Title: : Bank Creditor Hierarchy Directive
IA No:

RPC Reference No: RPC-4304(1)-HMT
Lead department or agency: HM Treasury
Other departments or agencies:

Impact Assessment (IA)

Date: 06/11/2018
Stage: Final
Source of intervention: EU
Type of measure: Secondary legislation
Contact for enquiries: Noelita.llardia@hmtreasury.gov.uk

Summary: Intervention and Options

RPC Opinion: Fit For Purpose

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANDCB in 2016 prices)	**One-In, Three-Out**	**Business Impact Target Status**
£105.26m	£106.46m	-£12.38m	Out of scope	Not qualifying

What is the problem under consideration? Why is government intervention necessary?

When a financial firm fails, losses are imposed on creditors and distributed according to the creditor hierarchy. Ordinary unsecured creditors can bear losses ahead of others by being 'subordinated' contractually ('contractual subordination'), structurally via issuance from a holding company ('structural subordination') or via the law stipulating the instrument's hierarchical position ('statutory subordination'). This EU directive creates, via statutory subordination, a new class of senior unsecured debt called 'non-preferred senior' debt. It provides an additional method for firms to issue their requirements under MREL (the minimum requirement for own fund and eligible liabilities), which require instruments to be subordinated to be eligible.

What are the policy objectives and the intended effects?

The introduction of statutory subordination by establishing this 'non-preferred' senior debt class in UK law will give firms an alternative way to issue subordinated debt instruments to meet their MREL. This may be of particular benefit to building societies that cannot issue debt from a holding company. It will also promote convergence in the approach to statutory subordination in the EU.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

1) Do nothing – under this option, the UK would be in violation of its obligations, as a Member State of the European Union, to implement the Directive by 29 December 2018, and therefore this option is not viable.

2) Implement the directive to create a new class of liabilities in the creditor hierarchy.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 12/2023

Does implementation go beyond minimum EU requirements?		No		
Are any of these organisations in scope?	**Micro** No	**Small** No	**Medium** No	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)		**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister John P. Glen Date: 26 November 2018

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2018	PV Base Year 2016	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -1.27	**High:** 394.57	**Best Estimate:** 105.26

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	1.27	1	0	**1.27**
High	1.27		0	**1.27**
Best Estimate	1.27		0	**1.27**

Description and scale of key monetised costs by 'main affected groups'

There will be wage costs incurred by parties that will need to learn about this regulation and disseminate the information around their firms. The wage costs relate to 1) enforcement officers in the insolvency service 2) compliance officers in firms and 3) compliance officers in the client institutions purchasing the debt.

Other key non-monetised costs by 'main affected groups'

There are no non-monestised costs.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	0	0	0	**0**
High	0		39.58	**395.84**
Best Estimate	0		10.65	**106.53**

Description and scale of key monetised benefits by 'main affected groups'

Currently some firms issue Tier 2 debt rather than subordinated debt that ranks above it in the creditor hierarchy to meet their MREL requirement. Tier 2 debt can be more expensive for firms as the debt is lower in the creditor hierarchy and therefore creditors face greater losses if a firm became insolvent. Non-preferred senior debt provides a means of issuing debt that is more senior than Tier 2 and subordinated on a statutory basis. Firms may therefore benefit from lower funding costs by being able to issue non-preferred senior debt. We expect there to be particular benefit to building societies that cannot issue debt via a holding company (i.e. achieve structural subordination).

Other key non-monetised benefits by 'main affected groups'

There are no non-monetised benefits.

Key assumptions/sensitivities/risks	**Discount rate**	3.5

The key assumptions relate to 1) the funding cost savings associated with issuing non-preferred senior debt versus Tier 2 debt 2) the maturity profile of the debt (how long the debt is issued for) and 3) the amount of issuance assumed that will switch from Tier 2 to non-preferred senior debt.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**Score for Business Impact Target (qualifying provisions only) £m:**
Costs: -0.01	**Benefits:** 12.39	**Net:** 12.38	Not applicable

Evidence Base (for summary sheets)

Background

1. Resolution is the process by which authorities can intervene to manage the failure of a financial institution. ‘The Bank Recovery and Resolution Directive’ (EU Directive 2014/59/EU) requires the EU National Competent Authorities to set a minimum level of own funds and eligible liabilities which financial institutions must hold. This is known as the minimum requirement for own funds and eligible liabilities (MREL), and is set by the Bank of England in the UK.

