



BANK OF ENGLAND

The Special Resolution Regime for Failing UK Banks

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Peter Brierley
Bank of England

Previous UK approach relied on corporate insolvency law

Previous UK regime for resolving banks, relying on application of general insolvency law, was inadequate.

Corporate insolvency law is inappropriate for banks because:

- It does not recognise that banks are vulnerable to losses of **confidence**, which may lead to runs, contagion and wider systemic consequences that may undermine the public policy objective of maintaining **financial stability**.
- Neither bankruptcy courts nor insolvency practitioners are required under corporate law to take into account this public policy objective, so actions in pursuit of their objectives may worsen a **banking crisis**.
- It may only be initiated at insolvency so inhibits **early/decisive intervention** to forestall potential problems – which in financial sector can escalate rapidly to affect not only bank in difficulty but also other banks which are, or are thought to be, in similar position.
- It is not well suited to ensuring **continuity of key banking functions**, especially payments to and from customer accounts and access to overdraft and other credit facilities.
- It is not well-adapted to allow **real-time decision making** of kind now necessary to manage risks to which most medium-sized and larger banks are exposed (eg dynamic hedging techniques).
- It does not recognise particular position of key group of creditors – the **depositors** – who are unlike professional creditors and whose claims on failing bank, as “money”, have significant role in wider functioning of economy.

All this clearly demonstrated by Northern Rock crisis



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Northern Rock crisis, 2007-08

- NR's performance deteriorating in 2007
- Initial problems reflected **liquidity rather than solvency** issues
- Without SRR, **authorities could not take control** of NR away from its senior management/shareholders while bank still balance sheet solvent
- This **inhibited early resolution** of NR's problems
- Bank continued to lose franchise value as a result, making **subsequent sale of its business more difficult**
- Authorities eventually left with two options: **liquidation or nationalisation**
- **Emergency legislation** – Banking Special Provisions Act – passed in February 2008 to nationalise NR
- BSPA also used later in 2008 to resolve **Bradford and Bingley** and **UK entities of failed Icelandic banks**
- BSPA contained **one-year sunset clause**



The solution adopted in the Banking Act 2009

A Special Resolution Regime (SRR) for banks

- Initiation and implementation under **control of authorities**.
- Bank's **stakeholders' rights** subordinated to powers of authorities.
- Main objective is to ensure **orderly resolution** consistent with preservation of financial stability, whether that takes form of closure and rapid payoff of insured depositors or a private sector solution, if necessary facilitated by the authorities, to ensure continuity of part or all of failed bank's business.
- **Repairs deficiencies** of previous approach by:
 - allowing bank resolution to be initiated while bank still has net assets, so maximising chances of successful resolution;
 - providing scope to ensure continuity of key banking activities, including critical payment services;
 - if accompanied by suitable deposit insurance regime, providing a way to maintain confidence in banking sector and protect depositors in event of bank failure;
 - removing need for authorities to keep open or bail out failing bank simply to secure position of depositors or other creditors, which contributes to moral hazard and encourages risky behaviour.



SRR Statutory Objectives

- Protect and enhance UK **financial stability**
- Protect and enhance **public confidence** in the stability of the banking system
- Protect **depositors**
- Protect **public funds**
- Avoid interfering with **property rights** in contravention of European Convention on Human Rights (ECHR)

NB: Although these objectives are specified in section 4 of the Banking Act, they are not ranked in order of importance: judgements will need to be made on case-by-case basis to **balance** the objectives



SRR: Role of the Authorities

Financial Services Authority (FSA)

- triggers SRR
- remains responsible for supervisory decisions and regulatory actions

Bank of England (“Bank”)

- operates SRR, including taking decisions on which SRR tool to use
- remains responsible for liquidity support to any bank

Her Majesty’s Treasury (HMT)

- remains responsible for public finances
- takes decisions if bank is nationalised

Financial Services Compensation Scheme (FSCS)

