BANK OF ENGLAND

Resolution

Discussion Paper

The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)

December 2020

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Discussion paper on a review of the Statement of Policy

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The Bank of England welcomes comments by 18 March 2021. Please provide those comments by email to: MREL.Review@bankofengland.co.uk

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Introduction

Background

The Bank of England (the Bank), as the UK resolution authority, is responsible for taking action to manage the failure of certain financial institutions – including UK-headquartered banking groups and UK-incorporated banks and building societies (together, banks) – a process known as 'resolution'. Resolution allows the shareholders and unsecured creditors of failed banks to be fully exposed to losses, while ensuring the critical functions of the bank can continue. Resolution reduces the risks to depositors, the financial system, and public funds that could arise due to the failure of a bank. By ensuring losses will fall on a failed bank's investors, rather than depositors or taxpayers, resolution can both reduce the risk of bank failures and limit their impact when they do occur.

The minimum requirement for own funds and eligible liabilities (MREL) is a minimum requirement for banks to maintain equity and eligible debt so that they can be 'bailed in' should a bank fail. The purpose of MREL is to help ensure that when banks fail, the resolution authority can use these financial resources to absorb losses and recapitalise the continuing business. As a result, MREL is a critical element of an effective resolution regime.

The Bank sets MREL for individual banks to achieve one of three broad resolution strategies – modified insolvency (insolvency)[1], partial transfer or bail-in. These strategies are designed to reflect the scale and nature of the impact of a bank failure. The Bank determines a resolution strategy for each bank, in line with the special resolution objectives[2], and sets the accompanying MREL. Generally, the amount of MREL steps up with the size of the bank, proportionate to the expected impact of the bank's failure. For banks with an insolvency resolution strategy MREL is set equal to minimum capital requirements. However, for banks of a certain size, the Bank judges that if they fail, recapitalising them with investors' funds and allowing them to continue while they sort out their problems, is preferable to them ceasing trading in an insolvency. For these banks the Bank sets higher MREL, usually equal to twice the bank's minimum capital requirements. The effect of placing a bank into insolvency on its critical functions and deposits is explored in greater detail in Section 2.

The Bank set out in its MREL Statement of Policy[3] indicative thresholds which will guide its judgment in determining the resolution strategy for individual banks. The indicative thresholds are 40,000 to 80,000 transactional accounts[4] for partial transfer strategies, and a balance sheet size of £15bn to £25bn for bail-in strategies. The Statement of Policy details how the Bank calibrates MRELs for each resolution strategy. MREL is currently set on a lower interim basis, allowing banks time to build up their MREL resources to meet their end-state MREL by issuing new instruments or restructuring existing funding.

The Bank's MREL Review in the context of regulatory developments

The Bank first published its MREL policy in 2016, updating it in 2018 to reflect the Bank's approach to the intragroup distribution of MREL resources. The Bank reaffirmed in June 2018 that it would review the calibration of MREL and the final compliance date, prior to setting end-state MRELs, having particular regard to any intervening changes in the UK regulatory framework as well as banks' experience in issuing liabilities to meet their interim MRELs. Having completed an initial analysis of banks' access to the market for MREL instruments[5], the Bank has decided to issue this Discussion Paper (DP) as the first part of the MREL Review. The DP will gather feedback and ideas from stakeholders to inform the Bank's views on the policy choices that it will consult on in the second part of the Review. In light of challenges faced by some banks that are currently

1 The Banking Act 2009 provides for a number of modified insolvency regimes for certain institutions (the bank insolvency procedure (BIP), building society insolvency procedure (BSIP) and the special administration regime (SAR)). The special administration regime is set out in the Investment Bank Special Administration Regulations 2011 issued by HM Treasury pursuant to section 233 of the Banking Act.

2 As set out in section 4 of the Banking Act 2009 and discussed further below.

3 https://www.bankofengland.co.uk/-/media/boe/files/paper/2018/statement-of-policy-boes-approach-to-setting-mrel-2018.pdf

4 Transactional accounts are defined as accounts from which withdrawals have been made nine or more times within a three-month period.

5 In this DP: 'MREL instruments' includes all instruments (including own funds instruments) that are eligible to contribute to meeting MREL; and 'MREL eligible liabilities' means MREL instruments other than own funds instruments

in scope of stabilisation powers but not G-SIBs or D-SIBs[6] of growing into higher MRELs and to enable the Bank to take into consideration the Financial Policy Committee (FPC) and Prudential Regulation Committee (PRC)'s review of the UK leverage ratio framework, the Bank has delayed the end-state compliance date for this group of banks by one year, from 1 January 2022 to 1 January 2023.[7] In this DP, the banks that are currently in scope of the Bank's stabilisation powers but are not G-SIBs or D-SIBs (or their subsidiaries) are referred to as 'mid-tier banks'.

The Bank considers that for the largest banks – the G-SIBs and D-SIBs – the use of a bail-in resolution strategy remains the only way in which the special resolution objectives will be met in the event of the failure of the bank. The Bank has also committed to parliament that these banks will be resolvable by 2022. G-SIBs are subject to additional loss absorbency requirements under the Capital Requirements Regulation.

This extension affords time for the Bank to engage more fully with a broad range of stakeholders in finalising the Review and the issues relating to MRELs for mid-tier banks. Completing the Review in 2021, rather than in 2020 as had been planned, takes into account the United Kingdom's withdrawal from the European Union (EU) and the new legal framework that will apply at the end of the Implementation period, and the operational impact of Covid-19 related disruption. It allows the Bank to accommodate consideration of the MREL framework in the context of broader regulatory changes that are now underway but not yet complete.

As noted above, the FPC and PRC have announced that they will conduct a review of the UK leverage ratio framework in light of revised international standards once there is further clarity on the new legal framework following the UK's withdrawal from the EU. This review will take place in the context of the FPC's stated commitment to the implementation of robust prudential standards in the UK, which will require maintaining 'a level of resilience that is at least as great' as currently planned, and 'which itself exceeds that required by international baseline standards'. The Prudential Regulation Authority (PRA)'s current approach to banking supervision[8] notes that this review will, amongst other things, cover the question of extending leverage ratio requirements and buffers to other PRA-regulated banks. The Bank recognises that, if the scope of leverage ratio requirements were to be extended, MRELs and leverage ratio requirements could interact so as to increase, potentially significantly, the amount of own funds and eligible liabilities that some banks and building societies would need to maintain. By completing the Bank's MREL Review in 2021, this will enable the Bank to take the FPC and PRC's decisions relating to the scope of leverage ratio requirements into full consideration when reviewing MREL policy for mid-tier banks.

The extension to the final MREL compliance date for mid-tier banks also reflects an acknowledgment that the experience of banks in issuing liabilities to meet their interim MRELs has been mixed. Some banks have been able to issue sufficient eligible debt, or to retain earnings, without significant challenges. Others have found it more challenging to meet the requirements. Larger banks have generally found meeting the requirements less challenging than have mid-tier banks.

The Bank aims to maintain a "fit and ready" resolution regime: fit for the purpose of maintaining financial stability and market discipline; and ready to be put into action to deal with the failure of one or more banks. The Bank's overall approach to ensuring resolvability supports financial stability through strong, effective standards appropriate for the maintenance of a credible resolution regime. Consistent with this, the Bank's MREL policy currently enables banks to plan for higher levels of MREL through engagement with the Bank from authorisation and as they grow. The Bank exercises its discretion to set transitional periods for banks as they grow into higher MREL of at least three years. Thresholds for higher MREL are indicative and they are

6 Respectively, global systemically important banks as identified by the Financial Stability Board in consultation with the Basel Committee on Banking Supervision and national authorities; and domestic systemically important banks, being those institutions that are subject to the PRA leverage ratio requirement (i.e. with retail deposits over £50 billion) and/or any institutions that are designated as an O-SII (other systemically important institution) by the PRA pursuant to the Capital Requirements (Capital Buffers and Macro-prudential Measures) Regulations 2014, and which have a resolution entity in the United Kingdom.

