MRELs : Minimum Requirements for Own Funds and Eligible Liabilities

BSA response to Bank of England consultation

10 March 2016

Building Societies Association

Introduction

The BSA is pleased to respond to the Bank's CP on MRELs, building on the challenging but useful dialogue we have had with the Bank's Resolution Directorate. Abbreviations used in the CP are used similarly in this response. We appreciate that the Bank is or will be constrained both by BRRD and by the final text of the RTS, relating to MRELs, so far drafted by the EBA. In this response we concentrate on matters relevant to building societies – as building societies are always at the head of any group, and cannot therefore use structural subordination, we do not address the various questions of group structure and external / internal MREL raised in the CP. We leave much of the technical details regarding MREL instruments and eligibility to be covered in separate contributions from senior practitioners.

Summary

The BSA supports the development of an effective regime for bank resolution. We agree that failing deposit-takers need to be able to be resolved safely, without the taxpayer bailouts or massive calls on FSCS levy payers which were a feature of the banking crisis (and in the latter case for which our members are still paying). So we agree that these costs need to be allocated first to the holders of any forms of capital, and then to categories of non-preferred creditors – and we recognise that for institutions such as building societies which do not have a large natural stock of liabilities eligible for bail-in, this may result in some needing to issue new bail-in debt. The cost of doing so will be considerable, and will ultimately be borne by customers, so MRELs need to be sensibly calibrated without overshooting. Like over-insurance, holding excessive levels of MRELs benefits no-one, and in the case of mutuals like building societies, will divert too much of the society's earnings away from members and into servicing MREL instruments held by wholesale bondholders. Moreover, the application of MRELs through the partial transfer strategy to medium sized deposit-takers which have entered the current account market risks creating, through a massive cliff effect at the boundary, a major barrier to competition in the current account market. Instead we need a more graduated result. And the potential inclusion of other types of accounts that may sometimes be used for transactional purposes may only encourage providers towards removing payment functionality from those accounts.

Detailed comments

Range of thresholds

There are at present a range of different thresholds that all broadly capture some aspect of systemic importance, and the lower boundary the Bank proposes for whole-firm bail-in (indicatively £15 to 25 billion total assets) sits towards the low end of the range. For UK ring fencing, the threshold[1] is £25 billion of core retail deposits, while for certain other regulatory measures – such as concurrent stress testing, and the PRA leverage ratio framework[2] – the threshold is £ 50 billion retail deposits. Finally, the current threshold for setting a systemic risk buffer[3] is much higher, at £ 175 billion total assets. At the other extreme, one threshold proposed in the PRA's concurrent CP on operational continuity[4] is £350 million of sight deposits. We propose a threshold for whole-firm bail-in more in the middle of this range of systemic boundaries – at £ 50 billion retail deposits.

For firms with fewer than 40,000 transactional accounts, the Bank is contemplating a modified insolvency strategy which would involve the winding up of the failed bank or building society, with *"any covered depositors being compensated* ***or transferred****….."* according to the CP (paragraph 3.16, emphasis added) . It is not clear to us why transfer should form part of the modified insolvency resolution strategy and, if transfers are contemplated for these smaller firms, how these would differ in practice from firms to which a partial transfer resolution strategy applies.

This is a significant concern for our smaller members. PRA has previously flagged that waivers from the continuity of access requirements may be available for small firms. However, if some form of transfer is contemplated as an option under a modified insolvency resolution strategy, that would appear to erode the possibility that a waiver application would succeed. At the other end of the scale, we understand waivers may be available for very large firms to which a bail-in resolution strategy is likely to apply. The rationale being that such a strategy would not involve a transfer of covered deposits to a third party.

There remains a lot of uncertainty about the availability of waivers under the continuity of access requirements, and confusion over the apparent inconsistency with resolution policy. Firms want to be sure that a waiver application has a good chance of succeeding as time spent pursuing a waiver application risks missed deadlines in the event that the application fails. Given that this question is closely linked to recovery and resolution planning, it would be helpful if the Bank and PRA could use the opportunity of their responses to the current round of consultation to clarify the overall position.