2. When financial institutions fail, the resolution authority can use the MREL resources to absorb losses and recapitalise the continuing business. The Bank of England requires that MREL is subordinated for the largest financial institutions, in order to reduce the likelihood that equally ranking creditors will not receive equivalent treatment in resolution.

3. In resolution, losses are allocated according to the creditor hierarchy for insolvency. Ordinary unsecured creditors can bear greater losses by being ‘subordinated’ to senior creditors. This can be achieved contractually in the terms of the debt contract (‘contractual subordination’), structurally via issuance from a holding company (‘structural subordination’) or via the law stipulating the position of the instrument in the creditor hierarchy (‘statutory subordination’). The ‘Bank Creditor Hierarchy Directive’ (the Directive) primarily concerns statutory subordination.

Rationale for Intervention

4. In November 2016, the European Commission proposed to harmonise the EU’s approach to statutory debt subordination. The proposal came in a context where a number of EU Member States had already introduced national approaches for statutory subordination which varied significantly, leading to concerns over discrepancies in creditor treatment across the EU.
5. The ‘Bank Creditor Hierarchy Directive’ (EU Directive 2017/2399), in introducing a senior non-preferred debt class in the creditor hierarchy, increases harmonisation across creditor hierarchies of Member States, creating a level playing field. This reduces the risk of legal challenges, particularly in circumstances of cross-border resolution.
6. A further rationale for intervention is to provide an additional method for firms to issue subordinated debt instruments on a statutory basis within UK law. Doing so will help firms to meet their requirements under MREL, set by the Bank of England, which require instruments to be subordinated in order to be eligible. Currently some firms issue Tier 2 debt to meet their MREL, which is typically a more expensive form of funding than non-preferred senior debt for firms as Tier 2 debt is lower in the creditor hierarchy and creditors would face losses before senior debt if a firm became insolvent. Alternatively, firms can issue contractually subordinated debt, by having lawyers draw up contracts between the firm and the creditor stipulating the creditor hierarchy, or structurally subordinated debt from a holding company.

Policy Objective

7. The introduction of statutory subordination by establishing this ‘non-preferred’ senior debt class in UK law will give firms an alternative way to issue debt instruments to meet their MREL requirements. This may reduce the cost of funding for some debt issuers. It will also increase harmonisation across creditor hierarchies in the European Union.

8. In accordance with the Directive, firms are not required to use statutory subordination alone to meet their MREL requirements. The other options for subordination, contractual subordination and structural subordination, will still be available to firms which currently have this option.

Policy Options

9. There are two policy options:

a) Do nothing – under this option, the UK would be in violation of its obligations, as a Member State of the European Union, to implement the Directive by 29 December 2018, and therefore this option is not viable.

b) Implement the Directive to create a new class of senior non-preferred debt in the creditor hierarchy.

Costs and Benefits

10. All costs and benefits outlined in this impact assessment are in 2018 base year prices, with a Present Value base year of 2016. Impacts are assessed over a ten-year period (2018 to 2027), and the regulation comes into force on 29 December 2018. The discount factor used to calculate the Equivalent Annual Net Direct Cost to Business (EANDCB) is 3.5 per cent in line with HM Treasury's Green Book guidance for appraisal.
11. When wage costs are listed, we uplift the reported wage cost by 20.6 per cent in line with the 'Appraisal of guidance' 2016/17, the Cross-Whitehall Group Regulator Appraisal Group sub-group report to reflect total employer costs such as National Insurance and pension contributions.

Consultation

12. HM Treasury ran a four-week public consultation on the introduction of senior non-preferred debt by Statutory Instrument, which was published on 12 September 2018. The consultation was used to inform our Impact Assessment.

13. HM Treasury has also consulted with the Bank of England, the UK's resolution authority and the Insolvency Service.

Direct Benefits

Building Societies

Cost of Funding

14. Banks and building societies issue debt, and have to pay an interest rate on the instruments they issue to fund themselves. The following section outlines the benefit for firms from issuing the new category of senior non-preferred debt rather than Tier 2 debt. We look at the five building societies in scope of MREL and assume that these building societies will issue the new class of debt to meet their MREL obligations as it is typically cheaper than the debt which they are currently issuing. We do not look at other building societies as they are not obliged to hold additional funds under MREL and therefore we have no evidence that they will issue additional MREL-eligible debt in the future. Further, other firms have not informed us of their intention to issue this type of debt. Past issuance of debt is not a reliable indicator of future debt issuance as institutional requirements change over time. This assumption is highly uncertain.