7 Some mid-tiers banks currently have end-state compliance dates after 2023. For these banks the end-state compliance date is unchanged. For mid-tier banks with their current end-state compliance dates in mid-2022, the delay will be to 1 January 2023.

8 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2018.pdf

structured as ranges so that the Bank can apply a bank-specific judgment when applying the standards. The Bank is interested in the industry's experience of the Bank's current graduated approach.

The Bank also recognises that there have been market, technological, and consumer behavioural developments that may have a bearing on MREL policy: in particular the definition of transactional accounts for the purposes of the indicative threshold for partial transfer resolution strategies.

The Bank wishes to use this DP to open up a broad dialogue with interested parties on the development of the MREL framework in this wider context. Given mid-tier banks' experience of issuing MREL instruments, the focus of the DP is on these banks.

This DP discusses how the different resolution strategies help to deal with the impact of bank failures and, in the case of the mid-tier banks, shares analysis of the consequences should they have their resolution strategies, and so MRELs, altered such that they would enter an insolvency procedure in the event of failure.

The Financial Services Compensation Scheme (FSCS) provides protection for customers when financial firms fail, which helps to raise public confidence in the financial services industry. Its responsibilities include paying out covered depositors in an insolvency and seeking recoveries to reduce the impact on industry. In developing this DP, including in assessing the potential impacts on the Bank's resolution objectives of a mid-tier bank entering insolvency, we have assumed that the existing deposit protection framework remains unchanged. However, the interaction between transactional accounts and FSCS's operational functioning is covered in greater detail in Section 4.

As such, feedback is requested on how the Bank's MREL framework could evolve, taking into account these developments, and other possible innovations. The Bank will also consult HM Treasury, the Financial Conduct Authority (FCA), and the FSCS.

The Bank's MREL Review will consider the resolution strategy thresholds, the calibration of MREL, instrument eligibility, and the application of MRELs within banking groups. The Bank intends to publish a Consultation Paper in summer 2021, setting out any proposed changes to its MREL framework. The Bank intends to make any policy changes by the end of 2021, in light of feedback received on the Bank's Consultation Paper.

Structure of this Discussion Paper

The first section of this DP summarises the purpose of MREL in the context of the development of effective resolution regimes. The second section provides an overview of the Bank's analysis of the potential impact on the statutory special resolution objectives of a hypothetical mid-tier bank failure in the event that insufficient MREL resources were available for an orderly resolution, and the bank had to instead enter an insolvency procedure. The third section sets out a high level summary of banks' experience in issuing liabilities to meet their MRELs. The fourth section considers the potential interactions of the MREL regime with other regulatory developments. Finally, the Annex provides an overview of the existing MREL regime.

Questions for public consideration and comment

1. Are there any issues or evidence that respondents would like to bring to the Bank's attention that would inform its review of the MREL framework, in particular relating to the thresholds for resolution strategies, the calibration of the requirements, the eligibility of instruments or the application of MREL within banking groups?
2. Does the discussion in Section 2 capture all relevant potential impacts of the entry into insolvency of a bank which meets the current indicative thresholds? If not, what other impacts should be considered?
3. Does the discussion in Section 3 accurately reflect the experience of banks in issuing MREL instruments? If not, please set out your perspective on banks' issuance.
4. Does the discussion in Section 4 capture all of the regulatory developments relevant to MREL? If not, which other regulatory developments are relevant to the Bank's review of MREL policy.
5. What are your views on the Bank's current graduated approach to 'growing into MREL' and in particular, the provision of a transition period of at least three years? The experience of some mid-tier banks in issuing MREL instruments suggests that this period may be insufficient for them to establish

themselves as issuers of those instruments. The Bank would particularly welcome public comments on this point.

6. Should the Bank update its definition of transactional accounts for the purposes of its indicative resolution thresholds, and if so how? The Bank would welcome feedback on whether and how it should be adjusted to take account of changes in market structure and customer behaviour.

The Bank would welcome written responses to these questions, or any other relevant observations, by 18 March 2021.

Please provide those responses by email to: MREL.Review@bankofengland.co.uk.

1. The purpose of MREL

The purpose of MREL is to ensure that banks in scope of the resolution regime have sufficient resources to absorb losses and, if necessary, recapitalise them in the event of their failure. Recapitalisation ensures the continuity of the critical functions which banks provide, avoiding the disruption and financial stability impact of a disorderly failure. MREL provides a credible means by which recapitalisation can be achieved without recourse to public funds, and therefore helps to maintain market discipline and competition.

The global financial crisis that began in 2007 saw widespread and severe disruption to the financial system. The banking sector faced significant losses and in many cases banks' access to funding markets was heavily restricted. The crisis revealed a lack of clarity about how public authorities could and should respond to failing banks, revealing shortcomings in the tools available to policymakers.

There were no adequate bank resolution frameworks in place in the UK and many other jurisdictions to manage these failures. Therefore governments concluded that it was necessary to use public funds to rescue failing banks and in effect 'bail out' their creditors and in some cases shareholders. These decisions were taken to avoid the negative consequences that the insolvency of banks would have had on their depositors, the wider financial system, and the economy as a whole. In other words, these banks were 'too big to fail'.

Box 1
Use of public money to rescue banks during the global financial crisis

Between 2007 and 2009 the UK government invested £137bn of cash into banks through capital injections and loans. Royal Bank of Scotland and Lloyds Banking Group received the bulk of this investment with their combined receipt of capital injections totalling £66bn.

However, smaller banks also received significant government support. Bradford & Bingley received a £11.9bn working capital facility, while Northern Rock was supported with a £1.4bn of equity for its "good bank" and with £27.4bn that was loaned to the entity that was created to house Northern Rock's non-performing loans. HM Treasury also provided a further £29bn of loans to support depositors of failed banks, of which £15.7bn was used by the FSCS to compensate the depositors of Bradford & Bingley.

Government support was not limited to cash investments. The government provided a further £1,029bn of guarantees, indemnities and commitments to the UK financial system through the crisis. RBS and Lloyds benefited from a combined £465bn of these government guarantees. Bradford & Bingley and Northern Rock received total guarantees of £51bn over the course of the crisis, of which £41bn was used to guarantee liabilities.

Sources:
https://commonslibrary.parliament.uk/research-briefings/sn05748/.
https://www.nao.org.uk/wp-content/uploads/2014/09/Departmental-Overview-the-performance-of-HM-Treasury-2013-14.pdf.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/221558/hmt_annual_report_2012.pdf.
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https://www.ukar.co.uk/~/media/Files/U/Ukar-V3/Attachments/press-releases/2017/b-and-b-annual-report-and-accounts-report-2017.pdf.

There is now an effective resolution regime in the UK[10]. The Bank has powers to manage bank failure in an orderly way, designed to protect financial stability and help to prevent public money from being used to ensure banks continue to operate.

The Bank, as resolution authority, is responsible for developing strategies for how it would manage the failure of every bank, in order to meet the special resolution objectives in the Banking Act (further detail on the objectives is set out in Section 2). The Bank's implementation of the resolution regime for individual banks provides for one of three broad strategies in the case of each bank:

- Bail-in is the likely strategy for the largest and most complex banks with balance sheets greater than £15-25bn. Bail-in restores the solvency of a failed bank, enabling it to continue providing, without interruption, functions that are critical for the UK economy, and then undertake an orderly restructuring of the business to address the underlying causes of failure.
- Partial transfer is likely to be appropriate for smaller and medium sized banks whose operations can be sold in short order to another bank, but which are significant enough, in the event of failure, to meet the public interest test for use of resolution powers.
- An insolvency procedure[11] is the preferred strategy for small banks, unlikely to justify the use of resolution powers.

The Bank sets MREL on the basis of the resolution strategy that it has determined for a bank. For banks with an insolvency strategy, there is no need for MREL to exceed minimum capital requirements, because recapitalisation is not required. The Bank requires MREL for banks with a bail-in resolution strategy to be met in the form of legally or structurally subordinated resources[12], and in general MREL must be at least twice the bank's minimum capital requirements. This ensures that liabilities can effectively absorb losses and deliver recapitalisation in resolution. The bank's capital position must be restored to a sufficient level to ensure that it[13] meets minimum capital requirements and commands market confidence. This stabilisation allows for an orderly restructuring which addresses the root causes of the bank's failure.

