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All Party Parliamentary Group on Challenger Banks and Building Societies
c/o APPG Secretariat: Barndoor Strategy

28 April 2021

Metro Bank response to All Party Parliamentary Group on Challenger Banks and Building Societies Inquiry into post Brexit regulation in banking services

Dear APPG Members,

We greatly welcome your review into post Brexit regulation in banking services.

In particular, we would like to bring to the attention of the inquiry one specific issue regarding the UK's resolution regime and how this limits our ability to better support the efforts to rebuild the economy post-Brexit and post-pandemic. The UK's resolution regime currently acts as a barrier to growth and impedes the ability of mid-tier and specialist banks to compete with large UK banks – as further outlined in the letter (of 20 April 2021) to the Chair of the APPG on Challenger Banks and Building Societies from a number of mid-tier banking sector CEOs.

You may be aware that the Bank of England has recently published a Discussion Paper on the review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL)[1]. We want to work with all stakeholders to construct an appropriate and proportionate MREL regime, which delivers the Bank of England's resolution objectives, while also promoting healthy competition in the banking sector.

It is critical that the UK financial system should be prepared for, and be resilient to, the wide range of risks it could face. At the same time, a strongly competitive mid-tier banking sector is a critical component of the future growth and prosperity of the UK economy, especially as we enter a post-Brexit environment and post-coronavirus recovery.

While the regulatory regime has been strengthened significantly over the past decade, the ability of Metro Bank to support UK consumers and businesses remains hampered by the barriers to growth that we – and other mid-tier organisations – face as a result of the present structure of the MREL regime.

We have therefore set out a series of recommendations intended to reform MREL without compromising the safety of the banking system. We believe that these recommendations can address unintended consequences created by the MREL regime which were not fully understood when the regime was first established in 2016.

Context

It has never been more important that the UK financial system is prepared for, and resilient to, the wide range of risks to which the banking sector is exposed. Metro Bank accordingly supports the objectives of the UK's resolution framework: resolution reduces the risks to depositors, the financial system and the taxpayer that could arise from the failure of a bank. Metro Bank also recognises that MREL is a critical element of an effective resolution regime. Requiring systemically important banks in the UK to hold additional capital to ensure the stability of the industry for the protection of depositors and taxpayers is the right thing to do.

However, the current approach to setting MREL creates a number of unintended consequences for the UK banking industry that ultimately harm competition and its ability to deliver for consumers and businesses.

As the PRA's Annual Competition Report[2] explains: 'competition intensity was strong in the mid-1990s, following a notable period of deregulation in the 1980s. Competition became less intense in the early 2000s

[1] https://www.bankofengland.co.uk/paper/2020/boes-review-of-its-approach-to-setting-mrel
[2] https://www.bankofengland.co.uk/-/media/boe/files/annual-report/2020/pra-2020.pdf?la=en&hash=FA3ACE22B2A28BEC0A029B92FBA0340F9FB62248

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and decreased in the period immediately ahead of the financial crisis (2003/07), and also fell during the 2007/09 financial crisis. Since that time, competition intensity has remained subdued at levels below those evident just before the financial crisis, and notably lower than those recorded in the mid-1990s.'

The last 20 years have seen significant consolidation in the UK retail banking market. Much of this occurred following the global financial crisis, when a number of failing banks were either merged or acquired. By 2018, fifteen of the banks and building societies which existed in 2000 were absorbed into six major groups: LBG, Barclays, RBS, HSBC, Nationwide and Santander. As a result, the structure of UK retail and commercial banking is concentrated, with a notable absence of mid-tier competitors of scale.

The importance of a strong mid-tier

A lack of competition across the sector ultimately impacts on the quality of products and services that customers receive, and results in a lack of switching due to little differentiation between the larger providers that dominate the market.

