Client Alert

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BRRD – The UK's Approach to MREL

The Bank of England ("BoE") recently published a consultation paper[1] ("Consultation"), detailing its approach to setting a minimum requirement for own funds and eligible liabilities ("MREL") to be maintained by UK banks and other covered entities pursuant to the EU's Bank Recovery and Resolution Directive ("BRRD"). The MREL requirements will apply to all UK institutions within the scope of the bail-in provisions of the Banking Act 2009, which implemented the BRRD into UK law, and the BoE's powers to set MREL for each such institution derive from its status as the national resolution authority for the UK. The Consultation remains open for comment until 11 March 2016.

Background

The BRRD was partially implemented into the laws of the UK in January 2015, pursuant to the Banking Act 2009, with the provisions on MREL taking effect from 1 January 2016. Under the BRRD, each national resolution authority is required to set the applicable level of MREL in relation to each bank and investment firm headquartered in its jurisdiction. In the UK, the BoE's MREL-setting powers apply to (i) banks, building societies and so-called 730K investment firms, (ii) parent companies of such institutions that are financial holding companies or mixed financial holding companies, and (iii) financial institutions that are authorised by the Prudential Regulation Authority ("PRA") or the Financial Conduct Authority ("FCA"), and that are subsidiaries of such institutions or such parent companies. For the purpose of this alert, we will generally refer to all of the above entities as "banks".

It is worth noting here the extensive degree of overlap between the MREL provisions of the BRRD, and the final TLAC Principles published in November 2015 by the Financial Stability Board[2]. Both sets of provisions aim to establish an appropriate level of liabilities that can be bailed-in, i.e. converted into equity instruments or written down, and thereby absorb losses in order to achieve an effective resolution of the relevant entity. However, there are significant differences between the two sets of provisions, in particular in relation to their scope. The FSB's principles currently apply only to the 30 entities designated by the FSB as Global Systemically Important Banks ("G-SIBs"), whereas the MREL provisions apply to all European banks. The BoE must set MREL for all UK banks in accordance with the final binding technical standards drafted by the European Banking Authority ("EBA") pursuant to the BRRD but it states in the Consultation that it will use its MREL-setting powers to implement the FSB's TLAC Principles in relation to UK G-SIBs.

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[1] "The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)" – December 2015, http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf.

[2] "Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution" and "Total Loss-absorbing Capacity (TLAC) Term Sheet" – 9 November 2015, http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf. See also the MoFo publication "Resolution of G-SIBs – FSB Final TLAC Principles", http://www.mofo.com/~/media/Files/ClientAlert/2015/11/151109ResolutionGSIBs.pdf.

Proposals

According to the EBA's draft regulatory technical standards in respect of the setting of MREL, a bank's MREL must consist of both an amount necessary for loss absorption prior to and during resolution, and also an amount necessary for the subsequent recapitalisation of the bank. The loss absorption amount must at least equal the minimal capital requirement pursuant to the Capital Requirements Regulation[3] ("CRR"), including any applicable leverage ratio requirement set by the relevant UK competent authority[4].

The BoE considers that UK banks would be resolved by one of three resolution strategies – either a modified insolvency procedure, a deposit book transfer or a bail-in.

For those banks that are small or simple enough that their failure would not require the use of stabilisation powers in the public interest, such banks would enter into one of the UK's modified insolvency procedures, depending upon whether the entity is a bank, a building society or an investment firm. Since these entities would be entering into insolvency proceedings, there would be no recapitalisation element of their MREL requirement. Therefore, the BoE proposes to set their MREL at a level equal to their existing minimum capital requirements[5], and would not require any additional MREL issuance.

The BoE considers that where a bank provides more than 40,000 transactional accounts, it is likely that one or more of the stabilisation powers provided in the Banking Act 2009 would be used, rather than one of the modified insolvency procedures. If the bank's only critical economic functions were the provision of current accounts, the BoE would propose to transfer all deposits from retail customers and small and medium-sized enterprises to a third party purchaser or bridge bank. For these institutions, therefore, the MREL would be equal to the minimum capital requirement (to account for loss absorption) plus a percentage of the existing minimum capital requirements corresponding to the percentage of the balance sheet to be transferred (to account for recapitalisation needs).

For such institutions, the BoE will generally not require MREL to be subordinated to senior operating liabilities (such as uninsured corporate deposits and derivatives liabilities).

Where an institution has reached a certain size and/or complexity, the bail-in tool is likely to be used. The BoE has indicated that it would generally expect a bail-in strategy to be appropriate for a firm with a balance sheet that exceeded a figure of between £15-25 billion. For these banks, the BoE intends to set MREL at a level equivalent to twice the bank's current minimum capital requirements – once for the loss absorption portion, and once for the recapitalisation portion. For such banks, the BoE also proposes that MREL liabilities should be subordinated to senior operating liabilities. Such subordination is not strictly required under the terms of BRRD, although it is consistent with the FSB's TLAC Principles.

The BoE is also responsible for setting MREL for UK subsidiaries of foreign banking groups that are within the scope of BRRD. In a case where the foreign banking group's resolution authority will pursue a single point of entry resolution strategy, the subsidiary would not become subject to the BoE's stabilisation powers, though the BoE would prescribe MREL of a level necessary to support the overall agreed resolution strategy. MREL in such a case would be expected to consist of capital or subordinated liabilities issued to the foreign parent. However, in a case where the foreign banking group's resolution authority will pursue a multiple point of entry strategy, the BoE would apply its resolution tools and powers in the same way as for domestic banking groups.

