

The Bank of England's approach to resolution

October 2014



BANK OF ENGLAND





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This document describes the framework available to the Bank of England to resolve failing banks, building societies and some types of investment firm. The first part outlines the aims of resolution and describes the key features of the United Kingdom's resolution regime. The second part sets out how the Bank expects to carry out the resolution of a failing firm in practice, using the powers available to it as the UK resolution authority.

The most up-to-date version of this document can be found on the Bank's website at www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf, where it will be updated periodically.

Foreword



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One of the objectives of the Bank of England is to support and enhance the stability of the UK financial system. A significant element of this is underpinned by prudential regulation and supervision, which promotes the safety and soundness of firms, among other objectives. The regulatory system in the United Kingdom is not designed, however, to ensure that no firm ever fails. This document sets out the arrangements in place when certain types of financial firms do fail.

The Bank of England is the United Kingdom's resolution authority for banks, building societies, central counterparties and certain investment firms. Resolution is the process by which the authorities can intervene to manage the failure of a firm. The Bank seeks to ensure that firms — whether large or small — can fail without causing the type of disruption that the United Kingdom experienced in the recent financial crisis, and without exposing taxpayers to loss.

If a firm within scope of the resolution regime fails, the Bank will aim to ensure that the adverse effects of that failure are minimised. This will require that the firm stays 'open for business', to allow for access to protected deposits to be maintained and for payments to continue to flow, to ensure that the risk of disorderly fire-sales of the firm's assets or termination of its derivatives contracts is minimised, and that credit and other critical functions continue to be provided to the wider economy.

To achieve this requires that:

- the authorities have appropriate powers to resolve failing firms;
- firms are organised in such a way that they can be resolved effectively without risk to public funds;
- market contracts are structured in a way that supports the actions of resolution authorities; and

- for complex cross-border firms, authorities in different countries are prepared to co-ordinate with each other in planning for and resolving failing firms.

Having the necessary powers to resolve failing firms has required changes to be made to the arrangements for resolution in the United Kingdom. In the aftermath of the failure of Northern Rock, Bradford and Bingley and others, the United Kingdom adopted a resolution regime for deposit-takers in the Banking Act 2009. Subsequently, the Financial Stability Board ('FSB') set out the international standard for resolution regimes in 2011. The UK regime fell short of this standard in some respects.

In particular, in common with other jurisdictions, the UK regime did not have a bail-in tool, which ensures that the owners and unsecured creditors of the failing firm bear the losses associated with failure, even where the authorities are not in a position to break up the firm over a weekend or place it into an insolvency proceeding. But later enhancements to the UK regime, alongside changes that are being introduced through implementation of the European Union's Bank Recovery and Resolution Directive from 1 January 2015, will bring the UK regime into line with the FSB's international standard for banks and investment firms.

Having the right set of powers is a necessary, but not sufficient condition for orderly resolution. Firms also need to be organised in such a way that the powers can be used without significant adverse consequences for the rest of the financial system and the wider economy, and without bailouts by the taxpayer. In other words, firms that fall within scope of the UK regime need to be resolvable.

Hence firms need to be structured in a way that facilitates resolution, avoiding complex legal or operational structures. Resolvability also requires the largest firms to have enough loss-absorbing capacity available — in the right places — when the firm fails, so that a bail-in can be conducted. For medium-sized firms, there needs to be some capacity to absorb losses, so that the authorities can choose the best method to resolve the firm while maintaining continuity of its activities. And for the smallest firms, it must be possible to transfer, pay out or return protected deposits and/or client assets promptly and smoothly.

For those firms that are party to large numbers of financial market contracts — which may be governed by the laws of another country, and will contain clauses that allow one party to walk away in certain circumstances — the risk of disorderly termination of those contracts needs to be managed. An

international group of regulators, including the Bank, have been working with market participants to ensure that financial market contracts recognise the rights of resolution authorities to act in the event of failure of the firm. And that while legitimate creditor interests should be protected, counterparties should not be able to terminate contracts solely on the grounds that a resolution is taking place.

