BANK OF ENGLAND

December 2015

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

Consultation on a proposed Statement of Policy

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This consultation paper sets out the Bank of England’s proposed policy for exercising its power to direct institutions to maintain a minimum requirement for own funds and eligible liabilities (MREL) under section 3A(4) of the Banking Act 2009.

The Bank of England reserves the right to publish any information which it may receive as part of this consultation.

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Responses are requested by 11 March 2016.

Please address any comments or enquiries to:
Benjamin King
Resolution Directorate
Bank of England
Threadneedle Street
London
EC2R 8AH

Email: MRELfeedback@bankofengland.co.uk

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1 Context

Introduction

1.1 This consultation paper sets out the Bank of England's (Bank's) proposed policy for exercising its power, under the EU Bank Recovery and Resolution Directive (2014/59/EU) (BRRD) and associated UK legislation, to direct institutions to maintain a minimum requirement for own funds and eligible liabilities (MREL) and to take other steps for that purpose under section 3A(4) of the Banking Act 2009 (Banking Act) as amended following transposition of the BRRD. The BRRD was transposed into UK law in January 2015, with the provisions on MREL taking effect from 1 January 2016. The purpose of this paper is to describe the context of the BRRD requirement to set MREL using the Bank's new power and to consult on a proposed Statement of Policy regarding its use (set out in the appendix), as required by section 3B(9) of the Banking Act.

1.2 The BRRD – as transposed in the United Kingdom by the Bank Recovery and Resolution (No. 2) Order 2014[1] (the No. 2 Order) – requires the Bank to use its power under section 3A(4) of the Banking Act to set a minimum requirement for own funds and eligible liabilities for relevant institutions. The Bank's power of direction applies to: (i) banks, building societies and certain investment firms[2] (institutions) 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; and (iii) PRA or FCA-authorised financial institutions that are subsidiaries of such institutions or such parent companies. For the purposes of this paper, references to an 'institution' should in general be taken to also include the entities referred to in (ii) and (iii). The Bank is the United Kingdom's resolution authority, and the PRA or FCA is the competent authority.[3]

1.3 The PRA has published proposals in a number of areas of interaction between MREL and the PRA's existing regulatory capital framework.[4] Readers are advised to read the Bank's proposed Statement of Policy alongside the PRA's proposals.

1.4 Under section 3A of the Banking Act, which transposes Article 17 of the BRRD, the Bank has a power to direct those institutions defined in paragraph 1.2 to address impediments to resolvability. The Bank has published its final Statement of Policy relating to that power.[5]

1.5 This consultation paper is structured as follows:

- Section 1: Context sets out the legislative and policy context for MREL and provides a high level summary of the Bank's proposals;

1 SI 3348/2014, available at http://www.legislation.gov.uk/uksi/2014/3348/contents/made .
2 For the purposes of the United Kingdom special resolution regime, the term 'investment firm' means those firms that are required to hold initial capital of €730,000. The majority of such firms are those that deal as principal and are prudentially regulated by the Financial Conduct Authority; the nine largest, more complex investment firms are prudentially regulated by the Prudential Regulation Authority.
3 According to article 2 of the BRRD and article 4 of the Capital Requirements Regulation (EU No. 575/2013), 'competent authority' means a public authority or body officially recognised by national law, which is empowered by national law to supervise institutions as part of the supervisory system in operation in the Member State concerned.
4 The PRA consultation can be found athttp://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp4415.aspx.
5 Seehttp://www.bankofengland.co.uk/financialstability/Documents/resolution/barriersresolvabilitydec15.pdf.

- Section 2: Framework for setting MREL provides an overview of the legal framework in which the Bank must set MREL, introducing a distinction between the loss absorption and recapitalisation amounts of MREL;

- Section 3: Calibration of MREL outlines how the Bank intends to set MRELs for institutions according to their resolution strategies.

- Section 4: MREL instrument eligibility (external MREL) outlines the basic qualifications that liabilities must possess to be used to meet MREL.

- Section 5: MREL in the context of groups outlines the Bank's approach to setting MRELs for entities within groups (including ring-fenced banks) and sets out its proposals regarding structural subordination.

- Section 6: Transitional arrangements sets out the provisions that the Bank intends to apply in the phase-in period for MREL until 2020 (2019 in respect of G-SIBs), and provisions for MREL that will apply to institutions post-resolution.

- Section 7: Further issues describes a number of issues which are not included in the proposed statement of policy at this time, but which the Bank considers important for the MREL regime in the longer term;

- Section 8: Impact assessment provides the Bank's estimates of the costs and benefits of its MREL proposals;

- Section 9: Next steps sets out how to respond to this consultation.

1.6 The Bank welcomes feedback on its proposed approach to setting MREL.

Box 1: Overview of the proposals on MREL

The purpose of MREL is to help ensure that when banks, building societies and investment firms fail, that failure can be managed in an orderly way while minimising risks to financial stability, disruption to critical economic functions, and risks to public funds. In other words institutions can be 'resolved', where necessary, when they fail.

Under the Bank Recovery and Resolution Directive (BRRD), the Bank of England, as UK resolution authority, must identify a resolution strategy for each UK bank, building society and '730K' investment firm. The Bank is required to set a minimum requirement for own funds and eligible liabilities (MREL) that reflects the chosen resolution strategy and helps to ensure that it may be carried out, without public funds being risked, in a way which ensures the continuity of critical economic functions and avoids widespread systemic disruption.

The Bank will use its power to set MRELs for global systemically-important banks (G-SIBs) to implement the FSB's total loss-absorbing capacity (TLAC) standard published on 9 November 2015.[1] The Bank must set MREL in accordance with UK law and with a (draft) EBA binding technical standard further specifying the BRRD criteria for determining MREL, using a firm-specific power of direction. According to the EBA's draft regulatory technical standards (RTS), the Bank will be required to determine an amount necessary for **loss absorption** prior to and

[1] Available at http://www.financialstabilityboard.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/

in resolution, and an amount necessary for **recapitalisation**. The sum of these amounts constitutes a firm's MREL. The Bank must base the loss absorption amount on at least the minimum capital requirement, including any applicable leverage ratio requirement, set by the PRA (or FCA), as UK competent supervisory authority. It must determine a recapitalisation amount which reflects the capital that a firm is likely to require in order to comply with the conditions for authorisation and to command market confidence post-resolution. This recapitalisation amount must also be based on existing minimum capital requirements, with some possibility to adjust upwards or downwards more accurately to reflect the post-resolution balance sheet of the firm.

UK institutions are likely to be resolved by one of three broad resolution strategies: modified insolvency, deposit-book transfer, and whole firm bail-in.[1]

Institutions whose failure would not require the use of stabilisation powers in the public interest may enter a **modified insolvency procedure**: the bank insolvency procedure, building society insolvency procedure, or special administration regime (for investment firms). For banks and building societies, these procedures rely on the Financial Services Compensation Scheme (FSCS) to compensate insured ('covered') depositors, and may involve a delay of seven days or more before customers regain access to their covered deposits; they subsequently involve liquidation of the firm in a manner that best protects its creditors. The Bank anticipates that such a strategy would be appropriate for smaller, less complex institutions that do not provide a material number of current accounts, or other accounts used for day-to-day payments and cash withdrawals.

For such institutions, MREL does not need to include a recapitalisation element because no recapitalisation is required in insolvency. MREL can therefore be set at a level equivalent to the existing minimum capital requirements. It will not therefore, in practice, be a binding constraint for these institutions

The use of stabilisation powers – including the power to transfer certain of a firm's assets and liabilities to a third party, or to write down and convert to equity (or other securities) unsecured liabilities – involves interference with private property rights. Such interference must be justified in the public interest as being necessary for the Bank to achieve one or more of its statutory resolution objectives, which include the protection of covered depositors, the maintenance of financial stability, and the preservation of confidence in the financial system. The Bank expects that if a firm provides more than around **40,000 accounts** on which customers rely for day-to-day payments and cash withdrawals, the use of stabilisation powers to protect depositors and avoid discontinuity of access to covered deposits is likely to be justified in the public interest. This is also likely to be necessary to maintain financial stability and preserve confidence in the financial system.

Where a firm's only critical economic function is the provision of current accounts (or other accounts with similar features), the Bank would aim to use its powers to **transfer retail and small and medium-sized enterprise (SME) deposits to a third party purchaser or bridge bank**. The Bank would set the recapitalisation element of MREL to reflect the capital needed to support the transfer of assets alongside the deposit liabilities to be transferred. The starting point for MREL for these institutions would therefore be equal to **the minimum capital requirement (for loss absorption) and a percentage of existing minimum capital requirements that corresponds to the percentage of the balance sheet to be transferred (for recapitalisation)**. Depending on an institution's circumstances this amount may be

[1] The actual approach taken to resolve an institution will depend on the circumstances at the time of its failure. The preferred resolution strategy may not necessarily be followed if a different approach would better meet the resolution objectives at the time.

adjusted to reflect the fact that not all of the existing Pillar 2A capital requirements may apply following resolution.

For institutions subject to such a deposit book transfer resolution strategy, the Bank proposes not to require that MREL resources are subordinated to senior operating liabilities such as uninsured corporate deposits or liabilities arising from derivative contracts. This is on the assumption that such liabilities would be left behind in insolvency along with the MREL resources, thus avoiding the need to depart from *pari passu* treatment of senior liabilities in the resolution.

For institutions above a certain level of size and complexity, the Bank cannot rely on the use of its transfer powers because a willing purchaser for a very large deposit book may not be forthcoming, because of the complexities of carrying out a transfer over a potentially very short period of time, and because of the need to ensure the continuity of other critical economic functions as well as current account provision. Instead, the Bank is likely to need to use its **bail-in tool** to write down and/or covert certain liabilities to equity (or other securities) in order to stabilise the firm in resolution, to be followed by a thorough business reorganisation to address the causes of its failure. The Bank would generally expect a bail-in strategy to be appropriate for any firm whose **total balance sheet exceeded £15-25 billion**.

For institutions for which bail-in is the appropriate strategy, the Bank would generally need to set MREL equivalent to two times the current minimum capital requirements: once for loss absorbency, once for recapitalisation. This is on the basis that it is unlikely to be feasible or credible that the firm’s size or capital requirements would change materially, immediately as a result of resolution action.

Banks for which bail-in is the chosen resolution strategy will generally be required to raise MREL resources at their holding company and downstream it in the form of capital or another form of subordinated claim to material operating subsidiaries (this will not apply to building societies). In this way, the MREL liabilities will be ‘structurally subordinated’ to senior liabilities of operating companies.

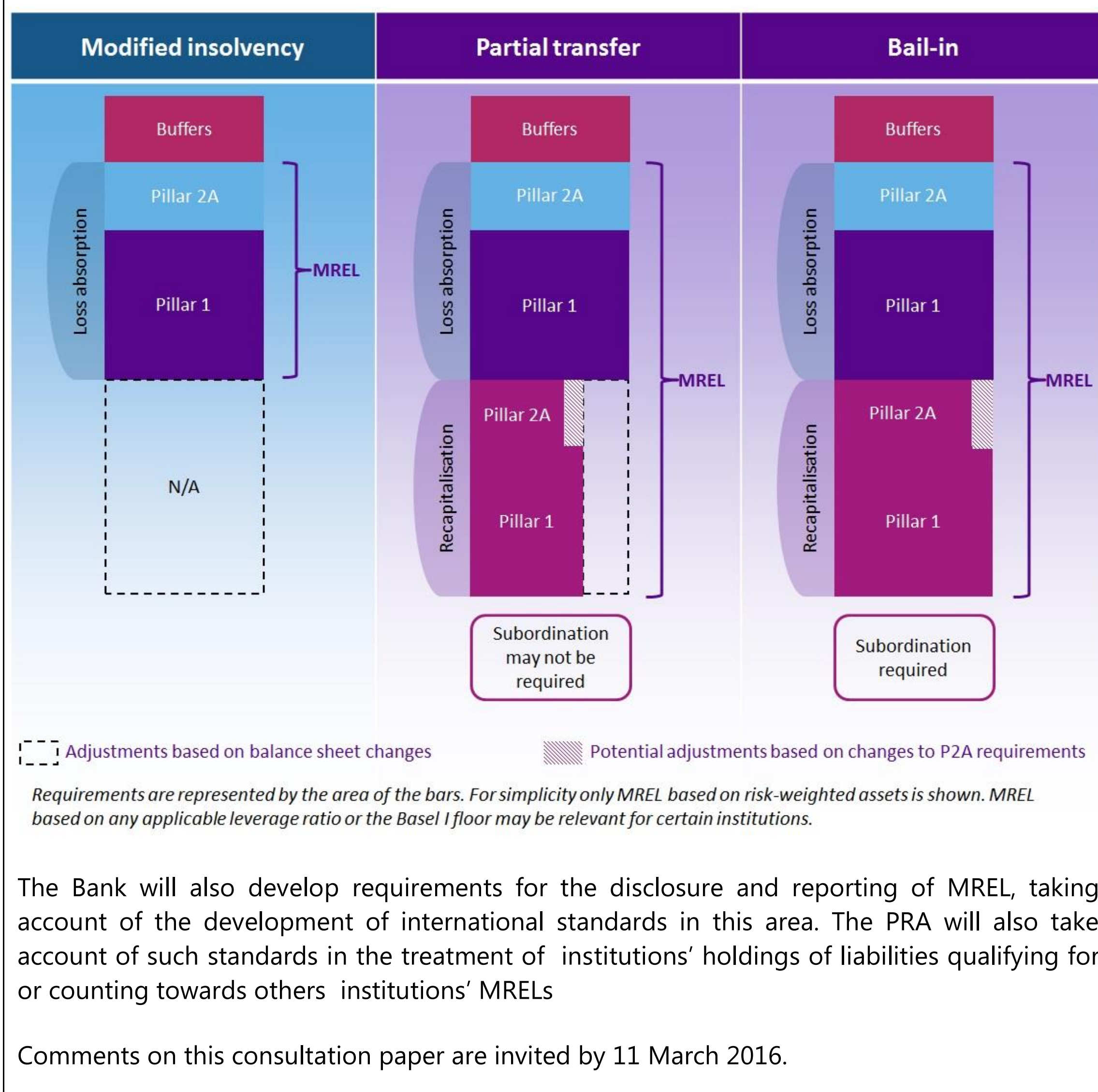
Resolution strategies for some foreign-headquartered institutions are based on the foreign (home) resolution authority taking the lead and the Bank, as UK (host) resolution authority, playing a supporting role. Where this is the case, the Bank will set MRELs for UK subsidiaries to reflect the agreed resolution strategy. MREL for such institutions will generally need to be satisfied through capital or subordinated liabilities issued to the foreign parent.

Where the Bank chooses to set the indicative boundary between resolution strategies has implications for the potential costs to firms in meeting MREL. But the indicative boundaries set out above will also have a bearing on the effectiveness of a resolution strategy in meeting the Bank’s special resolution objectives, as well as on the likely scale of losses that creditors and uninsured depositors of an institution could be exposed to should the institution fail.

The Bank intends to make use of the transition period allowed by the BRRD and draft MREL RTS, and proposes to require institutions to comply with MRELs set on the above basis from 1 January 2020. Until that time, MRELs will be set equal to the applicable minimum capital requirements, except where, for example, the Bank has particular concerns about a firm’s resolvability or to implement international standards. The Bank will indicate to institutions, in 2016, what their prospective MREL might be in 2020 (2019 for G-SIBs). As part of these discussions, the Bank will confirm to institutions the preferred resolution strategy that the Bank considers to be appropriate. The Bank will base its indications of institutions’ MRELs on current capital requirements, balance sheets, and resolution strategies. The MREL that will apply from 2020 will be based on 2020 capital requirements, balance sheets and resolution strategies.

Following consultation, the Bank will review the MRELs it has set annually or if there is a material change in an institution's circumstances. The Bank will in these reviews take into account any changes in minimum regulatory capital requirements such as those which may follow from changes to the PRA's approach to Pillar 2, as set out in Box 2.

