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The Implications of Metro Bank's Refinancing for the UK Banking Sector

The UK's Metro Bank announced a landmark refinancing package on 8 October 2023, following a series of regulatory setbacks and concerns in the markets over the financial condition of the bank. The proposal now awaits regulatory approval. Metro's case highlights the sometimes unique issues faced by smaller banking institutions and raises questions about how UK bank regulators should address them.

This comes at a time when the Prudential Regulation Authority (PRA), the UK banking regulator, is taking stock of the reforms to bank regulation required in the aftermath of the Credit Suisse and Silicon Valley Bank (SVB) failures earlier this year. In a recent speech, Sam Woods, CEO of the PRA outlined various lessons learnt from the PRA's perspective, some of which are relevant in the case of Metro Bank and which we consider in this alert. See also our 13 March 2023 client alert "Bank of England Resolves Silicon Valley Bank UK Through Sale to HSBC".

Background

Metro Bank was founded in 2010 with a community banking ethos that was, unusually and not without controversy, premised on enhanced customer service through an extensive branch network. At the time, many banks were shrinking their branch networks in response to the growing digitisation of banking.

Metro Bank experienced rapid growth in its initial years, but more recently faced a number of regulatory issues, culminating in the PRA imposing a fine in 2021 for submitting inaccurate regulatory returns. The PRA determined that the inaccuracies stemmed from the application of incorrect credit risk weightings to its commercial mortgages, as well as shortcomings in related governance and risk controls. Based on the same issues, a further fine was imposed in 2022 by the Financial Conduct Authority (FCA), the UK's conduct regulator, which cited breaches of rules governing the disclosure of risk-weighted assets (RWAs) on its balance sheet.

Metro Bank's proposed refinancing follows a period of share price volatility in part resulting from concern over the bank's efforts to gain regulatory approval to apply internal modelling to assess the capital required to support its loan assets. The use of internal models is an alternative to the application of a standardised, formulaic approach and, if approved, they were expected to improve the bank's capital position and release capital that could be deployed in expanding Metro's loan book.

The PRA has not yet accepted Metro Bank's application to use its own internal models. The bank had been seeking this approval for a number of years, which would have levelled the field with larger, established banks that rely heavily on their own internal models. Internal modelling typically results in lower capital charges for credit risk in a bank's loan book. By contrast, the standardised approach gives prescribed percentage risk weights according to whether, for example, a mortgage is a residential or commercial

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mortgage. The use of prescribed risk weights may be too crude and insensitive to certain factors relevant to credit risk assessments.

The inability to gain model approval has given rise to market concern over the bank's ability to apply and operate internal models, twinned with concerns over the quality of its loan book. There is a market perception that Metro Bank has focused on the development of its deposit book and service proposition rather than its loan book (reflected in its relatively low loan-to-deposit ratio).

The bank has not yet fully emerged from this fraught period. It is facing a significant capital dilution from the refinancing, which was reflected in the recent steep fall in its share price. With questions remaining about the bank's long-term future, the bank has resolved to further improve and rationalise its balance sheet through asset rotation to higher-yielding mortgages and a cost-reduction plan.

The Refinancing

The refinancing package totals £925 million, consisting of a £325 million capital raise and £600 million in debt refinancing.

New equity: The capital raise would consist of:

- £150 million in fresh equity;
- £102 million contributed by Spaldy Investments, whose shareholding would rise from 9% to a controlling stake of approximately 53%; and
- £175 million in MREL eligible notes, financial instruments that may be bailed-in in times of distress and which contribute to the bank's "minimum requirement for own funds and eligible liabilities" (MREL) obligations. As part of the package, the bank's existing MREL notes have had their call-date pushed back by five years.

Bond exchange: Over 75% of Metro Bank's Tier 2 bondholders (£250 million face value) agreed to the debt refinancing, despite the fact that they face a 40% haircut. That is partly offset, however, because the notional amount of their Tier 2 bonds will be exchanged for new Tier 2 instruments with a much higher coupon (14% compared to approximately 9% on the current Tier 2 bonds).