For the most complex cross-border firms, including the global systemically-important financial institutions (G-SIFIs), resolution and supervisory authorities in different countries need to co-ordinate actively and constructively with each other to ensure that the plan for resolution will work. This requirement is set out clearly in the FSB's international standard for resolution, and the authorities in the United Kingdom are working closely with international colleagues so that the strategies in place for resolving G-SIFIs operating in this country could be put into effect if needed.

This publication seeks to ensure that financial institutions, their owners, investors and customers understand the risks involved — and the protections in place — when a firm fails. It does so by explaining the UK framework for resolution and setting out how we expect to use our powers to resolve failing firms. It should be read alongside the Banking Act Code of Practice, which provides guidance on how, and in what circumstances, the authorities will use resolution tools.

As approaches to resolution, the legal regime and firm structures evolve, including those changes to banks' structures that will take place through implementation of the recommendations of the Independent Commission on Banking, the document will be updated.

A handwritten signature in black ink, appearing to be 'J. L. S.', written in a cursive style.

October 2014

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Part 1 Framework for resolution

I Aims of resolution

1 The Bank of England's (the Bank's) mission is to promote the good of the people of the United Kingdom by maintaining monetary and financial stability. The Bank's responsibilities — as resolution authority — contribute to that mission by ensuring that, if a firm within the scope of the regime fails, the adverse effects on the provision of financial services and the wider economy are minimised. Resolution is the process by which the authorities can intervene to manage the failure of a firm.

2 This document sets out the Bank's approach to the resolution of banks, building societies and certain investment firms,⁽¹⁾ including their parent and other group companies. It is intended to provide guidance on the Bank's statutory responsibilities as the resolution authority of the United Kingdom. It explains the purpose and objectives of the resolution regime, its key features, the approach that the Bank intends to take to resolve a failed firm, should that prove necessary, and the arrangements for safeguarding the rights of depositors, clients, counterparties and creditors. It is intended to complement the Code of Practice, issued by HM Treasury (HMT).⁽²⁾

3 The arrangements in the United Kingdom are evolving — this document sets out the resolution regime that will prevail when the EU Bank Recovery and Resolution Directive (BRRD),⁽³⁾ which covers deposit-takers, investment firms and their respective parent companies (and subsidiaries which are financial institutions), applies from 1 January 2015. The Bank's statutory responsibilities for resolution also extend to central counterparties — resolution of this type of financial institution is not covered in this document, but will be covered in future publications.

The need for a robust resolution regime

4 A core feature of a stable system is that financial institutions must be able to fail in an orderly fashion — that is, without excessive disruption to the financial system, without avoidable interruption to the critical economic functions that these firms provide, and without exposing taxpayers to losses. This principle underpins the Financial Stability Board's international standard for effective resolution regimes (the Key Attributes), agreed by the G-20 leaders in 2011.⁽⁴⁾ The arrangements for the resolution of failing banks, building societies and investment firms in the United Kingdom are designed to comply with the Key Attributes.

5 The need for an effective set of resolution arrangements was made clear during the recent financial crisis. Given the risks to financial stability that would have arisen had some institutions been allowed to fail and enter normal insolvency, it was necessary for the public authorities to intervene to limit the disruption, including by providing public funds to recapitalise some banks. This meant that the gains from banking activities in the run-up to the crisis accrued to the private sector, but when failures occurred, losses were shared with the public sector.

6 Robust resolution arrangements seek to ensure that losses arising from failure are borne by the shareholders and unsecured creditors of failed firms, rather than the general public. Just as they are when non-financial firms fail. This will sharpen incentives for the private sector to find a private sector solution to difficulties within a firm, avoiding the need for resolution altogether.

