banking groups

The consultation paper states that internal MREL for non-UK headquartered banks will be set in consultation with their home authorities. We value international cooperation on setting internal MREL and believe that regulators should be striving to ensure a level playing field for internationally active banks.

We also note that for subsidiaries of non-UK banks, MREL issuance may be subject to the home regulator's approval. This should be factored into timelines, as, for example, US regulatory approval could require a period of up to nine months. So, banks would need to be notified of indicative requirements and to be aware of final eligibility rules significantly in advance of the 1 January 2019 implementation date.

Paragraph 5.12 – Internal MREL for non-UK material subsidiaries of UK banking groups

We would welcome the Bank's clarification of the criteria that it will apply to decide whether to propose a higher level of internal MREL than a host's requirement. We would also welcome an explanation of how this assessment will link to the resolution plan and the Crisis Management Group (CMG) discussions. As a matter of principle, the requirements should start from an assessment of materiality as agreed by home and host resolution authorities during CMG discussions. The requirements should be set within the FSB principles for internal TLAC and in line with the FSB descriptions of home-host roles.

(3) What challenges do you see with the proposed policy that surplus MREL should be readily available to be deployed to material subsidiaries? Do you agree that this could be achieved through maintaining a central reserve of high-quality liquid assets at the resolution entity? Are there other methods that you think should be acceptable? (chapter 5)

Paragraphs 5.6 to 5.7 – The location of surplus MREL

We are unsure why the consultation paper makes assumptions about the availability of, or sets expectations for the application or location of, surplus MREL. We would welcome confirmation from the Bank as to whether the policy intention is to create a pool of surplus MREL to be held at the top.

Any prescription of surplus MREL, such as the use of high-quality liquid assets (HQLAs) held at the resolution entity, will cause inflexibility and add cost including: (i) negative carry cost of investing in HQLA, and (ii) increased leverage and hence capital requirements for the consolidated group. We suggest that banks should have full flexibility in down-streaming MREL resources to material subsidiaries, balancing the need to preposition resources in subsidiaries with the advantages of having a pool of unallocated resources which can be flexibly deployed as necessary in different parts of the group.

We also believe the Bank should make it clear that surplus MREL is not required to be held at the resolution entity at the top of a banking group. It should be possible to downstream the internal MREL to an intermediate sub-group that can provide liquidity to its material entities. In addition to assisting the resolution strategy, this approach provides significant benefits to material subsidiaries, namely: (i) funding for business assets, (ii) support to senior credit ratings, and (iii) a reduction in the likelihood of breaching internal MREL requirements, which may have severe consequences. The credit rating implications arise because Moody's "*Loss Given Failure*" and Fitch's "*Qualifying Junior Debt*" methodologies, can give material subsidiaries a higher credit rating depending on the scale of their down-streamed internal MREL resources. S&P is the exception, in taking a 'top-down' approach. But both Moody's and Fitch require that resources are pre-positioned to secure any ratings benefit and they ignore 'surplus' MREL held at a HoldCo.

We are not aware of any alternative approach that would definitively either reduce these costs, or deliver benefits which outweigh them. Whilst in theory at least removing the requirement for HQLA and replacing it with existing business assets would mitigate some of the issues (e.g. negative cost of carry, increased leverage and the loss of funding), it would not provide ratings support, and the universe of business assets suitable for transfer to all operating entities may be limited.

We are happy to continue this dialogue over time, and would certainly expect further industry consultation, including an impact assessment, were the Bank to consider requiring surplus MREL to be held at the resolution entity.

(4) Do you agree that firms should not be able to double count resources to meet internal MREL for both their individual balance sheets and those of their subsidiaries? (chapter 5)

We broadly agree with this proposal.

We also believe that a deduction approach is the most appropriate means to avoid double counting and ensure that adequate resources are available at all levels.

However, such a deduction approach should be on a corresponding basis, where internal TLAC is deducted from TLAC, aligning with the principle of the FSB term sheet.

The proposal should also factor in the existing deductions in the capital regime for investments in the capital of financial sector entities to avoid having to deduct resources twice for the purposes of the MREL regime.

