Bank Creditor Hierarchy Directive

HM Treasury

RPC rating: fit for purpose

Description of proposal

The impact assessment (IA) relates to the domestic implementation of The Bank Creditor Hierarchy Directive (EU Directive 2017/2399), which was adopted by the European Parliament on 12 December 2017. The directive aims to create a new class of senior unsecured debt called 'non-preferred senior' debt. This is a new type of debt banks can issue. It provides an additional method for firms to issue their requirements under MREL (the minimum requirement for own fund and eligible liabilities).MREL, according to the Bank of England, is *"a requirement for the minimum loss-absorbing capacity institutions must hold, and it can comprise both 'going concern' and 'gone concern' resources"*.[1] MREL requires financial instruments to be subordinated to be eligible. Subordinated debt is debt that is prioritised below other debt when a firm is bankrupt, and therefore less likely than other debt to be paid out.

Impacts of proposal

The proposals would bring net benefits primarily to businesses, specifically building societies, that issue Tier 2 debt rather than subordinated debt, which can be more expensive than the new proposed 'non-preferred senior' debt to meet their MREL requirement. The Department states that the policy would affect five building societies.

This is a non-qualifying regulatory measure, as it is the domestic implementation of an EU Directive.

Familiarisation costs

Public Costs

[1] Definition from Bank of England website: https://www.bankofengland.co.uk/financial-stability/resolution/indicative-mrels accessed on 16/11/2018

Insolvency Service Familiarisation cost: 1,264 insolvency practitioners will lead to a total one-off familiarisation cost to government of £1.21m in 2018.

Business Costs

Banks and building societies:

Assumption that all firms in scope of MREL will review the Directive to see if it applies to their firm. There are 16 firms in scope of MREL who would incur a total one-off familiarisation cost of £1,323 in 2018.

Purchasers of debt (Clients):

A total of 784 purchasers of debt (49 for each of the 16 building societies in scope) would incur a total one-off familiarisation cost of £60,842 in 2018.

Benefits

The Department expects businesses to benefit from the ability to issue non-preferred senior debt at a lower interest rate than the more expensive Tier 2 debt to cover their MREL requirements. For the five firms HMT believes will be affected by this directive, the total direct benefits are cost savings resulting in a net present value of the cost savings £106.53m (in the central scenario). This has been done by taking the shortfalls the businesses have between the regulatory capital held and their future requirements and multiplying it by the savings from lower interest rate of the firms' debts under 'non-preferred senior' debt.

Small and micro businesses

No small or micro businesses will be affected by these regulations, as none of the firms currently eligible have fewer than 50 employees.

Wider Impacts

No wider impacts have been considered, and the department does not provide a clear steer as to why these have not been considered.

The estimated net present value (NPV) of £105.26 consists of the aforementioned costs to business, government and clients and the benefits to business.

The RPC verifies the estimated equivalent annual net direct cost to business (EANDCB) of -£12.38 million. This will be a non-qualifying regulatory provision that will not score under the business impact target.

Quality of submission

The Department has provided a detailed, concise and well-informed IA on this technical EU Directive. The Department has clearly analysed the main direct costs and benefits of its proposal. It has conducted proportionate sensitivity analysis of several savings scenarios, which would result in either higher or lower (no) benefits to business. The Department has taken account of consultation feedback to improve and update their analysis. This has been used both for calculating the shortfalls in question, and for calculating the basis points the Department expects firms to save on by issuing ‘non-preferred senior debt’ as opposed to Tier 2 debt.

Overall, the evidence base for the IA appears to have been strengthened by the Department’s consultation.

The IA has helpfully considered whether or not the benefits from this measure constitute an economic benefit or a transfer. By reviewing the legal jurisdiction of the investor base, they have found that 93.47% of the purchasers of debt are not UK based, whilst all the building societies are UK based. Therefore, 6.53 percent of the potential benefit has been treated as a transfer between two UK based economic actors.