7 Robust resolution arrangements are also critical to ensuring that the risks attached to investing in firms are priced appropriately. Removing the implicit guarantee from the UK government to the largest financial institutions will improve market discipline in the pricing of risks being taken by these firms. This should strengthen incentives for firms to demonstrate to their customers, clients and investors, that they are not taking excessive risks. It should also help to reduce the risks to which investors in UK sovereign debt are exposed, thus lowering the cost of that funding.⁽⁵⁾

8 To achieve orderly resolution, the authorities also need feasible and credible resolution strategies for individual firms. A feasible strategy requires the authorities to have the necessary resolution powers, and the capacity to apply them. The United Kingdom's permanent resolution regime was put in place in 2009 and has been enhanced subsequently, including through the BRRD.

(1) For the purposes of the resolution regime, the term investment firms means those firms that deal as principal and are required to hold initial capital of €730,000. The majority of such firms are prudentially regulated by the Financial Conduct Authority; the nine largest, more complex investment firms are prudentially regulated by the Prudential Regulation Authority.

(2) See HMT (2010), 'Special resolution regime: code of practice', available at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/bankingact2009_code_of_practice.pdf.

(3) See Annex 1 for an overview of the BRRD.

(4) For the latest version, see FSB (2014), *Key attributes of effective resolution regimes for financial institutions*, available at www.financialstabilityboard.org/publications/r_141015.pdf.

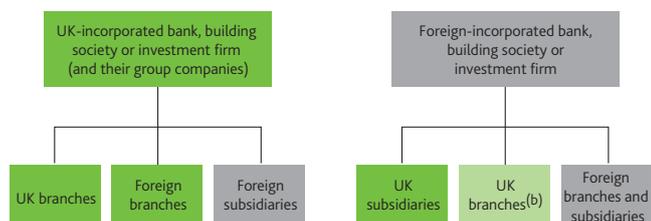
(5) The existence of an implicit public subsidy affecting the largest banks has been examined extensively. For a survey of the literature, see GAO (2014), 'Large bank holding companies: expectations of government support', at www.gao.gov/products/GAO-14-621.

9 For a strategy to be credible, the use of such powers must not result in unacceptable consequences for the rest of the financial system and the wider economy. If the critical economic functions of the failing firm are interrupted during resolution, for example when other market participants are not able to step in and replace the service quickly, this would be an unacceptable consequence. Some examples of critical economic functions include: making and receiving payments; extending credit and taking deposits; clearing and settling financial transactions; other retail and corporate banking; borrowing and lending between financial institutions; market-making in certain securities; and custody services.

II Key features of the resolution regime

10 The Bank has the responsibility for the resolution of a failing bank, building society or investment firm,⁽¹⁾ and their group companies, under the (amended) Banking Act 2009 (the Act). The resolution regime covers firms incorporated in the United Kingdom, including subsidiaries of foreign firms. The BRRD extends this scope to branches of firms from outside the European Economic Area (**Figure 1**).

Figure 1 Scope of the resolution regime^(a)



(a) Green boxes indicate entities that are within scope of the regime, grey boxes indicate entities that are outside its scope (although such firms may fall within the scope of a group resolution strategy conducted by the home authority).

(b) Tools to resolve branches of non-EEA firms are available under some circumstances, which are set out under the BRRD.

11 The regime sets out the objectives that the Bank must pursue when it carries out a resolution, as well as the formal responsibilities under the Act to consult the other UK authorities — the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA) and HMT — when placing a firm into the resolution regime and when choosing which of the regime's tools to use.

12 The regime comprises a set of tools that allow the firm to be stabilised so that its critical economic functions can be maintained in some form. These are known as stabilisation tools. They are accompanied by other tools to assist with winding down the remaining parts of the firm that do not need to be maintained. One or more of these tools may be used in a single resolution. The regime includes a set of modified insolvency procedures, for use alongside some of the stabilisation tools or where it is not considered necessary to use the stabilisation tools, taking into account the statutory objectives of the regime.