Quantum of bail-in debt

The clear explanations in the CP about not only the three resolution strategies, but also the quantification of bail-inable debt requirements, are helpful. While clear, we also think there is an element of overshoot, as follows. The premise for setting the

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[1] The Financial Services and Markets Act 2000 (Ring-fenced Bodies and Core Activities) Order 2014 Article 12: http://www.legislation.gov.uk/ukdsi/2014/9780111117118/article/12

[2] Policy Statement 27/15, Implementing a UK leverage ratio framework, December 2015: http://www.bankofengland.co.uk/pra/Documents/publications/ps/2015/ps2715.pdf

[3] The Financial Policy Committee's framework for the systemic risk buffer, January 2016, http://www.bankofengland.co.uk/financialstability/Documents/fpc/srbf_cp.pdf

[4] PRA CP 38/15 Addendum, December 2015.

recapitalisation amount at 100% of the failing institution's pre-failure Pillars 1 plus 2A capital requirements is that while failing, the institution's losses have consumed 100% of its original minimum capital, and that it must be recapitalised to an equivalent standard to enable it to retain authorisation. But this approach assumes that the loss absorption process does not change either the nature or amount of the assets and liabilities of the institution (apart from capital, which has been consumed). Whereas in fact, during the institution's failure trajectory, including vigorous but ultimately unsuccessful recovery attempts, losses will crystallise as some seriously impaired assets are realised by enforcement action (triggering some of the loss absorption, but also removing the assets from the balance sheet), while other less impaired assets will have been sold, even at a distressed price, as one of the recovery plans (again, this will crystallise losses but remove the assets from the post-recapitalisation balance sheet). Other deleveraging actions that feature in recovery plans– e.g. slowdown or cessation in new lending, non-renewal of maturing wholesale funds – will add to this effect. So we would argue that the progress towards 100% loss absorption will lead to a shrunken institution for which a 100% recapitalisation amount based on its total pre-failure balance sheet is not necessary, while if the institution remains at its pre-failure size and composition, it is unlikely to have reached the point of consuming 100% of its capital through loss absorption. We think this argument is particularly noteworthy for institutions that are not G-SIBs.

A separate but related point is whether the leverage ratio (where applicable) should also be used to calibrate the loss absorption and recapitalisation amounts, if it proves to be the binding constraint. At present, of course, the leverage ratio, while reportable, does not constitute a Pillar 1 requirement under the EU's banking single rule book, and will not do so until the requisite process under CRR Article 511 has been complete, and the CRR itself amended. In the meantime, some weaknesses in the simple leverage ratio concept are becoming apparent – the most obvious being the perverse results of including within the exposure measure a deposit-taker's holding of reserves at the central bank. The perverse effects would, of course, be seen as and when liquidity assistance were to be provided to that deposit-taker. To use the leverage ratio to set the loss absorption and recapitalisation components of MREL at a level higher than the RWA based P1 plus P2A would only compound the effect of these weaknesses. Moreover, as we explained above, we think the Bank's proposed calibration in relation to RWAs already builds in additional prudence, so the further increase from using the leverage ratio could see substantially diminishing incremental benefit from the extra cost. We suggest that, at least for the present, the leverage ratio is left out of the calibration.

Partial transfer lower boundary

This is the area of greatest concern to our members, and where the most serious issues of competition arise. We appreciate the desirability of retaining access to significant numbers of accounts providing critical transactional banking services. But we think the Bank's proposals could have unintended anti-competitive effects unless the extremely steep cliff edge at the lower boundary can be replaced by a more graduated approach.

First, we ask whether hard thresholds and definitions are appropriate anyway, given the dynamic nature of the resolution objectives? To give but one example, what is necessary during a system-wide crisis may not be the same as for an idiosyncratic failure. In a system-wide crisis, the cumulative effect of several smaller deposit-takers failing may assume a systemic dimension. Whereas a single idiosyncratic failure caused by the crystallisation of weaknesses at, say, an aggressively- expanding bank is clearly a much more containable event. We already mentioned above the apparent inconsistency with the continuity of access requirements, where a lower threshold of £350 million of sight deposits applies.