As demonstrated by the Competition and Market Authority's Service Quality Surveys, it is mid-tier providers that consistently deliver better service across all categories compared with the larger institutions. For example, Metro Bank is the number one rated high street bank for service quality for the sixth time running[3] and we have continued to open new stores to support communities at a time when other banks are reducing the size of their branch networks.

As the UK's original challenger bank, Metro Bank has grown over the past 10 years to serve more than two million customer accounts, and it is clear that our focus on customer service and our full service offering resonates with customers.

Throughout the Covid-19 pandemic, the mid-tier banking sector has played a vital role in supporting consumers and businesses as they face the greatest economic shock in a generation. Our sector is ready to support the UK's post-Covid recovery and the government's levelling up agenda. Metro Bank's customer focus and scale means we are more closely embedded in the communities we serve, providing a more tailored service to people and businesses. We are proud of this track record of delivery and want to do more.

Small businesses have diverse needs and require individual support to grow. Metro Bank, together with other mid-tier organisations, is well positioned to help small businesses by virtue of its focus on this segment and its personalised underwriting and service. We are committed to maintaining a strong regional presence — for example, through Metro Bank's store network in the North of England.

The unintended consequences of the MREL regime

The current approach to setting MREL causes a number of interconnected and unintended consequences.

The regime creates a barrier to growth for mid-tier organisations, harming competition in the sector to the detriment of customers

The current approach to setting MREL creates a substantial barrier to growth for mid-tier organisations seeking to challenge the large incumbent banks.

As mid-tier organisations grow, we need to continue to invest in competitive products, services and supporting infrastructure. But, our experience has shown that the resulting regulatory requirement for increased MREL debt can be met only by paying a punitive coupon. This significantly influences our decision-making and affects our asset strategy — evidenced, for example, by our decision in December 2020 to meet our MREL requirement by selling a portion of our residential mortgage portfolio to NatWest rather than by attempting to

[3] https://www.metrobankonline.co.uk/bank-accounts/i-want-some-information-about/personal-service-quality/

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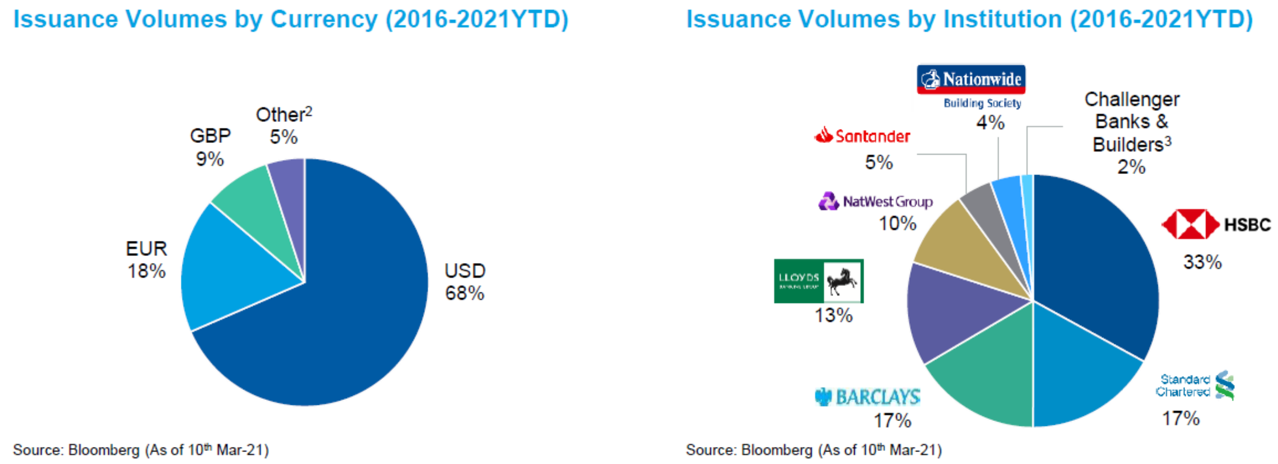
issue further MREL eligible debt.