13 Overall the regime allows the authorities to take early and pre-emptive action to forestall potential problems that might generate a widespread loss of confidence. It recognises the existence of certain public policy objectives, such as financial stability, that are not captured by normal corporate insolvency arrangements, but reverts to normal insolvency arrangements once those public policy objectives have been discharged. It seeks to ensure that critical economic functions, such as making payments and providing credit, can be continued rather than becoming frozen in insolvency. This section sets out the features of the regime in more detail, as well as the safeguards contained within it for depositors, clients, counterparties and creditors.

Objectives

14 The Act specifies a set of objectives which the Bank must have regard to when resolving a firm. These are to:

- ensure the continuity of banking services in the United Kingdom and of critical functions;
- protect and enhance the stability of the financial system of the United Kingdom;
- protect and enhance public confidence in the stability of the financial system of the United Kingdom;
- protect public funds, including by minimising reliance on extraordinary public financial support;
- protect depositors and investors covered by relevant compensation schemes;
- protect, where relevant, client assets; and
- avoid interfering in property rights, in contravention of the European Convention of Human Rights.

15 The Bank must consider each of these objectives in the selection and use of its tools, but they are not ranked in any particular order. Overall, the objectives set out in the Act explain what the Bank must take into account when preparing for, and conducting, a resolution.

Roles of the authorities

16 The Act provides a clear framework for use of the regime, with defined roles for each authority. In practice, all of the authorities will co-operate closely both in the run up to, and during, a failure. The roles are:

(1) Except in cases where HMT considers that a period of temporary public ownership is necessary to resolve or reduce a serious threat to the stability of the financial systems of the United Kingdom, or to protect public funds that have been provided. In such cases HMT conducts the resolution, in conjunction with the Bank.

- The prudential supervisor (which may be the PRA or, in the case of most investment firms, the FCA) and the resolution authority (the Bank) make the decision to put a firm into the resolution regime, having consulted HMT.
- The Bank, having consulted the other authorities, decides which of the tools to use and conducts the resolution, in all cases except temporary public ownership and the public equity support tool.
- HMT decides whether to put a firm into temporary public ownership or make a public equity injection, and conducts the resolution in this case, together with the Bank.⁽¹⁾
- The Financial Services Compensation Scheme (FSCS) pays out or funds the transfer of deposits protected by the deposit guarantee scheme, up to a limit of £85,000. The FSCS may also protect investors for losses up to £50,000.⁽²⁾

17 The firm itself is likely to be subject to intense and heightened supervision by the PRA or FCA as its difficulties increase. For example, under the PRA's Proactive Intervention Framework, which captures the supervisory judgement of how close a firm is to failure, supervisors will expect the firm's management to take action as the condition of the firm deteriorates.⁽³⁾ A range of possible actions should be contained within the firm's recovery plan, designed to enable it to return to a stable and sustainable footing. The actions taken should not hamper the authorities' ability to resolve the firm, should that become necessary. Supervisors may also instruct the firm to take specific action to reduce the likelihood of failure. If the firm continues to deteriorate, the Bank will accelerate contingency plans for the firm to be resolved.

18 The amount of time available for contingency planning will vary — for example, depending on the nature of the difficulties within the firm and the actions to recover being taken by the firm. In some cases, the failure could be sudden, but the regime is designed to be sufficiently flexible to adapt to such situations. A Memorandum of Understanding on financial crisis management outlines how HMT, the Bank and the PRA will co-ordinate with each other in the run-up to and during the resolution of an institution.⁽⁴⁾

International co-ordination

19 As required by the Key Attributes and implemented through the BRRD, the Bank will also consult with regulatory authorities in other jurisdictions — where relevant — when planning for, and carrying out, a resolution. This is in order to minimise the impact on financial stability elsewhere. This is particularly important for the United Kingdom, which is the home jurisdiction for a number of global systemically important banks (G-SIBs) and hosts a large number of

international firms — some of which are also G-SIBs — whose headquarters are outside the United Kingdom. The orderly resolution of a cross-border firm would require close co-operation between home and host authorities.

20 The aim of a home authority in leading a cross-border resolution would be to ensure that financial stability is maintained in both home and host jurisdictions. A host authority should not seek to take action with respect to subsidiaries or branches of foreign banks in its own jurisdiction which might frustrate the orderly resolution of the group being co-ordinated by the home authority.

