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Richard Williams
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Bank of England
Threadneedle Street
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United Kingdom

Internal MREL – Consultation on a proposed updated Statement of Policy

Dear Mr. Williams:

The Institute of International Finance (IIF)[1] welcomes the Bank of England's (the Bank's) consultation on a proposed updated Statement of Policy on 'Internal MREL – the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups, and further issues'. As a global association of financial institutions, the IIF has focused on the international implications of the Bank's proposal and the likely effects it will have on the development of the international regulatory agenda, effective resolution, cross-border cooperation and financial stability.

We concur with the Bank that the tools are now in place to resolve a bank by imposing losses and recapitalization needs on its shareholders and creditors without disrupting the critical functions the firm provides to the economy. Setting internal MREL is one of the final endeavors in implementing the Financial Stability Board's (FSB's) *Key Attributes of Effective Resolution Regimes for Financial Institutions*[2] (Key Attributes) which provide a sound basis for the resolution of a major cross-border bank. The IIF has consistently supported the *Key Attributes* approach to resolution.[3]

Internal MREL is an important tool to allocate losses to the resolution entity (or entities) within a banking group while maintaining critical functions on an operational level and preventing contagion within the group and beyond. In determining the level of internal MREL authorities have to reconcile different policy objectives.

[1] *See* the Appendix for a description of the IIF.
[2] *FSB*, Key Attributes of Effective Resolution Regimes for Financial Institutions (2014); available at http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf.
[3] See *IIF / GFMA*, The associations' Submission Re: FSB Consultative Document On Cross-Border Recognition Of Resolution Action, FSB Consultative Document On Guidance On Cooperation And Information Sharing With Host Authorities Of Jurisdictions Not Represented On CMGs Where A G-SIFI Has A Systemic Presence; available at https://www.iif.com/file/7060/download?token=6h71moTA.

The need to strike a balance

As the Bank correctly explains in their consultative document "(p)utting these resources (referred to as 'internal MREL') into the right parts of the group reduces the risk that if a subsidiary makes substantial losses, the rest of the group is unwilling or unable to inject additional resources. In an international group, it also helps provide comfort to overseas regulators and resolution authorities that there will be sufficient resources to meet losses in their local subsidiaries as well as at the group level to make the resolution credible and to avoid the need for authorities in these host jurisdictions to have to take independent resolution action in respect of the subsidiaries."[4]

On the other hand, banking groups benefit in robustness and flexibility to the extent they have the ability to deploy resources globally within the group. As a matter of principle, group supervision is based on the idea that the failure of a member of a bank group can have a powerful negative effect on the solvency and creditworthiness of other group members and the group as a whole. To counter this risk resources are pooled at a parent level in order to be able to provide support when and where needed within the group. However, assets that are pre-positioned at material subsidiaries are likely to be trapped by host authorities and unable to be readily deployed to recapitalize other material subsidiaries during periods of material financial distress. As a result, excessive pre-positioning of assets is harmful in that it decreases the amount of surplus TLAC/MREL that can be relied upon to recapitalize material subsidiaries, including material U.K. subsidiaries, when, as and where needed. Internal TLAC/MREL which is committed to a certain group member by definition reduces the resources available for any other group member. Consequently, the more internal TLAC/MREL is committed to certain group members, the greater the risk becomes of that group member failing as a result of shortfalls in other group members. This leads to the conclusion that raising internal TLAC/MREL levels beyond a certain level on one group member increases the risk of default of every group member.

More specifically, a lack of flexibility to deploy available resources where needed within a group can give rise to 'misallocation risk', i.e. the risk that the distribution of internal MREL does not match the distribution of losses in an actual financial distress scenario. Resources within a group might be over-committed to one subsidiary, at a time when such resources might be needed to support another part of the group, whether for safety and soundness or for economic efficiency reasons. Unnecessarily restricting excess resources that could be used to shore up other group entities can lead to a loss of resilience at key legal entities. Even more importantly, such restrictions may have broader repercussions on financial stability if contagion spreads within an international banking group and thus within the global financial system and leads to a loss of confidence in its other entities around the world.[5] Indeed, recent research has shown that the effects of multiple ring-fencing regimes can increase the risk of bank failure significantly[6] with adverse implications for global financial stability.

