FINANCIAL REGULATION

UK's MREL proposal: alignment with TLAC in one ratio

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On 11 December 2015, the Bank of England (BoE) published its approach[1] on setting the Minimum Requirement for own funds and Eligible Liabilities (MREL) for all UK banks, building societies and certain investment firms. The consultation is open for comments until 11 March 2016. This analysis will provide a summary of the BoE's proposal, with a special focus on an important feature of the document: the first implementation of the Financial Stability Board's (FSB) Total Loss Absorbing Capacity (TLAC) in Europe.

The UK has taken the lead as the first member state of the EU to release a proposal in order to implement into national law both the EU's MREL and the FSB's TLAC requirements. It does so by combining their principal characteristics into a **single loss absorbing/recapitalisation requirement**, also called MREL, that will be binding for all UK banks and other covered entities, but its calibration will depend on the characteristics of each bank. UK G-SIBs and other large institutions will have to comply with an MREL that will incorporate similar characteristics to those of the FSB's TLAC. The main features of the UK MREL are:

- **Scope**: the requirement will be binding for all UK banks.
- **Calibration**: depends on the size of the entity. The BoE sorts banks into three groups:
  - **Small banks** will have an MREL equal to their minimum capital requirements.
  - Banks which will use a **partial transfer** as their main resolution tool will have to maintain a larger MREL equal to that of small banks plus an additional amount **depending on the amount of assets transferred.**
  - **Banks with bail-in** as their main resolution tool (**G-SIBs and other large banks**) will have to hold an MREL equal to **double** that of the small banks, albeit with some adjustments.
- It will **not include any floor** such as the minimum of 8% of total assets.
- **Neutrality vis-à-vis MPE and SPE models**: it will be set according to the resolution strategy of the bank.
- **Eligible instruments:** very similar to TLAC, unsecured liabilities with a remaining maturity of one year, without "significant" derivatives components.
- **But requires structural subordination** for G-SIBs and other large banks.
- **Entry into force:** Fully binding for G-SIBs in 2019 and 2020 for the rest. This is a postponement compared to the European MREL because banks will not have to comply with an additional requirement until those dates.
- Introduces the concepts of **external and internal MREL** which are almost fully aligned with those of the FSB.

1: http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf

Also, the BoE's proposal includes an impact study. Its main findings are the following:

- MREL shortfall for UK banks will be £27bn. Annual costs related to MREL will be £1.5mn
- MREL reduces by 1/3 the probability of default of a G-SIB and reduces the cost of a financial crisis by 5.4 – 11.4% of annual GDP. MREL's overall benefits will increase annual GDP by 0.3 – 0.9%

All in all, the BoE's proposal **to set MREL and to incorporate TLAC related features to UK G-SIBs** and other entities with bail-in as their main resolution strategy represents an original yet proportionate approach. This proposal **respects the resolution strategy of each bank and takes into account their business models** when setting their MREL. In October of this year the EBA will publish a report on the implementation of MREL. On the basis of this report the EU Commission, if appropriate, may submit by 31 December 2016 to the EU Parliament and to the Council a legislative proposal to harmonize MREL in Europe. One of the expected modifications is the introduction of the TLAC, either by adding a new requirement or by amending MREL to include additional requirements for G-SIBs. For that purpose, **European authorities will surely take into account the UK's approach.**

Determining the MREL: Three types of entities, three sizes of MREL

The BoE's intention is to set the MREL according to the EBA's definition, that is, the sum of a Loss Absorbing Amount (LAA) and a Recapitalisation Amount (RA) and the maximum of either the own funds requirement, the leverage ratio or the Basel I floor. However, unlike the EBA's RTS, the BoE identifies three categories of banks depending on their size and resolution strategy, and sets different MREL requirements for each of them. The BoE also adds a requirement for debt subordination.

All institutions are required to have a LAA which is equal to the minimum capital requirements (Pillar 1 + Pillar 2A[2]). **The difference will be in the RA part of the MREL** which will depend on the size and resolution strategy of each bank:

1) **Small banks (Institutions with fewer than 40,000 "transactional accounts[3]")** would probably be subject to a modified insolvency process as they will most likely not use the stabilisation powers needed to maintain the public interest. Accordingly, their MREL is set equal to their minimum capital requirements. In other words, the **RA is equal to zero** which means that these institutions do not have to meet an additional obligation. Thus, no subordination is required.
2) **Institutions with more than 40,000 "transactional accounts" and a balance sheet of less than £15bn to £25bn** are likely to have a **partial transfer** resolution strategy (to a bridge bank for example). The MREL is equal to their current minimum capital requirements plus a **RA that will be calculated according to the proportion of the balance sheet to be transferred**. Generally, no subordination is required: banks with a partial transfer strategy will not be required to subordinate their debt if only liabilities benefitting from preference (e.g. covered deposits and uncovered deposits from natural persons and SMEs) are transferred.
3) **Institutions with a balance sheet size greater than £15bn to £25bn** are likely to have a **bail-in** strategy. Their MREL will **double their current minimum capital requirements** (one for LAA and one