21 In support of these principles of co-operation, the United Kingdom will co-ordinate a group-wide resolution strategy where it is the home supervisory authority of a failing cross-border firm. Regulatory authorities in other countries may need to take supporting regulatory or indeed resolution actions to assist in this. The Bank will co-ordinate with host authorities over any action that may be required.

22 Where the United Kingdom is a host of a foreign firm that needs to be resolved, the UK authorities will aim to co-ordinate closely with the home authorities, and only seek to take independent action in exceptional cases, in line with the approach for cross-border co-operation set out in the Key Attributes. These exceptions are set out in the BRRD, and include where the home country's proposed action, or inaction, is deemed not likely to maintain financial stability in the United Kingdom, and to ensure there is no discrimination against depositors or creditors of host subsidiaries or branches in a host jurisdiction.

Triggering the resolution regime

23 There are two key conditions that must be met before a firm can be put into resolution. The first is that the firm must be failing, or likely to fail — for example, if it is failing or likely to fail to satisfy its threshold conditions for authorisation in a way that justifies the withdrawal of its authorisation. Threshold conditions set out the minimum requirements that regulated firms must meet in order to be permitted to carry on regulated activities, such as taking deposits. In broad terms they require firms to have an appropriate amount and quality of capital and liquidity, to have appropriate resources to measure, monitor and manage risk, to be fit and proper and to conduct their business prudently. The assessment of whether a firm is failing or likely to fail is made by the PRA, or by the

(1) The Bank must expose 8% of the liabilities of the firm in resolution to loss, before HMT can put the firm into temporary public ownership or make a public equity injection.

(2) FSCS protection will be extended to amounts up to £1 million for certain types of deposits classed as temporary high balances. See *PRA Consultation Paper CP20/14*, 'Depositor protection' available at www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp2014.pdf. Further information on protection provided by the FSCS can be found at www.fscs.org.uk.

(3) See PRA (2014), 'The Prudential Regulation Authority's approach to banking supervision', available at www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1406.pdf.

(4) Available at www.bankofengland.co.uk/about/Documents/mous/mouinccrisis.pdf.

FCA for those investment firms regulated solely by the FCA, having consulted the Bank as resolution authority.

24 The second condition is that it must not be reasonably likely that action will be taken — outside the resolution regime — that will result in the firm no longer failing or likely to fail. This assessment is made by the Bank as resolution authority, having consulted the PRA or FCA, and HMT. When making this determination, the Bank must take into account the requirement, introduced through the BRRD, that any remaining regulatory capital must be written down or converted once the firm is no longer viable (that is, once it is failing or likely to fail) before stabilisation tools can be used. In practice, this is likely to occur as the firm enters resolution, since the write-down or conversion is unlikely to be sufficient in itself to resolve the difficulties of the failing firm.⁽¹⁾

25 Measures that may be taken to enable the firm to meet or continue to meet its threshold conditions could involve supervisory action (such as preventing the payment of dividends to shareholders to help to restore financial resources), but may also involve further action by the firm, for example a liability management exercise (such as a voluntary debt-for-equity swap) or sale of parts of the business. This test is based on judgement, for example, the standard is 'reasonably likely' to rather than 'certain' to; and forward-looking, for example, action could be taken if the firm is 'likely to fail'.

26 Hence the regime permits resolution to occur before a firm is 'balance sheet insolvent' (at which point the value of its assets falls below the value of its liabilities). The conditions for entry into the regime seek to strike a balance between facilitating an orderly resolution before all of the firm's franchise value has been eroded, and avoiding placing a firm into resolution before all realistic options for a private sector solution have been exhausted.

The public interest test

27 The decision to put a firm into resolution does not, on its own, directly allow use of all of the resolution tools. In order for the regime's stabilisation tools to be used, it must be necessary to do so, having regard to the public interest in the objectives of resolution. This is because these tools allow the authorities to take actions which may affect property rights. The Bank, having consulted the PRA, FCA and HMT, will assess whether use of the stabilisation tools is necessary to advance the statutory resolution objectives.