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[4] *Bank of England*, Internal MREL – the Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL) within groups, and further issues - Consultation on a proposed updated Statement of Policy, October 2017, p. 5; available at: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution /internal-mrel-consultation-october-2017.pdf?la=en&hash=33594C3FB3C7F1D129033AFE4E3A2BF20A4F9AA8.

[5] See *IIF / GFMA*, Response to FSB Consultation on Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs ("Internal TLAC", p. 6; available at http://www.fsb.org/wp-content/uploads/Institute-of-International-Finance-IIF-and-Global-Financial-Markets-Association-GFMA2.pdf.

[6] See *Ervin, Wilson D.*, The Risky Business of Ring-Fencing, Working Paper, December 12, 2017; available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3085649.

In trying to strike a balance, the introductory discussion of internal TLAC in the FSB's Consultative Document's had appropriately called for an amount that would provide "sufficient comfort for host authorities that sufficient resources are available to absorb losses in material subsidiaries but provide some flexibility to deploy non-prepositioned internal TLAC as necessary across the group in resolution."[7] While the reassurance of hosts is vital, it needs to be balanced against the interests of home regulators and consolidated supervision, as well as the system as a whole, in avoiding misallocation risk and unnecessary ring-fencing. It is vital to provide appropriate flexibility in the deployment of resources to assure the resilience of groups and the efficient use of resources in the system. The flexibility to deploy resources where they are most needed is particularly important in times of stress. Host countries ultimately benefit from such increased resilience.

Both home and host regulators have an interest in having enough resources in the local subsidiary that the host country can assume it will never be in the interests of the group – or of the home supervisor – to allow the subsidiary to fail and be liquidated. From that point of view, it is hard to see why more than 65-75% of comparable external TLAC/MREL would be necessary to establish such 'skin in the game'. A higher requirement, certainly at the 90% level, would seriously constrict the flexibility required to move resources to avoid difficulties that may arise in one market or another. This kind of misallocation creates the risk that – even if the firm overall remains fundamentally strong – one or more entities within a group could become distressed or even trigger the failure of the group in extreme cases. By contrast, a more moderate requirement would give greater assurances of flexibility to the global system.[8]

Excessive internal TLAC/MREL requirements may reflect preemptive ring-fencing of resources that is inefficient and unnecessary under most circumstances. As some jurisdictions have already set their requirements at the high end of the 75-90% range, the industry had expressed concern that other host regulators may feel induced unnecessarily to ring-fence material subsidiaries without the requisite consultation and cooperation of home authorities.[9]

The Bank of England's approach

Against the backdrop of these considerations, the IIF supports the Bank of England's proposal to calibrate internal MREL based on a starting point of 75% of external MREL — i.e., at the low end of the FSB's 75% to 90% range according to the FSB's TLAC Term Sheet[10]. A starting point of 75% strikes a reasonable balance between the amount of pre-positioned internal MREL and the amount of surplus MREL/TLAC at the top of the group, which can be used to recapitalize material subsidiaries when, as and where needed. This will enable banking groups to mitigate the misallocation risk. Making such funds available does not only increase the resilience of the single banking group but also strengthens the stability of the global financial system.

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[7] *FSB*, Adequacy of loss absorbing capacity of global systemically important banks in resolution – Consultative Document, 10 November 2014, p.8; available at: http://www.fsb.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

[8] See *IIF / GFMA*, IIF-GFMA Joint Comments - FSB Consultation on Adequacy of loss-absorbing capacity of global systemically important banks in resolution, February 2, 2015; available at: https://www.iif.com/system/files/20150202_cl_tlac.pdf.

