The Bank of England's approach to setting internal MREL

AFME consultation response

December 2017

Introduction

AFME[1] welcomes the opportunity to comment on the Bank of England's proposed approach to the setting of minimum requirements for own funds and eligible liabilities within groups ('internal MREL'), and further issues. As set out in our initial position paper[2], and further elaborated on in a paper focussing on internal MREL, AFME has taken a view on the approach being proposed by the European Commission in the Risk Reduction Measures package ('RRM package'). This includes both the integration of some aspects of internal Total Loss Absorbing Capacity ('TLAC') into the EU framework, whilst also amending the Bank Recovery and Resolution Directive ('BRRD') with regard to internal MREL.

AFME broadly supports the approach proposed by the Bank of England ('the Bank'), which incorporates key elements of the TLAC Standard, such as the full range of scaling in calibrating the requirement and the recognition that this applies only to material subsidiaries/sub-groups. This paper sets out our concerns on certain elements of the proposed policy approach.

Internal MREL is an important element of the resolution framework. It is vital that a considered approach is put in place to ensure the effectiveness of the new regime while minimising the impact on firms (for example through having an approach with an appropriate degree of flexibility). We look forward to engaging with the Bank of England on this topic and stand ready to discuss any of these matters further.

Please find below our comments on the proposals taken in the order found in the consultation paper.

Scope of internal MREL

1. Do you agree with the proposed approach to determining the entities within scope of internal MREL?

We broadly welcome the proposed scope of the internal MREL requirement within the Bank's draft policy statement, subject to the comments below. Applying an internal MREL requirement to material subsidiaries is sensible and supported. The proposed definition of materiality mirrors that within the Financial Stability Board's (FSB's) TLAC Term Sheet, which we believe to be the appropriate means of defining materiality.

However, we would like to highlight that should there be a divergence between the Bank's approach and that reached within the European Union (EU) with regards to the ongoing revisions to the resolution framework, the Bank should ensure its policy is appropriately aligned, and does not seek to 'gold-plate' internal MREL requirements. This is important to ensure that there is a level-playing field across the EU in this area. In particular, should waivers from internal MREL requirements at a solo level, or alternative arrangements to

[1] The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is listed on the EU Transparency Register, registration number 65110063986-76.

[2] **AFME** – https://www.afme.eu/en/reports/publications/afme-views-on-the-resolution-aspects-of-the-eu-risk-reduction-measures-package/

meet internal MREL be provided for within the EU, we would encourage the Bank to incorporate these into their policy in the UK. It is important that waivers or alternative arrangements to fulfil internal MREL that may be provided under the EU rules are also applied by the Bank to ensure a consistent approach to setting internal MREL across Member States.

The Bank's proposed approach to branches of foreign banks that perform critical functions in the UK is also supported. The assessment of such a bank's group resolution plan, and any necessary engagement with home authorities following this, is in line with the principles set out in the TLAC Term Sheet. International cooperation between resolution authorities is the correct means of resolving any issues that may arise in this circumstance. We encourage this collaboration and welcome this approach.

We would nevertheless welcome further clarity from the Bank with regards to any potential remedies they may wish to pursue in the circumstance that such discussions with home authorities are deemed necessary. Applying internal MREL for branches – in any jurisdiction – would be very difficult to apply in practice, and would not be in line with the TLAC Term Sheet as per Section 16: "*Branches are not subject to internal TLAC requirements separate from any external or internal TLAC requirement applied to the legal entity of which they are part*". If such an approach is to be taken into consideration, we wish to highlight that this would create an unhelpful precedent that would undermine the agreed principles within the TLAC Term Sheet, and may lead to similar practices elsewhere.

Further to this, under paragraph 4.11 of the consultation paper the Bank sets out the circumstances under which it may require a consolidated or sub-consolidated balance sheet be drawn up for the purposes of setting internal MREL. We think that this should only be required where absolutely necessary. This practice can be burdensome as it would also require further layers of additional financial and regulatory reporting. If this were to be required, we would recommend that the frequency of reporting be limited to mitigate the impact this may have. Before this is deemed necessary however we would encourage the Bank to consider alternative arrangements that may otherwise allow them to set internal MREL in the absence of requiring such action. The FSB guiding principles provide some examples of these alternative arrangements[3], and we would welcome from the Bank a commitment to considering these before further consolidation requirements are put in place.

To the extent this is required to capture non-bank entities within the material sub-group (permitted as a last resort measure under the FSB's guiding principles on internal TLAC), we would be concerned that this may give rise to the 'sum-of-the-parts' issue, i.e. internal MREL being higher than the applicable external MREL. Such a (sub-)consolidation requirement may therefore in turn result in funding inefficiencies for the group. As stated in the FSB guidance around this, alternative arrangements should be sought before requiring this.

Calibration of internal MREL

2. *Do you agree with the proposed approach to calibrating internal MREL and the factors that will be considered?*

We broadly support the Bank's proposed approach to implementing the TLAC Term Sheet's range for setting internal MREL, in particular starting the consideration on the appropriate levels of internal MREL at 75% - a 'down-payment' that should be fully sufficient to ensure home country support. It is important to recognise that scaling should be applied as per Section 18 of the FSB TLAC Term Sheet. The credibility of the resolution

[3] **FSB** - 'Guiding Principle 4' - http://www.fsb.org/wp-content/uploads/P060717-1.pdf

plan and any impediments to resolvability are important factors to consider in setting a level above the 75%. We agree that these should be taken into account within the Bank's decision-making process.