28 The weighting given to each objective will vary according to the institution in question and the conditions in the wider financial system when the firm fails. The probable impact of the firm's failure will be assessed assuming that it is placed into modified insolvency. If this assessment indicates that use

of the modified insolvency procedure would not meet the resolution objectives, the stabilisation tools may be used.

29 The decisions that need to be taken by the authorities in the run up to, and during, a resolution may take place in quick succession. **Figure 2** presents a stylised decision tree, setting out the decisions that the PRA as supervisor and the Bank as resolution authority need to make in the course of the resolution of a failing bank. A similar set of decisions would need to be taken in the failure of a building society or an investment firm.

Stabilisation and other tools

30 If the public interest test is met, the Bank may use one or more stabilisation tools contained in the regime. The purpose of using the stabilisation tools is to meet the resolution objectives by achieving continuity of the critical economic functions provided by the firm. The stabilisation tools are:

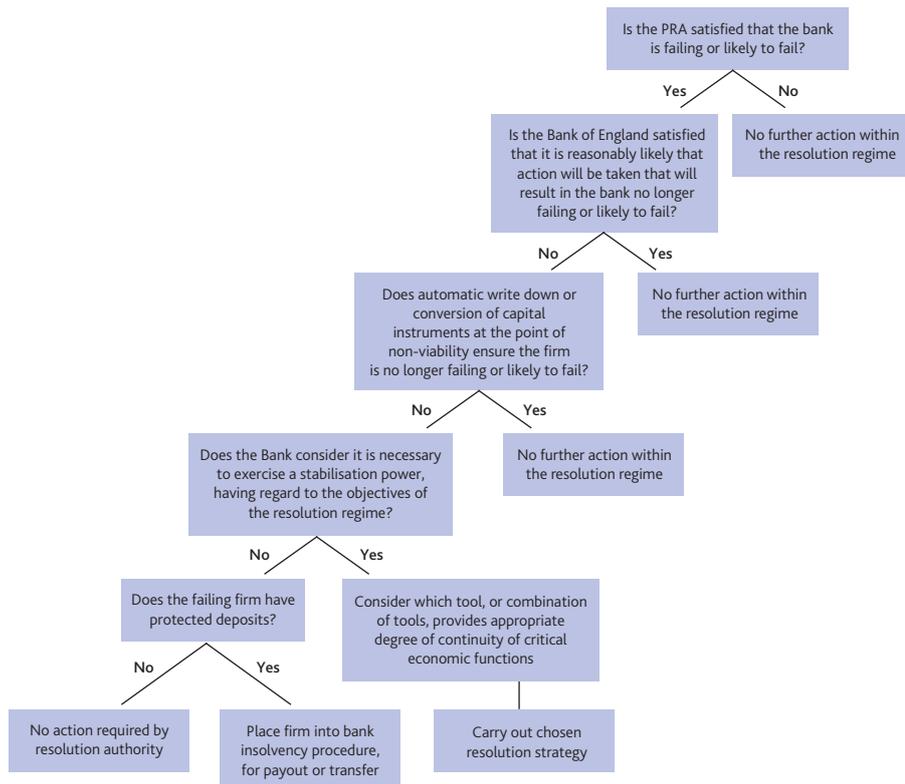
- **private sector purchaser:** this is used to transfer all or part of a firm's business, which can include either its shares or its property, to a willing and appropriately-authorized private sector purchaser;
- **bridge bank:** this is used to transfer all or part of a firm's business to a subsidiary of the Bank which meets the relevant conditions for authorisation, pending a future sale or share issuance;
- **bail-in:** this is used to absorb the losses of a failed firm, and recapitalise that firm (or its successor) using the firm's own resources. The claims of shareholders and unsecured creditors are written down and/or converted into equity to restore solvency, in a manner that respects the hierarchy of claims in insolvency.