MREL also supports financial stability by helping to remove any funding distortions caused by expectations that governments would bail out banks should they fail. Prior to the global financial crisis of 2008 this expectation resulted in an implicit subsidy that reduced the cost of funding for those banks which the market perceived to be 'too big to fail'. The price that investors charged for lending to such banks was lower than it would have likely been without this expectation of government support, which encouraged excessive risk-taking. This implicit subsidy for larger incumbents also posed a barrier to competition in the banking sector as, amongst others, growing mid-tier banks did not benefit from this implicit subsidy.

There are already signs that market discipline is improving as a result of post-crisis reforms. One way to measure this change is to look at market views of the credibility of resolution. While no measure is perfect, a range of market-based estimates suggest the implicit 'too big to fail' subsidy has fallen sharply since the crisis. Estimates suggest that the value of the implicit subsidy fell from around £45bn in 2010 to less than £5bn as of 2017 – down around 90%.[14]

Because it shifts risks from the public to the private sector, MREL imposes costs on banks which they would otherwise not have to bear, with implications for their profitability. The costs of meeting MREL may be

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10 For a full summary see the Bank of England's approach to resolution. https://www.bankofengland.co.uk/paper/2017/the-bank-of-england-approach-to-resolution.

11 The Bank Insolvency Procedure (BIP), or its equivalent for building societies, the Building Societies Insolvency Procedure (BSIP). Hereafter in this paper, 'insolvency' refers to the BIP or BSIP. They are based on a corporate insolvency procedure, but are 'modified' to ensure the safeguarding of deposits protected by the FSCS. Once this objective is fully achieved, the procedures revert to ordinary liquidation. Note that for entities which do not hold FSCS-eligible deposits, but hold investments eligible for FSCS coverage, the relevant insolvency regime is that in the Investment Bank Special Administration Regime Regulations 2011.

12 See paragraphs 6.2 to 6.3 of the Bank's MREL Statement of Policy.

13 Or the successor entity of the bank, including a potential acquirer of some or all of its business.

14 http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/capital-and-resolution/written/69208.pdf.

proportionately greater for newer, smaller and mid-tier banks; and this may itself have implications for competition.

Are there any issues or evidence that respondents would like to bring to the Bank's attention that would inform its review of the MREL framework, in particular relating to the thresholds for resolution strategies, the calibration of the requirements, the eligibility of instruments or the application of MREL within banking groups?

Box 2
The history and development of the UK MREL framework

Following the failure and nationalisation of Northern Rock, the UK government acted swiftly in 2008 to create the UK's Special Resolution Regime (SRR), establishing the Bank of England as the UK's bank resolution authority, at first on a temporary basis through emergency legislation and then, in 2009, on a permanent basis through the Banking Act 2009.

In 2011, the Independent Commission on Banking recommended the addition of a bail-in power, and requirements for systemically important and large ring-fenced retail banks to maintain increased loss absorbing capacity, including subordinated liabilities that could be used for recapitalisation on bail-in.

The regime was updated in 2013 to include a bail-in power, and again in 2014 to implement the EU's Bank Recovery and Resolution Directive (Directive 2014/59/EU), or BRRD. The BRRD required EU member states, including the UK, to implement resolution regimes broadly in line with the Financial Stability Board (FSB)'s Key Attributes of Effective Resolution Regimes for Financial Institutions, first published in 2011 and updated in 2014, the international standard for effective resolution regimes for systemically important financial institutions, including banks.

The BRRD required resolution authorities to ensure that credit institutions and certain investment firms are resolvable. As part of this they must set MREL for each individual bank or other credit institution in their jurisdiction, with the aim of ensuring that they have enough loss-absorbing capacity, including liabilities that can credibly bear losses before and in resolution, for example through being written down and/or converted to equity. The Bank consulted on a proposed approach to setting MREL in December 2015, and published its policy in November 2016. The published policy reflected the European Banking Authority's Regulatory Technical Standard (RTS) on MREL, which were adopted into directly applicable EU law in May 2016.

In the UK, the Bank's power of direction to set MREL applies to: (i) banks, building societies and certain investment firms that are authorised by the Prudential Regulation Authority (PRA) or Financial Conduct Authority (FCA); (ii) parent companies of such institutions that are financial holding companies or mixed financial holding companies (holding companies); and (iii) PRA or FCA-authorised financial institutions that are subsidiaries of such institutions or such parent companies.

The Bank's MREL Statement of Policy also reflects the requirements of the FSB's November 2015 Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution and Total Loss Absorbing Capacity (TLAC) term sheet, which apply to global systemically important financial institutions (G-SIBs). The Bank sets MRELs with respect to these banks to reflect this standard.

In June 2018, the Bank updated its Statement of Policy to set out its approach to the distribution of loss absorbing capacity within banking groups i.e. internal MREL. Internal MREL provides for the recapitalisation of subsidiaries and has the effect of passing up losses within the group, so that they can be absorbed by the shareholders and creditors of the resolution entity through the use of resolution tools.

Since 27 June 2019, UK G-SIBs and UK material subsidiaries of non-EU G-SIBs have also been subject to directly applicable requirements to maintain 'own funds and eligible liabilities' under Regulation EU/2019/876, amending Regulation EU/575/2013, (CRR II). The Bank clarified in June 2019 that banks affected should read the Bank's Statement of Policy, including the definitions of MREL and internal MREL, subject to the new CRR II requirements.

In July 2019, the Bank published a Statement of Policy on its Approach to Assessing Resolvability (RAF SoP). The RAF SoP sets out three outcomes that, as a minimum, each bank in scope must be able to achieve in order to be considered resolvable. The first such outcome is to have adequate financial resources in the context of resolution; that is to ensure that the bank has the resolution-ready financial resources available to absorb

losses and recapitalise without exposing public funds to loss. This includes resources to meet its financial obligations in resolution, such as MREL.

Following the end of the UK-EU Withdrawal Agreement Implementation Period on 31 December 2020, EU legal provisions relating to the Bank's obligations and powers as resolution authority and not already transposed into UK law will be 'onshored' with necessary modifications via regulations pursuant to the European Union (Withdrawal) Act 2018 . From this point, the Bank will be able, following public consultation and with other UK authorities, to amend the onshored RTS on MREL.

2. Potential impact on the public interest of a hypothetical mid-tier bank insolvency

The Bank has determined a preferred resolution strategy of bail-in for seven mid-tier banks and a partial transfer resolution strategy for a further three mid-tier banks. These banks are therefore required to meet end-state MRELs in excess of minimum capital requirements; generally equal to twice their minimum capital requirements. The Bank has explored the potential implications of changing the resolution strategy for one or more of these banks to an insolvency procedure. This would likely result from any decision to increase one or both of the indicative resolution strategy thresholds from their current levels.

The Bank has approached this by considering whether a hypothetical insolvency of one or more of the mid-tier banks would meet the special resolution objectives to the same extent as using a bail-in or partial transfer strategy, such that it was not necessary to use such a strategy in the event of the bank's failure. This is part of the assessment the Bank already conducts when setting resolution strategies, but here the Bank has explored the following questions in relation to the hypothetical insolvency of a mid-tier bank:

1. To what extent would insolvency protect and enhance public confidence in financial stability? As part of this the Bank has considered who bears the losses that crystallise in insolvency.
2. To what extent would insolvency protect public funds? As part of this the Bank has considered the impact of insolvency on FSCS funding.
3. To what extent would insolvency protect deposits covered by the FSCS? This includes the disruption to access which depositors may experience.
4. To what extent would insolvency ensure the continuity of critical functions? This includes the impact of insolvency on lending to the economy.

Figure 1: The special resolution objectives in the Banking Act

The purpose of the use of a bail-in or partial transfer strategy is to ensure the continuity of some or all of the banking services and critical functions provided by the bank, including continuous access to all deposits. In contrast, throughout this analysis the Bank has assumed that the insolvency would result in the immediate cessation of all banking services and critical functions at the point of failure and the pay-out of FSCS covered depositors, rather than the transfer of covered deposits to a willing buyer.