We note however that the FSB's principle of scaling is not provided for in the European Commission's proposals in this area (for either third country GSIIs or EU firms within scope of the BRRD). We would encourage the Bank to raise this as a matter of concern, as a failure to implement this range of scaling in the EU framework would represent a divergence from internationally agreed standards, and a potential barrier to implementing agreed levels of internal MREL as set within Crisis Management Groups (CMGs) or resolution colleges. Further to this, it may restrict the Bank of England in pursuing the approach set out in its consultation paper.

Where the Bank seeks to factor into its decision making the availability of uncommitted resources within the group, it should be clarified that it should not be the intention for firms to have to meet a predetermined level of such resources. The concept of surplus MREL should not in of itself become a requirement for firms to meet. This should be considered in the decision-making process to the extent such resources are available, to further justify a level of internal MREL at the lower end of the 75-90% range, but it should not per se mean that a lack of such available resources represents a need for them to be put in place. Where lower levels of available resources are present, action should not be taken to increase this where it is not necessary for the execution of the resolution strategy. Instead this should simply factor into the appropriate level of scaling that the Bank deems necessary for the purposes of setting internal MREL. A predetermined level of surplus MREL should not be the primary driver in setting the level of internal MREL, and this should be made clear in the final policy statement.

Similarly, the level of scaling that is set for a group's subsidiaries in other jurisdictions should not be used as a benchmark when setting internal MREL for material subsidiaries within the UK. The focus should be on the level of internal MREL that is necessary to provide confidence to the Bank as a resolution authority that the resolution strategy can be credibly implemented. We note that were such an exercise of comparing scaling in other jurisdictions to be taken forward, it is most likely that levels higher than what is necessary would be set. This is particularly concerning given the lack of a scalar in the European Commission proposals in this area, as mentioned previously. Taking such an approach is likely to see an obfuscation of the Bank's stated intention of starting the calibration at 75%, as several other authorities will already have implemented such requirements above this level. The FSB's guiding principles for internal TLAC provide a prominent role for home authorities in discussing any inconsistencies in the application of internal TLAC requirements across host jurisdictions, and we would encourage such discussions to take place where the Bank deems there to be an inconsistency.

The consultation also references "resources being insufficient for a solvent wind-down" as a reason for scaling internal MREL higher level. Given that solvent wind-down requirements are still evolving, we would be interested in understanding how the Bank would practically use the results of solvent-wind down planning for such calibration, and also the timing of this assessment. This also assumes that a post recapitalization restructuring would involve the wind-down of businesses, which is not necessarily the case.

Ring Fenced Bodies (RFBs)

With regards to the setting of internal MREL for Ring Fenced Bodies (RFBs), we question the assumption that 90% should be the starting point for such firms. We see no reason why RFBs should be treated differently to non-RFBs. We understand the objective is to have RFBs operate independently to the rest of the group, and

this should be factored into the decision-making process, but this should not justify a different approach to setting internal MREL. The determination of the appropriate amount of internal MREL should be judged in line with the approach the Bank is proposing to apply to other firms, i.e. by taking 75% as the starting point and considering the needs to support the execution of a credible resolution plan.

Taking a stance that 90% is the appropriate starting point undermines the broader arguments that are made to authorities in other jurisdictions that the level should be determined through collaboration. In having the starting point set by default at the highest level possible leaves other authorities no incentive to approach such discussions with a willingness to constructively engage to determine the most appropriate level to deliver the resolution strategy. It is more likely that they will in turn seek to start discussions at the higher end, which is potentially detrimental to the resilience of the group if this encouraged unnecessary levels of pre-positioning and the fragmentation of loss-absorbing or recapitalisation resources. However, we note from the Bank of England's webinar on this topic that the level required may be reduced as greater levels of external MREL are built up. This appears counter intuitive, and represents a 'reverse transition' mechanism, and we would encourage the Bank to review this intention. We therefore encourage the Bank to seek to apply a starting point of 75% for RFBs, as per their intention for non-RFBs, and at the very least look to review the level of scaling applied to RFBs in their planned review of MREL in 2020.

Simple structures

Regarding the Bank's proposed approach to setting internal MREL at 100% for simple structures, we would appreciate more clarity on this, including clear guidelines on criteria for qualifying as a simple structure.

Material sub-groups containing RFBs

Similarly, where the Bank also comments on its proposed approach to setting internal MREL at 100% for entities that are at the top of a material sub-group which contains an RFB (middle of paragraph 5.10), we would be grateful for further information regarding the treatment of such an entity where it also has non-RFBs within the sub-group. Where this is the case we would suggest that such an entity not have to meet internal MREL of 100%, and we would like to understand if this would be the case. Where the Bank can provide further clarity on the criteria it will seek to use in assessing the case-by-case assessment of whether the 100% internal MREL calibration is appropriate, this would be appreciated.