- assesses readiness of bank for payout to eligible depositors
- delivers payment to eligible depositors



SRR: legislative framework

- Statutory objectives set out in **primary legislation** (passed on 12 February 2009)
- Supporting **secondary legislation** to provide safeguards (several SRR orders/regulations published on and since 20 February 2009)
- **Code of Practice** (first published on 23 February 2009 and updated since) to provide guidance on (inter alia):
 - how SRR objectives are to be achieved
 - how to determine that SRR triggers are met
 - choice between different SRR tools
 - consultations between authorities
 - management and control of bridge banks and banks taken into temporary public ownership (TPO)
 - compensation that might be payable to failed bank's stakeholders
- **Banking Liaison Panel** to advise on wider effects of SRR, exercise of powers under secondary legislation and Code of Practice



SRR Trigger

- **Regulatory judgement** reached by FSA after consultation with other authorities and subject to right of Bank to make recommendations.
- Linked to FSA decisions that:
 - bank has failed or is likely to fail to meet **threshold conditions**;
 - it is not reasonably likely that action can be taken by or in respect of the bank to enable it once again to meet the threshold conditions.
- Previous work on triggers looked at:
 - **Quantitative thresholds** (eg US “Prompt Corrective Action”): these offer clarity, transparency and may reduce risk of regulatory forbearance; but they may lack flexibility and comprehensiveness.
 - **Qualitative thresholds** (eg Canada): these provide more flexibility, but if authorities act quickly they may be likely to be challenged by shareholders for arbitrary or draconian use of powers, or if they act slowly they may be challenged by depositors for unwarranted regulatory forbearance.
 - A mix of the two.
- Need to cover **liquidity** as well as capital.
- Linking trigger to threshold conditions offers best mix given that they include “adequate resources” and these relate to both capital and liquidity.



SRR Tools

- Power to direct transfer of part or all of failed bank's business to a **private sector purchaser** (PSP).
- Power to take control of part or all of a bank's property through a directed transfer to a **bridge bank**.
- **Temporary public ownership** (TPO) of failed bank.
- Modified **bank insolvency procedure** (BIP) to close bank and facilitate fast and orderly payout or transfer of depositors' FSCS claims.
- **FSCS funds** can be used to support non-payout resolution up to the amount FSCS would have incurred if it had paid out eligible depositors, net of recoveries.
- **Existing tools** retained, eg public sector liability or funding guarantees or capital injection.



Directed transfer to private sector purchaser (PSP)

- Facilitates **private sector solution** by ensuring rapid transfer of part or all of failed bank's business to one or more healthy private sector banks.
- If it can be arranged rapidly, sale to PSP is option most likely to meet all SRR objectives.
- By maintaining **franchise value** of failed bank and achieving going concern sale, likely to provide better returns to creditors and shareholders of failed bank than piecemeal liquidation.
- Much more flexible than existing procedures to facilitate sale to PSP, which may take too long given judicial process, or be frustrated by lack of agreement and attempts by counterparties of failed bank to exercise rights to close-out immediately or realise collateral.
- Can take form of either a **share transfer** ("merger and acquisition" or M&A) or a **property transfer** ("purchase and assumption" or P&A).
- Can be supported by FSCS or HMT **funds**.



Bridge bank

- Used if bank's failure likely to have adverse systemic consequences and sale to PSP cannot be arranged immediately.
- Aimed at:
 - preserving **franchise value**;
 - ensuring **continuity** of key banking services;
 - allowing time for potential purchasers to carry out **due diligence**.
- Will be company owned and controlled by **Bank of England**.
- Would have **new chief executive/senior directors** and business plan, but would otherwise use staff and systems of failed bank.
- Would need to be **authorised by FSA** and capitalised in line with EU directives.
- If necessary, both funding and liabilities of bridge bank would be **guaranteed** by authorities.
- Bank will run bridge bank, delegating day-to-day operation to market professionals, including **new senior management**.
- Bridge bank is **temporary entity**: maximum period of existence expected to be one year, although it may on occasion need to be longer.
- NB: a bridge bank is **not equivalent to nationalisation**.



