



# MREL: Financial implications for mid-size and challenger banks

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# Introduction

One of the biggest issues on the horizon of UK mid-tier banks is the impact of plans to include them in scope for the minimum requirement for own funds and eligible liabilities (MREL) regime. This ensures a minimum amount of equity and subordinated debt that banks must maintain to support an effective resolution. MREL was introduced to ensure that banks can fail safely by having extra capital that would allow an orderly transition as the Bank of England (BoE) decides the appropriate course of action. It is seen as a vital part of resolution, in avoiding taxpayer rescues and giving enough breathing space to allow failing banks to be rescued.

In March 2021, the EY Challenger and Specialist banking team in the UK published a paper addressing some of the issues that could impact mid-tier firms under [MREL](#). We introduced the different resolution strategies and mechanisms, and started highlighting the potential impacts on smaller players and their ability to compete and continue to grow in the market. With this paper, we aim to quantify those impacts, estimating what the cost of MREL for mid-tier banks would be and the impact that could have.

On 22 July 2021, the BoE published a Consultation Paper (CP): The Bank of England's review of its approach to setting a minimum requirement for own funds and eligible liabilities (MREL). Responses to the CP are due by 1 October 2021.

In the current uncertain economic environment, a review of the MREL framework is both appropriate and timely. Consistent and rigorous scrutiny of banks' financial stability and their ability to compete effectively is fundamental to the functioning of a fair and safe financial market. There is a delicate balancing act to perform at this juncture to ensure these somewhat competing forces coexist harmoniously. While the UK is home to some of the largest banks in the world, we must not forget the economic importance of the mid-tier institutions, which don't only inject essential competition into the market but, crucially, they also cover niche, often under-served, segments of the market.

This article sets out some of the factors for consideration during this consultation period, with a focus on the impact of MREL on mid-sized bank competitiveness and credit extension to the real economy (which should be considered in the context of the financial stability benefits of MREL).

Mid-tier firms are critical to the UK economy. In addition to boosting competition within UK banking, they also cover segments of the market that otherwise may be poorly covered or not even served at all. Examples of this include specific small to medium enterprise (SME) lending and specialist

mortgages and other non-mainstream lending. Of course, there are a diverse number of business models within small and mid-tier banks, and each will be impacted differently by MREL.

Based on the current proposed regulation, from 2022, the eight biggest banks in the UK will have to comply with the 'end-state' MREL requirements, with another 10 UK banks required to comply from 2023 or later. But the impact on the sector also extends to several other lenders that currently fall just short of the minimum thresholds and will enter the regime in the near future if they grow.

It is important to highlight that, for firms growing towards the total assets thresholds, the latest published BoE CP sets a phasing timeline for the application of the end-state requirements. It introduces a three-year advance notice before reaching the threshold, then a 'stepped glide-path' of six years to reach the end-state, with two intermediate steps (33% in year two and 66% in year four) to 'smooth the cliff-edge'. There is also an option to apply for a 'flexible add-on' of up to two additional years, should the BoE recognise there are specific market circumstances to warrant such an extension.

## The impact of MREL on mid-sized UK lenders

In order to estimate the potential impact of MREL on the profitability and balance sheet of the UK mid-sized bank sector, the EY-Parthenon Strategy and Transactions team analysed the impact of MREL on 11 leading UK mid-tier banks and specialist lenders,<sup>1</sup> some of which are already within the MREL thresholds and others near the threshold. As well as using publicly available data, we have worked with these banks to use projected growth and current MREL planning to find the aggregate impact.

### What are the proposed thresholds for MREL?

The current thresholds to move banks from an insolvency to a partial transfer resolution strategy, and from a partial transfer to a bail-in one are above 40,000 - 80,000 transactional accounts and GBP15bn - GBP35bn total assets respectively. Wherever a partial transfer or bail-in strategy applies, issuance of MREL is required.

## The current picture

We calculate that this group of 11 MREL-eligible (or soon to be eligible) banks accounted for circa GBP125bn of the stock of lending to customers in 2020, which represents circa 20% of the total UK mid-sized market.<sup>2</sup>

These banks, before taking the impact of MREL into consideration, are projected to grow strongly in the next five years. By 2025, we forecast that they will be on track to lend circa GBP200bn to customers (projected stock on balance sheet in 2025) with a projected growth rate of circa 10% 2020 - 2025 CAGR.

While fully understanding the phased approach to the introduction of MREL and the individual differences in when such banks will have to reach the end state, to assess the potential impacts on the economy and the market in the medium term, we have assumed that those banks will have to reach the end-state, on average, by year five and have taken the 2020 data as the starting point for our assessment.

## The impact of MREL

### 1. A 20% fall in the projected stock of lending to customers against a non-MREL scenario

We found that MREL would impact organic capital generation, leading to a lower income. The net impact of this would be foregone lending of circa GBP42bn by year five (and post the ramp-up phase), which represents a reduction of circa 20% of the projected amount without MREL (expressed in terms of stock of lending to customers on balance sheet). This assumes

lenders maintain their current capital ratios and risk weighted assets (RWA) densities (i.e., do not change their risk profile and risk appetite).