Figure 1 Summary of the calibration of MREL



Requirements are represented by the area of the bars. For simplicity only MREL based on risk-weighted assets is shown. MREL based on any applicable leverage ratio or the Basel I floor may be relevant for certain institutions.

The Bank will also develop requirements for the disclosure and reporting of MREL, taking account of the development of international standards in this area. The PRA will also take account of such standards in the treatment of institutions' holdings of liabilities qualifying for or counting towards others institutions' MRELs

Comments on this consultation paper are invited by 11 March 2016.

The purpose of MREL

1.7 Under the BRRD, MREL is a minimum requirement for institutions to maintain equity and eligible debt liabilities that can credibly bear losses before and in resolution, for example through being written down and/or converted to equity. The purpose of MREL is to help ensure that when banks, building societies and investment firms fail, that failure can be managed in an orderly way while minimising risks to financial stability, disruption to critical economic functions, and risks to public funds. In other words institutions can be 'resolved', where necessary, when they fail. Resolution is the process by which authorities can intervene to manage the failure of a firm. During the financial crisis, governments felt compelled to bail out failing banks, rather than risk the negative consequences their disorderly failure would have on the wider economy and financial system, as there were no effective arrangements for resolution in place. Following the financial crisis, there have been a number of legislative

changes to build comprehensive resolution frameworks to ensure that this alternative is available.

1.8 Authorities are now required by the BRRD to establish 'resolution plans' for all institutions, regardless of whether the institution is in difficulty. A necessary condition for resolution to be effective is that an institution's capital position can be stabilised. Any losses incurred on the institution's assets, both before and in resolution, need to be recognised. Once this has been done, the institution's capital position must be restored to a sufficient level to ensure that the institution (or successor entities) meets any necessary regulatory requirements and commands the confidence of counterparties. This puts the institution into a stable position from which a reorganisation to address the underlying causes of its failure can be carried out.

1.9 MREL is therefore necessary to make resolution plans credible. It ensures that institutions have a minimum amount of liabilities that can credibly bear losses before and in resolution. Not all types of liabilities are suitable for this purpose. Some are not in scope of all of the Bank's stabilisation powers or may be difficult to apply the powers to in practice. Others are connected to critical economic functions, or will not be reliably available at the point of resolution.

1.10 To ensure that MREL resources can feasibly and credibly fulfil their role in resolution, UK legislation implementing the BRRD excludes certain liabilities from counting towards an institution's MREL. Broadly, MREL can be met with regulatory capital and other long-term liabilities which are: (a) in scope of bail-in; (b) not subject to preference in insolvency; and (c) do not contain certain features that are likely to make them more difficult to bail in or otherwise expose to loss in resolution.

Legislative context

1.11 The Bank must set MREL in line with relevant statutory requirements. The principal requirements arise from:

(a) The Banking Act and associated legislation. The Banking Act and associated secondary legislation, including the No. 2 Order, transpose the BRRD into UK law. The No. 2 Order requires the Bank to set MREL, specifies the criteria that the Bank must consider when setting MREL, sets out the scope of entities and groups for which MREL must or may be set, sets certain eligibility requirements for MREL resources and imposes procedural requirements.

(b) Regulatory Technical Standards (RTS) on MREL. The European Banking Authority's (EBA) RTS on MREL (the 'MREL RTS') further specify the criteria which the Bank must consider when setting MREL. The MREL RTS will be binding on the Bank once they are adopted by the European Commission as a regulation. This consultation has been prepared on the basis of the EBA's final draft RTS published on 3 July 2015.[1] The Bank will review its approach to setting MREL to ensure it is compatible with the MREL RTS as finally adopted by the Commission.

1.12 The No. 2 Order requires the Bank to set MREL on the basis of criteria set out in the BRRD and reproduced below, which are further specified in the draft MREL RTS:

[1] Available at http://www.eba.europa.eu/regulation-and-policy/recovery-and-resolution/regulatory-technical-standards-on-minimum-requirement-for-own-funds-and-eligible-liabilities-mrel-

- the need to ensure that the institution can be resolved by the application of the resolution tools including, where appropriate, the bail-in tool, in a way that meets the resolution objectives;

- the need to ensure, in appropriate cases, that the institution has sufficient eligible liabilities to ensure that, if the bail-in tool were to be applied, losses could be absorbed and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU and to sustain sufficient market confidence in the institution or entity;

- the need to ensure that, if the resolution plan anticipates that certain classes of eligible liabilities might be excluded from bail-in under Article 44(3) of the BRRD or that certain classes of eligible liabilities might be transferred to a recipient in full under a partial transfer, the institution has sufficient other eligible liabilities to ensure that losses could be absorbed and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU;

- the size, the business model, the funding model and the risk profile of the institution;

- the extent to which the Deposit Guarantee Scheme could contribute to the financing of resolution in accordance with Article 109 of the BRRD;

- the extent to which the failure of the institution would have adverse effects on financial stability, including due to its interconnectedness with other institutions or with the rest of the financial system through contagion to other institutions.

1.13 The Bank's proposed Statement of Policy describes how the Bank will set MREL in line with the relevant statutory requirements; it does not reproduce or describe these requirements in detail. Readers should refer to the above documents where necessary.

FSB TLAC standard

1.14 The Financial Stability Board's (FSB) standard for total loss-absorbing capacity (TLAC), published on 9 November 2015[1], applies with respect to global systemically-important banks (G-SIBs). While the TLAC standard is not identical to the MREL provisions in UK and EU law and is not legally binding, the two requirements are conceptually equivalent and broadly compatible. The Bank intends to set MREL for UK G-SIBs[2] as necessary to implement the TLAC standard, and will set similar requirements for all institutions where the preferred resolution strategy is bail-in, as described in this consultation. The Bank will not set any TLAC requirements separately from MREL.

1.15 When developing its proposed policy on MREL, in general the Bank has taken note of the FSB's TLAC standard. This is reflected in the Bank's proposals on, for example, instrument eligibility and principles for setting MREL within group structures.

[1] Available at http://www.financialstabilityboard.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/

[2] The FSB identifies G-SIBs on an annual basis - see http://www.financialstabilityboard.org/2015/11/2015-update-of-list-of-global-systemically-important-banks-g-sibs/ for the list of 30 banks identified as G-SIBs in November 2015. At that date four UK-headquartered institutions were identified as G-SIBs: HSBC, Barclays, Royal Bank of Scotland and Standard Chartered.

Relationship with going-concern capital requirements

1.16 MREL builds upon the existing framework for setting regulatory capital requirements, given the need to ensure that institutions meet any applicable minimum capital requirements following resolution, and to avoid resolution authorities duplicating the work of competent authorities. But MREL is set as part of the resolution planning process. It is not a capital requirement, and while capital resources required under CRD IV[1] and associated institution-specific capital requirements set by the PRA or FCA may also count toward meeting MREL, MREL is separate and distinct from the CRD IV requirements. Going-concern capital requirements fall within the remit of competent authorities, which in the United Kingdom are the PRA and the FCA. The Bank is required to consult the PRA or FCA as relevant when setting MREL for individual institutions.

1.17 MREL interacts with the going-concern capital framework in a number of ways:

- the draft MREL RTS use an institution's existing and prospective going-concern capital requirements as key determinants of the level of MREL which should be set for that institution;

- the PRA is proposing to adopt policies on the interaction of capital buffers and MREL, as well as on how a breach of MREL will be considered when assessing a firm against the PRA's Threshold Conditions for authorisation; and

- the Bank will take account of the policies on capital buffers adopted by the PRA in determining the level of MREL set for institutions (see section 2).

1.18 As noted above, the Bank is required to consult the PRA or FCA (as relevant) when setting MREL for individual institutions. The Bank will coordinate with the PRA and FCA when communicating institutions' MREL, and ensure that the timing of communication of MREL is coordinated with the communication of capital requirements, as far as is practical.

Box 2: MREL and the PRA's minimum capital requirements

Setting of MREL

The Bank, as resolution authority, is required to determine an amount necessary for loss absorption in resolution, and an amount necessary for recapitalisation. The sum of these amounts constitutes a firm's MREL. The BRRD sets out certain criteria that the Bank must consider when setting a firm's MREL and the MREL RTS will provide further detail on these criteria and the required steps.

(i) Loss absorption amount

The statutory Threshold Conditions set out the minimum requirements that institutions must meet in order to be permitted to carry on the regulated activities in which they engage. In broad terms, the conditions require institutions to have an appropriate minimum amount and quality of capital and liquidity, to have appropriate resources to measure, monitor and manage risk, to be fit and proper, and to conduct their business prudently.

The MREL RTS set out the framework for setting MREL based on existing capital requirements. Resolution authorities are able to make certain adjustments to this (for example to exclude

[1] Capital Requirements Directive (2013/36/EU) (CRD) and Capital Requirements Regulation (575/2013) (CRR) – jointly 'CRD IV'.

certain buffers from the calculation of MREL or increase MREL if necessary to ensure an institution can be resolved) but are limited in their ability to exclude elements of existing minimum capital requirements from the calculation of MREL. The Bank will base the loss absorption amount on the minimum capital requirement set by the PRA (or FCA, for institutions that are regulated solely by the FCA). Currently, the PRA's minimum capital requirement comprises Pillar 1, which is the minimum capital requirement that institutions must meet at all times to comply with the Capital Requirements Regulation (575/2013), plus Pillar 2A, which is an additional amount of capital institutions should hold at all times to cover risks not captured or not adequately captured in Pillar 1 (for example, interest rate risk in the banking book). A full description of the new Pillar 2 regime applicable from 1 January 2016 is provided in PS 17/15 'Assessing capital adequacy under Pillar 2'.

Pillar 2A is expressed through Individual Capital Guidance (ICG) which is set by the PRA for each firm. Pillar 2A is a 'point in time' assessment and deviation by a firm from its ICG does not automatically mean the PRA will consider the firm is failing or likely to fail to satisfy Threshold Conditions. In discharging its general function of determining the general policy and principles by reference to which it performs particular functions, the PRA also acts in accordance with its secondary objective to act, so far as it is reasonably possible, in a way that facilitates effective competition in the markets for PRA-authorised institutions carrying on regulated activities. The PRA applies proportionality in determining actions.

From 1 January 2016, the PRA will implement a minimum leverage ratio requirement of 3% on institutions with retail deposits greater than £50 billion. This leverage measure will therefore form part of the PRA's assessment of Threshold Conditions.

The MREL RTS aim to avoid requiring the Bank as resolution authority to act as a 'shadow supervisor' in setting MREL. The loss absorption amount is expected to be equal to the minimum capital requirement (that is, the higher of the risk-based minimum requirement, any applicable minimum leverage ratio requirement or the Basel I floor). However, it is possible for the Bank as resolution authority to conduct its own assessment of the firm's loss absorbency needs, separately to that already reflected in the minimum capital requirement, and determine a loss amount that is greater (but not less than) the minimum capital requirement set by the PRA in certain limited cases set out in the RTS, for example to absorb losses on holdings of MREL instruments issued by other group entities. (See Section 5 for more detail on 'internal MREL'.)

(ii) Recapitalisation amount

The Bank must determine a recapitalisation amount that reflects the capital that an institution, or the entity/ies to which the institution's assets and liabilities are transferred, is likely to require to maintain PRA authorisation and to command market confidence after the resolution.

Following entry into resolution, the PRA will continue to assess whether the resolved entity will, or is likely to be able to, satisfy and continue to satisfy the Threshold Conditions in relation to the regulated activities for which the entity is authorised and which, under the resolution strategy, will continue. In conducting that assessment, the PRA will consider whether it is necessary to reassess the appropriate level of minimum capital requirements in light of the risks, scale and nature of the resolved entity. It is possible that elements of the pre-resolution capital requirements will not be necessary for the post-resolution entity. Equally, the review may identify risks that had not previously been fully recognised in the capital requirement.

The draft MREL RTS specifies that, in particular, the recapitalisation amount must reflect the amount of capital necessary to comply with risk-weighted capital requirements and any applicable leverage ratio requirement that would apply post-resolution. The recapitalisation

amount must be based on existing pre-resolution minimum capital requirements. It may only be different to the extent the resolution plan identifies and quantifies possible changes to capital requirements, in particular Pillar 2A requirements, that could credibly and feasibly take place immediately as a result of resolution action. The Bank will form this judgement after consultation with the PRA about what the PRA considers to be the appropriate capital requirement for the likely post-resolution entity.

The Bank must also determine if any additional amount would be required to maintain market confidence. The Bank expects that in general it will be unnecessary to require an additional amount for market confidence, on the basis that a resolved institution should meet minimum regulatory capital requirements, remains authorised and its assets will have been significantly 'cleaned up' following the recognition of losses through the fair, prudent and realistic valuation required in resolution. The Bank must, in making this judgment, take into account the capital position of the institution in comparison with the current capital position of its peers.

Individual institutions' MRELs will be largely based on their minimum going-concern regulatory capital requirements. To the extent that an institution's minimum capital requirements change over time, they can expect their MRELs to change proportionately.

The framework for capital requirements for UK banks is evolving

MREL is being phased in from 1 January 2016 to 1 January 2020. During this period the capital framework is changing. Given the link between MREL and minimum capital requirements, these changes will influence the level of MREL.

The precise composition and allocation of minimum requirements between Pillar 1 and Pillar 2A are likely to change as international developments progress to address shortcomings in the Pillar 1 measurement of risk-weighted assets. For example, it is likely that the Basel Committee's Fundamental Review of the Trading Book will see capital for UK institutions transfer from Pillar 2A to Pillar 1.

The Basel Committee is also considering revising the standardised approaches to calculating capital against credit and operational risks.

Starting in January 2016, the PRA will roll out its new approach to setting Pillar 2A that includes applying new, more transparent methods for calculating risk not captured, or not adequately captured in Pillar 1. The approach is set out in PS 17/15 'Assessing capital adequacy under Pillar 2'. This process is likely to reduce capital requirements for certain business models which would translate into lower MRELs in comparison with the levels of MREL if they were set using the existing Pillar 2A approach. The cost estimates in this consultation paper use the old (pre-2016) basis of calculating Pillar 2A.

As noted in the Supplement to the December 2015 Financial Stability Report, 'The framework of capital requirements for UK banks', the PRA is also reviewing the supervisory requirements for Pillar 2B and the PRA buffer to remove any potential overlap with the countercyclical buffer rate set by the FPC. In addition, supervisory requirements are likely to be adjusted as buffers, such as the global systemic importance buffer, begin to be phased in.

The FPC has stated that, subject to a review in 2017 of progress on international leverage ratio standards, it expects to direct the PRA to extend the requirement to all banks, building societies and PRA-regulated investment firms from 2018. The Basel Committee intends to finalise its calibration of a Pillar 1 leverage standard by the end of 2016 for implementation in 2018. The European Commission is also scheduled to present a report on the impact of the leverage ratio by the end of 2016, and, if appropriate, to accompany this with a legislative

proposal to introduce a leverage ratio requirement.

The Bank will base MREL indications for institutions on their current capital requirements, balance sheets, and resolution strategies. The Bank will review the MRELs it has set annually and when there are material changes in institutions’ circumstances. The Bank will in these reviews take into account any changes in minimum regulatory capital requirements such as those which may follow from changes to the PRA’s approach to Pillar 2.

International institutions

1.19 The Bank must set MREL for all relevant institutions incorporated in the UK. However, there are a number of international aspects that need to be considered when setting MREL for it to provide the greatest resolvability benefits for cross-border institutions:

- the Bank will set MREL for subsidiaries of international groups based in the United Kingdom. Requirements set for such entities need to take into account and work within the resolution strategy for the group as a whole;
- non-UK authorities will set MREL, or equivalent requirements, for international subsidiaries of UK banking groups. These requirements should be consistent with the group resolution strategy; and
- within the European Economic Area (EEA), the BRRD includes a framework in which MREL for institutions that are part of cross-border groups is generally set through a joint decision of EEA resolution authorities, taken at an institution’s resolution college.[1]

1.20 The proposed Statement of Policy should be read in light of the wider international context, the need to facilitate cross-border resolutions, and in some cases a statutory requirement to try to reach joint decisions. UK institutions with international subsidiaries will need to consider the MREL, or equivalent requirements, set by local regulators.

