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Stand out for the right reasons
Financial Services Risk and Regulation

Hot topic

The UK's approach to setting MREL

Only 3 weeks before the rules on MREL are due to come into effect, the BoE has set out its proposed approach to setting MREL for firms falling under the scope of BRRD. Designed to create the potential for loss absorbency where a firm is failing or likely to fail, the MREL requirement is broadly aligned with the TLAC standards proposed by the FSB for all G-SIBs. The BoE intends to set MREL on a case by case basis during 2016 and proposes a 4-year transition period (3 years for G-SIBs) to enable firms to restructure their debt and/or equity issuance.

The centrepiece of Europe's response to the disorderly bank failures seen during the crisis has been the wide-reaching Bank Recovery and Resolution Directive (BRRD). This introduces a resolution framework with tools for dealing with failing banks, building societies and €730k investment firms. It also requires these firms to produce recovery plans and grants supervisors sweeping powers to intervene when firms are experiencing a period of stress.

One of the most high-profile elements of the BRRD is the Minimum Requirement for own funds and Eligible Liabilities (MREL). This is intended to ensure that firms have sufficient capacity to absorb losses so that they can fail safely, thereby reducing (and ideally removing) the need for a public sector recapitalisation. The requirement can be met both through equity and/or loss-absorbing debt. It is conceptually similar to the Total Loss-Absorbing Capacity (TLAC) standard of the Financial Stability Board (FSB) which applies to Global Systemically Important Banks (G-SIBs) but MREL captures the wider population of firms in the scope of the BRRD.

The BRRD requires countries to set up resolution authorities that are expected to formulate resolution strategies. They are also given responsibility for setting a firm's MREL. In the UK the Bank of England (BoE) is the resolution authority. In order to operationalise MREL, the BoE has set out its proposed approach to setting MREL which provides an indication of the amount of MREL that firms will need to have – linked to the resolution strategy chosen for each firm – and applies criteria similar to those in the TLAC standards with respect to the criteria for MREL-eligibility and the distribution of MREL within groups.

The BoE's proposal provides clarity with respect to the application of MREL requirements to UK firms and the broad consistency with TLAC standards and pragmatic approach to the transition timetable are welcome. However, with some of the finer details yet to be confirmed and with the likelihood of different approaches to MREL (and TLAC) implementation by resolution authorities internationally, the operational challenges for firms remain significant.

Introduction

The BoE is using MREL as a mechanism to implement TLAC for the four UK-headquartered G-SIBs. But it also plans to apply some of the key TLAC principles to all of the other banks, building societies and investment firms that must comply with MREL. We have therefore applied a similar lens to that used in our recent TLAC publication to summarise the implications of MREL in four dimensions.

How much?

MREL will be set based on the following equation: *MREL = loss-absorption amount + recapitalisation amount* where the loss-absorption amount is equal to a firm's minimum capital requirement (the higher of: the sum of Pillar 1+2A risk-weighted capital requirements; leverage requirement; or Basel I floor) and the recapitalisation amount ranges from 0% to 100% of the loss-absorption amount, depending on a firm's BoE-prescribed resolution strategy. The criteria that the BoE will use to evaluate appropriate resolution strategies and the consequential impact on the MREL requirement are summarised in Figure 1.

Figure 1: Resolution strategies and MREL implications

	Resolution Strategy		
	Modified Insolvency	**Partial Transfer**	**Bail-in**
Criteria			
Stabilisation in the public interest?	No	Yes	Yes
Number of "transactional" accounts	<40,000	>40,000	>40,000
Other critical economic functions?	No	Maybe	Yes
Balance sheet size	N/A	<£15-25bn	>£15-25bn
Impact			
Amount of MREL (as % of minimum capital requirement)[1]	100%	100-200% pro rata to size of transfer	200%
Requirement to subordinate MREL?	N/A	No	Yes

[1]The BoE may vary these amounts depending on idiosyncratic resolvability challenges posed by firms.

Most firms will be given a resolution strategy of "modified insolvency" as their operations are not deemed critical to the UK economy (with modification required to ensure that customer deposits are protected and continuity of access is maintained). The recapitalisation amount will be zero so MREL will be set equal to the loss-absorption amount.

When resolving firms with more than 40,000 transactional accounts (broadly equivalent to current accounts), the BoE expects to use its stabilisation powers which include the transfer of certain assets and liabilities to a third party or the write down and conversion of unsecured liabilities. For firms at the smaller, less complex end – with a balance sheet below £15-£25bn and few critical economic functions – the BoE will perform a "partial transfer" of retail and SME deposits to a third party purchaser or bridge bank. The recapitalisation amount will be a percentage of the loss-absorption amount proportionate to the relative size of the transferred balances so MREL will be set at somewhere between 1x and 2x the loss-absorption amount.

For larger, more complex firms, the BoE considers bail-in to be the appropriate resolution strategy. The recapitalisation amount will be set equal to the loss-absorption amount, resulting in MREL being set at 2x the minimum capital requirement (subject to potential adjustment for the likely shape and size of the recovered entity post-resolution).

Of what?