If the MREL regime in the UK were aligned with the EU criteria (i.e. setting the threshold at €100bn, equivalent to c.£85bn) and our existing / ongoing MREL requirements were removed, Metro Bank would instead be able to open 40 more stores serving local communities in the North of England, extend c.£3bn extra in lending for small businesses, and create 1,000 more jobs.

The regime leads to market distortion, given limited access to capital markets and high cost of borrowing for mid-tier firms, exacerbating instability in times of stress

The large UK banks have long established debt issuance programs, issuing into a wide range of USD, EUR and GBP markets. Mid-tier UK banks do not have similar market access and are typically limited to issuing in the GBP market to a more limited set of investors. As can be seen from the charts below, the GBP market accounts for just c.9% of MREL debt issuance since 2016, and the mid-tier banks account for only 2% of that restricted GBP market.

Figure 1 Issuance volumes by currency and institution since 2016, for HoldCo senior issuance (and senior non-preferred issuance from building societies)



Notes:
1. Includes HoldCo Senior issuance from SANUK, LLOYDS, BACR, HSBC, STANLN, NWG, VMUKLN, COOPBK, MTROLN, YBS, LEED, TSBLN). Includes Senior Non-Preferred issuance from NWIDE, YBS, LEED, COVBS, SKIPTN. Issuances >£200m from Jan 1st 2016 – Mar 10th 2021.
2. Other: AUD, CAD, CHF, JPY and NOK.
3. Challenger Banks: VMUKLN, TSBLN, MTROLN, COOPBK. Builders: SKIPTN, LEED, COVBS, YBS.

To illustrate this point further, in 2019 UK banks issued £34 billion of MREL-eligible debt, but only £9 billion (the remainder being AT1 and Tier 2) was issued in GBP — and, of the sterling issuance, only £1 billion was issued by mid-tiers.

The result is that UK mid-tier banks are beholden to a relatively small number of investors who are able to dictate the terms on which they will provide MREL finance. In other words, this is a buyer's market.

The Bank of England's discussion paper on MREL notes that 'during 2020, UK G-SIBs (globally systemically important banks) and D-SIBs (domestic systemically important banks) issued MREL eligible liabilities with an average coupon of 2.3%'. However, in contrast to the discussion paper's assertion that mid-tier banks have issued MREL debt at coupons only 'slightly higher' than larger competitors, the fact is that mid-tier banks, like Metro Bank, have had to pay much higher rates than the larger banks. Comparing the coupon rate for mid-tiers with that of larger banks over the past four years demonstrates that large banks achieve a weighted average coupon of c.2.5%, whereas the weighted average coupon for mid-tier banks has been c.4.5% – a rate differential of 80%. Moreover, this delta is exacerbated in times of stress, as evidenced by Metro Bank's MREL issuance in 2019 at 9.5% coupon, and the Co-operative Bank's issuance at 9.0% in 2020.

In times of stress – either idiosyncratic or market driven — the equity-like MREL debt coupons demanded in this thin market will compound any stress an institution might be facing. This can further accelerate potential instability and hamper future growth prospects for firms that are otherwise well funded and solvent.

Furthermore, paying a high MREL coupon obviously constrains our ability to invest into new products and services for customers.

In short, the thin capital markets for UK mid-tier MREL debt, combined with the current MREL rules, discourage sustainable, organic growth and create pressure instead for consolidation, as challengers and mid-tier organisations are forced to seek the support of parent companies to secure lower MREL borrowing costs.

The regime creates an uneven playing field for investment into the UK compared with the rest of the world

A regulatory regime out of kilter with the rest of the world also creates an uneven playing field. If capital requirements due to MREL are higher for UK mid-tier banks compared to similar banks in other developed countries, this is likely to limit potential inward investment to banks in the UK and creates a direct disadvantage compared with our European competitors.