1.21 The PRA is currently reviewing its approach to the supervision of subsidiaries of international banking groups.[2] The Bank will ensure that its approach to setting MREL for such institutions is consistent with any relevant changes the PRA makes to its approach.

[1] A resolution college is a forum in which the group-level resolution authority and other relevant authorities must make certain joint decisions relating to ensuring that the institutions in question are resolvable.
[2] Following a review of the PRA’s approach to branch supervision, available at http://www.bankofengland.co.uk/pra/Pages/publications/ss/2014/ss1014.aspx

2 Framework for setting MREL

2.1 MREL must be set with the goal of making institutions resolvable by ensuring that resolution plans can be carried out effectively. Given this, the preferred resolution strategy for an institution, and the level of recapitalisation necessary to implement that strategy, will be key drivers of the necessary MREL. The choice of resolution strategy emerges from the process of resolution planning. This is conducted by the Bank, working with the PRA or the FCA and relevant overseas authorities.

2.2 MREL resources need to be available to a) absorb losses; and b) be converted to equity (or other securities) in bail-in and/or 'left behind' in an insolvency to recapitalise the firm subject to bail-in, or the part of the institution's business subject to a partial transfer to a third party. As set out in the draft MREL RTS, an institution's MREL should be thought of as the sum of:

(a) a loss absorption amount, that is the amount needed to absorb losses up to and in resolution; and

(b) a recapitalisation amount, that is the amount needed to recapitalise an institution to ensure that it can continue to meet conditions for authorisation and sustain market confidence (dependent on the resolution strategy).

2.3 Sections 3 and 4 of the proposed Statement of Policy sets out the Bank's approach to the calibration of the amount, or 'quantum' of externally-issued MREL. The MREL RTS describes starting points for the quantum of MREL based on an institution's regulatory capital requirements, but enables resolution authorities to depart from these starting points under certain circumstances. The proposed Statement of Policy sets out how the Bank expects to apply the MREL RTS framework.

Loss absorption amount

2.4 The default loss absorption amount is defined in the draft MREL RTS as an institution's risk-based minimum capital requirements (Pillar 1 and Pillar 2A requirements), or, if higher, any applicable leverage ratio requirement or the Basel I floor, plus any applicable CRD IV capital buffers. Part of these buffers may be excluded where they are not relevant to the need to ensure that losses can be absorbed in a resolution in which stabilisation powers are applied.[1]

2.5 In past episodes failed institutions have experienced a range of losses. In some cases losses were lower than their capital requirements; in other examples losses were higher than their capital requirements. But regulatory capital requirements provide a consistent measure of potential losses in a severe stress, particularly following post-crisis reforms to address key deficiencies. Capital requirements include an assessment of the riskiness of an institution's assets. As required by the MREL RTS, the Bank will generally take a firm's minimum capital requirements – including leverage-based requirements – as the loss absorption amount. The Bank will take account of the judgement of the PRA (or FCA) in doing so. The Bank considers

[1] The MREL RTS uses the term 'resolution' to refer to the use of what are known in the Banking Act as 'stabilisation powers', as opposed to an insolvency process. By contrast, modified insolvency procedures form part of the resolution regime in the United Kingdom, so we specify where resolution is by use of stabilisation powers, rather than through modified insolvency.

this appropriate, given that the PRA (or FCA) is best placed to judge the risks to the institution and the Bank needs to carry out its functions as resolution authority in an efficient way.

Interaction of the loss absorption amount and regulatory capital buffers

2.6 The capital framework explicitly prohibits institutions from using the same Common Equity Tier 1 (CET1) resources to meet their minimum capital requirements and capital buffer requirements (in the United Kingdom, both buffers arising from CRD IV and any other buffers set by the PRA). This effectively means that capital buffers 'sit on top' of minimum capital requirements (see Figure 1), and resources held to meet capital buffers can explicitly be used without a breach of minimum capital requirements.

2.7 The PRA is consulting on policy that institutions should not be able to double-count CET1 capital towards on the one hand, MREL, and on the other, risk-weighted capital and leverage buffers. Hence institutions that count CET1 towards MREL will also need to have sufficient CET1 to meet their buffers (see Section 3 of the PRA consultation paper on MREL – buffers and Threshold Conditions). This policy extends the rationale of the CRD IV capital requirements framework to MREL. It would mean that capital buffers remain usable while an institution is operating as a going-concern and supports the BRRD requirement that MREL must be set as a minimum requirement which must be met at all times.[1]

2.8 If the PRA concludes that institutions should be required to maintain capital buffer resources separately and in addition to meeting MREL, the Bank is of the view that these buffer requirements would not be relevant to the need to ensure that losses can be absorbed when an institution is resolved using stabilisation powers – as buffers are usable in a going-concern before MREL is breached. Subject to the PRA's final policy, the Bank therefore expects not to include capital buffers (including the CRD IV buffers and any PRA buffers) in the loss absorption amount of MREL. Institutions would need to maintain any CET1 resources to meet such buffer requirements separately from resources used to meet their MREL.

2.9 Many institutions will not meet the conditions for the use of stabilisation powers, and will instead enter modified insolvency upon failure. In such cases the capital buffers will also not be relevant to ensure that losses can be absorbed through use of stabilisation powers, as no such use will take place. Therefore the Bank also proposes not to include capital buffers in the calculation of the loss absorption amount for institutions for which the preferred resolution strategy is modified insolvency, regardless of whether or not they are affected by the PRA's policy on MREL and buffers.

Recapitalisation amount

2.10 The second component of MREL is the amount needed to recapitalise the institution. While the amount needed for loss absorption will not generally vary[2] based on the approach to resolution, the amount of MREL needed for recapitalisation will depend on the resolution strategy for the institution. This is because it is the resolution strategy which determines whether all, part, or none of the institution's balance sheet will need to be recapitalised in resolution.

2.11 The following outlines the likely recapitalisation needs for the three broad resolution strategies:

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[1] See BRRD Article 45(1).
[2] Beyond the variation already incorporated into capital requirements.

(i) **Modified insolvency**: no recapitalisation required;

(ii) **Transfer strategy**: sufficient capital to support the transfer of certain assets and liabilities to a private purchaser or adequately capitalise a bridge bank, which will need to be authorised and maintain market confidence;

(iii) **Bail-in strategy**: sufficient capital to ensure conditions for authorisation and market confidence are maintained by the institution after resolution.

2.12 Section 3 sets out some of the specific points the Bank will take into account when setting the recapitalisation amount.

3 Calibration of MREL

3.1 The Bank will set MREL on an institution or a group-specific basis in accordance with the preferred resolution strategy for that institution or group. Section 4 of the proposed Statement of Policy sets out how different resolution strategies will affect the MREL set for an institution.

3.2 The Bank will engage with institutions on the MREL that will apply at 1 January 2020, and for G-SIBs at 1 January 2019, over the course of 2016. As part of these discussions, the Bank will confirm to institutions the preferred resolution strategy that the Bank considers to be appropriate.

Determination of the appropriate resolution strategy

3.3 Table 1 opposite shows in summary the indicative boundaries that the Bank proposes to use as part of its determination of whether an institution should be resolved using (a) a bail-in strategy; (b) a partial transfer strategy; or (c) a modified insolvency process. As described further in this section, the choice of resolution strategy will play a significant role in determining the MREL set for an institution. Broadly speaking, very large institutions that provide multiple critical economic functions are more likely to have bail-in strategies requiring higher levels of subordinated MREL. Smaller institutions that do not provide critical economic functions other than providing a substantial number of transactional accounts are more likely to be subject to transfer strategies and accordingly are likely to be set lower MRELs, which may not need to be met with subordinated liabilities. The smallest institutions subject to modified insolvency will not be set MREL beyond their existing going-concern capital requirements.

3.4 Where the Bank chooses to set the indicative boundaries between these strategies has implications for the potential costs to institutions in meeting MREL. But the indicative boundaries will also have a bearing on the effectiveness of a resolution strategy in meeting the Bank's resolution objectives, as well as on the likely scale of losses that creditors and uninsured depositors of an institution could be exposed to should the institution fail. Given these important implications, the Bank welcomes views on its proposed approach to the indicative boundaries.

Modified insolvency/partial transfer boundary

3.5 When deciding on the appropriate resolution strategy, the Bank determines whether an institution would be likely to meet the conditions for use of stabilisation powers should it fail. Failing institutions may only be resolved using stabilisation powers if this is necessary, having regard to the public interest in advancing one or more of the resolution objectives, and insolvency would not achieve the objectives to the same extent. If the Bank determines that an institution would be likely to meet these conditions if it failed, then the resolution strategy will involve the use of stabilisation powers.[1] As all or part of the institution will continue to operate immediately after resolution, an amount of MREL for recapitalisation will be necessary to facilitate the resolution strategy. The proposed Statement of Policy sets out key factors the Bank will consider when making the judgement as to whether the use of stabilisation powers is

[1] See Section 4 of the Banking Act. For further details on the objectives, please see The Banking Act Code of Practice https://www.gov.uk/government/publications/banking-act-2009-revised-special-resolution-regime-code-of-practice and 'The Bank of England's approach to resolution' http://www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf, particularly pages 12-13.

likely to be necessary. If placing the institution into insolvency would not achieve the resolution objectives – for example because the institution is a significant provider of critical economic functions or its failure may have an effect on confidence in the financial system in more than extremely limited circumstances – the Bank would expect to plan to use stabilisation powers to resolve the firm. If the use of stabilisation powers is not justified, the Bank would expect to plan to use a modified insolvency process.

Table 1: Indicative thresholds for resolution strategies

Scope	Description	MREL*
All UK banks, building societies and 730k investment firms	Institutions within scope of the Bank Recovery and Resolution Directive (BRRD)	All institutions within scope of the BRRD will be subject to MRELs.
Institutions with fewer than 40,000 'transactional accounts'	Institutions that are likely to be subject to a modified insolvency process.	No greater than minimum capital requirements.**
Institutions with more than 40,000 'transactional accounts' and balance sheet of less than £15bn to £25bn	Institutions that are likely to have a partial transfer resolution strategy.	Equal to current minimum capital requirements plus a proportion of minimum capital requirements equal to the proportion of balance sheet to be transferred. Generally no subordination requirement.
Institutions with balance sheet size of greater than £15bn to £25bn	Institutions that are likely to have a bail-in resolution strategy.	Equal to two times current minimum capital requirements, minus any changes to post-resolution capital requirements that might apply. Subordination to senior operating liabilities required.
Subsidiaries of foreign institutions for which the home authority is to lead a 'single point of entry' resolution	Subsidiaries not to be subject to UK resolution, instead to be resolved as part of 'single point of entry' resolution strategy.	It is not envisaged that stabilisation tools would be applied at the subsidiary level. The quantum of MREL will be determined at a level necessary to support the resolution strategy for the group. Subordination to senior operating liabilities required.

* Indicative only – MREL must be set on a firm-specific basis.
** 'Minimum capital requirements' refers to the greater of (i) own funds requirements, (ii) any applicable leverage ratio and (iii) the Basel I Floor.

3.6 The PRA is consulting on requirements for operational continuity in resolution.[1] While the proposed PRA rules on operational continuity and the Bank's use of stabilisation powers are intended to capture broadly the same institutions, the exact thresholds proposed differ due to the different legal bases of the two proposals. The PRA is proposing rules of general application and has therefore proposed financial metrics, based on data available in regulatory returns, to define the scope of those rules. By contrast, the Bank will be exercising its powers to set MREL, based on a firm-specific judgement of the appropriate resolution strategy, as

[1] Available at http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp4415.aspx

required under the BRRD. The conditions for application of the operational continuity rules are expected to capture at least those institutions in scope of partial transfer or bail-in resolution strategies – and therefore MREL in excess of existing capital requirements – and, where other institutions are included, the PRA can consider waivers if the rules would be unduly burdensome. Institutions that are expected to enter insolvency upon failure would not be required to comply with either requirement, and the Bank will coordinate with the PRA in this regard.

3.7 In exercising stabilisation powers, the Bank is subject to the resolution objectives set out in the Banking Act. One of these objectives is to protect depositors covered by the Financial Services Compensation Scheme (FSCS) or other EEA deposit guarantee scheme. A key consideration relevant to determining whether this objective would require smaller institutions to be resolved using stabilisation powers is whether those institutions provide a significant number of critical transactional banking services in accounts covered by the FSCS.[1] This is because this is the main critical economic function that smaller institutions tend to provide in practice. It may also be relevant to the objectives of maintaining financial stability, preserving confidence in the financial system and ensuring the continuity of critical economic functions.

3.8 The Bank suggests that a possible approach would be to base this concept of 'critical transactional banking services' on an appropriate definition of 'current accounts'. Such accounts might be those used to hold deposits and make withdrawals without having to give notice and would enable account holders to receive and make payments through a number of different methods, including by direct debit, standing order, cheque, continuous payment authority, or other electronic means.

3.9 The term 'current account' is not exhaustively defined, though its general meaning is well understood. One method of establishing a more precise definition would be to use the definition of 'payments accounts' set out in the Payments Account Directive[2] and UK regulations pursuant to that Directive. This definition includes accounts which are not labelled 'current accounts' or intended to be used as current accounts, but which nonetheless can be used to make and receive payments and are, in practice, used for day-to-day transactions. Using this definition might help to reduce regulatory burdens because banks are already required to identify payments accounts that meet this definition. Alternative possibilities would be to use the definition set out in the terms of reference for the Competition and Markets Authority's retail banking market investigation (which would exclude accounts offered to business accounts in foreign currencies and accounts linked to mortgages or loans other than overdrafts); or the definition in the Office of Fair Trading's report on the proposed Lloyds / HBOS merger of 2008 (which would expressly exclude basic bank accounts and savings accounts); or the definition used in the FCA's March 2015 report on making current account switching easier (which would include instant access savings accounts with payments functionality).

3.10 For accounts that provide critical transactional banking services, the Bank considers that payout by the FSCS within the target of seven days may not always offer adequate protection

[1] The FSCS pays out or funds the transfer of deposits protected by the deposit guarantee scheme, up to a limit of £75,000 (from 1 January 2016). See http://www.fscs.org.uk/ and http://www.bankofengland.co.uk/pra/Pages/publications/cp/2014/cp2014.aspx

[2] Directive 2014/92/EU.

for depositors, because a payout would disrupt their ability to make and receive critical daily payments.[1]

3.11 Where institutions provide more than around 40,000 of such accounts covered by the FSCS, the Bank considers that modified insolvency is generally unlikely to be sufficient to meet one or more of the resolution objectives, including but not limited to that relating to protection of insured depositors and maintaining confidence in the stability of the financial system. For institutions that provide fewer such bank accounts, the Bank is likely to consider a modified insolvency strategy to be appropriate provided they are not significant providers of other critical economic functions, and their failure would be unlikely to undermine public confidence in, or the wider stability of, the financial system. This threshold would be indicative only and the Bank will make a judgement as to the appropriate resolution strategy on an institution-specific basis – and in relation to all of the resolution objectives – as required by the BRRD.

3.12 The Bank is considering the appropriate definition of 'critical transactional banking services' and welcomes views on whether this definition would best be based on 'current accounts' or 'payment accounts' as set out above or if there are other possibilities which should be considered. The Bank welcomes views on whether a number of 40,000 current or payment accounts represents an appropriate indicative threshold for application of stabilisation powers on the basis of the resolution objective for protection of covered depositors and other relevant resolution objectives (such as protecting and enhancing confidence in the financial system).

3.13 The Bank is also considering whether it would be appropriate to consider the overall value held in such accounts provided by institutions, alongside the number of accounts. This might capture institutions that provide a relatively large number of small and medium-sized enterprise (SME) current accounts, where deposit balances are likely to be higher on average than individual consumers' balances. The rationale for this would be to capture the adverse impact that the disruption to SMEs' access to working capital might have on their business, suppliers, employees, and customers. An indicative value threshold may also serve to capture the potential for a disorderly failure to undermine public confidence in the financial system or to cause broader financial instability. The Bank would expect to consider an indicative value threshold exceeding the £350 million of sight deposits that the PRA proposes to use for the purpose of defining the scope of operational continuity requirements. The Bank welcomes views on whether a value threshold should be employed and, if so, what it ought to be.