Temporary public ownership

- A matter for the **Chancellor of the Exchequer**
- Triggered by two conditions:
 - Necessary to resolve or reduce **serious threat** to financial stability
 - Necessary to protect **public interest** where HMT has provided financial assistance to bank to resolve or reduce serious threat to financial stability
- Might apply where significant public funds already made available to stabilise bank, where **long-term restructuring** needed to return bank to private sector, or for **very large and complex bank**
- A **last resort** in the SRR



Bank insolvency procedure (BIP)

- Ensures SRR is **not** a no-failure or **no-closure** regime.
- Main objective is to facilitate **rapid payout** from FSCS to insured depositors (**or transfer** of deposits to a healthy bank).
- Based largely on **existing insolvency proceedings**, drawing on administration and liquidation processes.
- Rights of creditors and directors of failed bank to petition for insolvency would be **subordinated** to rights of authorities to act in public interest.
- Initiated by Bank or FSA applying to Court to appoint nominated liquidator (“**bank liquidator**”).
- Subject to main objective, bank liquidator required to manage resolution and **liquidate assets** of bank in manner best satisfying interests of creditors as a whole.



Partial property transfers

- Bank will have power to **transfer part** of failed bank's business to bridge bank or private sector purchaser.
- **Examples** of partial transfers:
 - deposit book, or insured component of it, is moved to bridge bank or private sector purchaser;
 - higher quality/saleable assets moved to bridge bank to facilitate its eventual sale or direct to private sector purchaser; lower quality assets left behind (similar to "**good bank/bad bank**").
- Any essential systems/services that cannot be immediately transferred will be maintained in rump of failed bank ("**residual company**") and used to service bridge bank.
- In a partial transfer to a bridge bank, residual company may go into "**bank administration procedure**" (BAP).



Residual company in partial property transfer

- Likely to be **insolvent**
- BAP initiated by Bank through application to Court to appoint a special administrator (“**bank administrator**” or BA)
- BA’s **objectives aligned with Bank’s statutory objectives** under SRR during period where facilities provided by residual bank to transferee
- **Supplementary** and **reverse** transfers of assets and (in very limited cases) liabilities between bridge bank and residual company are possible, subject to safeguards for creditors
- Residual company will not be fully wound up until after bridge bank is sold, whereupon BAP reverts to **ordinary administration**



Safeguards in partial property transfers

- Net proceeds of operation and sale of bridge bank revert to residual company's creditors (and, if any surplus remains, shareholders) through "**resolution fund order**".
- Scope also for separate or additional **compensation orders** in any use of an SRR tool, subject to independent evaluation.
- **Set-off and netting arrangements** largely protected.
- Bank of England not allowed to **cherry pick** financial contracts covered by set-off and netting arrangements with given counterparty.
- **Secured claims** will not be separated from assets securing the liabilities.
- **Structured finance arrangements** (eg covered bond programmes) fully protected.
- Normal **priority ranking** of creditors respected in BAP
- Creditors in residual company will be compensated so they are no worse off than they would have been in an immediate liquidation of whole bank ("**no creditor worse off**" or NCWO safeguard).
- Details of safeguards enshrined in **secondary legislation** published on 20 February 2009.



