ALERT MEMORANDUM

Internal MREL: The Bank of England Finalises Its Approach

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On June 13, 2018 the Bank of England ("**BoE**") published a policy statement and a statement of policy (the "**Statement**") on setting minimum requirements for own funds and eligible liabilities ("**MREL**") which updates its draft policy document published in October 2017. It includes the BoE's final guidance on the approach it will take to setting MREL issued by non-resolution entities within a banking group ("**Internal MREL**"). The Statement also implements the Financial Stability Board's ("**FSB**") total loss-absorbing capacity ("**TLAC**") standard.

The Statement does not have the force of rules but sets out the BoE's expectations regarding Internal MREL. It provides that Internal MREL requirements will be applicable to UK resolution entities which are globally systemically important banks ("**G-SIBs**") and to UK material subsidiaries of non-UK G-SIBs from January 1, 2019. It includes a number of clarifications to the draft policy document relating, in particular, to Internal MREL instrument eligibility conditions and, more broadly, whether structures proposed by in-scope institutions are compatible with its policy objectives. These may cause firms to revisit their approach to implementing the requirements.

The BoE also makes reference to EU proposals amending the Bank Recovery and Resolution Directive ("**BRRD2**") and the Capital Requirements Regulation ("**CRR2**"). Once implemented, these proposals will introduce Internal MREL requirements for EU institutions and may require changes to the Statement in due course.

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The BoE has statutory power to direct institutions to maintain Internal MREL pursuant to section 3A(4) of the Banking Act 2009. In anticipation of the exercise of this power, it published a consultation paper in October 2017 (the "**Consultation Paper**") which set out policy proposals as to how institutions might choose to satisfy their Internal MREL requirements. During the consultation period the BoE received feedback from a number of industry participants with respect to its proposed approach. As a result of this feedback, a number of clarifications have been made to the revised Statement. We summarise these below.

What has changed in the final Statement?

1. *Internal MREL: instrument eligibility conditions*

The Statement clarifies the eligibility conditions applicable to "*eligible liabilities*," that is, non-regulatory capital instruments intended to qualify as Internal MREL instruments. The most noteworthy clarifications relate to the holder of the Internal MREL eligible liabilities and the contractual trigger requirement.

a. *Holder of the instrument – issuance outside the ownership chain*

One of the most significant changes is to the requirements as to the holder of the eligible liability. In its Consultation Paper, the BoE suggested that "*internal MREL eligible liabilities must be issued either directly or indirectly via other entities in the same resolution group to the parent resolution entity*." The BoE suggested that indirect issuances to the resolution entity may be acceptable provided that conversion of Internal MREL to equity would not result in a change of control that could be an impediment to resolution. In the Statement, the BoE maintains this expectation and, in addition, states that "*direct issuance, or indirect issuance to the resolution entity that is not along the ownership chain"* could also be acceptable, provided that there are no technical obstacles to resolution. Examples of such technical obstacles include the possibility of a change of control (on conversion of the Internal MREL instrument to equity) or governance and tax issues associated with the write-down or conversion of Internal MREL instruments.

The final policy leaves the door open to issuance of Internal MREL to affiliates outside the ownership chain, subject to satisfying the BoE of any residual concerns it may have. This added flexibility is likely to be welcome for a number of institutions, whose capital and funding does not necessarily follow the chain of control up to the resolution entity.

b. *Contractual trigger*

In its Statement, the BoE maintains the expectation that Internal MREL eligible liabilities include a contractual trigger for the BoE to direct a write-down or conversion to CET1 of the Internal MREL eligible liability.

The language of the contractual trigger has significantly changed, however. The Statement continues to provide for triggers based on non-viability of the material subsidiary or resolution of the parent resolution entity. However, the former arm of the trigger provides that the BoE should be in a position to direct a conversion or write-down of internal MREL eligible liabilities where "*any own funds instruments of the material subsidiary have been written-down and/or converted into equity pursuant to any statutory or regulatory power linked to the financial condition or viability of the institution.*" The Consultation Paper previously provided that the BoE should have the right to exercise a write-down or conversion where "*the resolution authority determines that the institution is failing or likely to fail and will, disregarding any write-down and/or conversion of the instruments, continue to be so.*"

This change in approach suggests that the BoE will only exercise write-down or conversion where the material subsidiary is failing by way of the exercise of the statutory obligation to write-down and/or convert own funds instruments (such as those covered in sections 6A to 6B of the Banking Act 2009) at the point of non-viability.

We note that this revised contractual trigger diverges from the FSB TLAC term sheet and its guidelines on internal TLAC, which requires the internal TLAC issuer to be at the "*point of non-viability*" before the instruments can be converted to equity. Similarly, the US internal TLAC rules only allow US authorities to trigger the conversion of internal

TLAC instruments when the issuer is "*in default or danger of default*."

The BoE's approach also diverges from the latest compromise proposal from the Council of the EU on BRRD2, which contemplates the extension of this write-down power to Internal MREL eligible liabilities – which would render the trigger redundant.

The consultation draft of the Statement had required the inclusion of the contractual trigger in non-CET1 own funds instruments as well as eligible liabilities. The final Statement is more equivocal, indicating that institutions should consider whether the absence of triggers could create difficulties for resolution.

Both of these changes may have tax ramifications for the treatment of Internal MREL instruments for non-UK groups in particular, and may influence the choice of whether to include contractual triggers in non-CET1 regulatory capital instruments.

c. Write-down, conversion or both?