(5) Do you agree that instruments eligible for internal MREL should be subject to a contractual trigger? (chapter 6)

Paragraph 6.7 to 6.10 Contractual triggers for internal MREL

We are unclear why internal MREL should have a contractual trigger on the point of non-viability of the material sub-group. This is not required by the TLAC term sheet. The 24-hour home authority consent to trigger internal TLAC also differs from the TLAC guiding principles, which suggest up to 48 hours' notice, established in advance through cooperation.

We are also concerned by the Bank's proposal that the contractual trigger should give it the power to trigger internal MREL where a resolution entity which is a direct or indirect parent of the material subsidiary is subject to resolution proceedings. This would effectively allow the Bank to trigger internal MREL in the UK even if no losses have been incurred by the UK subsidiary. We do not believe this would be proportionate and it would be preferable for the Bank to qualify this policy by stating that internal MREL where, as a result of the resolution entity being in resolution, the material UK entity would also be likely to fail.

We also ask for greater clarity on what the contractual trigger should look like and whether the relevant starting point should be the example contractual trigger for internal TLAC. In our view, a best approach would be to say that if the Bank directs a write down/conversion, the issuer will action this and such write down/conversion will be pro-rated as required.

We would welcome clarification from the Bank as to why it considers the requirement for contractual triggers necessary where statutory powers are considered effective.

Furthermore, contractual triggers across entities (i.e. not limited to just the entity in resolution) will cause contagion risk (which runs against the PRA's guiding principle on group risk which seeks to limit intra-group contagion). The proposed triggers could also impact the credit ratings of material subsidiaries and may not be consistent with the market's current understanding of the way that Point of Non-Viability (PoNV) will operate, with uncertain market reaction (i.e. given the risk of contagion risk across any ring-fence).

We have several other concerns about contractual triggers:

- BRRD2 proposes to extend the statutory PoNV write-down/conversion powers from capital to internal MREL. This would make a contractual trigger redundant.
- Contractual triggers may give rise to embedded derivatives that create unwanted accounting profit and capital volatility and also potential tax volatility.
- To the extent that interest on internal MREL is paid to a non-UK affiliate, it may be characterised as being "results-dependent" and therefore not deductible.
- It may not be practical for non-UK subsidiaries to comply with the requirement.
- Contractual triggers in internal MREL instruments issued by non-UK subsidiaries may create local legal, accounting and tax inefficiencies. For example, interest paid by US subsidiaries may not be deductible for US tax purposes and US withholding tax may apply.

Paragraph 6.11 – Mismatching of internal and external MREL

We would appreciate greater clarity about the Bank's approach to the 'matching' of internal to external MREL:

- What the risk/concern/resolution objective is that motivates the requirement that banks "match" the form/terms (e.g. equity/debt; currency, interest rate, maturity, etc.) of their internal MREL to that of their external MREL. The congruity should, in our view, be limited to commercial terms of the instruments such that balanced cash flows can be assured. No congruity is required, in our view, for example, as regards the capital quality of the instrument and there should be no automatic link between external and internal instruments as regards the triggers.

- o How the Bank intends to monitor and enforce this. For example, how this will be managed where a host authority's eligibility requirements are different.
- o Whether the Bank would be open to taking a more flexible and pragmatic approach based on a firm's overall risk management and risk appetite.

The PRA has released a consultation paper on double leverage which significantly overlaps with the proposed requirement on mismatches between internal and external MREL. The internal MREL consultation paper does not give any guidance to firms as to what an acceptable mismatch might be. As such it is not possible for us to comment on the impact of the proposals.

We would like to highlight that the Bank should recognise that a banking group's external issuance will be dictated by market conditions and that internal issuance also needs to observe local eligibility requirements which vary across jurisdictions. There are many legitimate reasons for terms and conditions to vary across internal and external issuances and banks should be allowed to manage any risks arising within the normal course of its activities. Any concerns about group resilience should be discussed with the bank, as it happens today with other risks.