[9] See *IIF / GFMA*, supra (note 5).

[10] *FSB*, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution, Total Loss-absorbing Capacity (TLAC) Term Sheet, 9 November 2015; available at: http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

In addition to reducing misallocation risk, the Bank's proposed 75% starting point mitigates another key risk of excessive pre-positioning — the risk that other host authorities will, as a result of a collective action problem, set internal MREL/TLAC requirements above the optimal level. If a host authority believes that other host authorities will require an excessive amount of internal MREL or TLAC, effectively trapping any corresponding pre-positioned assets in those other host jurisdictions, any host authority will face a strong incentive to also impose internal MREL/TLAC requirements at excessive levels. If most, or all, host authorities were to act independently to require an excessive amount of internal MREL or TLAC for their jurisdictions, this would deplete the surplus MREL/TLAC and the corresponding assets held at the top of the group, which would otherwise be available to recapitalize material subsidiaries, thereby aggravating misallocation risk and negative repercussions on global financial stability. Resolution authorities find themselves exposed to a prisoner's dilemma: Every prisoner tries to prevent the worst outcome and thus only achieves a second-best solution for themselves. However, the classical prisoner's dilemma assumes that the parties cannot communicate and cooperate.

By making the scaling of internal MREL/TLAC requirements by other host jurisdictions a factor for consideration in its own calibration of a material U.K. subsidiary's internal MREL, the Bank has acknowledged this collective action problem and issued a constructive call for international cooperation and coordination. The IIF strongly supports this approach. We are convinced that international cooperation is best suited to strike the balance between legitimate national interests in preserving operational continuity and the interests of banking groups in maintaining flexibility to tackle misallocation risks and thus preventing contagion within the group and beyond. We encourage resolution authorities around the globe to enter into a constructive dialogue with the aim to come to an agreement that reflects the Bank's policy approach on an international scale. We concur with Governor *Mark Carney* that "(t)he combination of robust international standards and trust built through transparent implementation and intensive supervisory cooperation can create a system of enhanced equivalence and mutual deference. Such an approach would allow capital to move more freely, efficiently and sustainably between jurisdictions. (…) This high road leads to more jobs, higher sustainable growth, and better risk management across the G20. But there is another path – the low road – where trust and cooperation diminish, fragmentation hardens, capital flows are disrupted, and trade and innovation are curtailed."[11]

The IIF also supports the Bank's approach not to impose a separate minimum internal debt requirement in addition to its proposed internal MREL requirement, but rather allow the entire internal MREL requirement to be satisfied with equity capital. In particular, we welcome the Bank's approach not to require firms to issue a certain minimum of long-term debt. Granting firms the flexibility to satisfy their internal MREL requirement through own funds or through a combination of own funds and eligible liabilities facilitates compliance in a cost-efficient manner by recognizing different business models.

The IIF's Recommendations

While we support the Bank's proposal to calibrate internal MREL based on a starting point of 75% of external MREL, we note that the internal MREL requirement in practice ultimately will depend on the corresponding external MREL requirement. Importantly, the Bank's approach deviates from

[11] *Carney, Mark,* The high road to a responsible, open financial system, April 7, 2017, p. 8, available at: https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/the-high-road-to-a-responsible-open-financial-system.pdf?la=en&hash=0264C2348F1C0E8225C7ACCC83ABF85AE827394A.

the FSB's recommendation in so far as it also involves the buffer provided by Pillar 2A. The Bank's fully phased-in external MREL requirement based on a risk-weighted assets (RWA) measure amounts to 2x(Pillar 1 + Pillar 2A). Because Pillar 2A is firm-specific, the internal MREL requirement for each material U.K. subsidiary will vary based on its Pillar 2A figure. Under certain circumstances the effective internal MREL requirement under the Bank's approach can exceed the internal MREL figure that would result by applying the upper bound of the FSB's 75%-90% range to the FSB's calibration for external TLAC at 18% of RWAs. Given that Pillar 1 in the European Union has been set at 8% of RWAs[12] this is the case if the Bank's Pillar 2A exceeds 2.8%. As a result, and although the Bank calibrated its internal MREL requirement at the low end of the FSB's 75% to 90% range, the actual internal MREL requirement will for many firms be at the FSB's high-end or even higher.