2: Additional amount of capital institutions should hold to cover risks not captured in Pillar 1 (ex: interest rate risk). For information, Pillar 2B is a buffer which helps to ensure that firms can meet minimum requirements (P1 and P2A) during a stress period.
3: Current or payment accounts, however the proposal leaves this definition open for comments

for RA) minus any changes to post-resolution capital requirements that the resolution authority might apply. Subordination to senior operating liabilities is required[4].

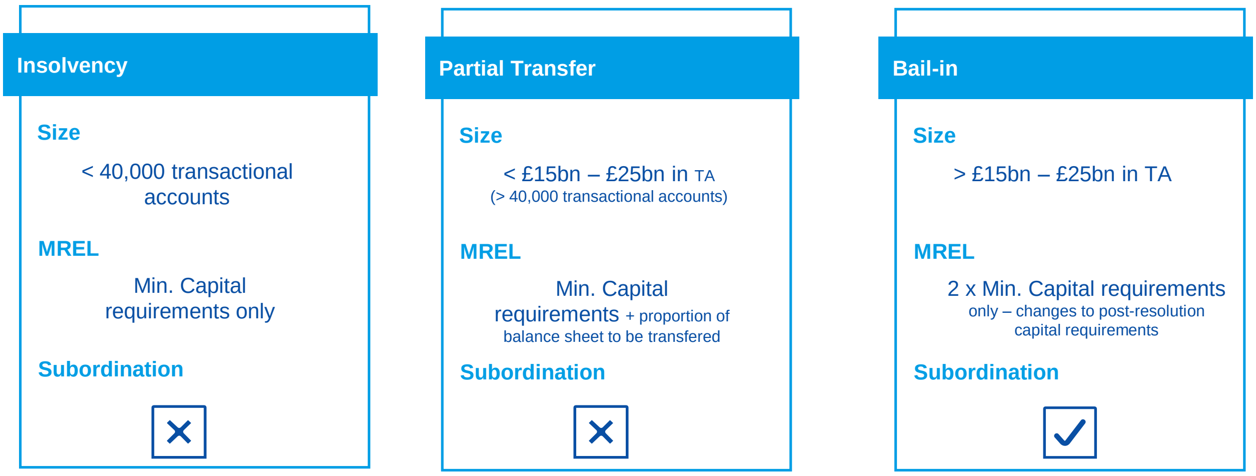
The UK proposal **does not contain any references to** an MREL level of at least **8%** of total liabilities and own funds. This reference appears in the BRRD and the EBA's RTS as a binding obligation that must be met before a bank can access the resources of the resolution fund. Furthermore, the SRB has repeatedly said that it will use the 8% constraint to determine the minimum MREL level for banks under its remit. However, the UK is not part of the Banking Union and its banks are beyond the scope of the SRB.

Regarding its entry into force, the MREL will be **fully binding in its final form by 1 January 2020; until then the BoE expects to set a level of MREL equal to institutions' minimum capital requirements**[5].

Therefore, and unlike banks under the SRB's authority, UK banks will:

- Not have the obligation to comply with the 8% floor.
- Not have to comply with an additional requirement until 2020 (European banks will have to comply with an individualized calendar to reach their final MREL from 2016 until 2020 at the very latest).

Figure 1
MREL Calibration in the UK



TA = Total Assets
Transactional accounts = current or payment accounts
Minimum Capital requirements = Pillar 1 + Pillar 2A
Source: BBVA Research

TLAC is implemented through MREL

In addition to those new features previously analyzed, the BoE plans to implement the FSB's TLAC standard through MREL. It will not demand that banks comply with an additional separate requirement, but it will require UK G-SIBs and other institutions to comply with a ratio which includes characteristics of the MREL and of the TLAC. **The main features adopted from the TLAC requirement are the eligibility of instruments, the mandatory subordination and the distinction between internal and external MREL/TLAC**. Altogether, this new MREL is a balanced mix of both the FSB's and the European loss absorbing and recapitalization requirements, although it contains several additional elements worth mentioning:

The main characteristics of the UK proposal as compared to the FSB's TLAC are the following:

4: The BRRD does not require subordination but the BoE's requisite is consistent with the TLAC principles.
5: "Except where, for example, the Bank has particular concerns about a firm's resolvability or to implement international standards".