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[3] Regulation EU No. 575/2013, which, *inter alia*, implemented the Basel III capital requirements in the EU.
[4] The relevant UK competent authority will be either the PRA or the FCA, depending on the entity in question.
[5] This will be the higher of the risk-based minimum requirement under the Capital Requirements Regulation (as implemented in the UK), the minimum leverage ratio requirement in the UK and the Basel I floor.

Subordination

Where subordination to senior operating liabilities is required, the BoE has indicated that it expects such a subordination to be achieved by way of structural subordination. In practice, this means that the BoE expects that the relevant bank will raise MREL funds at the holding company level and downstream those funds in the form of capital or another form of subordinated claim to material operating subsidiaries, so that the MREL liabilities will be structurally subordinated to the senior liabilities of the operating subsidiaries.

Timing

The BoE, as is the case with all European national resolution authorities, was required to set MREL for all of its banks as from 1 January 2016. However, the regulatory technical standards published by the EBA allow for a transitional period in which lower MRELs can be set for institutions for a period of up to 48 months, i.e. until 31 December 2019. The BoE states that it does not expect to set MRELs at a level any higher than the minimum capital requirements during such period or, in respect of G-SIBs, until 31 December 2018 (to conform to the FSB's TLAC Principles). However, during such period, the BoE expects UK institutions to produce plans as to how they intend to meet their "usual" MREL levels, and to discuss the plans with the BoE.

MREL criteria

Pursuant to the BRRD, MREL can consist of own funds and eligible liabilities. Own funds means capital instruments that qualify as Tier 1 or Tier 2 capital for the purposes of a bank's capital requirements pursuant to the CRR. Eligible liabilities in this context means all liabilities and capital instruments that do not count as Tier 1 or Tier 2 capital and are not excluded from the scope of bail-in according to the prescribed list specified by Article 44(2) of the BRRD.

The prescribed list of excluded liabilities includes:

- deposits (to the extent that they are covered by a deposit guarantee scheme);
- secured liabilities;
- liabilities in respect of client assets or client money;
- liabilities arising by virtue of a fiduciary relationship;
- liabilities to institutions with an original maturity of less than seven days;
- liabilities with a remaining maturity of less than seven days owed to payment and settlement systems; and
- various liabilities owed to employees, commercial or trade creditors, tax and Social Security authorities and deposit guarantee schemes.

In addition to the MREL criteria specified by the BRRD, secondary legislation passed pursuant to the Banking Act 2009 sets out a number of requirements that liabilities must meet in order to qualify as MREL. A number of these specifications have been adopted in order to be consistent with the FSB's final TLAC Principles. One such requirement is that the liability must have an effective remaining maturity of greater than one year, taking into account any rights of early repayment available to the investor. In addition, the BoE states that it expects UK institutions to consider the overall maturity profile of their external MREL resources, to ensure that temporary lack of access to debt issuance markets would not be likely to cause a significant breach of their MREL requirements.

The BoE also states that it expects UK institutions not to structure their MREL instruments in such a way as to create incentives for the issuer to redeem the instruments ahead of their contractual maturity date.

Consistent with the FSB's final TLAC Principles, the BoE does not consider it appropriate to count, as MREL resources, those liabilities whose values significantly depend on derivatives, such as over-the-counter or exchange-traded derivatives, and structured securities. It also states that liabilities which are subject to contractual set-off or netting arrangements are not appropriate to be counted towards MREL.

In addition, where a liability is governed by the law of a non-EEA jurisdiction, the BoE will need to be satisfied that the liability can absorb losses in resolution, as required by the BRRD.

Relationship between MREL and other capital requirements and buffers

Simultaneously with the Consultation, the PRA issued its own consultation paper entitled "The Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – Buffers and Threshold Conditions". In its consultation, the PRA points out that by 1 January 2020, the capital requirements of UK firms will be influenced by 3 elements: the CRR as implemented in the UK; the leverage ratio framework; and MREL. It regards MREL as complementary to the capital and leverage regimes, particularly because both the capital and leverage ratio regimes are satisfied only by regulatory capital, whereas firms will be able to meet their MREL requirements by counting eligible liabilities that are not regulatory capital.

The PRA has stated that it expects UK firms not to double-count Core Equity Tier 1 capital towards, on the one hand, MREL and, on the other hand, the capital buffers that it must maintain pursuant to the CRR. This will mean that UK firms that count their CET1 capital towards MREL will also need to maintain sufficient CET1 capital to meet their capital buffers. The PRA has also stated that it proposes to adopt a policy to prevent the double counting of CET1 capital between MREL and any applicable leverage ratio buffers.

MREL in the context of banking groups

In addition to setting an external MREL at the group consolidated level, the BoE will also set individual MREL for all in-scope entities within the group. The BoE is also allowed to set individual MREL for entities such as holding companies that are important from a resolution perspective. In terms of setting MREL within groups, the BoE will require that internal MREL resources:

- must be subordinated to the operating liabilities of the group entities issuing them;
- must be capable of being written down or converted to equity without the use of stabilisation powers in relation to the operating entity that issues those liabilities; and
- must be appropriately distributed within the group.

The resolution entities will be required to issue external MREL resources that are at least equal to all of the internal MREL resources to be issued by their subsidiaries. The BoE also requires that the distribution of internal MREL resources within the group must ensure that there is sufficient loss-absorbing capacity prepositioned at the individual entities that are within the scope of MREL, and that the distribution within the group ensures that losses can be absorbed and passed up to the resolution entity.

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