Partial transfer/bail-in boundary

3.14 Some institutions are of a size and importance that their failure would be likely to have a negative impact on the UK financial system as a whole. Where those institutions' size or complexity means that the prospects of finding a willing purchaser for significant parts of the business are low and the technical complexities of carrying out such a resolution are high, the Bank expects to resolve them using the bail-in stabilisation option. Bail-in allows the Bank to write down and/or convert to equity (or other securities) the claims of shareholders and unsecured creditors (including MREL resources) without splitting up the institution or transferring parts of it to different legal entities.[2] This means that the institution's capital position can be stabilised quickly while it continues to operate, providing critical economic functions as needed. The necessary restructuring or reorganisation to address the causes of

[1] See the Banking Act Code of Practice (https://www.gov.uk/government/publications/banking-act-2009-revised-special-resolution-regime-code-of-practice), in particular paragraph 6.29.

[2] For further details, please see 'Bank failure and bail-in: an introduction' at http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q302.pdf.

failure can then occur over a longer period, supported by a stable and well-capitalised balance sheet.

3.15 The Bank considers a bail-in strategy appropriate for UK G-SIBs and other UK banking groups subject to ring-fencing requirements under the Banking Reform Act 2012. The Bank expects that a bail-in resolution strategy would also be appropriate for other relevant institutions with balance sheets of approximately £25 billion or more where a partial transfer resolution is unlikely to be feasible. Large institutions often provide a significant number and volume of critical economic functions, and it is unlikely that these can all be transferred without disruption. Furthermore, as a transfer increases in size the number of credible purchasers decreases, since there are fewer institutions of a sufficient size to absorb the new business. The Bank will also consider a bail-in strategy for smaller institutions, for example those with balance sheets of around £15 billion or more. For subsidiaries of non-UK institutions, the Bank may set MREL in line with a home authority-led bail-in resolution of the group as a whole, where that is the preferred resolution strategy for the group.

Modified insolvency resolution strategy

3.16 If a failing institution is very small, or does not provide critical economic functions that must be protected under the Banking Act as described above, then it is likely that it could safely enter a modified insolvency process (for example the bank insolvency procedure or the special administration regime for investment banks).[1] The institution would be wound up, any covered depositors compensated or transferred in line with the statutory framework for depositor protection, and any client assets returned. In such a case no part of the institution needs to continue operating as a regulated institution following resolution, and so its recapitalisation needs are zero.

3.17 The Bank therefore proposes to set the recapitalisation component of MREL to zero for institutions which the Bank is confident could be resolved using modified insolvency (that is where the Bank is confident that an institution is very unlikely to meet the public interest test for the use of stabilisation powers). This does not preclude the possibility that such an institution might, in certain circumstances, need to be resolved using stabilisation powers.

3.18 Formally, MREL must be set for all banks, building societies and 730K investment firms. The Bank's intention is to set MREL no higher than minimum capital requirements for institutions for which the resolution strategy is modified insolvency. This will be achieved by setting the recapitalisation component of MREL to zero and by excluding capital buffers from the loss absorption amount of MREL, meaning that in practice an institution's MREL will be equal to its current minimum capital requirements.

3.19 The Bank would not impose any formal subordination requirements on institutions with modified insolvency strategies.

Partial transfer resolution strategy

3.20 Some institutions may provide critical economic functions such that they would meet the public interest test for resolution (for example because insolvency proceedings would disrupt the provision of those critical economic functions), but there is likely to be a willing purchaser for all or part of the business such that their critical economic functions could be transferred to

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[1] The special administration regime for investment banks is set out in the Investment Bank Special Administration Regulations 2011 issued by HM Treasury pursuant to s233 of the Banking Act 2009.

another firm. In a partial transfer, loss absorption and recapitalisation are likely to be provided by transferring more assets than liabilities from the failed firm to a private sector purchaser, or to a bridge bank (temporarily). The rest of the institution would be put into an administration process, with those creditors who are 'left behind' likely to face a shortfall on their claims in respect of assets of those parts of the firm in administration.

3.21 The proposed Statement of Policy sets out the factors the Bank would consider when determining if a transfer strategy is appropriate, and what effect this might have on the MREL set for a firm either to ensure that the transfer is not significantly detrimental to the capital position of a purchaser, or so that a new bridge institution can be adequately capitalised. However, the quantum of MREL needed for recapitalisation may be lower than that based on the full balance sheet if only a portion of the firm is expected to be transferred (for example those liabilities and assets connected to critical economic functions).

3.22 The starting point for the recapitalisation amount for transfer strategies is the existing Pillar 1 and Pillar 2A capital requirements relating to the assets that would be transferred according to the preferred resolution strategy. The Bank will consider, for institutions subject to a partial transfer resolution strategy, whether the firm's balance sheet is likely to reduce in size significantly following resolution, that is, whether some of the firm's assets and liabilities may be 'left behind' rather than transferred. While a firm may have experienced significant losses up to and in resolution, a partial transfer strategy envisages that the critical liabilities and matching assets may be transferred. This would mean that part of the firm could continue to operate as a viable business. Any decision to adjust the recapitalisation component of MREL for transfer institutions will be taken on a firm-specific basis.

3.23 The Bank may also make further adjustments to take account of possible changes in the Pillar 2A requirements that might be relevant to the part of the firm's business which is expected to be transferred in resolution. The Bank, in consultation with the PRA, will consider whether it is feasible and credible for any components of an institution's current Pillar 2A requirements not to apply to the institution following implementation of the resolution strategy. This will be determined on an institution-specific basis in light of the resolution strategy. For institutions which will continue to operate following resolution the PRA's published policy on setting Pillar 2A will continue to apply. [1]

3.24 The Statement of Policy outlines the Bank's proposed approach to the inclusion of buffers in the recapitalisation amount of MREL. The Bank does not believe it will always be necessary for an institution emerging from resolution immediately to meet all applicable capital buffer requirements. Such an institution would by definition have been through a severe stress event, exactly the point at which capital buffers should be usable. Market confidence should be assisted by positive signalling effects from: a) the fact that the institution's assets will have been significantly 'cleaned up' following the recognition of losses, through the fair, prudent and realistic valuation required in resolution; and b) the institution continuing to remain authorised by the PRA. Therefore the Bank is proposing that the recapitalisation amount of MREL will generally not include any amount related to the institution's capital buffers unless the Bank determines, after consulting the PRA, that an amount of capital in excess of minimum capital requirements would be necessary to maintain market confidence following resolution.

3.25 The BRRD, as implemented in the Insolvency Act 1986, provides for preferential treatment in insolvency of the part of deposits covered by the FSCS, and secondary preference

[1] See PRA Policy Statement 17/15 'Assessing capital adequacy under Pillar 2 – PS17/15', July 2015; http://www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps1715update.aspx

for uncovered eligible deposits of natural persons and SMEs.[1] Where a partial transfer only includes such preferred deposits, the remaining senior liabilities left behind will be treated on a *pari passu* basis in the administration process. This means that subordination of MREL resources to senior operating liabilities may be unnecessary, as all senior liabilities are treated equally. Remaining liabilities that could be left behind and exposed to losses may include uncovered corporate, charity and public sector deposits above any applicable deposit guarantee scheme compensation limit. If the resolution plan instead called for those deposits to be transferred, there would be a need for MREL resources to be subordinated to them in the creditor hierarchy.

Bail-in resolution strategy

Quantum

3.26 The recapitalisation amount of MREL must be sufficient to allow the whole of the institution's balance sheet to be recapitalised to meet its minimum capital requirements post-resolution. That is, its Pillar 1 and Pillar 2A requirements or, if higher, any applicable leverage ratio requirement or the Basel I floor (that is, its minimum capital requirements). Therefore the starting point for the recapitalisation component of MREL for an institution with a bail-in strategy will be the institution's current minimum capital requirements.

3.27 To take proper account of the firm's resolution strategy, adjustments may be made to this baseline. In particular, adjustments may be based on: (1) expected changes in Pillar 2A immediately as a result of resolution; (2) expected changes to any other regulatory capital requirements immediately as a result of resolution; and (3) adjustments to any buffer that must be restored immediately following resolution, as outlined in the previous section.

Subordination requirements

3.28 The bail-in stabilisation option must be applied to liabilities in scope of bail-in on a *pari passu* basis (that is, treating liabilities in the same creditor class equally) unless exceptional circumstances mean that certain discretionary exclusions are necessary, as set out in the Banking Act.[2] Furthermore, the Banking Act provides safeguards for creditors and shareholders of an institution in the event of resolution, including that they are not left worse off than if the institution had entered insolvency instead – this is known as the 'no creditor worse off' (NCWO) safeguard. Affected creditors must be compensated if the NCWO safeguard is breached, increasing the cost of a resolution.

3.29 Subordination aligns the order of loss absorption in resolution and insolvency; whether subordination is achieved through structural or contractual means, MREL resources would rank below liabilities related to the day-to-day operations and critical economic functions of an institution. The Bank is proposing to require subordinated MREL resources for all institutions where the preferred resolution strategy is bail-in. This ensures that MREL resources can fulfil their purpose of providing the capacity to absorb losses and recapitalise without the Bank needing to treat similarly ranking liabilities differently. This minimises the risk of successful NCWO claims. It also provides clarity as to creditors' relative positions in resolution.

[1] As well as deposits that would be eligible deposits from natural persons and SMEs, were they not made through branches located outside the EEA.

[2] Liabilities may be excluded from bail-in on a discretionary basis under exceptional circumstances if: (a) it is not practically possible to bail in a liability; (b) necessary to maintain the continuity of critical functions; (c) necessary to avoid widespread contagion; and (d) to not exclude the liability would cause severe value destruction. The European Commission is empowered under Article 44(11) BRRD to adopt a delegated act in order to further specify the circumstances in which exclusion may be necessary. The EBA has provided technical advice to the Commission which is available here: http://www.eba.europa.eu/-/the-eba-advises-on-resolution-procedures-for-eu-banks

3.30 Subordination of MREL resources can be achieved in a number of ways, as described in the TLAC standard. Structural subordination makes use of group structures to ensure that MREL resources issued to external investors are subordinated, that operating entities which provide critical economic functions are not generally placed into formal resolution, and that existing group structures are maintained through the resolution process. Contractual subordination relies on contractual clauses to subordinate a liability to other liabilities of the issuing entity. The Bank's view is that structural subordination provides the greatest resolvability benefits. Structural subordination avoids the need to put operating entities into resolution, which has the benefit of simplifying resolution and also supporting resolution from a cross-border perspective. The resolution is likely to be simpler because the disruption at the operating entity level, where critical economic functions are provided, will be minimised. In addition cross-border risks to implementation of the resolution strategy are reduced, by eliminating the incentive of host authorities to seize assets of local branches of operating entities.

3.31 Mutually-owned institutions such as building societies may not be able to operate with holding companies without changes to their form of incorporation, limiting their ability to achieve structural subordination of MREL resources. In such cases the Bank expects institutions with a bail-in strategy to issue contractually-subordinated instruments to satisfy their MREL.

3.32 Therefore the Bank proposes that:

- MREL resources maintained to enable a bail-in strategy must be subordinated in insolvency to an institution's operating liabilities (for example derivative liabilities or corporate deposits), in line with the TLAC standard; and
- this subordination of MREL resources must generally be achieved through structural subordination. In the case of building societies, MREL resources must be contractually subordinated.

3.33 In order to ensure that MREL resources are issued externally by the resolution entity[1] (or entities) within a group, the Bank expects to set entity-specific MREL for the holding companies of those groups for which structural subordination is required. The Bank will require relevant operating entities within those groups to issue MREL resources to the relevant resolution entity as 'internal MREL resources' (that is, MREL resources held within groups to facilitate group resolution and structural subordination). This ensures that sufficient MREL resources are pre-positioned at appropriate entities within a group to ensure that losses can be passed up to the resolution entity. Section 5 provides more detail on how the Bank proposes to implement structural subordination.

[1] The entity (or entities) to which stabilisation powers would be applied under the preferred resolution strategy.

4 MREL instrument eligibility (external MREL)

4.1 The Banking Act and the No. 2 Order sets out a number of conditions which liabilities must meet to qualify as MREL resources. In addition, the Banking Act gives the Bank the power to require relevant institutions to maintain or issue particular kinds of eligible liabilities or take other specified steps for the purpose of meeting MREL. The Bank proposes to exercise this power to apply a certain number of additional eligibility requirements to institutions' externally-issued MREL resources. These additional requirements are in line with the FSB's TLAC standard.

4.2 In order for MREL resources to fulfil their intended purpose, it must be practically straightforward for the Bank to apply its stabilisation powers to them, including the bail-in stabilisation power.

4.3 In particular, where the value of a liability depends significantly on derivatives or embedded derivative components, it is likely to be difficult to value rapidly in resolution. This presents a practical barrier to bailing in these liabilities. The Bank therefore considers that liabilities with significant derivative components, including structured notes, are unlikely to be suitable MREL resources. Liabilities subject to set off or netting arrangements are also not appropriate MREL resources.

4.4 The No. 2 Order requires that non-capital MREL resources must have a residual effective maturity of at least one year. The Bank is not proposing to apply any additional maturity criteria, but expects institutions to monitor the overall average maturity of their MREL resources to ensure that they are resilient against temporary problems in debt and capital markets or a period of institution-specific stress that may temporarily prevent them from issuing new liabilities.

4.5 The No. 2 Order also requires institutions to determine the maturity of MREL-eligible liabilities taking into account whether the liability confers a right to early reimbursement upon its owner. Where such a right does exist, the maturity date of the liability shall, for the purposes of determining eligibility for MREL, be considered to be the first date at which such a right arises. The Bank expects institutions not to structure their MREL resources in such a way as to reduce their effective maturity, for example instruments which create incentives for the issuer to redeem them ahead of the contractual maturity date.

4.6 Liabilities governed by the law of a non-EEA state may be eligible for MREL only where the Bank is satisfied that such liabilities are reliably within scope of UK stabilisation powers, including bail-in. This could be achieved through the inclusion of contractual recognition clauses in the terms of the liability in line with PRA rules on the contractual recognition of bail-in[1], or through statutory recognition of the Bank's resolution actions in the non-EEA state's legislative framework. The Bank may require the institution to demonstrate that the application of the Bank's stabilisation powers in respect of the liability governed by non-EEA law would be effective and require the institution to provide a legal opinion to support this.

[1] Contractual recognition of bail-in 3.1-3.3 ('Transitional Provisions') of the PRA Rulebook, available at http://www.prarulebook.co.uk/rulebook/Content/Part/211722/10-12-2015.

5 MREL in the context of groups

5.1 As stated above, MREL must be set for all banks, building societies and 730k investment firms, including those within wider groups. MREL must also be set on a consolidated basis, and the Bank may set MREL for certain other group entities including holding companies. MREL should be set so as to ensure groups can be resolved effectively.

5.2 The Bank is proposing to set individual MREL for UK-incorporated entities within UK-headquartered groups, including ring-fenced bodies (RFBs), and does not expect to apply the option to waive MREL for parent or subsidiary entities available under BRRD Article 45(11) and (12). This is in line with the PRA's approach of applying capital requirements at an individual entity as well as consolidated level. The Bank generally expects to align the scope of MREL with the scope of capital requirements, unless there are compelling reasons to deviate from this. The Bank will, on an entity-by-entity basis, consider whether individual entities within a group could feasibly enter insolvency upon the resolution of the group as a whole. Where this is the case those entities may be set an individual MREL equal to their regulatory minimum capital requirements.

5.3 As set out in section 3, the Bank considers that structurally-subordinated MREL provides the greatest resolvability benefits, and proposes to require structural subordination for all institutions subject to a bail-in resolution strategy (except for building societies). Box 3 provides background on structural subordination in the context of the subordination of MREL resources. The Bank considers that subordination (in any form) is not needed for institutions subject to a partial transfer resolution strategy in which only preferred deposits are to be transferred. This section of the consultation and section 6 of the proposed Statement of Policy set out the principles that need to be met for structural subordination to be effective. The Bank welcomes views on how these principles can best be put into practice.