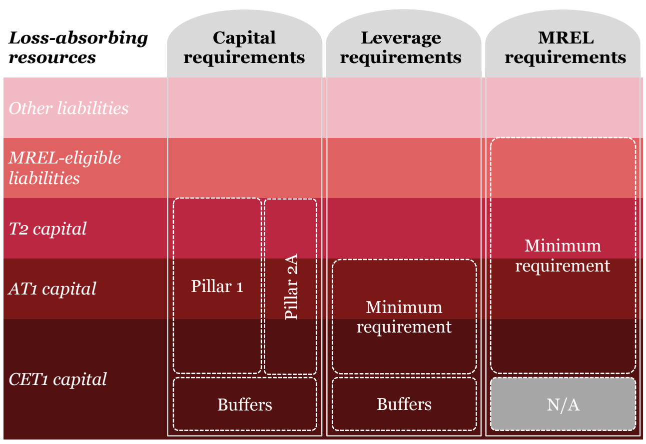
The BRRD stipulates a number of eligibility criteria for equity and debt instruments to qualify as MREL:

- issued and fully paid up;
- not owed to, secured by or guaranteed by a firm itself;
- not funded directly or indirectly by a firm;
- remaining maturity of at least one year;
- not a derivative liability; and
- not a preferred deposit.

The BoE proposes to extend these criteria to capture two additional exclusions consistent with the TLAC standards: liabilities subject to netting/set off; and liabilities with significant derivative components (e.g. structured notes). In addition, liabilities governed by the law of a non-EEA country will be required to include clauses on contractual recognition of the BoE's resolution powers in their terms or to have a statutory framework that recognises the same.

In a complementary consultation, the PRA clarified that CET1 capital which counts towards firms' RWA or leverage buffers cannot count towards MREL (and a breach of MREL would be treated equivalently to a breach of minimum capital requirements). This is illustrated in Figure 2 which summarises how firms' loss-absorbing resources may count towards capital, leverage and MREL requirements.

Figure 2: Summary of prudential regulatory requirements to enhance loss-absorbency



Located where?

The BoE proposes to apply strict subordination requirements to external MREL issuance of firms subject to a bail-in resolution strategy. These firms must achieve effective subordination of MREL-eligible liabilities via structural subordination; in other words, issuance of external MREL from a resolution entity (typically a holding company) which sits above (one or more) operating subsidiaries and which itself does not carry out any critical economic functions. Other (non bailin-able) liabilities of the resolution entity must be *de minimis* (less than 5% of the external MREL liabilities). The only exception to this rule is for building societies which are prohibited from establishing holding companies. These firms must instead ensure that their MREL liabilities are contractually subordinated to other liabilities. No subordination requirements will be applied to firms subject to a modified insolvency or partial transfer resolution strategy.

MREL requirements will be set on a solo and consolidated basis broadly consistent with the application of capital requirements. For groups, this means that external MREL must be issued out of the top resolution entity and then passed down to subsidiary operating entities which will need to meet internal MREL requirements.

The exact terms of these requirements remain under consideration but it is clear that external MREL resources must match internal MREL resources and that individual operating entities must meet their MREL requirements on a solo basis. It is also clear that internal MREL must be subordinated to operating liabilities of the subsidiary operating entities and must be subject to write-down or equity conversion without or before resolution of the operating entities themselves.

By when?

The MREL provisions under BRRD come into effect on 1 January 2016. However the BRRD provides for a 4-year transition period and (fortunately for firms) the BoE has chosen to exercise this option. As a result, the full MREL requirements won't be set until 1 January 2020 except in the case of G-SIBs which will need to comply with the first phase of TLAC by 1 January 2019. In the consultation, the BoE declares its intention to communicate each firm's MREL in 2016. This is likely to be in advance of the SRB's implementation in Europe, potentially causing difficulty for firms with subsidiaries in Europe.

The Bank notes that it still has the power to set an earlier target or higher MREL for particular institutions in the transitional phase. The Bank may consider doing so, for example, where action is needed to enhance an institution's resolvability or where MREL is necessary to advance the Bank's objectives as resolution authority.

What do I need to do?

While the BoE ultimately conducts the resolvability assessments that will be used to inform the MREL calibration for individual entities, the consultation provides more clarity to firms about which resolution strategy is likely to be applied to them. Firms should be assessing their resolvability themselves either before or in parallel to the resolution authority to mitigate the risk of being considered less resolvable than peers and therefore subject to a higher MREL requirement. Once the regulatory expectation become clear, firms can then determine the best way to meet their MREL. For firms which rely heavily on deposits, a decision will need to be made on the feasibility of meeting the requirements by issuing debt or whether capital issuance will be the preferred option. For firms that already make extensive use of wholesale funding, consideration will need to be given to the potential impact on capital allocation across the group as well as balance sheet optimisation more generally. These firms will need to review their existing liabilities to see how easily they can be replaced with MREL-eligible debt (the exclusion of structured notes will not be helpful in this regard). Internationally active firms will need to grapple with the different approaches being taken by countries authorities when implementing both TLAC and MREL. So far we have seen the US and Switzerland go above and beyond the minimum TLAC standards and other countries may well follow suit. Countries in Europe that are host to G-SIBs will be aligning their approaches to MREL with the TLAC standard to varying degrees. Finally, the scope of the proposed rules (in particular, the relatively low balance sheet size hurdle rate for 'triggering' a bail-in resolution strategy) is broader than anticipated so we recommend mid-tier firms or those on the cusps of the triggers set by the BoE remain vigilant to the possibility of more onerous requirements than they may have been expecting. Firms that wish to respond to the consultation need to submit their response by 11 March 2016.

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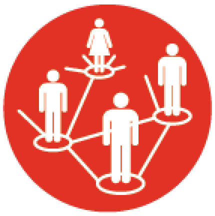

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