15. For the five building societies for whom the Bank of England has disclosed[1] an indicative MREL requirement, we:

a) Took the average MREL requirement (for all applicable firms except for Nationwide this is 18% Risk-Weighted Assets (RWAs) in 2020 and 24.4% in 2022. For Nationwide we took 6.5% of the firm's leverage exposure in accordance with the Bank of England's MREL policy);[2]
b) Multiplied the MREL requirement by the firm's RWAs (data noted as of December 2017) disclosed in their published Pillar 3 disclosures (for Nationwide the requirement in a) was multiplied by the leverage exposures disclosed in the firm's Pillar 3 disclosures); This gives us the projected required amount of MREL resources.

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[1] The Bank of England has published indicative 2020 and 2022 MRELs for the UK's most systemically important banks and an average indicative MREL for other firms with resolution plans that involves the use of bail-in or transfer powers. This is available at: https://www.bankofengland.co.uk/financial-stability/resolution/indicative-mrels

[2] Risk-weighted assets are used to determine the minimum amount of capital that must be held by banks and other institutions to reduce the risk of insolvency. The capital requirement is based on a risk assessment for each type of bank asset.

c) Took the difference between the required amount of MREL resources (calculated in b)) and the current level of MREL resources (taken from firms' Pillar 3 disclosures), which is the MREL shortfall.

16. If a financial institution has an MREL shortfall, it will have to issue new debt prior to the 2020 and 2022 requirement deadlines.

17. Note that we used December 2017 Pillar 3 disclosures for all firms for consistency as, with the exception of Nationwide, no applicable firm has published its Pillar 3 disclosure for 2018.

Table 1: MREL shortfall and surplus calculations[3]

£m	Estimate of 2020 Shortfall/ Surplus	Estimate of 2022 Shortfall/ Surplus
Total	**-155**	**-1186**

18. Table 1 shows the estimated total of the MREL shortfall of all financial institutions within the scope of MREL requirements. Based on our estimates, several financial institutions were found to have an MREL shortfall. An assumption is made that these firms would opt to issue non-preferred senior debt rather than Tier 2 debt as it will be cheaper.

19. We assumed that the other financial institutions without a MREL shortfall will not be issuing this new type of debt to replace existing debt which is locked into a debt agreement. However we explore later on in this impact assessment what would happen if an institution's debt agreements are about to expire and could roll over and be issued as senior non-preferred debt. We also adjust our calculations based on responses to HM Treasury's consultation.

20. We used selected publicly available primary issuance data of building societies from February 2018 to May 2018, to inform our assumptions about cost savings by these building societies. See Annex 1 for detail on our calculations.

    a. In a high savings scenario, we find that building societies save 182bps in the interest rate of their debt.[4] The spread was calculated by taking the lowest non-preferred senior debt funding cost for any issuance away (53bps) from the highest Tier 2 debt funding cost (235bps). This is the maximum saving in interest rate cost in the data set.

    b. In a central savings scenario, we find that building societies save 49.79bps in the interest rate of their debt. The spread was calculated by taking the average of non-preferred senior debt funding costs weighted by the volume of debt issuance (76.66bps) away from the average of Tier 2 debt funding costs weighted by the volume of debt issuance (126.45bps). This is in line with a consultation response from the Building Societies Association which estimated that senior non-preferred debt would carry a spread 50bps lower than a corresponding issue of Tier 2 debt.

    c. In a low savings scenario, we assume there is no benefit from issuing non-preferred senior debt versus Tier 2 debt. This is illustrative for comparison purposes.

21. We assumed that the non-preferred senior debt would have an expected maturity of seven years. This is the average maturity of non-preferred senior debt issuance in publicly available data regarding issuance of foreign firms of this debt class in their respective countries, with the same data source referred to in paragraph 20.

22. However we adjusted our estimates of MREL shortfalls based on responses to HM Treasury's consultation. One financial institution responded to HM Treasury's consultation stating that they would issue £250m of senior non-preferred debt in the medium-term. We assumed equal issuance over three years in the absence of evidence of common issuance patterns, and we assume firms

[3] These MREL shortfall or surplus estimates refers to how much less or more capital the banks hold relative to the requirements under MREL.

[4] Basis point (BPS) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%.

will be unlikely to issue the full amount in one year due to lack of investor demand. Therefore we assume this financial institution issues £83.3m in 2019, 2020 and 2021 and that in 2019 the financial institution will make up its remaining MREL shortfall by retaining profits.