5.4 Section 7 of the proposed Statement sets out the Bank's proposed approach to the transitional phase-in period for MREL. The Bank intends to apply the principles therein to MRELs for individual subsidiaries within groups, meaning that during the transitional period institutions need not directly match externally-issued MREL resources with internal issuance. However, the Bank will expect institutions to ensure that intra-group arrangements for MREL are structured appropriately by 1 January 2020 (or, for G-SIBs, 1 January 2019).

5.5 The Bank considers that the following principles need to be met for structural subordination to work effectively:

(a) internal MREL resources must be subordinated to the operating liabilities of the group entities issuing them;

(b) internal MREL resources must be capable of being written down or converted to equity without or ahead of any actual resolution of the operating entity which issues them; and

(c) MREL resources must be appropriately distributed within groups.

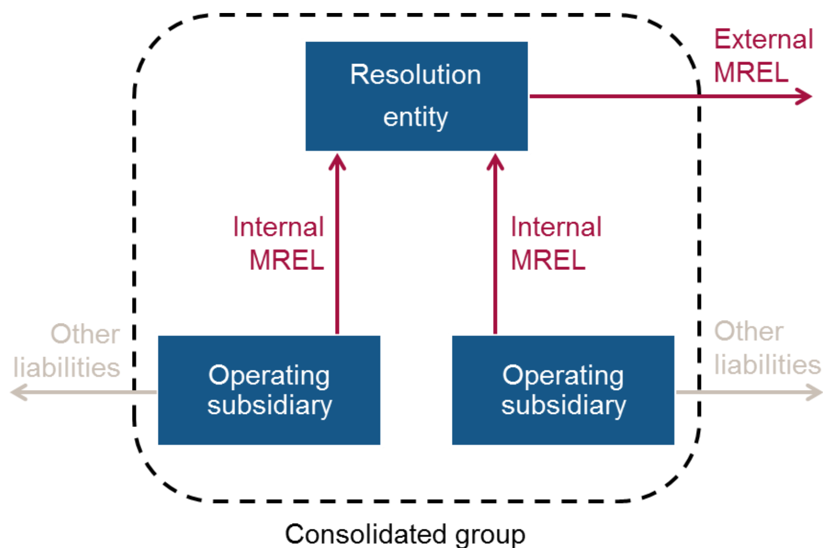
Box 3: Structural subordination

For institutions subject to a bail-in strategy, there are significant benefits from MREL resources being subordinated to operating liabilities such as derivatives and corporate deposits. There are a number of different ways to achieve this subordination. This section briefly describes structural subordination, which is the Bank's preferred approach to subordination of MREL resources.

In structural subordination, individual operating entities issue MREL-eligible instruments to other entities within their group. These instruments are subordinated to the external liabilities of the operating entity which relate to its business and critical economic functions (such as deposits or derivatives). This consultation refers to requirements to issue MREL resources to other entities within a group as 'internal MREL'. This is conceptually similar to the FSB's internal TLAC requirements.

The internal MREL instruments are issued, directly or indirectly, to a designated resolution entity within the group (that is, the entity to which stabilisation powers will be applied). This will usually be a holding company, but importantly it should not provide critical economic functions itself. Groups subject to a 'single point of entry' resolution strategy will only have one resolution entity, while groups with 'multiple point of entry' strategies will have multiple resolution entities.

Figure 2 Illustrative structural subordination diagram



When losses arise in an operating entity such that it is no longer viable, the intragroup liabilities will be written down or converted to equity (in general without use of stabilisation powers), passing the losses up to the holding company (because these liabilities of the operating company represent assets for the holding company). If these losses cannot be absorbed by the holding company it will be placed into resolution, and the externally-issued liabilities of the resolution entity will be written down and/or converted as necessary using the bail-in tool. This means that in a resolution of the group, formal stabilisation powers should only be applied at the resolution entity level.

This approach has a number of advantages. In particular, structural subordination avoids the

need to put operating entities into resolution, which has the benefit of simplifying resolution and also supporting resolution from a cross-border perspective. The resolution is likely to be simpler because the disruption at the operating entity level, where critical economic functions are provided, will be minimised. In addition cross-border risks to implementation of the resolution strategy are reduced, by eliminating the incentive of host authorities to seize assets of local branches of operating entities.

5.6 This section considers some of the implications of the principles set out above.

(a) Internal MREL resources must be subordinated to the operating liabilities of the group entities issuing such resources

5.7 For structural subordination to function effectively, and achieve the maximum resolvability benefits, internal MREL resources must absorb losses ahead of the institution's operating liabilities. Subordination of internal MREL resources aligns the creditor hierarchies in insolvency and resolution, reducing the risk of breaches of the NCWO safeguard when carrying out a group resolution.

(b) Internal MREL resources must be capable of being written down or converted to equity ahead of any formal resolution of the operating entity which issues such resources

5.8 One of the primary benefits of structural subordination is that it facilitates formal resolution at a designated resolution entity only. The goal is that when major operating entities would otherwise no longer be viable, they can be recapitalised using internal resources with the minimum disruption to their external functions, including critical economic functions. This requires that internal MREL resources can be written down or converted to equity by the resolution authority without applying stabilisation powers to the operating entity.

5.9 This could be achieved either using statutory or contractual means. Under the Banking Act regulatory capital instruments must be written down or converted when an institution reaches the 'point of non-viability' (PONV) using a mandatory reduction instrument. This means that any CET1, Additional Tier 1 and Tier 2 instruments which qualify as regulatory capital must absorb losses, up to the extent required to meet the resolution objectives, before or together with the use of any stabilisation powers. The Bank's view is that regulatory capital in scope of this statutory write down at the PONV would meet this principle. Non-regulatory capital debt instruments may also be able to meet this principle if they contain a contractual clause which would achieve the same effect, that is they could be written down or converted to equity when the operating entity reached PONV.

5.10 Under the TLAC standard – which requires internal TLAC for material subsidiaries[1] outside the resolution entity's home jurisdiction – the contractual write-down clause for any non-regulatory capital debt instruments that are used to meet an institution's internal TLAC requirement should include a 'joint trigger', such that the group resolution authority and the resolution authority of the subsidiary issuing internal TLAC must agree to the write down of non-regulatory capital internal TLAC, if that is to occur without the use of stabilisation powers. Instruments with this kind of trigger have yet to be developed, and the Bank expects to work with its international counterparts, as well as the relevant institutions, to consider the properties of non-capital instruments used to meet the internal TLAC standard.

[1] Section 17 of the TLAC standard sets out minimum criteria for a subsidiary or sub-group to be considered material under that standard.

5.11 A pre-resolution trigger is relevant for internally-issued MREL resources in groups subject to structural subordination requirements. MREL resources issued externally from a resolution entity need not contain such a trigger, as the resolution plans foresee the application of formal stabilisation powers to the resolution entities that issue those liabilities.

(c) MREL resources must be appropriately distributed within groups

5.12 This is a wide-ranging principle covering a number of aspects of setting MREL within groups. The No. 2 Order and BRRD do not set specific requirements for intragroup MREL, other than making clear that each subsidiary that is a credit institution or investment firm must meet MREL – whether issued internally or externally – on an individual basis and having regard to the group consolidated requirement. The TLAC standard is, however, more specific about how internal TLAC should be distributed within a group.

Resolution entity requirements

5.13 For groups in which the holding company will be the resolution entity subject to bail-in, the Bank expects to set entity-specific MREL for the holding company to ensure there is sufficient MREL to meet the needs of the resolution group in resolution.

5.14 For structural subordination to work effectively, MREL resources issued externally by (holding company) resolution entities should not rank *pari passu* with significant amounts of other liabilities that are not expected to be bailed in. Otherwise the resolution authority will need to depart from *pari passu* treatment when bailing in liabilities of the resolution entity, which under the Banking Act can only be done in specific exceptional circumstances. Ideally such holding companies should have 'clean' balance sheets with no operating liabilities, although in practice some liabilities that are not eligible as MREL may be unavoidable (for example, tax liabilities). The TLAC standard allows for such liabilities as long as in aggregate they are no greater than 5% of the resolution entity's eligible external TLAC. The Bank expects to apply a similar approach to setting holding company MREL for institutions subject to structural subordination.

5.15 Under the TLAC standard, externally-issued regulatory capital in operating entities can count toward meeting a resolution entity's TLAC, to the extent that such capital would count towards the group's consolidated capital requirements, until the final TLAC conformance date of 1 January 2022. After that point, only externally-issued CET1 issued by subsidiaries would count towards meeting a group's external TLAC requirement. The Bank is considering whether it should follow a similar approach when setting MREL for resolution entities.

Distribution of internal MREL resources

5.16 Internal MREL provides a transmission mechanism for moving losses around groups. It is important that internally issued MREL resources are: a) ultimately matched by an equivalent amount of external MREL resources; and b) all entities within a group have enough MREL resources to meet their requirements. The Bank will take account of both of these points when setting MREL within groups. For example, if internal MREL resources are issued from one operating entity A to another entity B, the Bank will set MREL for entity B such that it is required to issue sufficient MREL resources to the ultimate holding company for its own MREL needs, as well as to cover fully the MREL resources issued to entity B by entity A. Holding companies will need to issue external MREL resources from their balance sheet at least equal to all the internal MREL resources issued to the holding company by its subsidiaries. This ensures that all internal MREL resources within a group are matched by externally-issued MREL resources. The Bank welcomes comments on the most effective and transparent way to achieve this in practice.

5.17 It is important that the conversion of subsidiaries' MREL resources to equity does not lead to unintended changes in the subsidiaries' ownership during resolution. The Bank will consider subsidiaries' non-equity MREL resources in relation to such potential effects on group structures in resolution. The Bank will discuss the distribution of MREL resources generally with institutions as part of the process of setting MREL.

Calibration of internal MREL

5.18 The No. 2 Order requires the Bank to set an MREL for subsidiaries at a level which takes account of the consolidated MREL set for the group. In some respects this is similar to provisions in the TLAC standard that provide for internal TLAC for subsidiaries to be scaled down relative to the requirements which would be set for them were they a standalone entity. Any adjustments to internal MREL would need to be justified by reference to the consolidated MREL for a group. Such adjustments aim to strike a balance between the need for sufficient MREL resources to be pre-positioned at subsidiaries to cover loss and recapitalisation and provide reassurance to authorities and investors, and the desire to take account of consolidation effects that, without scaling, may mean that the sum of the requirements set for individual entities within a group is greater than the equivalent requirement applied at a consolidated level. Scaling makes it more likely that there are some resources at the resolution entity, above the sum of internal MREL, which can be used flexibly across the group.

5.19 The Bank intends to calibrate internal MREL in a manner that is as consistent as possible with the final TLAC standards, including for domestic entities. Scaling would not be relevant for the resolution entities of 'multiple point of entry' institutions, as these will need to issue external MREL resources sufficient to cover the needs of their sub-group. The Bank is also considering not applying any scaling to the internal MREL set for RFB sub-groups, reflecting RFBs' relative separation from the rest of their group and their importance in providing critical economic functions.

6 Transitional arrangements

6.1 The Bank will be required to set MREL by the No. 2 Order from 1 January 2016. The MREL RTS allows MRELs to be set at levels lower than the full requirements that a resolution authority would set for institutions, for up to 48 months. This means that 'transitional' MRELs can be set until 1 January 2020. The MREL RTS does not specify the nature of this transition to full MREL levels. MREL must still be set annually over this period.

6.2 The Bank expects to set consolidated MREL in 2016 no higher than institutions' current regulatory minimum capital requirements,[1] or, where relevant, make such a proposal to resolution colleges. There would therefore be no immediate change in regulatory requirements. For most institutions, the Bank proposes to set a final MREL conformance date of 1 January 2020. The Bank's view is that it would generally be appropriate to allow institutions flexibility as to how to make the transition to meeting a steady-state MREL at 1 January 2020. As noted in the proposed Statement of Policy, this will be achieved by setting MREL equal to current minimum capital requirements until the final conformance date, which is the approach the Bank expects to take in most cases. The Bank generally anticipates that institutions will build up to their MREL on a gradual basis over the transitional period and the Bank will monitor their plans and progress. Setting lower, non-binding MREL during the transitional phase allows institutions time and flexibility to manage their liability structures, for example by issuing new debt or migrating existing debt from one issuing entity to a resolution entity.

6.3 This general approach does not preclude the Bank from setting an earlier target or higher MREL for particular institutions in the transitional phase. The Bank may consider doing so, for example, where action is needed to enhance an institution's resolvability and requiring MREL resources is needed to advance the Bank's objectives as resolution authority.

6.4 Under the TLAC standard G-SIBs must meet a minimum TLAC requirement, on a consolidated basis, of 16% of risk-weighted assets, or 6% of leverage exposures, by 1 January 2019. The Bank expects UK G-SIBs to meet this interim TLAC minimum by 1 January 2019, and will confirm this when reviewing those institutions' MREL implementation plans.

6.5 For the purposes of the transitional period, the Bank intends to:

(a) provide institutions over the course of 2016 with an indication of their consolidated and individual holding company/group parent entity MREL at the end of the transitional period, based on currently available data. The Bank will reassess this MREL annually, including to take account of any changes to minimum regulatory capital requirements;

(b) discuss with institutions their plans to meet such a requirement by the conformance date; and

(c) monitor institutions' progress against these plans.

6.6 The Bank may set reduced MRELs (compared to the MREL which the Bank would normally expect to set for an institution) in certain limited circumstances after 1 January 2020. Where

[1] Specifically the higher of (i) the own funds requirement, (ii) any applicable leverage ratio and (iii) the Basel I floor.

an institution has been subject to the use of stabilisation powers and its MREL resources have been ‘used’ (that is they have been written down, converted to equity or otherwise absorbed losses) the institution may initially not meet the MREL that the Bank would normally expect to set for it. This is a natural consequence of MREL resources being used in resolution, and the institution will need time to rebuild its resources. In such cases the Bank will set MREL as necessary to ensure that MREL resources are effectively usable in resolution.

6.7 The Bank will also consider setting reduced MRELs for smaller institutions undergoing growth or business model changes which would likely mean that they would no longer be placed into an insolvency procedure on failure and would instead require the use of stabilisation powers. The Bank would discuss this with individual institutions as necessary and ensure that such institutions had an appropriate length of time in which to meet any new requirement.

6.8 The Bank expects to provide an indication of final internal MREL – beyond current minimum capital requirements and applicable from the end of the transition period – to institutions for individual entities within groups later in the transition period. It does not expect to set internal MREL higher than entity-level minimum capital requirements during the transition period.

7 Further issues

7.1 This section highlights a number of issues which, although not included in the proposed Statement of Policy, the Bank considers essential aspects of the MREL framework in the long-term. The Bank expects to revisit these issues and may update its Statement of Policy on MREL in due course.

Disclosure of MREL

7.2 A key benefit of a credible resolution regime, including MREL or equivalent requirements, is that by removing the implicit government guarantee for banks and other financial institutions it ensures that those institutions are subject to normal market discipline. But in order for market participants to price the risk of lending or providing equity capital to an institution correctly, there must be appropriate information available. This means that disclosure by institutions subject to MREL will be an important aspect of realising its benefits.

7.3 The Basel Committee on Banking Supervision (BCBS) is working to define disclosure standards in relation to TLAC, and the Bank is involved in this work through its membership of the BCBS. The Bank will consider MREL disclosure requirements once these international standards have been finalised, to reduce the risk of unintended divergences between UK arrangements for disclosure of MREL and any global agreements.

7.4 Any final disclosure standards should ensure that creditors have sufficient information to understand and price the risk of investing in an institution. The disclosure standards should require a breakdown of creditor hierarchies on a legal entity basis. This will increase transparency as it will enable creditors to understand the order of loss allocation in resolution and their respective position in the creditor hierarchy. The Bank expects that the UK disclosure regime for MREL is likely to require the disclosure of MREL resources and creditor hierarchies at a legal entity level from the MREL conformance date.