Implications of SRR for shareholders and counterparties of failed bank

- ECHR means shareholders of bank may be entitled to **compensation** if bank placed into resolution prior to insolvency.
- ECHR requires **fair balance** be struck between private interests of shareholders and wider public interest.
- One possibility is minimum compensation to shareholders based on **net asset value** of failed bank when placed into SRR.
- Counterparties' rights under financial contracts to **close-out/realise collateral** are enshrined in EU directives, eg Settlement Finality Directive and Financial Collateral Directive.
- These rights designed to maintain financial stability by preventing adverse **contagion** effects from failed bank to its counterparties.
- But widespread recourse to immediate close-out may undermine chances of successful resolution of bank, so net effect may be to undermine financial stability if bank is "**systemic**".
- This provides case for **short stay** (24-48 hours?) on close-out, pending transfer of contracts to healthy private sector bank or bridge bank (a feature of US regime).



Scope of SRR

- Applicable to **UK-incorporated banks and building societies**, including UK subsidiaries of non-UK banks
- Also applies to **branches in other countries** of UK-incorporated banks and building societies
- But does **not** apply to **branches in UK** of non-UK banks
- Not applicable (at this stage) to **credit unions**
- Tools apply to **deposit-taking entities** within larger financial groups
- Aim is also to facilitate resolution of larger group if in the public interest
- “**Continuity obligations**” on former group companies servicing a deposit-taker placed into SRR to provide these services to a transferee to which all or part of deposit-taker’s business is transferred
- Option to place **bank holding companies** into TPO, with full share and property transfer powers applicable to holding company and its bank subsidiaries
- Enabling power used to change insolvency regime for **investment firms** (“special administration regime” introduced in February 2011)



SRRs: Where next?

- **Action in EU** to implement European Commission's draft Recovery and Resolution Directive
- G20 endorsement of **FSB's "Key Attributes of Effective Resolution Regimes"** at Cannes summit
- Extension of **scope** of SRR beyond deposit-takers to other financial institutions and groups whose failure could have systemic effects (cf US Dodd-Frank Act)
- **Recovery and resolution plans** ("living wills")
- Need for an explicit tool to "**bail-in**" (ie impose losses on) creditors as part of an open or closed bank resolution without recourse to public funds
- Need to broaden **funding** arrangements for resolution?
- Application of SRRs to **cross-border** activities of financial institutions



Cross-border application of UK SRR: the theory

- Applies to UK-incorporated banks and building societies
- This extends to UK banks' branches in other countries
- It does not extend to UK banks' subsidiaries in other countries
- It includes subsidiaries but not branches in UK of non-UK banks



Cross-border application of SRR: the practice

- UK authorities have no powers to prevent non-UK authorities ring-fencing local assets of branches of UK banks
- Such action could undermine UK resolution under SRR
- Assuming SRR resolution recognised as proceeding covered by CIRWUD 2001, then it would apply to all EEA branches of UK bank
- BUT: that does not of course address possibility of separate resolutions/proceedings for branches of UK banks outside EEA
- This raises complex issue to do with international insolvency law



International insolvency law: three broad paradigms

1 PURE UNIVERSALISM

Home country controls resolution of bank and all its entities abroad; host countries have no rights to bring local resolution which ring-fences assets within their jurisdictions

2 MODIFIED UNIVERSALISM

Home country resolution of bank may extend to its branches abroad; host country authorities may remit assets immediately to home country authorities if deemed appropriate but retain rights to bring local resolution

3 TERRITORIALITY

Home country only controls resolution of parent bank and its domestic branches; host countries mandated or able to bring local resolutions which ring-fence local assets



The “middle way”: conditions for modified universalism

- Broad **harmonisation** and mutual recognition of supervisory and resolution regimes
- Cross-border sharing of information and **cooperation** between supervisory and resolution authorities, eg through CMGs
- **Equitable treatment** of worldwide creditors of home bank and all its branches at home and abroad
- **Burden-sharing principles** for imposing costs of resolution on private sectors across borders
- Some form of **enforcement mechanism**, eg Basel-type Concordat/international standard promulgated by FSB/G20, international treaty or convention
- In absence of above, danger that SRRs will only be effective in resolving purely domestic banks so “**too big to fail**” still not addressed
- **FSB and EU proposals** consistent with modified universal approach to cross-border resolution