In order to enter an insolvency procedure, a bank must have met the first two conditions for resolution[15]. Banks must develop recovery plans, which may include options for solvent wind-down[16] and which might reduce the likelihood of failure all else being equal. However, banks are highly leveraged institutions, and to ensure a credible resolution regime, resolution strategies are set for circumstances where these recovery options are no longer available. Given the PRA operates a non-zero failure supervisory regime that allows banks to enter and leave the market, it follows that a resolution regime is necessary for the circumstances in

15 These are set out in Section 7 of the Banking Act.
16 A number of smaller banks have exited the market in this way in recent years, avoiding any losses for unsecured creditors and depositors.

which the bank no longer has a realistic prospect of recovery. In this way the resolution regime removes barriers to exit and supports banking sector competition.

(1) To what extent would insolvency protect and enhance public confidence in financial stability?

Capital requirements are calibrated to absorb unexpected losses that might crystallise on a bank's assets[17]. However, the historical experience of bank failure has demonstrated that insolvency typically results in an additional deterioration in the value of a bank's assets i.e. a deadweight loss[18]. This additional cost accrues because insolvency typically results in a sale of assets below their book value, and the destruction of any additional value that the bank may have had as a going concern. Although the outcome of any resolution in terms of value preserved is inherently uncertain, it is most likely that insolvency would result in the crystallisation of a higher level of losses than would be the case for a bank that continues to operate in resolution.

Moreover, a bank with an insolvency resolution strategy would not be required to maintain any subordinated resources over and above its minimum capital requirements and buffers. Consequently, after capital resources and any other subordinated debt have been exhausted, losses in an insolvency would be borne by the following classes of creditors in ascending order:

- Senior unsecured (including, as well as the bank's general unsecured creditors, holders of deposits which are ineligible for FSCS coverage – such as deposits made by other financial institutions and larger local authorities).
- Preferred (including holders of deposit amounts above £85,000 from individuals and micro, small or medium sized corporates).
- Super-preferred (including the FSCS, which replaces and in turn protects all FSCS-eligible deposits, including amounts at or below £85,000 per depositor[19]).

The scale of possible deadweight losses in insolvency could make it likely that deposits which rank as senior unsecured or preferred would bear loss in the failure of a mid-tier bank. Even though deposits held by mid-tier banks are for the most part covered by the FSCS, on average 25% of deposits are uncovered or ineligible[20] and hence potentially exposed to deadweight losses. The extent of any such losses will always be subject to uncertainty. However in the hypothetical event a mid-tier bank were placed into insolvency rather than resolution, the individuals and groups which *might* face losses include:

- In relation to the excess, those holding deposits in excess of £85,000 that are eligible for protection up to £85,000. This may include: SMEs, some charities, small local authorities, local public institutions, or households facing a full range of individual circumstances.
- Those whose deposits are ineligible for FSCS protection altogether. This may include: pension and retirement funds, insurance undertakings and large public authorities – though these depositors are likely to be active and responsive in managing their accounts and may move their funds out before a bank's insolvency – increasing the losses to which eligible but uncovered deposits are exposed and potentially hastening a bank's failure.

17 https://www.bankofengland.co.uk/knowledgebank/what-is-capital.

18 This can be considered an inefficient fall in asset value, which has a knock-on effect on economic activity. Davila and Walther (2017) calibrate the deadweight losses during a bank's insolvency at 20% of the bank's asset value. They consider deadweight losses as assets value destruction in addition to the direct losses that shareholders and credits suffer when a bank defaults. This estimate comes from Davydenko et al. 2012, who study a sample of 175 US (financial and non-financial) banks that defaulted between 1997 and 2010. For an average defaulting bank, they estimate the mean (median) cost of default to be 21.7% (22.1%) of the market value of assets. Balla et al. 2019 considers bank failures in the US during the global financial crisis and finds that additional losses (further to those absorbed by a bank's equity) that took place in FDIC receivership were over 25%.

19 The FSCS also provides compensation up to £170,000 for joint accounts and in respect of certain qualifying temporary high balances up to £1 million for up to 12 months from when the amount was first deposited.

20 Calculations by Bank staff based on data submitted by banks.

Deposits are integral to financial stability and public confidence. Large scale losses to unprotected deposits could result in a broader loss of confidence in the safety of bank deposits more broadly, with spill-over effects for banks and the wider economy. As with the extent of deadweight losses, the scale of the fallout should this risk crystallise is subject to some uncertainty.

(2) To what extent would insolvency protect public funds[21]?

A pay-out by the FSCS of covered depositors in an insolvency may pose consequences for public funds given the amount that may be needed to be raised by the public sector to effect any pay-out.

Some jurisdictions' deposit insurance schemes, such as the Federal Deposit Insurance Corporation (FDIC) in the US, are directly pre-funded. In contrast, the FSCS assesses on an annual basis its likely funding needs for the following year (including the costs of pay-outs made previously) and levies the industry accordingly. The amount of levy that can be raised from banks and building societies in aggregate is currently limited by the PRA to £1.5bn.[22]

If demands on FSCS resources exceed the annual levy limit of £1.5bn or the PRA determines that the FSCS is unable to levy other banks, the FSCS may make a request to borrow from the National Loans Fund (NLF).[23] Resources lent by the NLF may need to be raised by HM Government, thereby raising public sector net debt. Once the pay-out is complete, the FSCS becomes a super-preferred creditor in the insolvency and can repay amounts borrowed from the NLF over time, either through recoveries from the insolvency process of the failed bank or increased levies on surviving banks. The time it may take for the FSCS to recover costs from the insolvency would depend on the complexity of the insolvency process for the failed bank.

To assess likely risks to public funds in the event of the insolvency of a mid-tier bank, the Bank considered the scale of these banks' covered deposits. The size of covered deposits would far exceed the FSCS's current levy limit of £1.5bn and so would necessarily result in a fiscal exposure. The scale of temporary public borrowing for even a single mid-tier bank insolvency may be significant, given that on average c.75% of mid-tier banks' deposits are covered.

The Bank judges that, for mid-tier banks, the risks to public funds which are outlined in this section may be greater than those which may result from a bail-in resolution strategy in which the Bank provides banks with liquidity support from the Resolution Liquidity Framework[24], or a partial transfer resolution strategy where the purchaser assumes the failed bank's deposits and matching assets. The Bank would assess the risk to public funds posed by both strategies on a case by case basis.

(3) To what extent would insolvency protect deposits covered by the FSCS?

While an FSCS pay-out is underway, depositors may temporarily lose access to their money in insolvency. This could have financial stability implications. An insolvency of a mid-tier bank may result in many thousands of depositors losing access to day-to-day banking services for more than a few days. The impact of this would depend on the depositor profile of the bank in question, in particular the proportion of depositors whose primary source of income is paid into the bank and / or who rely on their accounts for day to day banking services, for example (in the case of small businesses), to make payments to their employees and suppliers.

The Bank's current MREL policy includes an indicative threshold of 40,000 to 80,000 transactional accounts in deciding whether a bank should be in scope of a stabilisation powers resolution strategy. The Bank defines a

21 A crisis management Memorandum of Understanding (MoU) between the Bank and HMT sets out the respective responsibilities of each authority in a crisis and the co-ordination needed for resolution planning, policy and execution. HMT has sole responsibility for any decisions involving public funds. In order to give HMT sufficient notice of plans that could have implications for public funds, the Bank is required to provide HMT with information before determining a resolution plan for a bank that involves the use of resolution tools. This includes an assessment of the systemic risks and potential risks to public funds from the bank's failure. https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/resolution-planning-and-financial-crisis-management.pdf.

22 https://www.fscs.org.uk/about-us/funding/levy-info/.

23 https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/bank-and-fscs-september-2019.pdf.

24 Further detail on the Resolution Liquidity Framework is set out in the Bank of England's approach to resolution. https://www.bankofengland.co.uk/paper/2017/the-bank-of-england-approach-to-resolution.

transactional account to be one which has been used at least nine times in the last three months to make payments. The Bank has defined this metric by usage because it is a proxy for a financial stability risk appetite around the disruption which depositors may experience in insolvency from losing access to day-to-day banking services.