In addition, as the Bank recognized in its consultation, the requirement for material U.K. subsidiaries to calculate their capital requirements at the subsidiary level, which includes intragroup exposures that would net out at the group level, results in double counting and therefore a higher internal MREL calibration across the firm.

Although we support the Bank of England's proposal to calibrate internal MREL at a starting point of 75% of external MREL, we recommend that the Bank applies this percentage to a figure that is in line with the FSB's standard (i.e. 18% of RWA) and excludes intra-group liabilities, provided the firm operates on a single point of entry (SPE) strategy with a credible and funded resolution plan.

The Bank's laudable approach to calibrate internal MREL at the low end of the 75% to 90% range – provided other resolution authorities follow the same logic – would improve bank safety and resilience, because a lower requirement helps build a larger 'central reserve' that can be allocated wherever it is needed. However, improved resilience and a level playing field can only be achieved if the 75% is multiplied against an internationally consistent baseline. Further, the ultimate numerical requirement should not be inflated by gold-plating RWA or by requiring additional buffers, both of which could lead to the same problem of excessive capital trapping and lower overall resilience.

In the interest of international consistency, the IIF highly encourages resolution authorities worldwide to use the FSB's minimum standard as defined in the TLAC Term Sheet[13] as the correct benchmark, and to calibrate internal TLAC/MREL at the lower bound of the 75% to 90% range against that figure. This would provide ample local resources (and ensure strong home country support to protect this investment), while helping to build more resilience and safety into the overall group structure while fostering global financial stability.

Finally, the IIF has some concerns about the Bank's proposals in relation to loss absorbing capacity for operational continuity. In particular, the proposal states that the loss absorbing requirement would apply to "each provider of critical services within the group". This approach would have a significant extra-territorial effect as services are often provided by a number of different entities within a banking group. A large range of entities would be required to maintain loss absorbing resources even though only a small fraction of their services is provided to the U.K. entity. Further, we are concerned that the 25% loss absorbing requirement relates to total operating costs which would include the cost of non-critical services. In our view, a proportionate approach would be to

[12] See Article 1 (a) (iii) Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities; available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1450&from=en.
[13] See *FSB*, supra (note 10), No. 4 (p. 10).

apply the policy primarily to U.K.-based service providers. Cross-border requirements should be agreed upon with the relevant resolution authorities. The 25% loss-absorbing requirement should also be amended so as to only apply to the costs of providing critical services.

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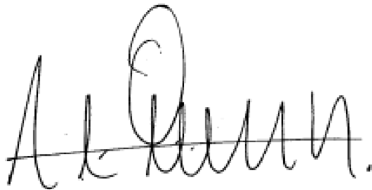
The IIF and their working groups stand ready to support the Bank of England in its ongoing effort to improve cross-border resolution. Should you have any comments or questions on this letter, please contact Andrés Portilla (aportilla@iif.com) or Thilo Schweizer (tschweizer@iif.com).

Very truly yours,



Andrés Portilla

CC: Mr. Mark Branson, Swiss Financial Market Supervisory Authority
Mr. Mark Carney, Financial Stability Board
Mr. Martin J. Gruenberg, Federal Deposit Insurance Corporation
Mr. Ryozo Himino, Financial Services Agency
Ms. Elke König, Single Resolution Board
Mr. Randal Quarles, Board of Governors of the Federal Reserve System

APPENDIX: Description of the Institute of International Finance

The Institute of International Finance (IIF) is the global association of the financial industry, with close to 500 members from more than 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks. For more information, please visit http://www.iif.com.