Shareholder dilution: Existing shareholders will see a substantial dilution in their holdings as the number of the bank's issued shares would increase fourfold. A waiver from independent shareholders is also required because Spaldy Investments' shareholding would rise above the 30% "control" threshold that would otherwise trigger a mandatory bid by Spaldy for the balance of the shares.

Metro Bank is looking to attract bids for its residential mortgage book of up to £3 billion. The bank undertook a similar asset sale in 2020 to NatWest. The disposal would reduce the bank's risk-weighted assets and therefore its capital requirements. However, it remains to be seen whether there will be a significant positive impact on the bank's capital position, particularly if older fixed-rate mortgages are sold at a discount in the current higher-yielding environment, which would cause an immediate hit to the bank's regulatory capital. A smaller loan book will also impact the bank's ability to generate capital organically through reduced net interest income (NII). That said, proceeds of a disposal could be invested in higher-yielding government bonds, which would help the NII without adding to the bank's RWAs.

Broader Implications

There is a case to be made that smaller banks with simpler business models are disadvantaged compared to their larger competitors because they do not have the resources to develop their own credit risk models to the satisfaction of the regulator. This could result in smaller banks being required to maintain a proportionately greater amount of capital to support similar loan books, which could make them less competitive in terms of their pricing of loans.

A greater willingness by the PRA to approve the use of internal models by smaller banks could help to overcome this disadvantage and enhance competition in the UK retail banking sector. This would align with the PRA's new secondary mandate to promote competitiveness of the UK economy broadly. The PRA has already embarked on a "strong and simple" project designed to simplify the regulations and ease the compliance cost for small, domestically focussed banks.

Increasing complexity of bank capital structures brought about by post-financial crisis reforms may not be appropriate or suitable for a small challenger bank if the aim is clarity and transparency of the bank's financial health. Under the Basel accords, a bank's capital is made up of ordinary equity capital (Common Equity Tier 1 capital) as well as Additional Tier 1 capital (typically perpetual and non-cumulative preference share capital) and subordinated debt in the form of Tier 2 capital. The amount of capital required is also impacted by additional buffers, such as the mandatory capital conservation buffer and the countercyclical capital buffer (which is imposed in times of excessive credit growth), as well as a discretionary "Pillar 2" surcharge that the PRA can largely determine if it considers that a bank is facing additional risks not addressed in the prescriptive "Pillar 1" requirements.

In addition, there is the MREL requirement, which is designed to ensure a minimum amount of overall loss-absorbency on the

balance sheet, but serves to add further complexity to a bank's capital structure. A simpler capital structure may be more appropriate for smaller challenger banks while complex structures may be more necessary for larger banks.

One perennially important lesson, of course, is the need for strong governance and risk controls. Regulations designed to strengthen bank capital requirements rely on risk being measured correctly. In the case of Metro Bank, it is clear from the enforcement decisions of the PRA and FCA that there were insufficient controls and governance around the proper risk weights to be applied. This is an important reminder for all banks, whether new or established. In the case of SVB, federal regulators found that the bank failed to manage interest rate risk in the banking book, and unrealised losses on its Treasuries and asset-backed securities holdings had to be realised when confidence evaporated and these assets had to be liquidated.

We expect that the PRA will increase its focus on the viability of business models, particularly in light of its new objective of facilitating economic growth and competitiveness. The burden falls on the PRA in equal measure to apply a supervisory framework that is forward-looking and can identify weak business models at an early stage. This is all the more challenging in the light of international banking reform in the years ahead, including through the Basel 3.1 reforms.

We will continue to watch with interest the evolution of the UK prudential regime for banks as the PRA wrestles with the many challenges of international reform, bank failures and market challenges of this year, as well as navigating the post-Brexit environment. We will keep you informed.