23. Another financial institution also responded to HM Treasury's consultation. They stated that they would have £1.5bn of issuance outstanding by 2022. We assume that this financial institution would roll this issuance over to cheaper senior non-preferred debt in equal issuance over three years, issuing £500m in 2019, 2020 and 2021.

24. We also reviewed the annual reports of the building societies to identify Tier 2 debt that would mature and could be reissued as senior non-preferred debt. The following table identifies all planned issuance, either due to maturing debt being rolled over or issuance in order to meet MREL requirements.

Table 2: Expected senior non-preferred debt issuance from 2018-2027.

£m	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**
Total	**0**	**708**	**1,394**	**708**	**0**	**0**	**254**	**26**	**896**	**0**

25. We calculated the spread levels saved on the debt by multiplying the expected issuance by the expected reduction in funding cost (i.e. the interest rate on the debt). The below tables show the value of the cumulative savings from issuing non-preferred senior debt, which have not been discounted.

Table 3: high savings scenario benefits

High savings scenario benefits (£m)	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**
Fall in funding costs	0.0	13.9	39.9	53.8	53.8	53.8	58.2	58.7	74.4	74.4

Table 4: central savings scenario benefits

Central savings scenario benefits (£m)	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**
Fall in funding costs	0.0	3.8	10.9	14.7	14.7	14.7	15.9	16.1	20.4	20.4

Table 5: low savings scenario benefits

Low savings scenario benefits (£m)	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**
Fall in funding costs	0	0	0	0	0	0	0	0	0	0

26. We considered whether the reduction in the cost of funding for applicable firms represented an economic transfer rather than an economic benefit. Whilst in principle the allocation of funds from capital market investors to the applicable firms represents an economic transfer, we found that investors were mainly international investors. This means that there is a large economic benefit to applicable firms in the UK.

27. We reviewed issuance of Tier 2 and senior non-preferred debt instruments by all 16 banks and building societies in scope of MREL. We took the average number of clients of this debt. We assume conservatively that there are 49 clients per bank and building society.

Table 6: number of client purchasers of Tier 2 debt upon initial issuance of the applicable bond.[5]

Bank	Number of client purchasers
Metro Bank	4
Yorkshire Building Society	7
HSBC	50
Barclays	88
RBS	79
Lloyds	69
Standard Chartered	61
Nationwide	33
Average	49

28. We analysed the legal jurisdiction of the investor base (sourced from Bloomberg), using up to 49 clients of each financial institution as a sample. We found that 93.47 per cent of the investor base were international. We therefore assume in the central scenario that 93.47 per cent of the investor base are international, and therefore that 6.53 per cent of the benefits to building society represent an economic transfer between stakeholders rather than a net economic benefit. Therefore we remove 6.53 per cent of the economic benefit calculated from our central scenario estimates of the benefit to firms. In our high economic benefit scenario, we assume that all investors are international based, due to Nationwide being the only building society to have issued senior non-preferred debt and all investors were found to be international. Therefore we assume the full economic benefit of the reduction in funding costs in the high economic benefit scenario.

29. Once these savings have been deflated to 2016 prices, the net present value of the cost savings is £106.53m in the central scenario (£0 in the low scenario, £395.84m in the high scenario).

Other Benefit Considerations

30. Currently building societies can issue subordinated senior debt contractually, even though there is no statutory basis for the issuance of this debt at present. Statutory non-preferred senior debt still requires a contract saying that the debt bought is non-preferred senior debt. Therefore, we do not assume any benefit from firms issuing non-preferred debt through statutory rather than contractual subordination, for example savings in legal and compliance fees from drawing up contracts.
31. We assume that banks will not be affected as they can currently issue senior instruments from their holding company (i.e. use structural subordination) to meet their MREL requirements. No banks informed us in response to the consultation that they would be issuing senior non-preferred debt externally. As non-preferred senior debt sits below senior instruments in the creditor hierarchy, in a resolution non-preferred senior debt would be exposed to loss before senior instruments, and so non-preferred senior debt is expected to be more expensive to issue than senior instruments from a bank's holding company. (In theory, the overall cost of funding could be unchanged for the bank – i.e. senior funding could get cheaper as the non-preferred senior debt layer reduces the expected loss for senior funding – but in practice this is unlikely to be true due to market frictions.) For this reason, banks will not have a financial incentive to issue non-preferred senior debt, as is the case for building societies, because they have a cheaper alternative available. Therefore we have not considered the impact of this Directive on banks.