Material subsidiaries of non-UK banking groups operating in the UK

In line with our views set out above regarding scope, we support the Bank's proposed approach to the calibration of internal MREL for material subsidiaries of foreign banking groups operating in the UK. Collaborating with the relevant resolution authorities in CMGs and/or resolution colleges is vital to ensure a coordinated approach to cross-border resolution. We encourage the Bank to take forward this approach, and also to continue to encourage other authorities to take this approach when setting internal MREL (or equivalent i.e. internal TLAC). Flat-level, hard-wired internal MREL or internal TLAC requirements will lead to a 'collective action' problem, where one authority setting internal MREL at the top end of the 75-90% range induces other authorities to impose similarly excessive requirements. This is not conducive to cross-border collaboration on resolution and it is unfortunately something that is being seen in the proposed EU legislation implementing TLAC, as well as in other key jurisdictions.

This approach is also considered for the setting of internal MREL for material subsidiaries of EU banking groups operating in the UK. The calibration will be the subject of discussion alongside those for external MREL – i.e. the joint decision process. Such a joint decision should be based on the resolution strategy for the group, and we strongly encourage collaboration between the relevant authorities seated on the resolution colleges.

Where elements of the current negotiations on the Commission's proposals to amend the BRRD touch on this process, we would encourage the Bank to highlight the need for cooperation, and recognition of the single resolution framework that is in place within the EU, as well as the mutual recognition of resolution actions that is also in place. Any elements that may undermine the Bank's proposed approach should be opposed, including for example any proposals to permit host authorities to set internal MREL at levels above those agreed, even if within a predetermined range.

We also suggest that it may be helpful to incorporate within the final policy statement an articulation of the home/host principles within the FSB's guiding principles on internal TLAC, such that the Bank's interpretation of them is set out clearly.

In addition, we believe that in setting internal MREL requirements the Bank should coordinate with the home jurisdiction authority to avoid an excessive total requirement at the group consolidated level, which could arise if the percentage amount of pre-committed MREL is set at the high end.

Non-UK subsidiaries of UK banking groups

For non-UK subsidiaries of UK banking groups, their internal MREL (or equivalent/internal TLAC) requirement will be determined by the relevant host authority. The Bank, as home resolution authority, should be consulted on this. This is in line with the FSB Term Sheet, as previously stated, and in the spirit of fostering greater international cooperation on resolution planning, which we strongly support.

However, the proposal states that where such requirements are not set the Bank may determine this as an impediment to the resolvability of the group. If a material non-UK subsidiary of a UK banking group were subject to such a determination, the Bank has proposed that it would expect to propose quantum for internal MREL to be set for that material subsidiary. We find that the Bank's proposed policy around this, as confined to paragraph 5.12 of the consultation paper, lacking in much needed detail. Significantly more clarity around this is necessary to help inform potentially affected UK banking groups of what such proposals will likely be, how and the extent to which they will be set as binding requirements and subsequently enforced.

Internal MREL is necessary to provide comfort to host authorities of the resolvability of material subsidiaries in their jurisdiction. Where host authorities are comfortable with levels on internal MREL that are below what the Bank may have required, this should not be in of itself a reason to determine that there is an impediment to resolvability. This should instead be based on the ability of losses to be transferred from the subsidiary to the resolution entity – including potentially through alternative means to prepositioned internal MREL.

In line with the Bank's own view of ensuring there is sufficient resource available at the group level (i.e. surplus MREL), lower requirements at subsidiaries outside the UK would increase this available pool and in turn should strengthen the group's resilience and resolvability (provided they can be deployed as necessary). We would therefore welcome greater clarity on their proposed policy for setting internal MREL for material non-UK subsidiaries of UK banking groups where the above situation occurs. Furthermore, we would expect any level of internal MREL that the Bank would seek to propose be in alignment with the resolution strategy of the

group as agreed between the relevant authorities and informed by the assessment of those entities within the group that are considered material subsidiaries or material sub-groups.

Surplus MREL

3. *What challenges do you see with the proposed policy that surplus MREL should be readily available to be deployed to material subsidiaries? Do you agree that this could be achieved through maintaining a central reserve of high-quality liquid assets at the resolution entity? Are there other methods that you think should be acceptable?*

We do not consider it appropriate to impose strict requirements in relation to surplus MREL.

Imposing restrictions on how surplus MREL can be held, for example requiring it to be held in High Quality Liquid Assets (HQLA), may have significant implications for bank profitability, and in turn a firm's ability to finance its external MREL issuances. Where a 75% scaling is applied to a firm's internal MREL requirement, the remaining 25% would be deemed surplus. If this is required to be held in low yielding HQLA there would be additional pressure on the remaining 75% of down-streamed resources to cover the costs of 100% of the externally issued MREL. This may produce adverse incentives for firms to seek to preposition greater amounts of MREL internally thus reducing the pool of resources available at the resolution entity, counter to the Bank's own aims.

Firms should be able to downstream more MREL (beyond the minimum requirements) where it is in line with their own risk-management and commercial objectives, i.e. to ensure an adequate management buffer or to provide funding to a material subsidiary where this is required. In addition, firms should be able to increase pre-positioning in order to provide the market with comfort regarding their credit worthiness – surplus MREL would not necessarily be considered in credit ratings[4], whereas down-streamed internal MREL resources support the resolvability of operating entities and therefore provide an uplift to the credit ratings.