Alongside this, overseas investors are deterred from investing in the UK mid-tier sector by the complexity of the current UK regulatory regime – with a number of different regulatory requirements set at different thresholds (for example, the MREL trigger point is £15bn of total assets, the trigger for ring-fencing is set at £25 billion of retail deposits, whereas the triggers for both the leverage ratio and annual stress testing exercise are set at £50 billion of retail deposits).

The current structure of the MREL regime

We believe that the unintended consequences described above are ultimately caused by the following:

1. Lack of clarity on when the MREL regime applies

Transparency of prudential rules and regulations for banks is essential for markets to function effectively. The current MREL regime does not provide clarity for those firms close to triggering an MREL debt requirement, leaving them unable to determine when the regime will apply to them and how best to plan for it. Similarly, this obfuscates investor understanding of the pathway to MREL.

2. Transition period too short

The transition time from an insolvency resolution strategy to a bail-in strategy – currently at three years – does not recognise the time firms will require to build a new franchise in the debt capital markets and future refinancing risks they will continue to face on a cyclical basis.

3. £15bn threshold / attachment point

The current thresholds are vastly out of kilter with international comparators and are greatly below the levels that would be representative of a systemically important bank in an economy of the UK's scale.

In the UK, the MREL threshold is set at £15bn – in the context of an economy with GDP of more than £2tn. The UK's threshold is set lower than any other economy in the developed world. As shown in *Figure 2*, in the Eurozone, the requirement to raise loss-absorbing debt applies only to banks with assets over €100bn. In the US, the threshold is $250bn. Considering these thresholds as a proportion of total deposits in that regime demonstrates that an EU bank has to be c.40% bigger compared with a UK bank, before it requires MREL.

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Figure 2 MREL / TLAC thresholds in different jurisdictions

Criteria	UK	Eurozone	Canada	Hong Kong	Japan	Switzerland	US
Resolution strategy	Bail-in	Bail-in	Bail-in	Bail-in	Bail-in	Bail-in	Bail-in
Number of "transactional" accounts	>40,000	n/a	n/a	At HK Monetary Authority's discretion	n/a	n/a	n/a
Balance sheet size	>£15bn	>€100bn (>c.£89bn)	All G-SIBs / D-SIBs (smallest balance sheet £165bn)	All D-SIBs (smallest balance sheet £91bn)	Covered SIBs (smallest balance sheet £311bn)	G-SIBs	G-SIBs >$250bn (>£200bn)
% of total deposits* (approx. at 31 Dec 2020)	0.3%	0.7%	6.0%	6.0%	3.5%	-	1.6%

G-SIBs: globally systemically important banks
D-SIBs: domestic systemically important banks
**Sourced from Bank of England, ECB, OSFI, HKMA, Bank of Japan, and Federal Reserve Board (deposits converted to US dollars using FRB end-period rate).*

4. Cliff-edge nature of capital requirement

The minimum capital requirement plus recapitalisation creates a significant cliff edge for mid-tier institutions and is not proportionate to the level of risk associated with the institution, nor the increase in the level of risk that arises by an institution moving across the threshold.

Reaching the MREL threshold sees a bank's capital requirement effectively double in a short time-period. It is simply not feasible for an organisation to deliver sufficient earnings potential via organic growth in order to fund this rapid increase in its capital requirement. Therefore mid-tier banks have little choice other than to issue potentially expensive MREL eligible debt capital, or grow through merger or acquisition.

5. Formulaic nature of capital requirement despite evolving regulatory landscape

UK banks are much better prepared for recovery and resolution than ever before. This has been facilitated by a robust regulatory regime including for example, ICAAP, ILAAP, stress testing, ring-fencing, and recovery planning, together with the emerging Resolvability Assessment Framework – many of which have been introduced, strengthened and/or matured significantly since MREL was first consulted on. In this context, it is not appropriate that end state MREL requirements of 2 x (Pillar 1 capial +Pillar 2A capital) remain unchanged. The additional levers that the wider regulatory regime provides should be used by the PRA and Resolution Authority, working in unison to ensure synergies are captured, understood and taken into account as a more proportionate, risk sensitive MREL regime is developed.