MREL reporting

7.5 In addition to public disclosure, the Bank (as well as the PRA and FCA) will need appropriate data on institutions' MREL resources and requirements to enable it to monitor and set individual MRELs. The Bank is not proposing to introduce formal reporting on MREL as part of this consultation process. The Bank will consider the design of any regular and formal MREL reporting in light of its final policy, and will consult separately ahead of introducing any new reporting requirements. The Bank does not envisage any formal reporting requirements being introduced before 2018.

7.6 Ahead of the introduction of any other reporting the Bank intends to collect MREL data from relevant institutions as part of its ongoing data collection for resolution planning. The Bank will work with relevant institutions to ensure any data requirements are understood. To facilitate the implementation of MREL, the Bank may request data from institutions outside of its regular data collection cycle for resolution planning.

Treatment of MREL holdings

7.7 If MREL resources are to fulfil their function of providing credible loss absorption and recapitalisation capacity for institutions in resolution, the nature of the holders of MREL-eligible instruments must be considered. An excessive concentration of holdings of MREL resources in the banking sector (that is, banks and building societies investing in each other's MREL resources) could present a barrier to resolution if writing down MREL resources would be likely to have a strong direct contagion effect, weakening other parts of the banking sector. Banks are generally required to deduct their holdings of other banks' capital instruments from their own measured regulatory capital in order to limit these effects for capital instruments.

7.8 As with disclosure, the BCBS is currently considering what sort of restrictions on the holding of TLAC would be appropriate, and published a consultative document on 9 November 2015.[1] The Bank will consider its own policy in the area following the conclusion of these international discussions.

Large exposures

7.9 For institutions subject to structural subordination and internal MREL, the Bank's proposed approach requires operating entities to issue internal MREL resources to resolution entities. This will create intragroup exposures which may be subject to large exposures limits, depending on the entities involved. The Bank is aware of the possibility that intragroup issuance of MREL resources may create large exposures, insofar as the exposures stemming from the holding of the recapitalisation amount of MREL will need to be factored into the calculation of an entity's large exposures. The Bank will work with the PRA to ensure that any interactions between the large exposures framework and MREL are managed appropriately.

[1] Available at: http://www.bis.org/bcbs/publ/d342.htm

8 Impact assessment

8.1 The Bank has conducted an analysis of the costs and benefits of its proposed approach to setting MREL. All estimates provided are sensitive to the underlying assumptions and data.

Baseline for calculations

8.2 The analysis set out here compares the proposed MREL policy to a counterfactual in which UK institutions do not have to satisfy any MRELs. The BRRD and Banking Act require the Bank to set MREL, so a counterfactual in which no MREL is set may overstate the marginal impact of the Bank's proposals. However, it should affect the size of both the costs and benefits. Hence, we do not believe this approach distorts the results of this impact assessment.

8.3 The Bank has recently published analysis of the costs and benefits of going-concern capital requirements in Brooke et al, 2015,[1] which informed the FPC's assessment of the appropriate medium term capital framework. The methodology used in this impact assessment to estimate the costs and benefits of MREL is based on the analysis presented in Brooke et al, 2015. This analysis has been extended to reflect the specific policy proposals contained in this consultation paper.

8.4 Other bodies have also carried out impact assessments in relation to resolution loss-absorbing capacity requirements, in particular the FSB/Bank for International Settlements (BIS), the European Commission, and the EBA. [2]

Estimated shortfalls and costs of MREL

8.5 In this impact assessment the Bank has estimated the private costs of MREL to UK institutions, specifically the potential increase in ongoing funding costs arising from maintaining particular kinds of liabilities to meet MREL. The approach to making these estimates was to:

(a) estimate institutions' consolidated end-state MRELs (that is, hypothetical MRELs expected to be set following the transitional period, based on current balance sheet data and capital requirements);

(b) compare those estimated MRELs to institutions' current eligible, and near eligible, resources using data from resolution planning information packs, regulatory returns and published accounts;

(c) use the information from (a) and (b) to calculate shortfalls where institutions' current resources are lower than their estimated MRELs; and

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[1] Brooke et al, 2015, 'Measuring the macroeconomic costs and benefits of higher UK bank capital requirements', available at: http://www.bankofengland.co.uk/financialstability/Pages/fpc/fspapers/fs_paper35.aspx.

[2] For example, the FSB has undertaken an impact assessment on TLAC requirements for G-SIBs (see http://www.financialstabilityboard.org/2015/11/summary-of-findings-from-the-tlac-impact-assessment-studies/) ; the European Commission carried out an impact assessment on the BRRD, including on the provisions relating to MREL (see http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_assessment_final_en.pdf ; and the EBA has undertaken an impact assessment on the requirements proposed in its draft MREL RTS (see https://www.eba.europa.eu/-/eba-publishes-final-technical-standards-to-ensure-effective-resolution-under-the-brrd).

(d) estimate the annual cost of altering existing liabilities or issuing new MREL-eligible instruments to eliminate the shortfalls calculated under (c).

8.6 When estimating shortfalls the Bank has used balance sheet data as of 31 December 2014. The analysis is therefore 'static' and does not take into account changes in institutions' assets or liabilities, or going-concern capital requirements over the course of the transitional period. Institutions' end-state MRELs were estimated based on the policy framework set out in this consultation paper and the proposed Statement of Policy. These estimates necessarily require broad assumptions, given that MREL in practice will be set on an institution-by-institution basis and for cross-border EEA institutions ideally on the basis of a joint decision at a firm's resolution college. The estimates set out in this impact assessment only include institutions that the Bank expects may be in scope of resolution using stabilisation powers, that is institutions that are expected to enter insolvency have not been included. It is possible that some institutions are included which would, in fact, have a modified insolvency resolution strategy.

8.7 Cost estimates are calculated at the group consolidated level for all UK institutions. For the subsidiaries of overseas institutions where the resolution strategy involves the subsidiary entering the UK resolution regime, the cost estimates were based on the requirements applicable to the highest UK sub-consolidation. Cost estimates were constructed in a similar way to the FSB / BIS TLAC quantitative impact study.

8.8 The Bank has not sought to estimate the funding cost of MREL for the UK subsidiaries of overseas G-SIBs with a single point of entry resolution strategy. These subsidiaries will be covered by internal TLAC and as such the MREL impact assessment would duplicate existing work conducted by the FSB. Furthermore, as MREL for these institutions is expected to be met via intragroup liabilities, the cost analysis would have to concentrate on transfer pricing arrangements between a UK subsidiary and its parent to measure the changes in the internal borrowing cost. The Bank does not consider it feasible to estimate these costs accurately. Hence, these banks are not included in the cost-benefit analysis.

8.9 The 'long-term debt restructuring needs' reported below are conservative estimates, as the requirements were assessed against the current resources that satisfy all of the MREL eligibility criteria proposed by the Bank. In the next step, the restructuring needs were revised taking into account liabilities that are structurally similar to MREL eligible resources, but which do not meet all the eligibility criteria. For example, for institutions subject to a bail-in strategy, senior unsecured debt issued by a bank operating company that does not meet the subordination requirement could be replaced with similar liabilities (such as structurally-subordinated debt issued by a holding company), which would meet all the eligibility criteria. The revised 'net shortfalls' represent the Bank's estimate of the shortfalls that could not be met by changing the properties, including the location of issuance within a group, of existing long-term unsecured wholesale debt liabilities.

8.10 The shortfalls shown in Table 2 are against the binding requirement for a given institution, which for institutions subject to a bail-in strategy is: the higher of 2 x (P1+P2A); or 2 x any applicable leverage ratio requirement.[1] This is on the assumption that the requirements which applied pre-resolution would continue to apply in their entirety post-resolution. For

[1] We have only calculated figures based on a minimum leverage ratio requirement for firms currently in scope of the PRA's UK leverage ratio framework. We have not estimated MRELs on the basis of the Basel I floor, as under EU legislation this will not apply from 31 December 2017 and there is uncertainty as to if and how it will be replaced. The MRELs which apply to firms will change to the extent that different leverage requirements or capital floors apply at 1 January 2020.

institutions subject to a partial transfer strategy, the recapitalisation component of MREL was scaled down to reflect an estimate of the size of the transfer.

8.11 Apart from this scalar used for institutions subject to a partial transfer strategy, no other adjustments were made (for example to the Pillar 2A requirements applicable following resolution). The shortfalls do not take into account any possible deductions of MREL cross-holdings.

8.12 The methodology used for estimating the cost of MREL was based on calculating the direct increase in funding cost for the institutions and draws upon the current funding models that institutions have in place. The cost estimates do not include one-off and on-going costs for IT systems, reporting, staff, management time and other relevant costs such as potential set up costs.[1]

Table 2 Summary of MREL shortfalls and cost estimates for UK-headquartered institutions

	Estimated long-term debt restructuring need		**Estimated net shortfall**	
	£bn	% total assets	£bn	% total assets
Bail-in	221	3.3%	26	0.4%
Partial transfer	2	2.6%	2	2.0%
Total	223	3.3%	27	0.4%

Estimated upper-bound ongoing costs

	£bn per annum	As a percentage of CET1
Bail-in	1.4	0.6%
Partial transfer	0.1	1.2%

8.13 Although the estimates exclude one-off and on-going operational costs, the Bank considers the estimates to be conservative and represent the upper end of the possible ongoing costs of MREL because they are, as with the shortfalls, calculated on a static basis. An increase in the amount of subordinated liabilities should reduce the riskiness and hence the cost of both senior debt (which is then less likely to suffer a loss in resolution) and existing subordinated debt (which will then suffer smaller haircuts following a loss of given size, as losses are spread out over a larger set of liabilities). These effects are not reflected in our analysis.

8.14 The costs were estimated using two broad methods:

(a) The cost of long-term debt restructuring is based on the estimated ongoing cost of replacing current near-eligible MREL term debt with MREL-eligible term debt. A similar methodology was employed by the FSB in their study to measure the cost of TLAC requirements.

[1] Set up costs might include the cost of accessing wholesale debt markets for the first time, the cost of establishing a credit rating for the instruments concerned, establishing a holding company etc.

(b) The cost of closing any *net shortfalls* that may remain for some institutions after the restructuring of term debt is measured either by:

(i) the estimated ongoing costs of replacing short-term debt with MREL-eligible debt, where available; or

(ii) issuance of new debt or equity which results in the expansion of the balance sheet.[1] This method was applied where there was insufficient near-eligible debt outstanding. We have assumed that the proceeds of any issuance are invested in assets earning a yield of 2.4% (based on the 2013 yield of 10-year gilts). Where institutions are able to invest in higher yielding assets, or replace existing funding rather than expand their balance sheets, this would reduce the net cost of MREL.

8.15 The costs, term debt restructuring needs, and net shortfall estimates summarised above are calculated on a conservative basis. Factors which may mean the actual costs and shortfalls are lower than these estimates include:

- adjustments to MREL and changes in institution's capital requirements may reduce the MRELs set by 2020;
- issuance of MREL resources should reduce the cost of more senior and equally ranking liabilities, reducing the net cost of meeting MREL;
- we assume that where institutions need to issue new liabilities to meet MREL they invest the proceeds in UK government bonds. If institutions are able to invest in higher yielding assets, or replace existing funding rather than expand their balance sheets, this would reduce the net cost of MREL;
- developments in the market for MREL-eligible debt and other similar instruments may reduce the overall cost of issuing such debt;
- where limited data were available on institutions' cost of wholesale funding we have used conservative cost assumptions based on the debt of institutions with the highest costs. This may overstate the funding costs for these institutions; and
- where there was uncertainty as to institutions' access to wholesale debt markets we have assumed they will need to raise equity to meet their MREL, which again may overstate the costs of meeting MREL on the assumption that raising equity is more costly to institutions than issuing debt.

Macroeconomic costs

8.16 Any increases in institutions' funding costs represent a private cost of MREL to institutions. To the extent that these are simply the result of a transfer from one party to another (for example of withdrawing the implicit 'too big to fail' subsidy from governments to institutions), they are not necessarily a social cost and should not be included in an assessment of macroeconomic costs.

8.17 However, it is generally accepted that increases in banks' (and similar institutions') funding costs impose some social cost: they increase the cost of bank credit to the real

[1] In practice, firms may find it cheaper to follow a different strategy to close any net shortfall, for example by replacing secured debt with MREL-eligible liabilities.

economy, which may have a negative effect on investment and the level of gross domestic product (GDP). This is considered to be the key economic cost of imposing (privately costly) funding requirements.[1]

8.18 In order to approximate the potential macroeconomic cost of setting MREL, we use two different macroeconomic models that translate changes in bank lending rates into changes in GDP. The approach used is consistent with the one used in Brooke et al, 2015, that informed the FPC's assessment of the appropriate medium-term capital framework.[2] To avoid making any judgements on the appropriate model we use a simple average of the two models used in that work.

8.19 In order to derive the increase in lending rates, we employ the following approach: we assume that each bank and building society increases its lending rates so as to offset its increases in funding costs in a way that leaves its return on equity unaffected. That is, we assume that:

(a) shareholders *require* the same expected return on equity as before, even if MREL reduces institutions' risk-taking incentives and hence reduce the riskiness of holding the institutions' equity; and

(b) institutions *are able to* pass on the full cost to consumers without considerably reducing demand (for example because all institutions increase lending rates simultaneously and aggregate demand is sufficiently inelastic).

8.20 We assume that for each bank, loans that will be re-priced constitute 40% of its total assets. This is in line with the assumptions made in Brooke et al, 2015 and implies that a 0.01 percentage point increase in an institution's weighted average cost of funding translates into a 0.025 percentage point increase in that institution's lending rates.[3] Furthermore, we abstract from substitution effects between different banks and assume that the increase in lending rates faced by a representative borrower is in line with the average increase in individual banks' lending rates (weighted using *current* balance sheet sizes).

8.21 Using this approach, we find that setting MREL increases the cost of credit to a representative borrower by around 0.06 percentage points per annum. Using our standard macroeconomic models, this translates into a reduction in the level of GDP by 0.04%. That is, in any given year GDP would be 0.04% lower due to MREL. However, this gross cost has to be compared to the benefits (see below).

8.22 We do not consider any costs that may arise from the process of transitioning towards meeting MREL.

Benefits

8.23 Ensuring that institutions have sufficient loss-absorbing capacity in resolution is necessary to make resolution credible without public capital support and therefore to end the

[1] See eg BCBS, 2010, 'Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements' and BCBS, 2010, 'An assessment of the long-term economic impact of stronger capital and liquidity requirements'.

[2] 'Measuring the macroeconomic costs and benefits of higher UK bank capital requirements', available at: http://www.bankofengland.co.uk/financialstability/Pages/fpc/fspapers/fs_paper35.aspx .

[3] Under the assumption of a 'full pass-through' of costs, the impact on lending rates is larger than the impact on a firm's own funding costs as loans constitute less than 100% of a firm's assets and the returns on other assets are assumed to remain constant.

'too big to fail' problem. It can also ensure the continuity of critical economic functions and reduce uncertainty associated with institution failures.

8.24 While MREL is necessary to deliver a credible resolution regime, its effectiveness is predicated on other elements of a credible resolution framework being in place, such as the appropriate legal powers and safeguards, operational continuity, structural reform, and arrangements for funding in resolution. Purely for the purpose of this impact assessment, we make the simplifying assumption that all other elements of a credible resolution regime are in place and MREL is hence necessary and sufficient to deliver the benefits associated with making banks resolvable. This approach means that we attribute most if not all of the benefits of a credible resolution regime to MREL. Since it is not always possible to distinguish the benefits of MREL from the benefits of effective resolution more broadly we will refer to the benefits identified in this impact assessment interchangeably as the 'benefits of MREL' or the 'benefits of credible resolution'.