But if hard thresholds and definitions cannot be avoided, we suggest alternative approaches below. On numbers of accounts, for instance, we propose that this should be more explicitly related to system-wide considerations, by setting the threshold not as an absolute number, but as a (very small) proportion of the stock of active personal current accounts in the UK. We consider a threshold of 0.25% of that stock (which would currently equate to around 187,500 based on around 75 million active PCAs) would be a better fit with the resolution objectives and the systemic dimension, and would not need constant recalibrating as both individual institutions and the whole market grow.

As to definitions, we favour a narrow specification of what is a current account, that does not include savings accounts that may possess some payment or transaction features, but which are intended more as a store of value. As was appreciated during our discussions, while every current account holder may be presumed to use their account as a critical transactional account, the same cannot be said for, say, an instant access savings account with ATM / debit card access and bill payment and credit transfer functionality. Some customers, perhaps a minority, may choose to use that account (whether or not the account was designed for this purpose) continuously for essential day to day needs, while others may well be using it to save for a specific purpose, or just to hold a rainy day fund. So there is an important behavioural dimension to such accounts which is not captured by bare numbers.

The Bank has also made the important point that the determination of resolution strategies is an individual case- specific function of the Bank, and will not involve the making of explicit general rules. As the Bank's CP states (paragraph 3.9) –" *The term "current account" is not exhaustively defined, though **its general meaning is well understood***" (emphasis added) . Is a more precise definition needed? If so, the wording in paragraph 3.8 of the Bank's CP, which is quite close to the language used by the CMA, would be a good place to start.

Account coverage of partial transfer strategy

The rationale for the partial transfer strategy is based, reasonably enough, on the needs of customers who rely on uninterrupted access to their principal current account to access cash and make payments essential for day to day life. The rationale does not apply to other customers of the same institution who may hold conventional savings accounts (or even to the same customers who may have both a current and a savings account). So the logic of the partial transfer strategy is that it is the significant block of current accounts that need to be transferred, not necessarily the remainder of the institution's protected deposits held in conventional savings accounts. However, in discussion with the Bank, it is clear that – largely for operational rather than policy reasons – what is envisaged is that once an institution passes the significance threshold (proposed at 40,000 current accounts) the partial transfer strategy will in practice require the transfer of the entirety of the protected deposits with MRELs calibrated accordingly. The Bank has given several reasons, each worthy of consideration, why this should be so, but we consider that even taken together they are not insurmountable – and the alternative, of insisting on transferring more or less the whole deposit book, and establishing an extremely steep cliff edge at the lower boundary, is – we think – a worse outcome. The problem is particularly acute for building societies as almost their entire business on the liability side is personal savings – so practically the entire business would have to be transferred. Consequently, the quantum of MRELs needed might be not far short of the 100% recapitalisation amount required in whole-firm bail-in.

At the most practical level, the Bank pointed out that there are clearly systems challenges in separating a customer's current account from any savings accounts – not least that the total amount of FSCS protection, £75,000, will have to be allocated between these accounts. But our understanding is that this is going to be required anyway, as a result of other measures, with the general approach being that the £75,000 will be allocated between accounts in descending order of accessibility – so the allocation between any current account and other savings accounts will have to have been made. Moreover, since the resolution strategy is a bespoke decision, the Bank can ascertain when setting the quantum of MRELs whether the institution's systems are capable of readily segregating the current accounts with a view to transfer.

A further objection raised by the Bank is that the block of current accounts, separated from any savings accounts that may be held by the same customers, would be an unattractive portfolio for another bank to acquire, not least because those same customers (rather than being grateful to have kept uninterrupted access to their day to day cash) will be disgruntled that their savings accounts - though still protected up to the balance of the £75,000 - remain in an institution that enters special administration and the protected sums will be paid out by the FSCS. Again, this is a reasonable objection, but we consider that it would simply be one of many factors that would have a bearing on the price extracted by the recipient bank for accepting the transfer, and is most unlikely on its own to be a deal-breaker.