(6) Do you agree with the proposed approach to the loss-absorbing capacity for operational continuity in resolution? (chapter 8)

Paragraph 8.8 – calibration of loss-absorbing capacity for operational continuity

Whilst we recognise the Bank's concerns about ensuring sufficient loss absorbing capacity for operational continuity, we have a number of concerns about the scope of the proposed requirements. Firstly, the Bank intends its proposed requirements to be additive to other requirements even though operational continuity was included in the calibration exercise undertaken by the FSB. An additive approach would therefore be super-equivalent to international standards, raising level playing-field issues, and potentially, sum-of-the-parts issues where the sum of internal MREL/TLAC requirements for a bank exceed its external MREL/TLAC requirement.

In addition, the consultation paper states that the loss absorbing requirement would apply to "each provider of critical services within the group". This would have a significant extra-territorial effect as services are often provided from a number of different entities within a banking group. This would bring into scope a range of entities even if only a small proportion of their services are provided to the UK entity and they would be required to have 25% loss absorbing capacity. A more proportionate approach would be to apply the policy to UK-based service providers and any cross-border requirements should be agreed with the relevant resolution authorities.

We are further concerned that the 25% loss absorbing requirement will be based on total operational costs for all in-scope entities within a banking group as defined by Column 150 of PRA Template 109. We believe this would be an excessive requirement as total operating costs under this definition include non-critical services. This would run completely counter to the Bank's stated aim of requiring loss absorbing capacity for the provision of critical services. It would also be inconsistent with the PRA's Financial Resilience requirements for Liquidity which only include critical services and allow for certain costs to be excluded from annual fixed overheads. In our view, the scope of the requirement should be amended so it is consistent with the PRA's Financial Resilience requirements and therefore should be based on Column 170 of PRA Template 109 which specifically relates to Annual Fixed Overheads for Critical Services.

Moreover, the proposed calibration of 25% looks arbitrary and is not backed up by evidence. We think there is an opportunity to set an appropriate scalar on a case-by-case basis.

We also believe it is important to ensure that there is no double-counting of requirements. Critical services are often provided by entities within banking groups that are already subject to their own TLAC/MREL requirements. If the Bank follows its proposed approach and increases the internal MREL quantum of a UK subsidiary to account for these critical services, this will in effect be double-counting. It is also important to point out that operating entities, which are the consumers of services, also have to hold loss-absorbing capacity to ensure operational continuity. If the service provider needs to also hold additional capital, this is another form of double-counting. We would also recommend verifying that there is no double-counting of liquidity requirements, as set out in PS 21/16.

In relation to non-UK firms, paragraph 8.9 of the consultation paper states "where UK firms are part of non-UK groups and rely on critical services providers in the group that are outside the United Kingdom, the Bank will seek assurance in discussion with other authorities that appropriate arrangements are in place for loss-absorbing capacity for operational continuity." We would welcome clarification from the Bank about how they intend to approach this and what the timeframe will be given that internal MREL requirements are intended to apply from 1 January 2019. We would also welcome clarification as to whether the Bank would expect regulators in other jurisdictions to increase their TLAC/MREL requirements to account for operational continuity should the Bank conclude that their existing requirements are insufficient.

Lastly, we would appreciate greater clarity on the Bank’s expectations on the location of the loss-absorbing capacity for operational continuity. In particular, paragraph 8.10 of the consultation states "if the critical services provider is an unregulated service company that is part of a sub-group of other unregulated service companies the Bank may permit the loss-absorbing capacity to be maintained at the parent entity within the service-providing group." It would be helpful to have more information on what conditions the Bank would impose in order to allow loss-absorbing capacity to be held at the parent entity within the service-providing group.

(7) Are there any tax and accounting implications that we should be aware of in setting our internal MREL policy?

We would like to draw to the Bank’s attention the challenge that will arise from the adoption of a contractual trigger requirement for internal MREL, from an accounting and tax volatility perspective.

This arises due to the different basis of accounting that would apply to external and internal instruments, under IFRS 9 – whereby internal instruments with contractual write-down/trigger would need to be fair valued whilst the external instruments would in principle follow amortised cost. Additionally, the tax treatment of external instruments follows the accounting base whereas for internal instruments the amortised cost is the relevant basis.

This generates accounting and tax volatility.