The consultation was not clear as to whether Internal MREL instruments should provide for power to effect contractual write-down *and* conversion, or whether one only of write-down *or* conversion would be sufficient to meet the BoE's expectations. The Statement makes a number of helpful clarifications in this regard. It indicates that, while the contractual trigger should afford the BoE with the opportunity to either write-down or convert, the BoE acknowledges that it would be willing to accept a contractual trigger providing *either* conversion into CET1 *or* a write-down feature provided that institutions which take this approach can demonstrate (i) that the inclusion of their preferred option credibly supports the group's resolution strategy for the passing of losses and recapitalisation need up to the resolution entity and (ii) that there is no technical obstacle to resolution in such circumstances (with examples of such a technical obstacle being change of control on conversion; governance issues or tax implications).

Additionally, the BoE clarifies that the contractual trigger should provide it with the opportunity to direct an immediate write-down or conversion. Accordingly, a contractual trigger providing for some delay to the write-down or conversion would not be acceptable.

d. Legal opinions

The final Statement anticipates that firms will obtain independent legal advice on a liability's eligibility as Internal MREL.

e. Form of agreement

The Statement further states the BoE's preference for including contractual trigger features in a single "*umbrella agreement*". This may be helpful for the BoE, but for institutions contemplating multiple instruments, an umbrella arrangement may prove complex to draft and administer.

2. Internal MREL: critical service providers

In the Consultation Paper, the BoE explained that it was considering the imposition of a loss-absorbing requirement for critical service providers within banking groups (with such entities being required to maintain financial resources equivalent to 25 per cent. of the annual operating costs of providing such services within their relevant group). This requirement has been removed from the Statement: the BoE notes that it expects to clarify its approach to loss absorption and operational continuity at a later stage.

3. Internal MREL: surplus MREL and calibration

The BoE previously proposed that surplus MREL (the difference between external MREL and the sum required to be issued to the resolution entity to absorb internal losses) should be held by institutions and be readily available to recapitalise any direct or indirect subsidiary in order to provide a lower calibration of Internal MREL in the hands of material subsidiaries (*i.e.* closer to the bottom of the 75% - 90% range provided by the FSB TLAC termsheet).

The BoE has decided not to set requirements as to the location or form of surplus MREL although it has noted that surplus MREL will be a factor that it considers when setting quantum for institutions. A further review of the treatment of surplus MREL will be the subject of a forthcoming consultation by the BoE.

4. *Internal MREL: co-operation with overseas resolution authorities*

The BoE has confirmed that it will liaise with overseas resolution authorities through crisis management groups, resolution colleges and other appropriate forums to enable joint decisions to be reached with respect to relevant institutions.

This statement is made notwithstanding the fact that the BoE has made it clear that it will proceed with setting the quantum of Internal MREL for non-UK material subsidiaries of UK groups where the "*host authority has not published regulations or regulatory proposals*" as to Internal MREL. The BoE appears to intend pre-positioning of Internal MREL in non-UK material subsidiaries.

5. *External MREL: issuances of own funds instruments by a non-resolution entity subsidiary*

In its Consultation Paper, the BoE stated that external issuance of MREL from non-resolution entity subsidiaries is likely to constitute an impediment to resolution. The final Statement appears to depart slightly from this view. The Statement notes that the FSB TLAC term sheet provides that externally issued non-CET1 own funds instruments should not count towards internal TLAC from January 1, 2022, but that currently under the Bank Recovery and Resolution Directive such instruments may count towards group consolidated MREL. However, the Statement notes that institutions should consider whether conversion to CET1 of such instruments could lead to a change in control of the subsidiary, and that the BoE may consider any challenges to resolvability presented by these instruments. The Statement further provides that existence of such instruments from January 1, 2022 that are counted as MREL may lead the BoE to set a higher end-state MREL to compensate for those issuances. Notwithstanding the slightly more equivocal tone of the final Statement, it appears likely that the BoE will continue to incentivise institutions to redeem such instruments by imposing additional MREL requirements where they are left in place.

Next steps

The Internal MREL requirements will apply from January 1, 2019 for G-SIBs, and from January 1, 2020 for other institutions. Affected G-SIBs will need to prepare for issuance (or repapering), including structuring, regulatory liaison and obtaining approvals over the second half of the year. Institutions proposing to depart from the model contemplated by the Statement are also likely to need to undertake further advocacy to provide the BoE with detailed explanations as to how its policy objectives will be satisfied and agree the structure.

Interplay with BRRD2 and CRR2

The European risk reduction package, including changes to the BRRD2 and CRR2, is expected to be finalised in the second half of this year. Once CRR2 and BRRD2 are implemented, their provisions relating to Internal MREL will be binding on EU institutions. There are, at present, inconsistencies between the Statement and CRR2 and BRRD2. In particular, the latest compromise proposal from the Council of the EU on CRR2 requires material subsidiaries of non-EU G-SIBs that are not resolution entities to issue Internal MREL instruments (both non-CET1 regulatory capital instruments and eligible liabilities) to "*the parent undertaking of the institution in a third country*," which is considerably more restrictive than the Statement and would ban issuance of Internal MREL to affiliates. Institutions should monitor the current proposals as they pass through the European legislative process. Where such inconsistencies are not resolved, additional work may need to be done to ensure compliance with the EU Internal MREL rules. The BoE states that it will assess as necessary whether to make any changes to its MREL framework as a result of amendments under BRRD 2 and CRR2.

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