The IA could be improved further by addressing the following additional points:

<u>Assumptions</u>

Given the range of uncertain assumptions, the analysis in the impact assessment would have been improved by more sensitivity analysis. The impact assessment would also have benefited by challenging the following assumptions in more detail;

Assumptions surrounding future debt issuances:
The impact assessment highlighted that ‘Past issuance of debt is not a reliable indicator of future debt issuance as institutional requirements change over time’. Given that institutional requirements may change over time, the impact assessment would have benefitted from sensitivity analysis surrounding to impacts changing institutional requirement levels would have.

Assumption of equal issuance over three years:
The department assumes that debt would be issued in equal amounts over three years, providing a lack of investor demand as the main reason that full issuance could not occur for the full amount in one year. This assumption could have been

tested during consultation and should be examined when the policy is reviewed in 2023.

Assumption of market impacts:
The measure, which only impacts 16 businesses, and allows them to cover their MREL requirements at a lower cost, may have adverse impacts on other businesses in the industry, as it favours a small number of firms and individuals in the industry.

Assumption of impact on other creditors following the credit hierarchy following the introduction of non-preferred senior debt:
The department assumes that the introduction of non-preferred senior debt will not impact the cost of debt belonging to creditors higher up and lower down the debt hierarchy. The argument in favour of this uses the Modigliani-Miller theorem to support this statement, however provides no analysis to support this assumption.

The impact assessment also states that industry responded stating that *"ordinary non-preferential debt holders higher up in the hierarchy would have additional protection and therefore in principle this debt could benefit from a better credit rating which one financial institution proposed could lead to a tightening of spreads"*. There is therefore no clarity as to whether or not the regulations will have any knock-on effects, and this assumption does not appear to be justified.

Monitoring and Evaluation

The impact assessment would have benefitted from a more in depth monitoring and evaluation plan. The impact assessment outlines a need to review in five years, but does not provide any further detail. Specifically, the impact assessment could recommend monitoring whether:

1) the department's estimated cost of issuance of the debt is accurate;
2) the assumption that the introduction of non-preferred senior debt will impact the cost of debt belonging to creditors higher up and lower down the debt hierarchy hold; and
3) the department had adequately identified how many firms would use non-preferred senior debt, and whether or not the amount of debt issued was correctly measured.
4) The department has engaged thoroughly with industry, providing a very informed view of how many businesses are currently in scope of this measure. The impact assessment could however be improved by a more detailed monitoring and evaluation section that aims to track how many

firms ultimately use 'non-preferred senior' debt. The number of firms subject to MREL and who may use this type of debt may grow, for example through mergers of small building societies over the coming years.

Drafting

Due to the complexity of the measure, the impact assessment could do with slightly clearer drafting, as some of the technicalities of the measure can be lost on lay-readers. Specifically:

- In paragraph 29 the Department has now corrected 'discounted' to 'deflated', however it still needs to change the words 'present value terms' to 'prices' as this could cause confusion; and
- in paragraph 34 the Department writes that it is uplifting by 30 per cent for non-wage costs, which is incorrect.

Small and micro business assessment (SaMBA)

The SaMBA is sufficient. Small and micro businesses are not estimated to comprise any of the market. This is because the Department anticipates that the threshold value band mean small or microbusinesses will not be drawn into MREL in the near-term.

Wider impacts

The impact assessment would have benefitted from quantification of the impacts the measure had the relevant lawyers, accountants and auditors outside the firms impacted by the measure. Although these are not direct impacts, these would have helped provide some context on the limited wider impacts of this measure.

The impact assessment has also not made mention of the wider benefits this measure will bring about, in particular, this measure is likely to contribute to general financial stability (and the continued operation of these institutions) and hence maintain competition in the sector and consumer choice.

Departmental assessment

Classification	Non-qualifying regulatory provision (EU)
Equivalent annual net cost to business (EANCB)	-£12.38 million (final estimate)
Business net present value	£106.46 million
Overall net present value	£105.26 million

RPC assessment

Classification	Non-qualifying regulatory provision (EU)
EANCB – RPC validated[2]	-£12.38 million
Small and micro business assessment	Not required (European origin)

Regulatory Policy Committee

[2] For reporting purposes, the RPC validates EANCB and BIT score figures to the nearest £100,000.