31 The stabilisation tools allow the Bank to ensure that the critical economic functions and the parts of the failing firm that have a ready market value can be maintained.

32 For those parts of the firm that do not need to be maintained permanently but may need to be wound down in a measured way, there are two tools that can be used only in conjunction with one or more stabilisation tools. These are:

- **asset separation tool:** this is used to allow assets and liabilities of the failed firm to be transferred to and managed by a separate asset management vehicle, with a view to maximising their value through an eventual sale or orderly wind-down;

(1) See Annex 1 on point-of-non-viability (PONV) requirements introduced through implementation of the BRRD.

Figure 2 Example decision tree for a bank entering resolution^{(a)(b)}

(a) Excludes temporary ownership and public equity support, which are to be used only where HM Treasury considers this is necessary to reduce or resolve a serious threat to financial stability, or to protect existing public financial assistance to the firm in question.

(b) For simplicity, assumes the bank has no client assets, and therefore the relevant modified insolvency procedure is the bank insolvency procedure.

- bank (or building society) administration procedure:** this is used to put the part of a failed firm that is not transferred to the bridge or private sector purchaser (known as the residual bank) into administration. The priority of the administrator is to ensure that the residual bank continues to provide necessary services (for example, IT infrastructure, or mortgage servicing) to the new owner of any transferred business until permanent arrangements for those services can be put in place. Once this priority has been discharged, normal administration follows.⁽¹⁾

33 In order for the stabilisation tools to be effective, it must be possible for the Bank to use them without triggering disorderly termination of the firm's existing contracts. This means that counterparties to financial contracts entered into by the failing firm should not be able to exercise rights to terminate their contracts early. Hence the regime also includes provisions to ensure that a firm's entry into resolution does not, by itself, trigger contractual early termination rights or other events of default.⁽²⁾ If the firm in resolution fails to honour its obligations under the terms of the contract — in other words, it does in fact default — termination and other rights over collateral may be exercised. And the regime also provides for services and facilities from other companies in the group to continue to be provided to the firm in resolution.

34 When considering which stabilisation tool to use, the Bank must balance the resolution objectives set out above. In some circumstances it may be appropriate to use a single tool; in other circumstances it may be more appropriate to use several tools at once. The likely choice of tools could change over time for an individual firm, as the structure of the firm evolves and barriers to resolution are removed. Some tools may be more or less useful depending on the prevailing economic and financial conditions at the time. The choice of strategy and the way this interacts with resolution planning and resolvability is set out in Box 1.

Safeguards for creditors

35 Given the broad nature of the tools and powers set out in the resolution regime, and that the use of stabilisation tools affects individual property rights, the regime provides certain safeguards for creditors. These are designed to achieve a balance between providing certainty to creditors about how they would be treated in a resolution and giving the authorities sufficient flexibility to effect an orderly resolution as quickly as is necessary.

(1) Where a firm has client assets, the residual firm may be placed into a special administration (bank administration) procedure, which combines bank administration and special administration. In this procedure, the objectives of bank administration are given precedence over the objectives of special administration.

(2) The Bank also has the right to suspend payment and delivery obligations and other termination rights for a short period to facilitate bail-in or the transfer of contracts to a solvent purchaser or bridge bank.

Box 1

Choice of resolution strategy

The choice of resolution strategy emerges from the process of resolution planning. This is conducted by the Bank, working with the PRA and/or the FCA and relevant overseas authorities, based primarily on information provided by the firms. For example, PRA-regulated firms are required to prepare and maintain information on their financial, legal and operational structure, as well as the critical economic functions they perform, and to provide this information to the PRA in the form of resolution planning packs.⁽¹⁾ This information is used by the authorities to identify the preferred resolution strategy, before a firm encounters difficulties. A stylised example of the choice of resolution strategy for a failing bank that is likely to require the use of one or more stabilisation tools — for example bail-in of a holding company, sale to a purchaser, or temporary transfer to a bridge bank and subsequent sale — is set out below.