The Bank is assessing whether the current transactional accounts definition is the right metric to assess the significance of an account from a financial stability perspective, and whether it appropriately captures 'day-to-day banking services' (see Section 4).

(4) To what extent would insolvency ensure the continuity of critical functions?

Depending on the extent to which mid-tier banks' lending is substitutable by the wider banking system, insolvency may result in an interruption to the provision of credit to the economy.

When a bank enters insolvency, while its stock of loans outstanding (and share of activity across the system) is unchanged, its lending flow immediately falls to zero, reducing overall system-wide lending flow. The hard stop to all of a bank's lending that would arise in insolvency could cause spill-overs – the magnitude of such a reduction in lending would be much greater than if a mid-tier bank were to deleverage gradually, for example as a recovery action. If credit demand remains constant, the bank's competitors may promptly close the supply shortfall, with little effect on the provision of financial services to the real economy. This is likely to be the case for the smallest banks and some mid-tier banks. However for some of the larger mid-tier banks, and given a context where more than one failure may be occurring in a similar timeframe, this judgement is more finely balanced. Some mid-tier banks may also offer services to niche markets, which are less easily substitutable.

While mid-tier banks' stock of loans outstanding is far smaller than that of G-SIBs and D-SIBs, over the last three to four years their total lending flow was just below one-third of that of G-SIBs and D-SIBs – c.£9bn per year. The insolvency of two or more mid-tier banks may result in a reduction of annual lending flow at least equivalent to that of a D-SIB. Simultaneous failure may be more likely in a general economic downturn. In these wider economic conditions, the risk appetite of a competitor bank to increase its lending to substitute for the credit supply lost to an insolvency may be diminished.

Does the discussion above capture all relevant potential impacts of the entry into insolvency of a bank which meets the current indicative thresholds? If not, what other impacts should be considered?

Box 3

International comparisons on thresholds

Different jurisdictions have a range of policies on the size at which a bank should be required to have recapitalisation capacity. This may reflect differences in: local banking markets and the plausibility of finding a willing buyer for a failing bank at point of failure; the authorities' risk appetite for the disruption caused by insolvency; and the use of public funds. The UK's indicative total assets threshold is set at a range of £15-25bn. Some of the analysis underlying the risks of insolvency for banks larger than this and / or with more than 40,000 to 80,000 transactional accounts is set out in greater detail in this DP.

In the US, the requirement to have recapitalisation capacity applies only to US G-SIBs and operations of the largest and most systemic foreign banking organizations. This may be due to a greater prevalence of private sector purchase-based resolution strategies as facilitated by the Federal Deposit Insurance Corporation (FDIC) and its pre-funded Deposit Insurance Fund (DIF), which in turn averts the need for insolvencies and their adverse financial stability consequences for medium sized banks. The pre-funded DIF balance totalled $114bn in Q2 2020, and the deposit insurance coverage limit is set at $250,000. The diverse, and often localised, US banking market may also help to support this process through a larger number of willing buyers in any resolution sales processes. The FDIC can also enter into loss sharing agreements when selling assets, which limits the downside risk for acquirers and helps to move assets quickly into the private sector.

In the European Banking Union, the threshold is set at €100bn in total assets. Banks with assets above €100bn are generally required to meet their MREL with subordinated resources. However resolution authorities in the Banking Union may extend this requirement to banks below the threshold at their discretion. Public funds have on occasion been used in relation to banks in stress. For example in 2017 Banca Monte dei Paschi di Siena (balance sheet size of €143.5bn) received precautionary liquidity support (state guaranteed) and recapitalisation, as well as guarantees on senior tranches of non-performing loan securitisations. Banca Popolare di Vicenza (€35bn) and Veneto Banca (€28bn) both received precautionary liquidity support (state guaranteed) and entered compulsory administrative liquidations. This included a €4.8bn cash injection and €12bn state guarantees for a combined sale of parts of the two banks.

Sources:
https://www.federalregister.gov/documents/2020/03/26/2020-06371/total-loss-absorbing-capacity-long-term-debt-and-clean-holding-company-requirements-for-systemically#footnote-2-p17003.
https://www.fdic.gov/deposit/insurance/assuringconfidence.pdf.
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https://www.fsb.org/wp-content/uploads/P280620-1.pdf.
https://www.fdic.gov/bank/analytical/quarterly/2020-vol14-3/fdic-v14n3-2q2020.pdf.
https://www.fdic.gov/resources/deposit-insurance/brochures/documents/deposit-insurance-at-a-glance-english.pdf.

3. Banks' experience of issuing MREL instruments

The FSB published the TLAC standard in late 2015. Since then, UK G-SIBs and D-SIBs have issued c.£220bn in aggregate of MREL instruments. Issuance volumes have remained strong even throughout a challenging period with a number of shocks including the UK's decision to leave the EU and, more recently, the Covid-19 pandemic. The major UK banks issued £16bn of Tier 2 capital instruments and MREL eligible liabilities between the end of February and the end of May 2020.

Over the course of 2020, UK G-SIBs and D-SIBs issued MREL eligible liabilities with an average coupon of 2.3%. Mid-tier banks are generally less likely to access global capital markets than their larger competitors and have issued proportionally less MREL eligible liabilities than G-SIBs and D-SIBs, with c.£3bn issued since 2017. The reasons for this are likely to include a lack of scale, less familiarity among overseas institutional investors, and a higher cost of funding for certain business models. As the market for mid-tier banks' MREL eligible liabilities has yet to mature, these banks have relied more on retained earnings to meet their MRELs.

However, most mid-tier banks have issued MREL instruments with only slightly higher coupons than their larger competitors. For instance most mid-tier banks have successfully issued Tier 2 capital instruments and MREL eligible liabilities with a coupon in the range of 2% to 4% in the last 3 years (compared to a range of 0.5% to 5% for UK G-SIBs and D-SIBs). This has allowed them, in most cases, to hold MREL resources in excess of their end-state MREL ahead of the final MREL compliance date.

The Bank estimates the marginal cost to existing mid-tier banks of holding end-state MREL resources will be c.£270m (2.3% of CET1). This cost analysis depends crucially on the counterfactual – how much own funds and eligible liabilities would banks hold in any event if they were not subject to MREL in excess of minimum capital requirements. The costs may also vary between banks and building societies. Various regulatory factors, such as for example the Net Stable Funding Ratio (NSFR), and market-based factors (including the need to be resilient relative to large peers) may mean that banks would retain at least some additional MREL resources even if not required to do so by the Bank.

Some market participants have argued that MREL can be a significant cost for them, that it negatively affects competition, and that the Bank should therefore consider taking some banks out of the scope of stabilisation powers. New and growing banks may find it particularly difficult to issue MREL instruments at a cost compatible with their desired strategic business plan. The increase in MREL from that which is required for an insolvency strategy (i.e. equal to minimum capital requirements) to that which is required for a bail-in resolution strategy (i.e. generally at least two times minimum capital requirements) is significant. A new and growing bank is less likely to have established a track record of profitability that would support the issuance of MREL instruments at lower coupons. The Bank's current approach of determining a bank-specific transition period of at least 36 months for banks which become newly subject to an MREL above their minimum capital requirements is designed to mitigate this challenge. The Bank intends to consider this aspect of its policy carefully in finalising the MREL Review.

Does the discussion above accurately reflect the experience of banks in issuing MREL instruments? If not, please set out your perspective on banks' issuance.

4. Regulatory and market developments

Regulatory developments

The Bank's end-state MREL policy is calibrated by reference to a bank's minimum regulatory capital requirements (see Annex for further details). Specifically, banks that are subject to a bail-in strategy can generally expect to be subject to an end-state MREL based on at least two times their regulatory capital requirements (i.e. 2 x (Pillar 1 plus Pillar 2A)) or at least twice any applicable leverage ratio requirement. As such, any developments in the PRA's approach to setting minimum capital requirements are automatically reflected in the Bank's MREL policy.