Cost and availability of bail-in debt

This important issue is addressed in the Impact Assessment in Chapter 8 of the CP. We strongly re-inforce some of the concerns raised, but not fully answered, in paragraphs 8.43-8.44.

Paragraph 8.43 mentions that :

- Smaller institutions may find it more costly to structure their funding to be MREL-eligible;
- Investor monitoring costs may increase the cost of wholesale debt funding by smaller institutions;
- Fixed costs (of smaller MREL issues) may also increase the cost for small institutions; and

- Some (smaller) institutions may be unable to access MREL from wholesale debt markets at all.

The last two points particularly relate to building societies. Paragraph 8.43 goes on to say : *"our evidence shows that at least 80% of the institutions we expect to be subject to substantive MREL have either issued unsecured wholesale debt of some form over the last seven years....."*. But there is no mention of those that have not – or how that affects the Bank's costing above.

Paragraph 8.44 of the CP suggests *"the increase in the weighted average cost of funding for institutions that are subject to partial transfer strategies would be 0.09 percentage points and hence higher than the impact on institutions subject to bail-in (0.02%)"*. We take this as acknowledgement that partial transfer firms are going to be hit disproportionately hard. But there is no information on how the Bank arrived at these figures, and in particular, what Bank officials have assumed in relation to partial transfer firms that have never issued debt before.

Firms subject to the full bail-in regime may also in practice face documentary constraints in existing instruments still in issue that in effect force them to raise MREL as Tier 2 regulatory capital, which may prove costlier than other options theoretically available.

The scale of aggregate demand for new issues of subordinated instruments to satisfy MREL raises serious questions whether this can be satisfied from the market over the timescale envisaged. The Bank's CP estimated the UK banking sector's net MREL shortfall (after retro-fitting of existing long term debt issues) at £ 27 billion. Comparable, perhaps greater, shortfalls almost certainly exist in other major markets. But the issuance needed to meet that shortfall will have to be telescoped into a relatively short period – for G-SIBs (where the bulk of the shortfall probably resides) by 1 January 2019; and for other banks one year later. The appetite of the largest banks for MREL issuance can only exacerbate the cost and availability concerns for affected building societies in the short term.

Accordingly, we urge the Bank to clarify that legacy capital instruments, which may no longer qualify as regulatory capital under the Basel 3 / CRR criteria and are being phased out under the grandfathering rules, should unambiguously qualify as MREL. Recycling these instruments is a highly efficient way to meet the initial quantum of MREL, and mitigate the capacity problem.

Anti-competitive effect of partial transfer lower boundary

Paragraph 8.46(a) states that not imposing MREL for small firms might make it easy for them to establish themselves – and then if they reached the threshold, they *"may be more confident investing into additional long-term growth, even if this means becoming subject to stricter MREL"*. But the level of 40,000 current accounts is far too small for this to be a credible threshold in relation to the costs of running a money transmission business and the investment needed in coping with its continual evolution. Constantly evolving technology in the last few years (chip and pin, internet banking, mobile banking, Apple Pay to name but a few) and generally low profits in money transmission, mean viability for numbers of current accounts is high; making any kind of return on 40,000 is a challenge. So the danger of this threshold is that it prevents current account challengers reaching viability before being hit with the disproportionate burden of MRELs calculated on the basis that the Bank now seems to envisage (i.e. not limited to the current account book, but including other protected deposits). A higher threshold, towards 200,000 – 250,000, might be more appropriate and would avoid effectively creating a solid barrier to entry. Our counter-proposal is to base the threshold on say 0.25% of the total of active PCAs in the UK. This would give a current figure around 187,500, and would naturally keep pace with growth in the PCA market.