A scenario analysis of foregone lending based on different levels of cost of MREL, as well capital ratio, is shown below (the highlighted figure represents the 'central scenario' based on the expected coupon rates for the analysed banks and their current RWA percentage):

#### Projected foregone lending, over five years, at varying combinations of coupon and RWA percentage (GBPbn)

		MREL coupon rates							
		3.5%	3.8%	4.0%	4.5%	5.0%	5.2%	5.5%	6.0%
RWA %	18.0%	24.8	25.6	26.0	27.3	28.5	28.9	29.7	30.9
	19.5%	27.1	28.2	28.7	30.3	31.9	32.4	33.5	35.0
	20.0%	27.9	29.0	29.6	31.3	33.0	33.6	34.7	36.4
	21.0%	29.4	30.7	31.4	33.3	35.3	35.9	37.2	39.2
	22.0%	30.9	32.4	33.1	35.3	37.5	38.3	39.7	41.9
	23.5%	33.2	34.9	35.8	38.4	40.9	41.8	43.5	46.0
	24.0%	34.0	35.8	36.7	39.4	42.0	43.0	44.7	47.4
	25.0%	35.5	37.5	38.5	41.4	44.3	45.3	47.2	50.2
	26.0%	37.1	39.2	40.2	43.4	46.6	47.6	49.7	52.9
	27.0%	38.6	40.8	42.0	45.4	48.8	50.0	52.0	55.7
	28.0%	40.1	42.5	43.8	47.4	51.1	52.3	54.8	58.4

### 2. An increased cost of funding of circa 11bps starting from the first year of issuing of MREL, from an average of 0.65% to 0.76%

This estimate is based on the introduction of MREL requirements as currently drafted. This will lead to equivalent pressure on the net interest margin (NIM), which contributes to the significant fall in projected lending.

### 3. Expected reduced profit (PAT) of this group of banks of circa 37% in year five

We estimate that the cumulative lost profits due to MREL for the sector will generate circa GBP240mn reduction in tax payments from this group of banks in five years; furthermore, we calculated that return on equity would fall from a projected average of 12.8% to 10.1% (a fall of 270bps) in year five, if MREL was introduced as drafted.

<sup>1</sup> 11 banks representing different business models and focusing on a variety of customer segments, ranging from GBP1bn to GBP50bn in terms of assets as at 31 December 2020.

<sup>2</sup> Total UK market, excluding the five biggest banks.

## Five key questions

These projections raise some important questions about the ability of mid-tier firms to lend, and for broader competition within UK banking. There are also implications around how lenders respond to the expected increased costs and reduced profitability of the sector.

### 1. Will vital small business lending be weakened?

In recent years, challenger banks and specialty finance players have been the main source of growth in lending to small SMEs. This has been supported by the many initiatives put in place to boost competition and ensure funding to sustain small businesses (e.g., Banking competition remedies (BCR) – Capital and Innovation Fund).

We also know that, despite the central role played by the challenger banks in lending to this segment, UK SMEs still struggle to get access to finance: we found<sup>3</sup> that circa 30% of SMEs still do not have access to finance, the main reasons being cost (41%<sup>4</sup>), complex fee structure (34%) and inflexible products (29%).

If MREL further impacts that lending, those who rely on challenger banks and specialty finance will be hit hardest. The loss of that funding may not be easily replaced, as many borrowers may not fit the stringent risk criteria of mainstream lenders. So while the amount of foregone lending may appear small in relation to the total lending to the UK economy, it may have a proportionally larger negative impact.

### 2. Will this put the enhancement of competition in UK banking at risk?

There is a risk that such a large fall in profitability and lending will make the challenger sector more fragile and less able to compete in the market and 'challenge' the mainstream banks. Some of this may be due to the lack of funds to compete or grow by having to operate within MREL. The other threat to competition is if firms make a deliberate strategic choice to stay small rather than compete. There could be a scenario

where a nimble, agile small bank grows market share until it nears the threshold for entering MREL. It may then decide to stop growing, rather than find substantial new capital.

### 3. Will mid-tier lenders still be seen as well placed to grow and invest?

We have already touched on whether some smaller players will still pursue growth and risk hitting the threshold, thereby incurring the additional costs of MREL. Combined with the projection of reduced profitability, will investors continue to actively look at this market? Any withdrawal of investor appetite could have a major impact on wider competition in UK banking.

### 4. Will banks change strategy to look for higher returns in response to the higher costs of MREL?

Challenger banks and specialist lenders today differentiate themselves from the mainstream players by targeting specialist segments. They serve niches, often with more complex customers and transactions and, in some instances, higher-risk ones. With the need for even higher returns, will they start focusing more and more on riskier customers? This could activate a spiral effect of higher default rates and weaken the banking system.

The other question is, will we see a polarisation of the playing fields where challenger banks will progressively leave (or at least limit) their presence in the spaces where mainstream lenders play and focus on very niched subsegments? This would fundamentally diminish the positives of healthy competition.

### 5. Will we see a rise of non-bank lending?

Another consequence could see challenger banks lose ground to non-bank lenders, which are not subject to capital requirements. This may impact consumers and small businesses as they struggle to fund their needs and businesses at affordable prices.

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<sup>3</sup>EY market survey – May 2021.

<sup>4</sup>Multiple answers were allowed: up to three reasons over a total of 15 potential choices.

## Conclusion

It is clear that the introduction of MREL increases the stability of the entire banking system. However, there are trade-offs when it comes to credit extension to the real economy and with it mid-sized bank competitiveness.

We welcome the BoE's approach to stimulate industry debate on the path forward for mid-tier firms. The projected rise in funding costs, and the subsequent fall in lending and profit, raises critical questions. It impacts individual institutions, short- and long-term competition in the sector and, ultimately, end users, especially customers that rely on specialised lending. A rigorous assessment of all the potential knock-on effects of our findings is recommended.

The industry and the authorities need to work together to ensure that the calibration of MREL's application will avoid, or at least limit, any undesired negative effects. This is especially relevant around weakening a healthy, competitive playing field.

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