That means, for example, that any changes to banks' minimum capital requirements that are brought about through the implementation of revisions to the Capital Requirements Regulation (CRR) in the UK will feed through into end-state MRELs. Recent changes to the way in which the PRA calculates Pillar 2A, and any changes resulting from the UK's implementation of "Basel 3.1" will be similarly reflected in end-state MRELs[25].

PRA leverage ratio requirements currently apply only to banks[26] with more than £50 billion of retail deposits, although the PRA currently expects all banks to consider whether their degree of leverage is appropriate against the internationally agreed measure of leverage.[27] In contrast to the leverage ratio requirement, this current PRA expectation does not affect MRELs. The FPC and PRC will conduct a review of the UK leverage ratio framework in light of revised international standards once there is further clarity on the new legal framework following the UK's withdrawal from the EU. International standards set out that all internationally active banks should meet a 3% leverage ratio minimum requirement at all times. The FPC has stated that it will remain committed to the implementation of robust prudential standards in the UK. This will require maintaining 'a level of resilience that is at least as great' as currently planned, and 'which itself exceeds that required by international baseline standards'[28]. In the June 2018 *Financial Stability Report*[29], the FPC noted that the UK leverage ratio framework delivered broadly similar levels of capital to the international standard, but that it required banks to meet it mostly with CET1 capital. The international framework, in contrast, allowed it to be met with any type of Tier 1 capital. In the EU, leverage ratio requirements will apply to all institutions within the scope of EU CRR requirements, from June 2021.

The Bank recognises that, if the scope of leverage ratio requirements were to be extended, MRELs and leverage ratio requirements could interact so as to increase, potentially significantly, the amount of own funds and eligible liabilities that some banks and building societies would need to maintain. In completing its review of MREL, the Bank will consult with the PRA and fully consider the FPC and PRC's review of leverage ratio requirements. The Bank confirmed in May 2020 that, in line with its current policy, the Bank intends to exercise its discretion with respect to the transition time banks are given to meet higher MRELs. Banks not currently subject to a leverage-based capital requirement, but which subsequently become subject to one, will be given at least 36 months after that requirement takes effect to meet the higher MREL resulting from it. The Bank is considering whether the duration of this minimum transitional period is sufficient, as part of its Review (see below).

The NSFR is intended to apply to UK banks, including mid-tier banks, from 1 January 2022.[30] This requirement will require banks to maintain a certain amount of stable sources of funding, including retail deposits and term debt liabilities, such as liabilities eligible for MREL. Banks may therefore maintain debt for the purposes of not only meeting MREL but also meeting the NSFR requirements.

25 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/conversion-of-pillar-2a-capital-requirements.pdf.
26 Including ring-fenced entities.
27 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/approach/banking-approach-2018.pdf.
28 https://www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2019/october-2019.pdf.
29 https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/june-2018.pdf.
30 https://www.bankofengland.co.uk/prudential-regulation/publication/2020/joint-statement-on-the-implementation-of-prudential-reforms-in-the-financial-services-bill.

The PRA is reviewing its approach to new and growing, non-systemic, banks. It released a consultation paper in June 2020 (CP 9/20) in which it set out expectations of banks as they mature, moving from the point of authorisation or exit from mobilisation with an untested business model and risk management framework and policies, to a settled business model and maturity in their control environment after around five years. The PRA would expect such banks to maintain a credible solvent wind-down plan.

As part of its MREL Review the Bank will consider the case for a more graduated approach to the application of MRELs. The Bank's current policy provides for a transition period of at least 36 months for banks whose MREL changes materially, for example if the resolution strategy applicable to a bank changes. The experience of some mid-tier banks in issuing MREL instruments suggests that this period may be insufficient for them to establish themselves as issuers of those instruments.

In considering this, the Bank will need to take into consideration the risks posed by banks in any extended transition period where an insolvency strategy is unlikely adequately to satisfy the Bank's resolution objectives. Without sufficient MREL resources to provide for recapitalisation should a bank need to be resolved during any transition period, the Bank would be unlikely to be able to execute a successful resolution without recourse to public funds for solvency support.

Market developments

Although large incumbents have continued to provide most of the banking sector's overall lending and deposits, smaller competitors have increased their market shares of certain types of loans and retail savings. For instance UK G-SIBs and D-SIBs retained a dominant position in retail mortgages and SME lending markets as of June 2020. However, UK mid-tier banks have reached c.20% market share of time deposits[31].

New and growing banks have generated more diversity and competition in the financial system. The PRA has, since 2013, authorised a total of 25 new domestic banks (and 24 international banks). Over the last four years, four banks have either grown past the thresholds or merged with another and been brought into scope of stabilisation powers as a result.

Technological developments, particularly in the payments sector, the emergence of fintech banks and wider socio-demographic changes have affected the structure of the UK banking system in the last few years. Banking services' users increasingly access their funds online rather than through a branch and make payments by card rather than cash. The proportion of transactions using cash has fallen from 6 in 10 payments a decade ago to just under 3 in 10 in 2018[32]. They also tend to spread their savings into multiple accounts with different providers and use more than one account in a transactional manner. For instance, the FCA estimated in 2017 that 44% of current account holders actively used more than one account.[33] The advent of some recent new entrants, particularly in the fintech sector, may have strengthened this trend. Depositors may be using their new fintech accounts for day-to-day transactions while using their previous account for more regular monthly transactions.

This poses a question as to whether the Bank should differentiate between different types of transactional accounts:

- Some transactional accounts might be 'primary' where the Bank may tolerate less disruption.
- Some transactional accounts might be 'secondary' where the Bank may tolerate more disruption.

31 Deposits where part of the balance is not accessible without penalty either on demand or by close of business on the day following that on which the deposit was made.
32 Future of Finance report, 2019.
33 Financial Lives Survey, 2017 and calculations by Bank staff.

The features of a transactional account that make it 'primary' could be as follows:

- The account is the holder's only bank account.
- A main income is paid into the account.
- The account is used to pay standing orders and/or direct debits.
- The account holder relies on an overdraft facility provided by the account.

For instance, it has been argued that whether access to an account is critical for financial stability does not depend on how regularly it is used (i.e. whether it is transactional), but on the types and value of transactions made. According to this view, when setting resolution strategy thresholds, the Bank should only focus on 'primary accounts', e.g. those where a household's main source of income is credited. The Bank should be less concerned, for this purpose, with 'secondary accounts', irrespective of whether they are transactional, especially if they are generally used for low-value payments and do not represent a household's main source of liquidity with which to make day to day payments. Depending on the exact operational arrangements in place, including the availability to the FSCS in appropriate format of information on linked accounts that is collected and maintained by banks, it may be possible to make it more straightforward for the FSCS swiftly to effect a pay-out of covered deposits in a "secondary account", for example via electronic transfer to a linked, primary account.

Does the discussion above capture all of the regulatory developments relevant to MREL? If not, which other regulatory developments are relevant to the Bank's review of MREL policy.

What are your views on the Bank's current graduated approach to 'growing into MREL' and in particular, the provision of a transition period of at least three years? The experience of some mid-tier banks in issuing MREL instruments suggests that this period may be insufficient for them to establish themselves as issuers of those instruments. The Bank would particularly welcome public comments on this point.

Should the Bank update its definition of transactional accounts for the purposes of its indicative resolution thresholds, and if so how? The Bank would welcome feedback on whether and how it should be adjusted to take account of changes in market structure and customer behaviour.