One option that we would encourage the Bank to consider and explore with HMT would be to apply a regime similar to existing regime for capital instruments.

(8) What other implications does internal MREL have for the operation of banking groups that the Bank should be aware of?

Paragraph 6.6 – External MREL issuance from a non-resolution entity

We do not understand why the Bank considers that the issuance of external MREL by non-resolution entities is an impediment to resolution, given that existing MREL issued by non-resolution entities counts towards regulatory capital. The new proposal might also distort the market, as it will set an expectation that these securities will be called.

(9) Do you agree with the Bank's proposed policy for setting consolidated MREL for UK multiple point of entry groups? (Chapter 9)

Paragraphs 9.1 to 9.3 – External MREL for MPE resolution entities

We do not understand the policy intention behind having a differentiated MREL requirement for firms with an MPE, rather than an SPE, resolution strategy. We believe that the amount of external MREL required should be the same, regardless of the resolution strategy chosen. As the purpose of external MREL is to provide sufficient loss-absorbing capacity to avoid bail-outs, if two banks have identical risks, and one operates an SPE strategy, and one an MPE strategy, they should have the same MREL requirement, as the groups would experience the same losses in a given scenario. The Bank's approach does not deliver this.

(10) Do you agree with the Bank's impact assessment of MREL? (Chapter 10)

Paragraphs 14.1 to 14.23 – Impact assessment

We have no specific observations on this.

(11) Do you have any comments on the Bank's thinking on the treatment of cross-bank MREL holdings and MREL disclosure? (Chapters 11/12)

Paragraphs 11.2 and 11.3 – Deduction of MREL cross-holdings

We are strongly in favour of the CRR2 approach of corresponding deduction, rather than the Basel proposal of Tier 2 deduction. The Basel approach could be particularly punitive for internal MREL. The Basel Committee preferred a deduction from Tier 2 as not all banks which held TLAC would have issued TLAC (the issuance requirement applying only to GSIBs, the holdings standard to all banks). We would note that in Europe, all banks (other than small banks subject to insolvency as their resolution strategy) will be required to issue MREL. The requirement to issue TLAC is a burden on G-SIBs. They should not be penalised twice by being denied the ability to deduct holdings on a 'like-for-like' basis – to have the ability to do so is not an advantage.

We encourage the Bank to adopt a corresponding deduction approach whereby deductions of MREL holdings are made from MREL resources. In our view, any divergence from this should be proportionate to the risks posed by cross-holdings of MREL, and should be justified through a focused impact analysis or monitoring period, which sets out the likely impact on the liquidity of MREL instruments. The starting point for an analysis of the proposed deduction approach should be the expected credit risk associated with MREL instruments, which is lower than that of regulatory capital. On this basis, an approach which requires MREL investments to be deducted from Tier 2 does not seem logical or justified.

We also think that market making and underwriting exemptions should be taken into account. To prevent disincentives to orderly market making in MREL securities, we recommend that the existing market making exemptions, as they relate to own funds instruments should be expanded to cover other eligible liabilities. In addition, we would like the Basel Standard which applies to the underwriting of TLAC liabilities, to be extended to MREL instruments.

(12) Are there any other comments which you would like to make which are relevant to this consultation and which you think the Bank should be aware of?

Yes, we would like to have more clarity on:

- Eligibility criteria – does "regulatory capital" refer to non-CET1 capital only?
- Consequences of internal MREL breaches. There is little information in the consultation paper on this. We are aware of the Bank's offline comments that internal MREL breaches are to be treated "as seriously as breach of external MREL" (and hence as seriously as a breach of capital requirements). It is important for industry to understand the precise consequences of internal MREL breaches, particularly because this will have affect the size and location of buffers (i.e. located at group, or entity level), including understanding who is accountable for internal MREL breaches (i.e. group or individual entities).
- MREL requirements apply on both RWA and leverage bases. We would like more clarity on whether internal MREL could be scaled using both measures even if the consolidated binding constraint is different (i.e. group external MREL calibrated for RWAs, but material subsidiary for leverage).
- When does the Bank expect to issue a final Statement of Policy?

We hope you find UK Finance's response helpful and would be happy to discuss any of the points raised in further detail.

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