Given these potential impacts and incentives, it is unlikely firms will want to have higher levels of surplus MREL were it to be subject to additional constraints. We encourage the Bank to take a more flexible approach that does not set such requirements around surplus MREL. Holding significant sums in HQLA is not a viable route to deliver on the intention of the policy, especially where such holdings would not be able to be used to meet other such requirements elsewhere in the group, for example a firm's Liquidity Coverage Ratio (LCR). Alternatives that could be explored include permitting such holdings to count to a firms LCR requirements, asset transfers, and enforceable parental guarantees.

The Bank should allow flexibility over which entity holds surplus MREL and not limit it to the resolution entity, in particular in situations where internal MREL is routed indirectly through entities within the same resolution group. This may in particular be the case if the additional restrictions referred to above on holding HQLA are implemented as this requires Treasury infrastructure at the level of the resolution entity (i.e. holding companies following SPE strategies).

A more flexible approach is appropriate, for example the Bank may seek to undertake a broader assessment as to how a group monitors its MREL resources and requirements. This should provide the Bank with a means to assess the effectiveness of more flexible alternatives.

[4] For example, under both Moody's Loss Given Failure and Fitch's Qualify Junior Debt methodologies, material subsidiaries could otherwise benefit from uplifts to their credit ratings depending on the amount of down-streamed internal MREL resources that are available. Both of these credit rating agencies require that resources be pre-positioned in order to ascribe any potential ratings benefit.

For material subsidiaries of non-UK groups operating in the UK, the Bank seeks to assess the level of available surplus MREL (or equivalent) held in the home jurisdiction, and others where a bank operates a material subsidiary. This is in order to help determine the level of internal MREL that should be required in material subsidiaries operating in the UK. It should be clarified that this approach should only be taken with regards to the approach set out previously in that internal MREL levels should be set as per the discussions at the relevant CMG or resolution college. We encourage greater levels of cooperation to limit the amount of prepositioning that is required to that which is truly necessary to deliver on the resolution strategy and provide comfort to host authorities – not excesses that may impose unnecessary impacts on the firm's business.

It is important to stress that the FSB internal TLAC guidelines determine that host authorities should consult with the home authorities and consider the implications that the internal TLAC requirement could have for the resolution group, in particular if the sum of internal TLAC requirements exceeds, or is expected to exceed, the resolution group's external Minimum TLAC. We believe that home authorities should work with host authorities in this assessment within the CMGs and relevant resolution colleges.

It is our understanding that other jurisdictions have proposed setting requirements for internal MREL at 90%, including in the current European Commission's proposals. This may indicate that the Bank in turn may require similar levels, which would undermine the starting position of 75% as set out in the Bank's consultation paper. As stated previously, we encourage the Bank to challenge the assumptions held by other authorities that 90% is necessary in all cases, and to push for a true transposition of the TLAC Term Sheet such that the full 75-90% range is available recognising that the additional surplus TLAC that this provides will enhance the resolvability of global firms.

Double counting

4. *Do you agree that firms should not be able to double count resources to meet internal MREL for both their individual balance sheets and those of their subsidiaries?*

We agree with the need to prevent double counting of resources to meet MREL for both a firm's individual balance sheets and those of its subsidiaries, as this would jeopardise the resolvability and resilience of the group – which runs counter to the objectives that we are all working to meet.

In this context we support the PRA's proposal on exempting internal MREL from large exposure limits as set out in its separate consultation (CP20/17). However, we would welcome further clarity from the Bank that it is also its intention that investments in internal MREL will also be deducted from RWAs and leverage exposures, in line with the FSB Principles on internal TLAC (Principle 10 (Annex 2)).

The proposal to increase the internal MREL requirement due to investments in MREL of subsidiaries/group entities should factor in the existing deductions in the capital regime for investments in the capital of financial sector entities. Only the amounts that are not deducted should be considered as relevant for the addition to the MREL requirement to avoid a firm having to unnecessarily hold twice the MREL. The deduction under the capital regime assumes the amount of capital deducted is utilised fully to absorb losses in the issuing entity and is not therefore available to the investing entity. By increasing MREL requirements by this amount means that the investing entity is effectively penalised twice.

Consideration should also be given to the need to avoid consolidation effects when setting internal MREL and in any policy action taken to avoid any double counting.

Internal MREL instrument eligibility

We broadly agree with the Bank's proposed policy with regards to the eligibility criteria that internal MREL instruments should be subject to, with the exception of two key points with which we have significant concerns that are set out below.