Annex: Outline of the existing MREL regime

MREL is designed as the sum of two components:

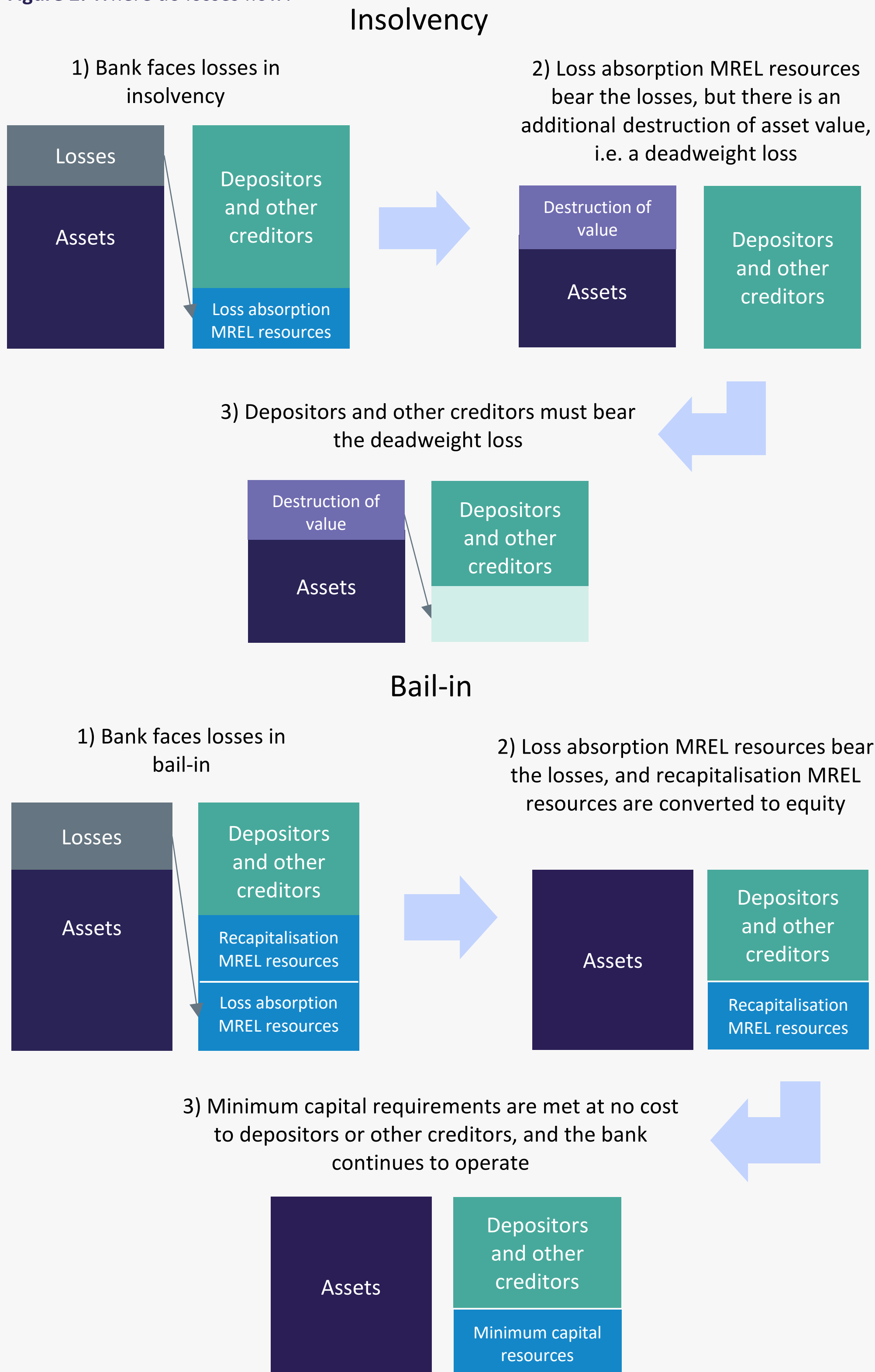
- a loss absorption amount, to cover the losses that would need to be absorbed up to and in resolution; and
- a recapitalisation amount, reflecting the capital that a bank[34] is likely to require in order to comply with the conditions for authorisation and to restore market confidence post-resolution.

34 The Bank is also required to set MREL and resolution strategies for those UK-incorporated investment firms that are required to hold initial capital of €730,000, in particular those that deal as principal.

Box 4
Where do losses flow?

Every time a bank lends it risks not being repaid. When a loan is not repaid the bank bears a loss. Banks are highly leveraged, so a small amount of losses (relative to a bank's size) could cause a bank to fail. The key difference between insolvency and resolution is who bears the losses in failure. Importantly, depositors eligible for FSCS protection may only face a loss if they have over £85,000 in their account.

Figure 2: Where do losses flow?



MREL must be met at all times, alongside any capital requirements[35] set by the PRA. MREL builds upon the existing framework for setting capital requirements, given the need to ensure that institutions meet any applicable minimum capital requirements following resolution. While capital resources required under Pillar 1 and Pillar 2A may also count toward meeting MREL, capital requirements are set by the PRA and the FCA. Setting MREL falls within the remit of the Bank as resolution authority. The Bank is required to consult the PRA or FCA as relevant when setting MREL for individual institutions.[36]

MREL interacts with the capital requirements set by the PRA in a number of ways. An institution's capital requirements are key determinants of the level of MREL set for that institution. The PRA has set out expectations relating to the interaction of MREL with capital and leverage buffers, as well as the implications that a breach of MREL would have for the PRA's consideration of whether a bank is failing, or likely to fail, to satisfy its Threshold Conditions for authorisation.[37] In summary:

- First, institutions are expected not to double count CET1 towards both MREL and the amount reflecting the risk-weighted capital and leverage buffers. This is so that capital buffers remain usable and banks have adequate loss absorbing capacity in a resolution.
- Second, institutions should expect the PRA to investigate whether any bank in breach or likely breach of its MREL is failing, or likely to fail, to satisfy the Threshold Conditions[38], with a view to taking further action as necessary. The PRA's response would depend on a supervisory judgement taken by reference to the relevant circumstances of the bank at that time. In line with the FSB's Total Loss Absorbing Capacity Standard, a breach or likely breach of MREL will be treated as seriously as a breach or likely breach of minimum regulatory capital requirements.[39]

35 References to 'capital requirements' mean: (i) the amount and quality of own funds the competent authority (PRA or FCA) thinks the institution should maintain at all times under the overall financial adequacy rule (for PRA-authorised persons the Internal Capital Adequacy Assessment 2.1 of the PRA Rulebook and for FCA-authorised persons IFPRU 2.2.1R of the FCA Handbook) as it applies on a solo or a consolidated level; and (ii) (if applicable) the minimum leverage ratio in Leverage Ratio 3.1 of the PRA Rulebook.

36 Under section 3A(4) of the Banking Act, the Bank may set MREL for a 'relevant person' as defined in section 3A(1), including an institution authorised for the purpose of the Financial Services and Markets Act 2000 by the PRA or FCA; references to 'institution(s)' in this Annex should be construed accordingly.

37 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2017/ss1616update.pdf

38 The PRA's statutory Threshold Conditions, which set out the minimum requirements that banks must meet in order to be permitted to carry on the regulated activities in which they engage, are designed to promote safety and soundness and are crucial to the operation of the PRA's regulatory regime.

39 https://www.bankofengland.co.uk/-/media/boe/files/paper/2018/statement-of-policy-boes-approach-to-setting-mrel-2018.pdf.

Figure 3: MRELs and transitional periods for different categories of banks

<table>
<tr><th></th><th></th><th>Transitional period</th><th colspan="2">Interim MREL</th><th>End-state MREL (G-SIBS and D-SIBs only)</th><th>End-state MREL (all firms)</th></tr>
<tr><th></th><th></th><th>to 1 January 2019</th><th>1 January 2019</th><th>1 January 2020</th><th>1 January 2022</th><th>1 January 2023</th></tr>
<tr><td rowspan="3">Bail-in</td><td>G-SIBs</td><td>Equal to regulatory capital requirements</td><td>16% RWA or 6% leverage</td><td>(2xP1) + (1xP2A); or 2 (leverage ratio); or 6% leverage</td><td colspan="2">2(P1+P2A); or 2(leverage ratio); or 6.75% leverage</td></tr>
<tr><td>D-SIBs</td><td colspan="2" rowspan="3">Equal to regulatory capital requirements*</td><td>(2xP1) + (1xP2A); or 2 (leverage ratio) if applicable</td><td colspan="2">2(P1+P2A); or 2 (leverage ratio) if applicable</td></tr>
<tr><td>Other institutions</td><td colspan="2" rowspan="2">18% RWA</td><td>2(P1+P2A); or 2 (leverage ratio) if applicable</td></tr>
<tr><td></td><td>Partial transfer</td><td>2(P1+P2A); or 2 (leverage ratio) if applicable**</td></tr>
<tr><td></td><td>Modified insolvency</td><td colspan="5">Equal to regulatory capital requirements*</td></tr>
</table>

*Pillar 1 + Pillar 2A or any applicable leverage ratio.
**Might be reduced to reflect the fact that less than the entire balance sheet of the institution will need to be recapitalised at the point of resolution.