8.25 The estimates presented below are based on the assumption that, without MREL, systemically-important institutions would be bailed out in the case of failure. This assumption is made for practical reasons.[1] Given that the BRRD imposes strict legal restrictions on the extent to which bailouts may be carried out, a disorderly insolvency may in fact be the more likely counterfactual outcome in future in the absence of effective resolution. By ignoring the possibility that MREL may be necessary, absent the possibility of public sector capital support, to avoid a disruptive disorderly failure of a systemically-important bank we may significantly underestimate the benefits.

Impact on the cost of crises vs the probability of crises

8.26 Conceptually, there are at least two key benefits of MREL. First, MREL can affect the probability of institution failures and of any financial crises that may be triggered by such failures. By ensuring that the cost of institution failures is borne by creditors rather than public funds we ensure that creditors have stronger incentives to provide market discipline, for example by charging interest rates that reflect the underlying riskiness of an institution, or by otherwise exerting pressure on the management to curb risk-taking. This should reduce moral hazard and provide incentives for the management of these institutions not to take excessive risks. This effect is likely to be particularly relevant for systemically-important institutions that in the past would have been most likely to have been bailed out using public funds. For smaller institutions whose funding comes mostly from deposits, MREL can reduce the distortion introduced by collective deposit insurance that may reduce the risk-sensitivity of institutions' funding costs. This effect is not captured in our estimates of the benefits of MREL set out below.

8.27 Second, sufficient loss-absorbing capacity may reduce the cost of bank failures and financial crises should they nevertheless occur. Where a systemically-important institution fails (that in the past might have been bailed out), the presence of MREL avoids losses being borne by the government and therefore has fiscal benefits, including increasing the scope, all else equal, for the use of a countercyclical fiscal policy. In addition, MREL can ensure more timely recapitalisations, support the continuity of critical economic functions, and avoid the uncertainty associated with bailouts or disorderly liquidations. These benefits should depend on all institutions (rather than just systemically-important ones) having sufficient MREL to support an appropriate resolution strategy.

[1] We do not have sufficient data to evaluate the cost of the only plausible alternative, a disorderly insolvency.

8.28 In the next subsections, we discuss these two types of benefit in more detail and attempt to quantify them. However, MREL and credible resolution should deliver additional benefits that are not captured in these estimates.

8.29 Resolution enables failing institutions or parts of them to exit the market in an orderly fashion, for example through the restructuring that may follow the initial stabilisation phase. This should make financial markets more contestable and allow more efficient entrants to replace inefficient incumbent institutions. To the extent that the largest 'too big to fail' banks currently benefit from perceived government guarantees that artificially lower their funding costs MREL may also be necessary to restore a level playing field between small and large institutions. We discuss factors related to competition in more detail below.

8.30 In addition, MREL may remove any (real or perceived) contingent liabilities of the government with respect to the financial sector. This should reduce sovereign funding costs even outside a financial crisis.

8.31 Our quantitative assessment of the potential benefits of MREL closely follows the analysis in Brooke et al, 2015. To reflect the uncertainty around all of these estimates we generally report ranges rather than point estimates. Moreover, below we reflect the fact that MREL does not only apply to the most systemically-important banks but is likely to also apply to other institutions.[1]

Impact on the probability of a crisis

8.32 As discussed above, a key benefit of MREL should be that banks that were previously considered 'too big to fail' will no longer be subject to moral hazard and will make more prudent investment decisions. This should reduce their probability of failure and ultimately the probability of financial crises. Our estimates of the impact of credible resolution on moral hazard and institutions' probability of failure are based on academic literature that considers the impact of expectations of government support on banks' risk-taking.[2] We can use these estimates to assess how much safer banks would choose to be if creditors would not expect a failing institution to be bailed out. These estimates suggest that systemically-important banks could become around one third less likely to fail. For example, a bank that that would have had a 1.5% probability of failing over a given time horizon will now have a 1% probability of failing over that horizon.

8.33 In a second step, we can translate this into probabilities of financial crises. To do so we use a portfolio model of the UK financial system and assume that a financial crisis is triggered whenever the aggregate recapitalisation needs of the financial sector exceed 5% of annual GDP.[3] We find that MREL reduces the probability of a crisis by between 26% and 41%.[4] Using Brooke et al's, 2015, estimates of the baseline probability of a financial crisis in the United Kingdom - in a time where there are no elevated threats to financial stability – this translates into a reduction in the probability of a crisis from 0.9% per year to between 0.5% and 0.7% per

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[1] Some of the effects of MREL for smaller firms were not explicitly reflected in Brooke et al, 2015, as the policy proposals on MREL had not yet been finalised.

[2] This literature is based on 'government support assumptions' that are published by rating agencies.

[3] This is a widely used definition of a crisis that is established by Laeven and Valencia, 2008, 'Systemic Banking Crises: A New Database' available at: https://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf.

[4] In the most conservative scenario we assume that only globally systemically-important banks (G-SIBs) benefited from perceived government guarantees and are hence affected, and that the G-SIB market share is the same as for an average G-SIB home jurisdiction (excluding China). This estimate is in line with the FSB's TLAC impact assessment. The upper end of the range corresponds to an estimate that (a) accounts for the high market share of G-SIBs in the United Kingdom and (b) assumes that a third of the non-G-SIBs that are subject to MREL requirements consistent with a bail-in strategy are also affected. It should be noted that the baseline probability of a crisis that we use is subject to considerable uncertainty. The FSB impact assessment on TLAC assumed a baseline probability of a crisis of 2.3%. This estimate captures the long-term average probability of a crisis and does not condition on a specific risk environment.

year. By conditioning our estimates on a standard, non-elevated risk environment we tend to underestimate the long-term benefits of MREL.

Impact on the cost of a financial crisis

8.34 Recent analysis in Brooke et al, 2015, suggests that absent an adequate regime to deal with a financial crisis, the net present value cost of a financial crisis can be as high as 122% of annual GDP. MREL may reduce this cost for two reasons.

8.35 First, if the most systemically-important institutions have sufficient MREL, then this can help to ensure that the government does not have to use public funds for any bailouts. This can also prevent a sudden increase in sovereign yields in a crisis. This may be beneficial since the cost of private sector credit (for example, corporate bonds) is often implicitly or explicitly linked to sovereign yields and may otherwise increase more sharply in a downturn. Taken together, these effects are predicted to reduce the cost of a financial crisis by between 5.4% and 11.4% of annual GDP.[1]

8.36 The second effect depends on all institutions having sufficient MREL to support the preferred resolution strategy, rather than just systemically-important institutions. MREL is intended to provide greater certainty about the resolution process, ensure more timely recapitalisations, and ensure the continuity of critical economic functions provided by all institutions, including those that in the past would have been less likely to be bailed out. Bank of England research suggests that the swift and effective management of a financial crisis can reduce the cost of a crisis (before adjusting for the channel described above) to less than 50 percentage points of annual GDP, from a baseline of 122 percentage points of annual GDP, that is, a reduction of around 60%. This estimate is based on the cost of crises that were particularly effectively managed, and it is not obvious that MREL will be sufficient to achieve these benefits. Moreover, even without MREL the cost of a crisis may be lower than 122% of GDP.[2] To reflect this uncertainty we assume a reduction in the cost of a crisis of between 0% and 60%.

8.37 These estimates are based on the implicit assumption that moving from bailouts to bail-in, or otherwise imposing losses on creditors, would leave the risk of 'contagion' between institutions with significant financial exposures unaffected. Some observers have argued that bail-in may significantly increase the risk of contagion. However, we believe that our assumption is reasonable for two reasons. First, the deterioration of public finances due to the cost of bailouts in the recent crisis exerted pressure on the value of sovereign bonds, which negatively affected the solvency of institutions with significant sovereign exposures. This suggests that 'contagion' (between governments and institutions) is also an issue in the context of bail-outs. Bail-in avoids such 'sovereign-bank feedback loops', so the net effect of moving from bailouts to bail-in is unclear. Second, proposals to restrict cross-holdings of MREL within the banking system should significantly reduce the risk of bail-in triggering contagion.

Summary of (net) benefits of MREL

8.38 Based on the estimates above, we find that the annual gross benefits associated with MREL are likely to be within a range from 0.3% to 0.9% of annual GDP. These benefits exceed the estimated macroeconomic costs of MREL (0.04% of GDP) by a considerable margin.

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[1] The lower and upper ends of the range correspond to the different assumptions described in footnote 4, page 43.

[2] The net present value cost of 122% of GDP corresponds to the cost of an 'inadequately managed' crisis. This is higher than the cost of the *average* crisis in the sample considered in Brooke et al, 2015.

The impact of MREL on competition

8.39 In general, regulatory intervention that addresses a source of market failure improves effective competition. Nevertheless, we are alert to the fact that it is very difficult to target the source of market failure precisely (for example because it is difficult to observe the extent to which a specific institution is systemic). Therefore, the costs of regulatory requirements could be exacerbated by any negative impact the requirement may have on competition. A reduction in competition could tend to increase the cost of financial services to the real economy and would lead to an under-provision of such services.

Impact on small versus large institutions

8.40 We expect to apply different levels of MREL across different groups of institutions. The average increase in minimum loss-absorbency requirements – that is the difference between MREL and existing minimum capital requirements expressed as a percentage of RWAs – for institutions subject to a partial transfer strategy is expected to be around 6 percentage points lower on average than for those subject to a bail-in strategy. Moreover, small institutions not in scope of stabilisation powers would not be subject to any binding additional requirements.

8.41 By ensuring that creditors bear the cost of failure across all institutions in the UK financial system, the MREL standard may contribute to ending any remaining 'too big to fail' perceptions that some of the largest institutions previously benefited from and that helped them to attract funding at artificially low interest rates. This should help create a more level playing field between small and large institutions and should support competition.

8.42 But there is a risk that the application of MREL to different groups of institutions goes beyond creating a level playing field and puts large incumbents (subject to proportionately higher MREL) at a disadvantage relative to smaller institutions. This could reduce the financial sector's ability to exploit economies of scale and scope. However, that there is little evidence regarding the extent of scale and scope economies in banking.

8.43 Due to market frictions, smaller institutions may find it more costly to structure their funding to make it MREL-eligible. Investors may find it more expensive to monitor a small institution, for example, which may increase the cost of wholesale debt funding for small institutions. The cost of issuing MREL resources may also be higher for smaller institutions due to fixed costs associated with accessing wholesale debt markets. Some institutions may even be unable to access wholesale debt markets altogether and would need to satisfy MREL via equity. Our evidence shows that at least 80% of the institutions we expect to be subject to substantive MREL have either issued unsecured wholesale debt of some form over the last seven years or have holding companies that we would expect to have access to debt markets. This suggests that even smaller institutions are in principle able to access debt markets, albeit potentially at a higher cost.

8.44 On balance, our analysis suggests that the increase in the weighted average cost of funding for institutions that are subject to partial transfer strategies would be 0.09 percentage points and hence higher than the impact on institutions subject to bail-in (0.02%). However, the gap between bail-in institutions and other institutions is likely to be largely driven by our methodology of estimating potential costs. For some of the largest bail-in institutions, we can estimate the cost of MREL by using current spreads between senior holding company debt and senior operating company debt, while for other institutions we use spreads between Tier 2 and senior operating company debt. This may bias the estimates for smaller institutions upwards since these institutions should be able to satisfy MREL via instruments that rank senior to Tier 2 debt. Moreover, the spreads for Tier 2 debt should decrease as institutions increase their levels of subordinated debt.

Impact on market dynamics

8.45 The differential impact of MRELs on institutions' average funding costs at a given size is only one factor that can affect competition. Competition can also be affected if MREL has a differential impact on institutions' marginal funding costs. This may for example affect competition for new business that would increase the size of a small institution's balance sheet (and thus its MREL).

8.46 These considerations are particularly relevant for institutions that are close to the threshold for use of stabilisation powers (or the threshold for bail-in) and that would become subject to significantly higher requirements if they were to grow any further. We consider any detrimental impact on competition to be contained for three main reasons:

(a) not imposing any MREL (above existing capital requirements) for the smallest institutions may make it easier for these institutions to establish themselves in the market. At the point where they would become subject to stricter requirements they may be more confident investing into additional long-term growth, even if this means becoming subject to stricter MREL;

(b) the proposed requirements for institutions subject to partial transfer are a function of the expected size of the transfer; and they are lower than those for institutions subject to bail-in. This goes some way towards mitigating any cliff-edge effects that may be harmful to competition.

(c) it may be advantageous for institutions, depending on their business model, to maintain MREL resources even if they are not formally subject to a requirement since having a 'protective layer' of MREL resources may help them attract uninsured depositors (see below). This should further reduce any cliff effects.

8.47 Should the proposed MREL framework affect institutions' incentives to compete for market shares, this is most likely to affect the market for current accounts. The number of current accounts is closely linked to the total number of transactional accounts, which has an immediate impact on the size of an institution's MREL. To the extent that current accounts are considered to operate as 'gateway products' in that they make it easier to expand into other complementary markets (for example saving accounts and SME lending) these competitive concerns may be magnified**.**

Impact on business models

8.48 Institutions that rely heavily on deposits to fund themselves may find it more costly to comply with MREL. This may be driven by three factors. First, for any given balance sheet size they are more likely to be in scope of substantive MREL especially if they provide transactional account services. Second, they may find it more costly to raise additional long-term wholesale debt than institutions that already rely on wholesale funding. Third, for an institution that is largely deposit-funded, the cost of senior liabilities may be less likely to decrease as the institution builds up protective layers of subordinated debt (for example because depositors are less risk-sensitive than other creditors). In this respect, it is worth pointing out that access to deposit funding appears to be by far the prevailing business model in retail banking, in particular, for small and new institutions.

8.49 But given the decreased probability of public sector bailouts for deposit taking institutions, bank liability holders are likely to become more focused on their position in the event of the failure of such an institution. Corporate and public sector depositors (who are not preferred or fully covered by the FSCS) in particular may become much more mindful of the extent to which they are insulated from losses by the existence of MREL resources. The

disclosure of institutions' MREL resources that is likely to be required will support this. This dynamic may provide an advantage for institutions which are required, or choose, to maintain MREL resources.

9 Next steps

9.1 The Bank invites feedback on the proposals set out in this paper by 11 March 2016. Please provide those comments by email to the address below:

MRELfeedback@bankofengland.co.uk

Alternatively you may provide comments by post to:

Benjamin King
Resolution Directorate
Bank of England
Threadneedle Street
London
EC2R 8AH

Appendix

1 Proposed Statement of Policy on the Bank's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)

1 Background and statutory framework

1.1 This Statement of Policy is issued by the Bank of England (the Bank), as UK resolution authority, under section 3B(9) of the Banking Act 2009 as amended (the Banking Act). The Statement of Policy sets out how the Bank expects to use its power to direct a 'relevant person' to maintain a minimum requirement for own funds and eligible liabilities (MREL).

1.2 A 'relevant person' means:

(a) An institution authorised for the purpose of the Financial Services and Markets Act 2000 (FSMA) by the Prudential Regulation Authority (PRA) or Financial Conduct Authority (FCA);

(b) A parent of such an institution which (i) is a financial holding company or a mixed financial holding company; and (ii) is established in, or formed under the law of any part of, the United Kingdom; or

(c) A subsidiary of such an institution or of such a parent which (i) is a financial institution authorised by the PRA or FCA; and (ii) is established in, or formed under the law of any part of, the United Kingdom.

1.3 The Bank is required to set MREL for all banks, building societies and 730k investment firms (collectively 'institutions'). MREL must be set on both an individual institution and group consolidated basis. The Bank may set MREL for certain types of other entities in an institution's group, including holding companies. As required by the Bank Recovery and Resolution (No.2) Order 2014 (the No. 2 Order) the Bank will use its power of direction pursuant to Section 3A(4) of the Banking Act to set MREL, in consultation with the PRA or FCA.

1.4 MREL must be set in line with the provisions of the No. 2 Order, the Bank Recovery & Resolution Directive (BRRD) and, after it is adopted by the European Commission, the European Banking Authority's Regulatory Technical Standards on MREL (the MREL RTS). The Bank will also consider the Financial Stability Board's total loss-absorbing capacity (TLAC) standard when setting MREL.