32. We assume that creditors higher up and lower down the debt hierarchy versus non-preferred senior debt will not be affected in terms of cost of debt. This is because the cost of capital is independent of capital structure, in line with the Modigliani-Miller theorem and we have no evidence to suggest otherwise. One financial institution responded to HM Treasury's consultation stating that Tier 2 debt holders would have their place in the hierarchy preserved and therefore they do not bear any additional risk. Two financial institutions responded to the consultation noting that ordinary non-preferential debt holders higher up in the hierarchy would have additional

[5] The source is Bloomberg via FINRA TRACE.

protection and therefore in principle this debt could benefit from a better credit rating which one financial institution proposed could lead to a tightening of spreads. However the same financial institution also noted that they are not aware of any proposals regarding this from credit rating agencies. Therefore, as there is no evidence to support this assumption, we assume no benefit to debt holders higher up in the debt hierarchy versus non-preferred senior debt.

Direct Costs

Government

33. There will be costs to the Insolvency Service from having to learn about the impact of this Directive and disseminate this information around the institution. Based on informal consultation with the Insolvency Service, we understand they will have 1,264 insolvency practitioners[6] each spending three hours to understand the implication of this action and disseminate it around the firm. Hourly rates of pay for each type of employee were estimated in a 2013 report on insolvency practitioner fees for managers[7]. For this impact assessment the hourly rates of pay have been uprated to 2016 prices using the GDP deflator and a 20.6 per cent uplift applied. This is in line in line with the 'Appraisal of guidance' 2016/17, the Cross-Whitehall Group Regulator Appraisal Group sub-group report to reflect total employer costs such as National Insurance and pension contributions, to arrive at an hourly wage rate of £318. The total one-off cost to government is estimated to be £1.21m in 2018.

Firms

34. We assume all banks and building societies in the scope of MREL will review this Directive to see whether it applies to their firm. The indicative MREL disclosure list published by the Bank of England shows there are sixteen firms within scope of MREL.[8] We assume that each firm has one legal and compliance officer that will spend two hours to understand the change in legislation and disseminate information to the firm, at an hourly wage rate of £41 (Annual Survey of Hours and Earnings, Office of National Statistics provisional 2017 data regarding financial institution managers and directors, deflated to 2016 prices using the GDP deflator and uplifted by 20.6 per cent. This is in line with the 'Appraisal of guidance' 2016/17, the Cross-Whitehall Group Regulator Appraisal Group sub-group report to reflect total employer costs such as National Insurance and pension contributions.) The total one-off cost to these banks and building societies is estimated to be £1,323 in 2018. No banks or building societies responded to the consultation with specific information on how much this Directive would increase their regulation costs by, except to say that the impact would not be material on their institutions.

Clients

35. We assume that clients of all banks and building societies in scope of MREL will spend time learning and disseminating information about this regulation. As stated in paragraph 27, we assume conservatively that there are 49 clients per bank and building society (784 in total) as we do not assume that these clients are the same for each firm.

36. We assume clients are firms, as consultation with industry informs us that most investors are institutional investors. We assume each firm has one legal and compliance officer that will spend two hours to understand the change in legislation and disseminate information to the firm, at an hourly wage rate of £41 ((ASHE provisional 2017 data regarding financial institution managers and directors deflated to 2016 prices using the GDP deflator). The total cost to clients is estimated to be £60,842 in 2018.

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[6] This information was obtained from the Insolvency Service's *2017 Annual Review of Insolvency Practitioner Regulation*: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/706354/Annual_Review_of_IP_Regulation_2017.pdf

[7] Available via the following link. http://www.bristol.ac.uk/media-library/sites/geography/migrated/documents/pfrc1316.pdf

[8] https://www.bankofengland.co.uk/financial-stability/resolution/indicative-mrels

Wider Impacts

Equalities impacts

37. The measure concerns subordination of debt, impacting banks and building societies. No impact is expected for individuals.

Small and microbusiness impacts

38. This measure is not expected to have an impact on financial institutions that are small or microbusinesses. The Bank's power of direction to set MREL applies to: (i) banks, building societies and certain investment firms (firms) 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 (holding companies); and (iii) PRA or FCA authorised financial institutions that are subsidiaries of such institutions or such parent companies. Of the firms currently eligible, we do not believe any to have fewer than 50 employees. Given the threshold value band HM Treasury does not anticipate small or microbusinesses being drawn into MREL in the near-term.