Loss absorption amount

The loss absorption amount is equal to an institution’s capital requirements and is predicated on all this capital being lost up to and following the resolution valuation that accompanies a bank’s entry into resolution. Although the UK resolution regime envisages placing a failed bank into resolution before it is balance sheet insolvent, the experience of the 2008 crisis was that a valuation of its assets following entry into resolution can uncover additional losses which wipe out any remaining capital.

Recapitalisation amount

The recapitalisation amount must restore the capital that an institution in resolution — or a successor entity to which its critical functions have been transferred — is likely to require to comply with the conditions for authorisation and command market confidence post-resolution. The calibration of the recapitalisation amount of MREL and quality of MREL is dependent on whether the preferred resolution strategy for an institution is bail-in, partial transfer or insolvency. The Bank is responsible for determining the preferred resolution strategy for each institution. Resolution powers (including the use of the bail-in tool or the partial transfer tool) are only applied if the Bank judges it is in the public interest and is necessary to advance the statutory special resolution objectives. If the public interest test is not met, banks are placed instead into an insolvency procedure.

Box 5
The use of public funds under the UK resolution regime

The resolution regime aims to ensure public funds are not put at risk by requiring that shareholders and creditors meet the costs of bank failure. Shareholders and creditors must bear losses equal to at least 8% of the liabilities of a bank before there can be any question of public funds being used to stabilise the bank by absorbing its losses or recapitalising it. In the unlikely case that the special resolution objectives are not met using any of the Bank's resolution tools, and as a tool of last resort, HM Treasury could take a failing bank into temporary public ownership. To consider this option, HM Treasury must be satisfied that such action is necessary to resolve or reduce a serious threat to financial stability, or that it is necessary to protect the public interest where financial assistance has already been advanced to a bank to resolve or reduce a serious threat to the stability of the UK financial system.

Current indicative thresholds for resolution strategies

MREL is set on a bank-specific basis to deliver the Bank's preferred resolution strategy in a way that meets the special resolution objectives. MREL must be set in line with the provisions of the Banking Act 2009, the Bank Recovery and Resolution (No. 2) Order 2014 and the European Commission Delegated Regulation (EU) 2016/1450 (the MREL RTS), as retained in UK law.[40]

As a public authority the Bank is under general public law duties governing the actions of public bodies, and aims to ensure that the policy benefits derived from the requirements it sets are proportionate to the costs or burden placed on banks.

The MREL Statement of Policy explains that a bank would be expected to enter insolvency if its failure was unlikely to cause disruption to the UK financial system and it does not provide a significant amount of critical functions. For banks subject to such a strategy, the Bank expects to set the recapitalisation amount of MREL equal to zero, on the assumption that the bank would not need to be recapitalised. This means MREL is set as the loss absorption amount i.e. equal to minimum capital requirements. The Bank will consider the appropriate calibration of MREL in the second part of the Review.

The Bank set out the current indicative thresholds for partial transfer and bail-in resolution strategies following a public consultation in 2015. The Bank set the thresholds as ranges to allow proportionality in the application of the requirements and accommodate banks' changing balance sheets as they grow. More detail is set out on the thresholds and the transitional periods for banks with changed resolution strategies below.

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40 The Technical Standards have been updated by the Bank to reflect the UK's withdrawal from the EU pursuant to the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018, see in particular the Technical Standards (Bank Recovery and Resolution) (Amendment etc.) (EU Exit) (No. 1) Instrument 2019. https://www.bankofengland.co.uk/-/media/boe/files/paper/2019/ps519-section-b-app7-brrd-april-2019.pdf.

The thresholds are no more than indicative ranges, and the Bank must make a judgement when setting a resolution strategy as to whether it would likely be necessary, in the event of a bank's failure, to make use of resolution tools in order to advance the special resolution objectives or whether insolvency would be sufficient. The expression of thresholds as ranges sets out a broad representation of the Bank's judgement. However, it is important to note that the thresholds are not quantitatively derived from any factors other than the Bank's judgement with respect to the advancement of the special resolution objectives – which is ultimately qualitative. Being within or above the indicative ranges does not automatically result in a bank being brought into scope of stabilisation powers.

Instead, the Bank makes a bank-specific judgement, and the thresholds represent an expression of the Bank's likely approach. Notably, at the point of actual failure, the choice of resolution strategy will take into account the circumstances of failure and may therefore vary from the earlier resolution strategy adopted during resolution planning. For example there may be scenarios where the Bank considers it necessary in the public interest to place a bank into resolution despite it having previously set an insolvency strategy due to wider market dislocation and instability at the point of actual failure. The absence of a willing private sector purchaser might make a bail-in necessary for a bank with a partial transfer strategy.

In setting out the indicative thresholds, and making determinations of resolution strategies for individual banks, the Bank acts in accordance with its legal obligations as resolution authority[41]. This means, for example, that the indicative thresholds for resolution strategies might be different to the thresholds which the PRA uses, for example, to designate certain banks as D-SIBs. Banks which do not meet the D-SIB criteria might still meet the threshold for resolution. The Bank must ensure that, if a bank met the four conditions for resolution, it could use the stabilisation powers effectively to resolve the bank in line with the special resolution objectives.

Sufficient loss absorbing and recapitalisation capacity is critical to ensure a successful resolution. If a bank were to fail without it, it is likely that the Bank would be unable to use its resolution powers effectively. There would not be enough resources for the Bank to write-down or convert into equity to recapitalise the bank. The alternative of an insolvency process could have adverse consequences for a bank's depositors and for financial stability more broadly.

It is therefore critical that the resolution strategies – and MRELs – that the Bank sets are consistent with the execution of an orderly resolution in the public interest without recourse to public funds in a sufficiently broad range of possible circumstances.

Bail-in resolution strategy: £15-25bn in total assets

The stabilisation power that is most likely to be appropriate for large complex institutions and groups is bail-in. The Bank is likely to make use of a bail-in strategy for institutions and groups with balance sheets above £25 billion, and will also consider whether bail-in is appropriate for smaller institutions, in particular those with balance sheets greater than around £15 billion. The Bank expects UK resolution entities subject to a bail-in strategy to ensure that their MREL resources are subordinated to operating liabilities, using structural subordination except in the case of building societies which may use contractual subordination or statutory subordination.

Partial transfer resolution strategy: 40,000 to 80,000 transactional accounts

The Bank will consider a number of factors when determining if it is reasonable to assume that an institution can generally be expected to enter insolvency upon failure rather than being resolved using stabilisation powers. Factors indicating that an institution is likely to be able to enter insolvency include:

a) if the institution's failure is unlikely to cause disruption to the wider UK financial system, either directly through the cessation of services it provides or indirectly by negatively affecting confidence in the financial system or similar institutions; and

41 In particular, as set out in the Bank Recovery and Resolution (No. 2) Order 2014; the Bank also takes into account the special resolution objectives in the Banking Act 2009 and its public law duties.

b) if the institution does not provide significant amounts of transactional banking services or other critical functions, particularly those which depend on continuous access to a service which would not be provided in an insolvency. The Bank considers that provision of fewer than around 40,000 to 80,000 transactional bank accounts (accounts from which withdrawals have been made nine or more times within a three-month period) is generally likely to indicate that an insolvency would be appropriate.

Transition periods for banks with changed resolution strategies

The Bank may also determine a bank-specific transition period for a bank to meet a higher MREL if its MREL materially changes. This might occur, for example, if the resolution strategy applicable to the institution changes, or if the regulatory requirements for the institution change in a way that affects its MREL. The Bank will determine the appropriate transitional period on an institution-specific basis, and expects to allow at least 36 months for transition for external MREL where the change in MREL is material.