Contractual triggers

5. Do you agree that instruments eligible for internal MREL should be subject to a contractual trigger?

The first of these concerns relates to the new requirements as set out in paragraphs 6.7 – 6.10 of the Bank's consultation document, i.e. the requirement to include a contractual trigger for internal MREL to provide the resolution authority the right to exercise a write-down or conversion. We note the necessary preconditions for such action to be permitted: i) the issuing material subsidiary has been deemed failing-or-likely-to-fail (FOLTF) and consent has been provided by the home authority (or sought and not received following 24 hours' notice), or; ii) a resolution entity which is a direct or indirect parent of the material subsidiary is subject to resolution proceedings. We are concerned by the latter proposal as this would effectively allow the Bank to trigger internal MREL in the UK even if no losses have been incurred by the UK subsidiary. We do not believe this would be proportionate and it would be preferable for the Bank to qualify this policy by instead stating 'ii. where, as a result of the resolution entity being in resolution, the material UK entity would also be likely to fail'.

The proposal for this trigger's inclusion in internal MREL contracts represents the provision of a new power for the Bank. If such a power is to be provided, it should be done through the amending of the necessary legislation, i.e. through a statutory instrument, and not through these requirements to have contracts provide for this. The Bank already has sufficient powers once an entity is deemed FOLTF, and a trigger beyond the point-of-non-viability (PONV) is not required within the FSB's internal TLAC guidance. Under the current European Commission proposals to amend the BRRD an extension of the statutory PONV powers from capital to internal MREL is provided for, making this requirement redundant.

In addition to this it is also noted that the 24 hours' notice envisaged by the Bank in the consultation paper is half that envisaged in the FSB guidance. We would encourage the Bank to keep to the FSB guidance.

Were such a requirement to be taken forward it is not clear what the contractual trigger should look like. In particular, due to the concerns that may come from recognition of write-down or conversion in instruments potentially giving rise to embedded derivative categorisation, and creating significant tax implications. Further to this it may trigger intra-group contagions and impact material subsidiary credit ratings, potentially leading to a broader market reaction.

It is also important to consider the consequences from the perspective of the accounting rules and its interaction with tax rules. We also have significant concerns regarding the potential tax implications of the proposed contractual triggers. These are set out in more detail below, in answer to question 7.

Beyond these concerns there may also be implications for non-UK subsidiaries that may not be able to legally comply with the requirement. This would also indicate the need for this power to be provided for under statute and not contract.

At the very least, should our concerns not be taken on board the Bank needs to acknowledge that transitional arrangements will be necessary to accommodate this new criterion so that the current stock is transitioned and repapered without cliff edge effects.

Internal MREL issuance restrictions

We agree that the issuance of internal MREL should credibly support the passing of losses and recapitalisation needs to the resolution entity. As recognised by the Bank, this can be achieved through the issuance of eligible liabilities directly to the resolution entity or indirectly via other entities in the same resolution group.

We strongly support the Bank providing firms the ability to allow internal MREL to be issued to group entities other than the direct parent entity. There are various business reasons why firms may implement an internal MREL issuance strategy which involves issuance outside the ownership chain and some such structures may enhance resolvability. Limiting issuance to the ownership chain could force banks to issue internal MREL in the UK through a strategy that is not in line with their global resolution plan and may impact on banks' ability to efficiently fund their operations. We note that the Bank intends to review these flows prior to permitting them to meet internal MREL requirements. We believe this is proportionate and are supportive of this part of the Bank's proposed policy statement.

Matching of internal and external MREL

In addition to our concern regarding contractual triggers, our second area of concern relates to the eligibility criteria and the Bank's proposals within paragraphs 6.11 and 6.12, surrounding the potential for mismatch in the form and type of internal and external MREL issuances. We note the Bank's intention to review these forms and seek to identify differences that may weaken the resilience and resolvability of a group, acting to remove any impediments should any be identified. However, we request that the Bank considers the operational difficulties that arise if banks were required to exactly match the forms of external and internal issuances, as it would be very difficult to achieve a one-to-one correspondence. Appropriate flexibility should be afforded to banks to manage their internal and external issuances, taking into account that these would be bound by market conditions for issuance as well as differences in rules across jurisdictions. Importantly, we would expect the Bank, in coordination with the PRA, to be able to assess how banking groups manage any risks arising from mismatching in terms, including double leverage concerns.

In addition to this, the Bank states within this section that "*firms should not change the form of their internal MREL resources in a way … that reduces the amount of MREL eligible liabilities, unless the Bank approves such a transaction*". This seems overly restrictive in our view, and would like to seek clarification from the Bank on this point. In particular, we propose that Bank approval should only be necessary where a change in form reduces the amount of MREL eligible liabilities such that the firm's ability to meet its internal MREL requirements is put at risk.

Composition of internal MREL

We welcome the Bank's decision not to include an expectation that internal MREL should consist of debt liabilities accounting for an amount equal to, or greater than, 33% of the material sub-group's internal MREL requirement as foreseen in the FSB internal TLAC principles. Banks should retain the flexibility to use equity

or a combination between equity and debt to satisfy internal MREL. We do not think this should be relevant for internal MREL in any case.

Collateralised guarantees

The FSB internal TLAC principles include the possibility to substitute on-balance sheet internal TLAC with internal TLAC in the form of collateralised guarantees, subject to the conditions in Section 19 of the TLAC Term Sheet.

We would welcome an acknowledgement from the Bank that it will also accept internal MREL in the form of collateralised guarantees or loan facilities in lieu of on-balance sheet cash loans.