6. Activity-based measure

In the UK, the MREL activity-based threshold is set at 40,000 transactional accounts. This compares to there

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being more than 70 million current accounts in the UK. We are not aware of any other country which uses a transactional accounts measure in setting its MREL or equivalent.

By its nature, retail banking is a largely high fixed cost business, for example owing to the significant cost to run the required corporate functions associated with being a regulated business and the cost of operating a physical store network. However, this fixed cost base can only be leveraged to generate adequate shareholder return over many years as a bank continues to scale.

Instead the activity-based measure disincentivises scale and new entrants to the market – limiting material benefit for UK consumers and small businesses. Indeed a number of organisations in the sector have chosen to fund themselves via fixed term deposit accounts only, instead of entering the current account market to avoid triggering this threshold.

Furthermore, consumers are now increasingly more multi-banked than was evident in the past, with many individuals having more than one account characterised as a transactional account for MREL purposes. This, together with the prevalence of the Current Account Switching Service, would mean that greater operational continuity could be provided in the event of a resolution scenario.

7. Cost of MREL borrowing and access to debt markets

As set out in the unintended consequence section above, the requirement for mid-tiers to access debt markets leads to high cost of borrowing, due to the necessity to issue to domestically focused investors with awareness of the UK mid-tier banking sector, and in pounds sterling, instead of the much deeper US dollar and Euro markets.

8. Unfunded deposit protection scheme

Part of the reason why UK banks and building societies are required to hold MREL on significantly smaller balance sheets, when compared to European and US markets, is undoubtedly that the UK does not have a pre-funded deposit protection scheme, and that taxpayers are consequently 'on the hook' for a large part of the liabilities arising from a bank failure.

It may therefore be helpful to consider the purpose of the Financial Services Compensation Scheme (FSCS) and to evaluate alternative funding models for it, focussing on ways to protect public funds, whilst reducing the application of MREL requirements amongst mid-tier firms.

Looking ahead

Our analysis leads us to propose a series of potential solutions for consideration:

1. Ensure that the regime and thresholds are clear and transparent to ensure banks can adequately plan and prepare for when they will be captured by the regime;
2. Increase the transition period for banks entering the MREL regime from the three years currently allowed to 10 years – and in enabling a more staggered approach to the debt issuance this would also help reduce some of the refinancing risk;
3. Adjust the threshold to align to other existing size-based thresholds alongside global standards;
4. Remove the cliff-edge nature of the approach;
5. Review and reduce the 2x (Pillar 1 capital +Pillar 2A capital) requirement in light of the strengthened wider regulatory landscape without compromising the safety of the banking system, to better reflect the risk and level of losses a firm would pose in resolution and the amount of capital they would require to be re-capitalised post-resolution, as opposed to taking a formulaic, generic approach;
6. Remove the activity-based measure associated with MREL;
7. Identify a funding solution to address the unintended high cost of borrowing that mid-tiers experience. This could be facilitated, for example, via a competition subsidy levied upon the large incumbents – who benefit from the lack of competition that the MREL framework creates, or a solution that sees MREL costs for mid-

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tiers capped at a reasonable coupon e.g. underwritten by larger banks;

8. Review the use of the bank corporation tax surcharge or an account based levy similar to that seen in the US in order to provide pre-funding for the deposit protection scheme. We would also be supportive of an appropriate fee structure that contributes towards building up the FSCS over time.

We very much appreciate your support in bringing this issue to the fore through your inquiry and would greatly welcome the opportunity to meet with APPG Members if helpful to discuss our concerns and also these potential remedies.

Finally, if I or my team can be of any assistance now or in the future, don't hesitate to get in touch.

Yours sincerely,

Daniel Frumkin
Chief Executive Officer
Metro Bank