- **Scope:** The BoE will set an MREL for the four UK G-SIBs[6] "as necessary to implement the TLAC standard and will set similar requirements for all institutions where the preferred resolution strategy is bail-in" (i.e. entities with balance sheets greater than £15bn to £25bn). TLAC is binding only for G-SIBs. Thus the BoE seems to **enlarge the scope** of entities that need to comply with TLAC or a similar requisite to include banks other than G-SIBs.

- **Sizing:** The MREL for UK G-SIBs and other institutions with more than £15bn to £25bn in assets is **twice the minimum capital requirements**. However the **BoE may adjust** the final amount by removing "all or part of any components of Pillar 2A that would not apply post-resolution". Compared to it, TLAC is a common minimum standard (Pillar 1). Therefore, for a firm with a minimum capital requirement of, let's say, 11% (8% of Pillar 1 and 3% of Pillar 2A) of its RWAs, its MREL would be close to the minimum TLAC requirement.

- **Buffers:** The BoE **plans to exclude them from the MREL calculation**. The final outcome will depend on a parallel PRA consultation on buffers (see next section). The TLAC term sheet excludes the buffers from the requirement's calculation which means that these buffers "come on top" of the TLAC requisite.

- **Eligible instruments:** Both the UK MREL and the TLAC **share more or less the same conditions for eligibility**: instruments with a remaining maturity of more than one year, no liabilities with significant derivative components (UK MREL) or no derivatives at all (TLAC), no structured notes and instruments that must not be subject to set-off or netting arrangements. However the BoE has **not yet adopted the FSB's TLAC exception in order to include an amount equivalent to 2.5 – 3.5% in RWAs** of senior debt ranking *pari passu* with excluded liabilities, if these do not represent more than 5% of the bank's external TLAC. The proposal says that the BoE expects to apply a similar approach for institutions with structural subordination.

  Furthermore, the proposal does not require banks to comply with MREL with a minimum amount of debt instruments such as the FSB's TLAC requirement with 33% of non-regulatory capital instruments.

- **Issuance of external/internal MREL:**
  - Here the BoE's approach matches that of the FSB and introduces the concept of internal and external MREL by copying the features of internal and external TLAC. It is a neutral proposal as regards to the choice of an entity's resolution strategy[7]. External MREL will be issued by resolution entities
  - However, there is a slight difference between internal MREL and internal TLAC. The first needs to be issued by "relevant operating entities", whereas the second is issued by "material sub-groups"[8]. Again, the BoE seems to widen the scope by requiring internal MREL at subsidiaries regardless of their material importance. Also, another difference with the TLAC term sheet is that the calibration of the internal MREL is not specified (no 75% - 90% scaling compared to the external MREL).
  - Furthermore, and contrary to the TLAC term sheet, the proposal does not mention the possible adjustments to minimize or eliminate the difference between the sum of MREL requirements of resolution entities within a G-SIB and the MREL requirement which would apply if the G-SIB were to have one resolution entity only.

6: In November 2015 the FSB G-SIBs list included HSBC, Barclays, RBS and Standard Chartered
7: By following the FSB's principles, no resolution model (MPE or SPE) is penalized
8: Have more than 5% of either: i) consolidated RWAs of the G-SIB, ii) 5% of total operating income of the G-SIB, iii) 5% of G-SIB's consolidated leverage exposure or iv) identified as such by the firm's CMG.

- **Entry into force:** The BoE's MREL enters into force in 2016 but the BoE's intention is to set MREL for all banks equal to their minimum regulatory capital requirements until 1 January 2019 for G-SIBs and 1 January 2020 for the rest of the banks. TLAC enters into force on 1 January 2019 with a phase in period of three years. Other European banks will have a tighter schedule as they will be required to comply with an increasingly higher MREL between 2016 and 2020.
- Concerning **debt subordination,** the BoE's **will require institutions with a bail-in resolution strategy to achieve structural subordination**. Unlike the FSB term sheet that allows 3 types of subordination: contractual, statutory and structural, the BoE clearly states its preference for the structural version and allows the contractual approach for building societies only.