Transitional arrangements for internal MREL

The transitional period to meet internal MREL requirements being kept in line with that put forward for external MREL is welcome. We note that an earlier compliance date may be set by the Bank, and would stress that where this is the case firms will need to receive this information in good time. Furthermore, to the extent the requirements around contractual write-down/conversion or the Bank's review of mismatches between internal and external issuances consequently imply a need to change the terms of instruments in issuance, we would expect the Bank to consider including appropriate transitional provisions for banking groups to comply.

We would also like to stress that it is vital that firms receive their final internal MREL requirements in good time, in order for them to sufficiently prepare and meet the incoming requirements. Given that the initial requirements for internal MREL apply from 1 January 2019, we would strongly encourage the Bank to liaise with firms to ensure sufficient information is provided to enable the requirements to be met on time.

We also note that for subsidiaries of non-UK banks, MREL issuance may be subject to home regulator approval. Whilst we welcome the setting of internal MREL through discussion with home regulators, this need for regulatory approval should be factored into timelines, as, for example, U.S. regulator approval could require a period of up to 9 months. As such, firms would need to be notified of indicative requirements and to be aware of final eligibility rules significantly in advance of the 1 January 2019 implementation date.

Loss-absorbing capacity for operational continuity

6. *Do you agree with the proposed approach to the loss-absorbing capacity for operational continuity in resolution?*

Whilst we understand the objective of ensuring adequate loss-absorbing capacity is in place for critical service providers (CSPs), we challenge some of the assumptions and the scope that have been used to calibrate the requirements suggested by the Bank.

In particular, we would ask for clarification on the Bank's proposal in paragraph 8.7 of the consultation that the loss absorbing requirement will apply to "*each provider of critical services within the group*". This would have a significant extra-territorial effect as services are often provided from a number of different entities within a banking group. This would bring into scope a range of entities even if only a small proportion of their services are provided to the UK entity and they would be required to have 25% loss absorbing capacity. In our

view, a proportionate approach would be to apply the policy to UK-based critical service providers and any cross-border requirements should be agreed with the relevant resolution authorities.

We also believe that where these are being placed on top of internal MREL requirements, that this is in effect a ‘gold-plating’ of existing requirements, as the need to support CSPs should already be factored into the calibration exercise undertaken to determine internal MREL requirements. We therefore would welcome confirmation from the Bank that this is not the case for regulated firms.

Further, the proposal to have CSPs hold 25% of annual operating costs appears to be an arbitrary calibration that lacks sufficient evidence to support this level of requirement. In place of a flat 25% scalar there should be one that is determined on a case-by-case basis, to adequately reflect the different CSP models.

In addition, critical services are often provided by entities within banking groups that are already subject to their own TLAC/MREL requirements. If the Bank follows its proposed approach and increases the internal MREL quantum to account for these critical services, this will in effect be double-counting. It is also important to point out that operating entities, which are the consumers of services, also have to hold loss-absorbing capacity to ensure operational continuity. If the service provider needs to also hold additional capital, this is another form of double-counting.

Further to this, the definition used for calculating the operational continuity loss absorption requirement (OCLAR) should be revised. According to the consultation, the Bank would impose a loss absorbing requirement of 25% of total operational costs for all in-scope entities within a banking group as defined by Column 150 of PRA Template 109. We believe this would be an excessive requirement as total operating costs include non-critical services. This would run counter to the Bank's stated aim of requiring loss absorbing capacity for the provision of critical services. It would also be inconsistent with the PRA's Financial Resilience requirements for Liquidity, which only include critical services and allow for certain costs to be excluded from annual fixed overheads. In our view, the scope of the requirement should be amended so it is consistent with the PRA's Financial Resilience requirements and therefore should be based on Column 170 of PRA Template 109, which specifically relates to Annual Fixed Overheads for Critical Services.

In addition, paragraph 8.9 of the consultation states "*where UK firms are part of non-UK groups and rely on critical services providers in the group that are outside the United Kingdom, the Bank will seek assurance in discussion with other authorities that appropriate arrangements are in place for loss-absorbing capacity for operational continuity.*" We would welcome clarification from the Bank about how they intend to approach this and what the timeframe will be given that internal MREL requirements are intended to apply from 1 January 2019. We would also welcome clarification as to whether the Bank would expect regulators in other jurisdictions to increase their TLAC/MREL requirements to account for operational continuity should the Bank conclude that their existing requirements are insufficient.

Finally, we would welcome clarification from the Bank on the proposal in paragraph 8.10 of the consultation which states "*if the critical services provider is an unregulated service company that is part of a sub-group of other unregulated service companies the Bank may permit the loss-absorbing capacity to be maintained at the parent entity within the service-providing group*." It would be helpful to have more information on what conditions the Bank would impose in order to allow loss-absorbing capacity to be held at the parent entity within the service-providing group.

Accounting and Tax implications

7. Are there any tax and accounting implications that we should be aware of in setting our internal MREL policy?

In formulating its final policy, it is important for the Bank to consider the consequences from the perspective of the accounting rules and the interaction with tax rules – both being areas where we have concerns and feel there is a need for clarification or action from the Bank.