1.5 The No. 2 Order requires the Bank to set MREL on the basis of the following criteria, which are further specified in the draft MREL RTS:

(a) the need to ensure that the institution can be resolved by the application of the stabilisation powers including, where appropriate, the bail-in tool, in a way that meets the resolution objectives;

(b) the need to ensure, in appropriate cases, that the institution has sufficient eligible liabilities to ensure that, if the bail-in tool were to be applied, losses could be absorbed and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU and to sustain sufficient market confidence in the institution or entity;

(c) the need to ensure that, if the resolution plan anticipates that certain classes of eligible liabilities might be excluded from bail-in under Article 44(3) or that certain classes of eligible liabilities might be transferred to a recipient in full under a partial transfer, the institution has sufficient other eligible liabilities to ensure that losses could be absorbed

and the Common Equity Tier 1 ratio of the institution could be restored to a level necessary to enable it to continue to comply with the conditions for authorisation and to continue to carry out the activities for which it is authorised under Directive 2013/36/EU or Directive 2014/65/EU;

(d) the size, the business model, the funding model and the risk profile of the institution;

(e) the extent to which the Deposit Guarantee Scheme could contribute to the financing of resolution in accordance with Article 109 of the BRRD;

(f) the extent to which the failure of the institution would have adverse effects on financial stability, including, due to its interconnectedness with other institutions or with the rest of the financial system through contagion to other institutions.

1.6 MREL is an institution-specific requirement, and the Bank will set MREL with the goal that individual institutions and groups can be resolved consistently with the resolution objectives under a preferred resolution strategy. This Statement of Policy describes the general framework the Bank will use when setting MREL, but is not definitive of any given institution's MREL.

1.7 Where an institution has significant branches or subsidiaries in one or more EEA states, its MREL may be subject to joint decision in a resolution college. MREL determined in line with this Statement of Policy would be the Bank's preferred outcome of that joint decision process.

2 Interaction of MREL and the capital framework

2.1 The PRA has published a concurrent supervisory statement on the interaction of MREL and the capital framework.[1] The statement sets out the PRA's approach to:

(a) the interaction of MREL and the capital framework; and

(b) the interaction of MREL and PRA Threshold Conditions.

2.2 Please consult the PRA's supervisory statement for further details.

3 Framework for setting MREL

3.1 This section sets out the framework the Bank uses to inform the calibration of an institution's MREL.

3.2 The No. 2 Order and the MREL RTS provide the framework for the calibration of MREL. The Bank will set MREL in accordance with this framework. The MREL RTS uses the pre-existing CRD IV[2] capital requirements (Pillar 1, Pillar 2A and capital buffer requirements) as a reference point.

3.3 The Bank will calculate an institution's baseline MREL as the sum of two components: a loss absorption amount and a recapitalisation amount.

[1] The PRA is consulting on its proposed approach. The consultation can be found at http://www.bankofengland.co.uk/pra/Pages/publications/cp/2015/cp4415.aspx.

[2] Capital Requirements Directive (2013/36/EU) (CRD) and Capital Requirements Regulation (575/2013) (CRR) – jointly 'CRD IV'.

3.4 The Bank will set the loss absorption amount to cover the losses that would need to be absorbed up to and in resolution. The starting point in the MREL RTS is that the loss absorption amount will equal an institution's 'minimum regulatory capital requirements' (Pillar 1 plus Pillar 2A or, if higher, the institution's applicable leverage ratio or the Basel I floor) plus its capital buffer requirements (the combined buffer requirement or, where binding, the PRA buffer requirement).[1]

3.5 The RTS gives the Bank the discretion to remove capital buffer requirements from the loss absorption amount if they are deemed not to be relevant to absorbing losses in resolution involving stabilisation powers. The Bank must take into account information received from the PRA, as the competent authority, relating to the institution's business model, funding model and risk profile.

3.6 In light of the PRA policy on the interaction of MREL and capital buffers – and in particular the policy that the PRA may use its powers to prevent Common Equity Tier 1 (CET1) resources from counting simultaneously to satisfy both – the Bank expects to exclude buffers from the loss absorption amount. Therefore the Bank expects generally to set the loss absorption amount equal to an institution's minimum regulatory capital requirements.[2] The Bank also expects to apply this approach to any institutions for which the preferred resolution strategy is modified insolvency, that is, use of the bank insolvency procedure, building society insolvency procedure, or investment bank special administration regime as relevant.[3]

3.7 The Bank will set the recapitalisation amount according to the institution's resolution strategy. The recapitalisation amount must be sufficient to ensure that any institution emerging from resolution meets the conditions for authorisation and maintains sufficient market confidence.

4 Resolution strategies and MREL

4.1 MREL will be set to ensure that institutions can be resolved in line with the resolution objectives. In particular MREL will be set to enable the preferred resolution strategy for an institution to be effected. This section outlines key factors the Bank will consider when determining the preferred resolution strategy, and how this determination may affect the MREL that is set for an institution.

4.2 It is important to note that the actual approach taken to resolve an institution will depend on the circumstances at the time of its failure. The preferred resolution strategy may not necessarily be followed if a different approach would better meet the resolution objectives at the time.

Modified insolvency

4.3 The Banking Act provides for a number of modified insolvency regimes for certain financial institutions (the bank insolvency procedure (BIP), building society insolvency procedure (BSIP) and the special administration regime (SAR)). Where an institution can enter one of these modified insolvency processes at the point of failure, without adversely affecting the achievement of the resolution objectives, the Bank expects to set the recapitalisation

[1] Please see the PRA Policy Statement on Pillar 2 for further details: http://www.bankofengland.co.uk/pra/Pages/publications/ps/2015/ps1715.aspx

[2] As set out in the MREL RTS, the loss absorption amount may be adjusted in certain circumstances.

[3] The special administration regime is set out in the Investment Bank Special Administration Regulations 2011 issued by HM Treasury pursuant to s233 of the Banking Act 2009.

component of MREL to zero. This would mean that an institution's MREL would be equal to its minimum regulatory capital requirements.

4.4 The Bank will consider a number of factors when determining if it is reasonable to assume that in the vast majority of circumstances an institution would enter modified insolvency upon failure rather than being resolved using stabilisation powers. Factors indicating that an institution is likely to be able to enter modified insolvency safely 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;

(b) if the institution does not provide significant amounts of transactional banking services or other critical economic functions, particularly those which depend on continuous access to a service which would not be provided in a modified insolvency. The Bank considers that provision of more than 40,000 transactional bank accounts is generally likely to indicate that a modified insolvency would not be appropriate.

Partial transfer

4.5 In some cases the Bank may determine that, although modified insolvency would not meet the resolution objectives, an institution could feasibly be resolved without use of the bail-in tool. Where it is feasible for the critical economic functions of a firm to be transferred to another entity at the point of the institution's failure, the Bank may determine that use of one or more of the Banking Act's transfer options is the preferred resolution strategy for the institution.

4.6 Factors indicating that it may be possible to rely on a partial transfer strategy, rather than assuming that bail-in would be used, include:

(a) if the institution's business and asset/liability structure are sufficiently simple so as to make rapidly separating and transferring critical economic functions feasible using the Bank's statutory powers;

(b) if the institution's systems are able to provide the necessary information to support a transfer within the required timeframe;

(c) if the institution's business, assets and liabilities (particularly those associated with critical economic functions) are reasonably likely to be attractive to a private sector purchaser; and

(d) if the institution is of a size such that the number of potential purchasers is reasonably high. The Bank considers that above around £15 billion to £25 billion in balance sheet size a bail-in strategy is more likely to be appropriate, but will make this assessment on an institution-specific basis.

4.7 Where an institution meets the necessary conditions for a partial transfer resolution strategy to be appropriate, its MREL will be set taking this into account. The Bank expects to consider the following principal adjustments to MREL for such institutions relative to that set to enable a bail-in strategy:

(a) Quantum: the recapitalisation component of MREL 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. For example, if an institution's critical liabilities[1] represented only a fraction of its total liabilities, the recapitalisation component of MREL may be reduced to reflect this. The Bank will also consider whether any components of Pillar 2A will cease to be relevant as a result of the transfer.

(b) Subordination: where a transfer resolution strategy assumes that only liabilities benefitting from preference in insolvency[2] will be transferred, the Bank may not require MREL to be subordinated to senior operating liabilities. This is because the transfer can allow all non-transferred liabilities to receive the same treatment in a bank administration procedure. This reduces the risk of breaches of the 'no creditor worse off than insolvency' (NCWO) safeguard which might occur if the bail-in stabilisation option had been applied but exclusions made for certain senior liabilities.

Bail-in

4.8 The stabilisation option that is most likely to be appropriate for large complex institutions is bail-in. The Bank is likely to make use of a bail-in strategy for institutions with balance sheets above £25 billion, and will also consider whether bail-in is appropriate for smaller institutions with balance sheets greater than around £15 billion. The Bank expects institutions subject to a bail-in strategy to ensure that their MREL resources are subordinated to operating liabilities, in the first instance using structural subordination.

4.9 The Bank's default assumption for institutions likely to be resolved through a bail-in strategy is that the recapitalisation amount must equal an institution's current minimum regulatory capital requirements (Pillar 1 plus Pillar 2A or, if higher, any applicable leverage ratio or the Basel I floor). The Bank does not expect to require the inclusion of capital buffer requirements in the recapitalisation amount but may do so, taking into account the advice of the PRA.

4.10 The Bank may adjust the recapitalisation amount to remove all or part of any components of Pillar 2A that would not apply post resolution. The Bank must take into account information received from the PRA, as the competent authority, relating to the institution's business model, funding model and risk profile. Any adjustments will be made on a case-by-case basis. The Bank may also, if advised by the PRA, adjust the recapitalisation amount to reflect changes to any other capital requirement (including the leverage ratio requirement) that might apply immediately as a result of the resolution.

5 MREL instrument eligibility (external MREL)

5.1 In order for MREL resources to fulfil their intended purpose, it must be practically straightforward for the Bank to apply its stabilisation powers to them, including the bail-in stabilisation power.

5.2 The No. 2 Order sets out a number of requirements that liabilities must meet in order to qualify as MREL resources.[3] One of these is that the liability must have an effective remaining

[1] Those liabilities necessary for the continuity of a critical economic function.
[2] The BRRD provides for preferential treatment in insolvency of the part of deposits covered by the FSCS or another EEA deposit guarantee scheme, and secondary preference for uncovered eligible deposits of natural persons and small and medium-sized enterprises as well as deposits that would be eligible deposits from natural persons and small and medium–sized enterprises, were they not made through branches located outside the EU.
[3] See in particular Section 123(4).

maturity (taking account of any rights for early repayment available to the investor) of greater than one year.

5.3 In addition, the Bank expects institutions to consider the overall maturity profile of their externally-issued MREL resources, and to ensure that temporary difficulties in accessing debt issuance markets would not be likely to cause a significant breach of their MREL. The average maturity of institutions' MREL resources may decrease in periods of market stress, and the Bank does not intend to apply a minimum maturity requirement beyond that applicable under the Banking Act.

5.4 The No. 2 Order states that where a liability confers a right to early reimbursement upon its owner the maturity date of the liability shall, for the purposes of determining eligibility for MREL, be considered to be the first date at which such a right arises. The Bank expects institutions not to structure their MREL resources in such a way as to reduce their effective maturity, for example instruments which create incentives for the issuer to redeem them ahead of the contractual maturity date.

5.5 The Bank does not consider liabilities the value of which is significantly dependent on derivatives to be appropriate to qualify as MREL resources. Liabilities subject to contractual set off or netting arrangements are also not appropriate MREL resources.

5.6 Where a liability is governed by non-EEA law, the Bank will need to be satisfied that the liability could absorb losses and contribute to recapitalisation costs in resolution, having regard to the terms of the contract and legal opinions, in line with the BRRD.

5.7 The Bank will use its power of direction to specify the eligibility criteria for MREL for each individual institution. The Bank will seek to ensure that the eligibility criteria are applied consistently across institutions of a similar nature.

6 MREL in the context of groups

6.1 This section set outs the framework the Bank will use to determine the intragroup distribution of MREL.

6.2 The Bank will set an external MREL at the group consolidated level. In addition, the Bank will set individual MREL for all banks, building societies and 730K investment firms within the group. The Bank may also set individual MREL for entities that are important from a resolution perspective (for example holding companies) on an entity-specific basis.

6.3 The Bank will apply the following principles when setting MREL within groups:

(a) internal MREL resources must be subordinated to the operating liabilities of the group entities issuing them;

(b) internal MREL resources must be capable of being written down or converted to equity without or ahead of any use of stabilisation powers in relation to the operating entity which issues them; and

(c) internal MREL resources must be appropriately distributed within groups.

6.4 The Bank will require institutions (other than building societies) subject to a bail-in strategy to structure their liabilities to achieve structural subordination of external MREL resources issued by resolution entities. Building societies subject to a bail-in strategy will need

to subordinate their MREL resources contractually, given that structural subordination is not possible in light of their mutual ownership.

6.5 Resolution entities will be required to issue external MREL resources at least equal to all the internal MREL resources to be issued to them from their subsidiaries. The proceeds of this external MREL issuance will be invested in the MREL resources of those operating entities within the scope of the individual requirements.

6.6 The Bank will require internal MREL resources to be subordinated to senior operating liabilities at the individual entity level.

6.7 Internal MREL resources must be in scope of write down and/or conversion without the use of stabilisation powers on the relevant operating entity. Regulatory capital instruments in scope of the Bank's powers to write down and convert at the point of non-viability through a mandatory reduction instrument under the Banking Act would meet this criterion.

6.8 Internal MREL will be calculated on an individual basis in accordance with the MREL RTS framework (see section 3). In setting MREL, the Bank will consider the interaction between the consolidated external MREL and the internal MREL. The Bank may adjust the internal MREL set for an individual entity having regard to the consolidated MREL set for the group and to ensure that internal MREL resources are pre-positioned in the appropriate entities. The Bank does not expect to adjust downwards the internal MREL applicable to ring fenced bodies (RFBs).

6.9 The conversion to equity of internal MREL resources should not lead to unintended changes in the group's internal ownership structure. The Bank will consider subsidiaries' non-equity MREL resources in relation to such potential effects on group structures in resolution. The Bank will discuss the distribution of internal MREL resources with institutions as part of the MREL-setting process.

6.10 Intragroup distribution of internal MREL resources must ensure that sufficient loss-absorbing capacity is pre-positioned at the individual entities within the scope of MREL. The intragroup distribution must ensure that losses can be absorbed and passed up to the resolution entity or entities.

7 Transitional arrangements

7.1 The Bank is under an obligation to set MREL under the No. 2 Order from 1 January 2016. The MREL RTS allows lower MRELs to be set for up to 48 months (that is, until 1 January 2020).

7.2 The Bank expects to set MRELs lower than an institution's expected final MREL to allow time for transition. In most cases the Bank will expect institutions to conform with a final steady state MREL by 1 January 2020. MREL in 2016 will be set at the level of institutions' current minimum regulatory capital requirements.

7.3 Generally the Bank does not expect to set MREL greater than institutions' minimum regulatory capital requirements between 1 January 2016 and 31 December 2019 (31 December 2018 for G-SIBs). The intention of this policy is to allow institutions the maximum permitted flexibility over that period in the timing of changes to their liability structures in order to meet MREL. The Bank expects institutions to produce a plan for how they intend to meet their steady state MREL, and to discuss this plan with the Bank and the PRA.

7.4 The Bank may set an earlier conformance date and / or MRELs greater than capital requirements during the transitional period, for example where it has concerns about the resolvability of an institution, or to implement international standards.

7.5 The MREL RTS allows the MREL applicable to an institution to be reduced where that institution has entered resolution and been subject to stabilisation options. This allows MREL resources to be ‘used’ in resolution and for the institution (or its successor entities) to rebuild these resources over time. The Bank expects to reduce the MREL applicable to an institution which has been resolved as necessary, such that the institution would not be in breach of MREL immediately following resolution.

7.6 The Bank may also set ‘transitional’ MREL, including after the end of the initial transitional period, for institutions undergoing changes to their business which affect the resolution strategy applicable to the institution, and thus the necessary MREL.