The following table summarizes the comparison between the UK MREL and TLAC:

Table 1
Comparison of UK's MREL with TLAC

	UK TLAC Implementation through MREL	FSB TLAC	Comparison
Scope	UK G-SIBs (**similar requirements** for large entities)	G-SIBs	≈
Eligible Instruments	* Liabilities without significant derivative components, no structured notes, not subject to set off or netting * Maturity >= 1 year * Liab. Governed by law of non-EEA state must include bail-in contractual clauses	* No derivatives, no structured notes, not subject to set off or netting * Maturity >= 1 year * No law requirement but resolution tools must be binding and effective (on the basis of statutory or contractual provisions)	✓
Sizing	(Min. Capital requirements * 2) - Adjustments	TLAC = 18% RWAs or 6,75% LR by 2022	≈
Entry into force	2019 for G-Sibs, 2020 otherwise	2019	✓
Issuance of Internal/External requisite	External: issued by resolution entity **Internal: issued by "relevant operating entity"**	External: issued by resolution entity Internal: issued by "material subsidiaries"	✓
Calibration of internal requisite	Scaling but not specified	Scaling of 75% - 90% of external TLAC	✗
Buffers	Planning not to include them	Not included	✓
Subordination required?	**Yes, structural**	Yes, contractual, statutory or structural	✓
Min. debt?	No	33%	✗
Exception to subordination	Not yet	Yes up to 2,5-3,5% RWAs	✗
Disclosure	Not yet	Yes	✗

Source: BBVA Research

Further considerations that need to be clarified

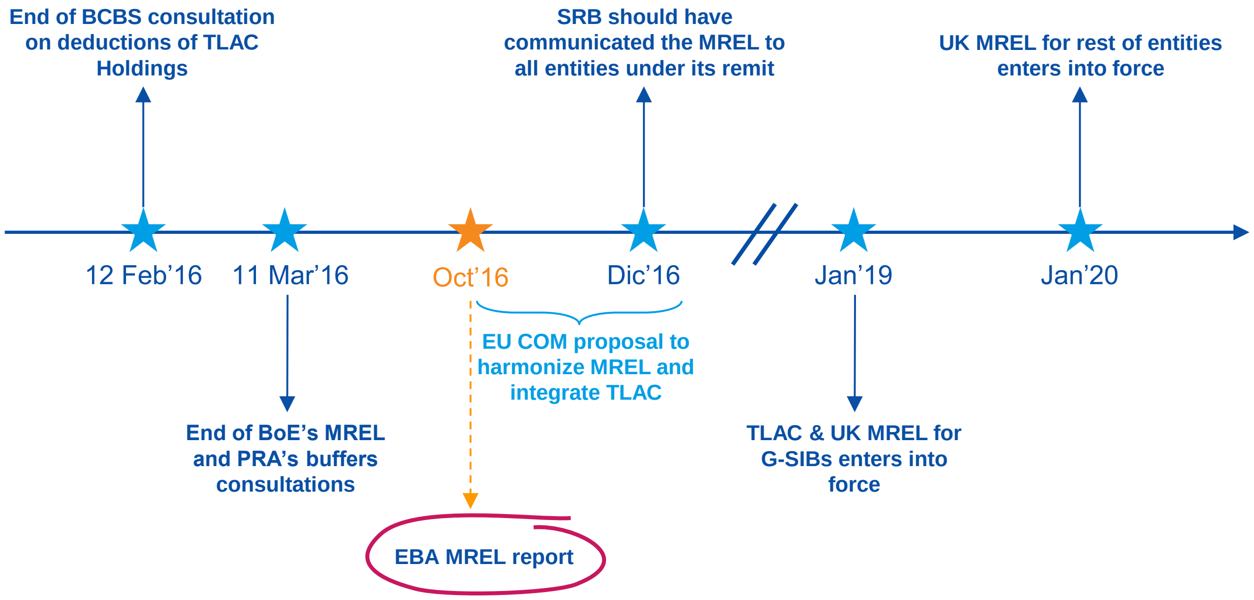
The BoE leaves certain topics up for discussion before the final policy document is released:

- The TLAC Term Sheet requires public **disclosure** of G-SIBs' eligible TLAC. The BoE might consider requiring disclosure of MREL once the BCBS publishes its corresponding standards in relation to TLAC.
- In parallel to the MREL proposed approach, the Prudential Regulation Authority (PRA) has released a consultation paper regarding the relationship between MREL and regulatory buffers[9]. This consultation is crucial as it will determine the final calibration of the MREL by including, or not, capital buffers in its calculation. Basically, the PRA's intention is to consider the FSB's TLAC proposal **not to double-count CET1 capital towards TLAC (MREL) and regulatory buffers at the same time**. The objective is that

9: http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp4415.aspx the first losses a bank suffers are absorbed by the buffers. MREL would only start absorbing losses once these buffers are depleted and would thus not include these buffers in its calculation.

- In order to reduce contagion risks in the banking sector, the BCBS is currently consulting on a proposal to **expand to other banks the FSB's requirement that G-SIBs have to deduct from their own TLAC exposures to external TLAC instruments issued by other G-SIBs**. Once published, the BoE will consider adding to its proposal a similar deduction of MREL holdings.

Figure 2
Upcoming events



Source: BBVA Research

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