Internal MREL held as a financial asset by the parent entity could, for example, be accounted for under IFRS9 as fair value through profit or loss (FVTPL). Whilst this would remove any need for expected loss impairments, it injects some volatility (net of any hedging) into the P&L and reserves of the parent entity. This would be compounded if externally issued MREL on the liability side of the balance sheet was not also accounted for on a FVTPL basis.

Where internal MREL is accounted for under IFRS9 on an amortised cost basis, this would remove the potential volatility associated with FVTPL accounting, it would however then require the investing parent entity to review the investment for credit impairment. Potential complications would be:

I. That in determining any need for an impairment charge, this is likely to result in classification under Bucket 2, necessitating lifetime expected loss provisions *prior* to any triggering of the internal MREL instrument, which may be interpreted as an adverse signal by the wider market;

II. If impairment charges are applied and provisions consequently held at the resolution entity of a bail-in firm, these will be classified as excluded liabilities, further complicating observance of clean holding company requirements.

We note however that from a tax perspective, regardless of the accounting treatment, the internal instruments would still need to be treated under an amortised cost basis, which would then create tax volatility with any instruments at FVTPL.

As a consequence of this, the Bank should consider the accounting implications in their final policy statement on internal MREL.

With regards to tax implications, we note that debt may be recharacterised as equity where there is a requirement for the contractual recognition of write-down and/or conversion in internal MREL instruments. However, there is no tax deductibility for interest paid on MREL debt instruments that are not Additional Tier 1 (AT1) or Tier 2 (T2) regulatory capital. Where a tax deduction is unavailable, efforts to enhance the resolvability of a firm could be restricted by a loss in profitability.

We would encourage the Bank to consider this further with HMRC/HM Treasury, and, in particular, consider whether it may be appropriate to permit the tax deductibility of interest paid on non-AT1/T2 debt instruments that are used for the purposes of meeting internal MREL requirements. For cross-border internal MREL instruments, firms will need to consider carefully how the instrument will be characterised in the third country. Where the instrument is characterised differently in two jurisdictions, this could inadvertently trigger the hybrid mismatch rules which were introduced in the UK on 1 January 2017 and would be an undesirable outcome. Again, we believe that this should be considered carefully by the Bank in conjunction with HMRC/HM Treasury.

Other implications

8. *What other implications does internal MREL have for the operation of banking groups that the Bank should be aware of?*

We wish to highlight to the Bank our concerns with regard to paragraph 6.6 of the consultation document – related to the issuance of external MREL from non-resolution entities constituting an impediment to resolution in the Bank's view. We wish to highlight that we disagree with this being the case as existing issuances continue to count towards regulatory capital requirements. Stating this may create market expectations for these instruments to be called early, thus distorting the market around these instruments.

External MREL for banking groups with MPE resolution strategies

9. *Do you agree with the Bank's proposed policy for setting consolidated MREL for UK multiple point of entry groups?*

The Bank's proposed policy with regards to MPE resolution strategies requires further clarification in our view. Ultimately, there should be a level playing field for all G-SIBs independently of whether their resolution strategy is labelled SPE or MPE and in fact certain banking groups may have adopted a strategy that combines features of the two.

First, we seek clarification as to whether paragraphs 6.8 and 6.9 of Appendix 2 imply that the higher of the consolidated group's MREL and consolidated group's TLAC would apply. In our understanding, the consultation paper proposes that for G-SIB groups with an MPE strategy, their overall group MREL requirements are the higher of (i) the consolidated TLAC requirements and (ii) the sum of the requirements of each of its resolution groups; however, this contrasts with the FSB term sheet which recognises that where the sum of the resolution groups is higher than the consolidated requirement (which would have applied if the group had only one resolution entity), an adjustment might need to be considered between home and host regulators. It is therefore unclear how the proposed approach to end-state MREL reconciles with the FSB Term Sheet Section 3.

Secondly, we would note that the consolidated requirement for those banks under an MPE approach is calibrated differently to the consolidated requirement for banks under an SPE approach, per the Bank's proposed policy. We would welcome clarification from the Bank in this respect, including how this reflects the FSB term sheet in all relevant respects.

Restrictions on firms' ability to hold each other's MREL

11. *Do you have any comments on the Bank's thinking on the treatment of cross-bank MREL holdings and MREL disclosure?*

We agree that the Bank should wait for further clarity surrounding the ongoing negotiations on the treatment of MREL cross-holdings at the European level, so as to ensure alignment. Whilst the Bank refrains from commenting further on this point of policy we would like to highlight our support for aspects of the approach taken forward within the European Commission's proposals on resolution aspects of the Risk Reduction Measures package.

The need to acknowledge that in Europe there is a broader application of resolution requirements under MREL than those put forward under TLAC, comes with the need to also adapt other policies related to TLAC to suit

the European framework. One such aspect is the deductions regime. We continue to strongly support a corresponding approach to deductions, rather than having deductions taken from Tier 2 capital instruments as suggested by the Basel Committee on Banking Supervision (BCBS) in order to create a level playing field between G-SIBs and other institutions which would have no TLAC to deduct from. Since MREL is applicable to all institutions within the scope of the Bank's internal MREL consultation, a deduction from MREL resources therefore makes sense. This approach is therefore more in line with the FSB's own suggested approach which contemplates deductions from TLAC for G-SIBs under section 15 of the TLAC Term Sheet. We encourage the Bank to support the corresponding deductions approach and are happy to engage with them further on this if necessary.