The following stylised illustration outlines our concerns at the anti-competitive effect of the lower boundary on the basis currently proposed by the Bank. For simplicity, the illustration assumes a clear distinction between current accounts and savings accounts, and that the lower boundary is set at 40,000 current accounts as in the paper. Consider three medium sized deposit-takers:

Firm A has total retail deposits of £2 billion but does not offer current accounts – all its retail funds are held in conventional savings accounts.
Firm B, which does offer current accounts, also has total retail deposits of £ 2 billion, but of that total £ 100 million is held in 50,000 current accounts.
Firm C, which also offers current accounts, but started doing so more recently, has total retail deposits of £ 3 billion, of which £ 30 million is held in 30,000 current accounts.

Under the Bank's proposals:

Firm A can be put into a modified insolvency procedure, and its MRELs will remain zero.
Firm B will be subject to partial transfer, and will require MRELs calibrated not on transferring the £100 million current account balances, but on transferring the entire £ 2 billion.
Firm C, 50% larger than Firm B, but with – for the time being – fewer current accounts, will also be subject to a modified insolvency procedure and its MRELs will be zero.

We now consider what incentives this creates for each of Firms A, B and C.

Firm A has explored the possibility of developing a current account within its next five year plan, but it sees what happens to Firm B in respect of MRELs, and these plans are hastily dropped.
Firm B computes the massive cost of issuing bail-in debt to meet its MRELs, drops any plans to develop its current account product further, and decides to manage down the stock of current accounts to below 40,000.
Firm C realises that it cannot grow its current account business because of the sudden burden of MRELs if they exceed 40,000, and similarly de-emphasises the product and manages down any volume growth.

What is needed, instead of these stark cliff effects, is some way to make the transition more gradual. We ask the Bank to think again in this area, including looking at ways (short of subsidiarisation) by which current accounts can more readily be segregated for potential transfer.

Disclosure: unintended signalling

The CP covers, in section 7, the general question of disclosure. Our detailed comment on section 7.4 is that it appears written very much from a wholesale creditor perspective. Building societies have relatively few unsecured wholesale creditors – their predominant funding source is retail, and much market funding is raised through repo and/or covered bonds on a secured basis. So the extent of disclosure of MRELs may add little practical value even in the terms of paragraph 7.4.

Disclosure also raises a wider question of perception – common to retail and corporate investors. The three-bucket structure of resolution strategies runs the risk, through unintended signalling, of re-creating (in conjunction with other post-crisis policies) the competition problems previously posed by "too big to fail", though in a different form. Assuming that disclosure of MRELs discloses at least implicitly the choice of resolution strategy, there is a risk that it will create a perceived tiering – with a first, second, and third division- in deposit-takers' suitability as counterparties. Those subject to whole-firm bail-in will now have official recognition that they are too big and important to be broken up, as they must be recapitalised as a whole. This is particularly attractive for depositors with total holdings over the FSCS limit. In the second division, deposit takers have some important protected deposits that merit transfer, though holders of unprotected deposits must fend for themselves, while the third division entities, subject to an insolvency procedure on the basis that their customers don't matter enough, will look the least appealing type of counterparty regardless of individual financial strength.

This tiering is to some extent unavoidable given the three-bucket resolution framework outlined by the Bank. But we would encourage the Bank and PRA to look carefully at all language used around resolution, MRELs and other related issues, to see how these perceptions could be minimised. The BSA would be happy to cooperate in this endeavour.

Demutualisation

Although this is not critical to the detail of the MREL consultation, we take this opportunity to re-iterate the BSA's firm view that demutualisation is not a necessary precursor to the bail-in of a building society, and moreover is not mandated by the BRRD in these circumstances, contrary to what has been asserted in earlier papers. From our recent discussions, we understand that the Bank's view is based more on the practicalities of ensuring continuity and legitimacy of Board governance and effective senior management through the resolution process, and the need for the shareholders of the recapitalised bank to have a positive incentive to see the bank recover and thrive. We understand the Bank's views, but we are confident that both these matters can be satisfactorily addressed for bail-in within a mutual structure. We will be pleased to engage in further discussions with the Bank on this subject in due course, separately from the immediate issue of setting MRELs.

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