Risks and Assumptions

39. The substantive estimates in this Impact Assessment relate to the benefits of the regulation. The benefits are sensitive to:
    a. the funding cost savings associated with issuing non-preferred senior debt versus Tier 2 debt;
    b. the maturity profile of the debt; and
    c. the amount of issuance assumed that will switch from Tier 2 to non-preferred senior debt.

40. We have consulted with the Bank of England and industry to ensure that the estimates used are based on the best possible evidence.

41. The activities of the concerned firms also present a potential risk to our assumptions. The government understands that the range of scenarios in its sensitivity analysis is not exhaustive. For example, the government has not assessed how net benefits would change in the event that financial institutions change their business models by 2027. This could be driven by wide-ranging and unpredictable factors, which may alter the institutions' MREL requirement and hence the need to issue MREL-eligible instruments.. Therefore, we have assumed that firms' business models will continue as at present for the duration of the assessment period.

42. We have also not considered the impact of a change in the Bank of England MREL policy.

Monitoring and evaluation

43. The review clause included in the Statutory Instrument ensures the scheme will be reviewed within five years at the latest.

Summary and preferred option

44. Our preferred option is to implement the proposed EU Directive which has a substantial net benefit. To do nothing would mean the UK would be inviolation of its obligations, as a Member State of the

European Union, to implement the Directive by 29 December 2018, and therefore this option is not viable.

Table 7: Summary Impacts

£m	Low Scenario	Central Scenario	High Scenario
Learning and dissemination costs for government	-1.21	-1.21	-1.21
Learning and dissemination costs for banks and building societies	0.00	0.00	0.00
Learning and dissemination costs for clients	-0.06	-0.06	-0.06
TOTAL COSTS	**-1.27**	**-1.27**	**-1.27**
Reduction in funding costs for building societies	0.00	106.53	395.84
TOTAL BENEFITS	**0.00**	**106.53**	**395.84**
NET BENEFIT	**-1.27**	**105.26**	**394.57**

Annex 1: Summary of Calculations

45. The main savings to building societies results from reduced funding costs from issuing non-preferred senior debt compared to if they issued Tier 2 debt. This is because non-preferred senior debt typically carries a lower interest rate compared to Tier 2.

46. Table 2 shows the expected issuance of Tier 2 debt over ten years. With this Directive, we expect that the applicable building societies will issue non-preferred senior debt instead of Tier 2 in line with this profile. Tables 3, 4 and 5 show the total savings per year if applicable firms were to issue non-referred senior debt instead of Tier 2 debt.

47. To find the savings per year, we separated our calculations into several steps. In the central scenario, the steps are:

    1) Take the average of interest rates (spread) on previously issued Tier 2 debt from a sample of financial institutions (126.45 bps), weighted by the volume of debt issued. Take the average of non-preferred senior debt from a sample of financial institutions (76.66 bps), weighted by the volume of debt issued.

    2) Calculate the difference in the average of these two interest rates. This gives the percentage saving of issuing non-referred senior debt rather than Tier 2 (49.79 bps).

    3) Multiply the spread saving (49.79 bps) by total expected issuance for one year. For example, in 2019 this would be:

       ~£791.7 million x (49.79bps x 0.0001) = ~£3.94 million

    4) Using a deflator to put this calculation in 2016 present value terms gives a total saving in cost of funding for 2019 of £3.8 million.

    5) Note that steps 1 to 4 will need to be repeated for each respective year that new debt is issued – that is 2019, 2020 2021, 2024, 2025 and 2026. However, given that the saving accumulates for each year in which the debt is outstanding, savings on debt issued in previous years must be added to savings from newly issued debt. For example, in 2024 steps 1 – 4 based on an issuance of £254.1million will result in a cost saving of £1.27 million. However, since debt issued in 2019, 2020 and 2021 is still outstanding, this saving from debt first issued in those years must also be added to the 2024 figure for a fall in funding costs. This brings 2024's total saving to £15.9 million. If there is no new issuance of debt in a year, the saving remains the same as the previous year as the amount on debt outstanding remains the same.

48. The only difference between calculations in the central scenario and calculations in the high scenario is for step 1. In step 1, the highest interest rate on Tier 2 debt (235bps) should be taken from the lowest interest rate on the non-preferred senior debt (53bps). This is as opposed to the averages in the central scenario.