We also wish to note the need to ensure market making and underwriting exemptions are fully applied in the UK to ensure a global level playing field is achieved.

In advance of any PRA proposals on this topic, we set out below some key issues we expect the PRA to consider:

The proposals cannot consider separately the holding of other banks' MREL and the holdings of internal MREL. This is because the PRA's solo regime applies the full set of consolidated prudential rules at the solo level. Therefore, as it stands, there would be no distinction in the solo regime between internal MREL and 'third party' MREL as both are issued by third-party entities from the perspective of the solo entity. The issue of whether MREL (third party or internal) should be a like-for-like deduction (as proposed in the EU rules) or a deduction from Tier 2 (as proposed in the Basel standard) is critical. We strongly support a like-for-like deduction for three reasons.

I. It provides for a sensible result at the solo level (i.e. if the deduction was to come from Tier 2 then all MREL would need to be down-streamed as Tier 2, which would have follow-on implications for transfer pricing.

II. This is consistent with the approach for other tiers of the capital structure, i.e. certain holdings of AT1 are deducted from an institution's own issuances of AT1.

III. The rationale for the deduction from Tier 2 in the Basel standard is flawed. The BCBS preferred a deduction from Tier 2 as not all banks which held TLAC would have issued TLAC (the issuance requirement applying only to G-SIBs, the holdings standard to all banks). We would note that in Europe, all banks[5] will be required to issue MREL; and secondly, the requirement to issue TLAC is a burden on G-SIBs, they should not be punished twice by being denied the ability to deduct holdings on a 'like-for-like' basis – to have the ability to do so is not an advantage[6].

We strongly support the market-making exemption proposed in the TLAC Holdings standard as a necessary and proportionate measure to ensure adequate provision of liquidity to this important market. But we have significant concerns over its size, which we would urge the PRA to investigate further as European policy is finalised.

To the extent that the size of the exemption was supported by empirical evidence – and none has been produced by the BCBS – we would assume it was a function of: (i) the size of the TLAC market and (ii) the consolidated capital base of major market-makers. However, as regards an exemption for market-making in MREL (as opposed to TLAC), we would note that the size of the market would be much greater as the scope of entities subject to requirements is extended beyond G-SIBs; and that the capital base which supports market-

[5] Small banks will still have an MREL requirement, this may however be limited to the level of their regulatory capital requirement.

[6] There is nothing to stop a bank that is not required to issue non-capital MREL from doing so if it wishes to take advantage of the like-for-like deduction regime.

making is smaller than the consolidated capital base, it is the capital base of the solo entities that conduct trading activities.

Finally, the standard is extremely complex and subject to significant interpretative issues in other areas, such as on the treatment of non-subordinated MREL and the recognition of hedges (i.e. the gross vs. net treatment of exposures). The PRA should engage with the industry to address these before finalising rules and the size of the exemption.

Disclosure

We agree with the Bank's view that the timing of EU implementation of the BCBS Pillar 3 standards is uncertain. We do not see any additional benefits in early adoption of these standards.

If the Bank were to explore this, we would expect them to consider whether existing disclosures were inadequate (we would strongly state that they are not) and how significant the benefits to investors will be of comparability given banks in the rest of the EU will not be subject to uniform disclosure requirements.

We would also expect the Bank to take into account the many additional reporting and disclosure burdens – including those associated with ring-fencing, Pillar 2 liquidity, and MREL itself – which regulators are imposing on firms during the next few years.

MREL reporting

The consultation paper notes that the timing of a European reporting regime is uncertain, and that PRA will consult on an MREL reporting regime in due course.

We wish to highlight that the trade-off between time to develop systems and uncertainty over final rules is a false choice. The PRA should await final rules and then introduce a reporting regime and give firms sufficient time to prepare systems. This is a very simple approach, and the only proportionate one.

We would particularly caution the Bank and the PRA against making multiple ad-hoc data requests which are frequently changing in the interim period (which to a certain extent is already happening). This is extremely burdensome to firms, and we are not convinced of the benefits to authorities.

Other comments

12. *Are there any other comments which you would like to make which are relevant to this consultation and which you think the Bank should be aware of?*

We wish to seek clarification that where the Bank refers to regulatory capital under the section on eligibility criteria, that this refers to non-CET1 capital only.

Further to this, clarity would be welcome on the consequences for breaches of internal MREL requirements, as this is not elaborated on within the consultation paper. It is important to set this out to firms as this will impact the size and location of a firm's own internal management buffers, and to understand who is accountable for any breaches should they occur.

Finally, further clarity would also be welcome on the different bases on which internal MREL requirements may be calculated, i.e. on an RWA or leverage basis. For example, could internal MREL requirements be scaled

on both measures even if the consolidated binding constraint is different, i.e. group external MREL is calibrated to the RWA measure, but material subsidiaries are bound by leverage and thus that is the measure that will be scaled?

If you have any questions regarding this response, or should you wish to discuss any points with us further, please do not hesitate to contact us.

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