The choice of strategy will be further informed by a number of additional factors, including the complexity of the firm's balance sheet, the scale of its trading book and the extent of its foreign operations.⁽²⁾ More detailed resolution planning based on the preferred strategy — with supplementary information provided by the firm — helps to identify any barriers that might prevent the Bank from carrying out the resolution strategy successfully, should that prove necessary.

For the most complex banks — those designated as G-SIBs by the FSB — resolution strategies are discussed in Crisis Management Groups (CMGs) made up of home and key host financial authorities. The objective of CMGs is to improve preparedness for, and facilitate the resolution of, each G-SIB. In the European Union, as part of the implementation of the BRRD, resolution colleges will aim to facilitate co-operation between home and host resolution authorities for firms that operate in more than one Member State, and provide a forum for joint decisions on resolution planning, assessing resolvability and addressing barriers to resolvability.

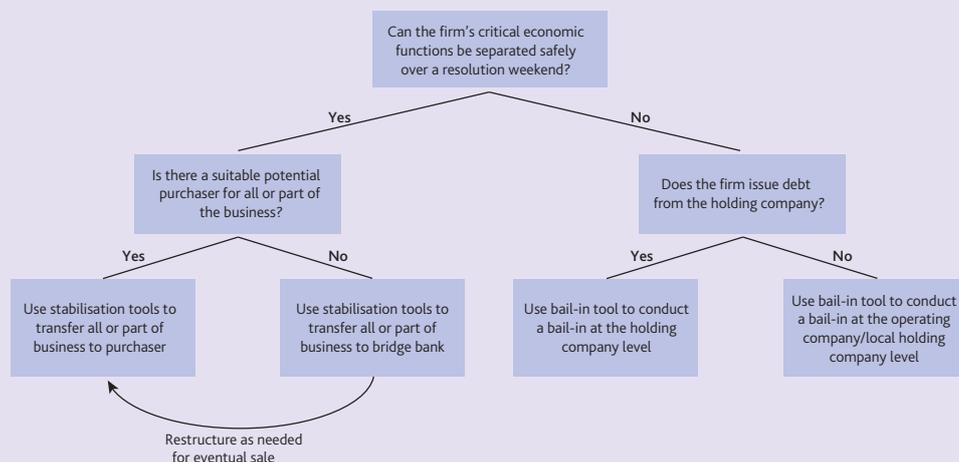
The resolution planning that the UK authorities have already carried out, in collaboration with their international colleagues where relevant, have identified a number of common barriers:

- insufficient loss-absorbing capacity at the holding company and/or operating company;
- the risk of disorderly close-out of contracts governed by foreign law once the firm enters resolution;
- an inability to ensure the supply of services from within the group that support critical economic functions; and
- a lack of flexibility in firms' systems that would affect the authorities' ability to value the firm rapidly.

The Bank will work with firms to ensure that any such barriers are removed, in consultation with the PRA or FCA and other relevant overseas authorities, as required under the BRRD. As barriers are removed, the preferred strategy might be updated to reflect changes in the firm's arrangements for providing essential services to support critical economic functions, or improvements in its arrangements for separating protected deposits from unprotected amounts (and so on).⁽³⁾

This extensive preparation before a firm actually encounters difficulties is essential to secure an orderly failure, that is, the appropriate degree of continuity to the firm's critical economic functions. This will increase the likelihood that any disruption is contained, avoiding a risk to financial stability or a loss of confidence in the financial system.

The final choice of resolution strategy is made only at the point that a firm enters resolution. It will be informed by the resolution planning that has previously taken place, up-to-date information on the condition of the firm, and conditions in economic and financial markets at the time.



(1) Details of revisions to the PRA's arrangements for resolution (and recovery) planning are in *PRA CP13/14*, 'Implementing the Bank Recovery and Resolution Directive'; www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1314.pdf.

(2) For more detail on holding company bail-in strategies for complex firms, see www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf.

(3) For example, as a result of *PRA DP1/14*, 'Ensuring operational continuity in resolution' and *CP20/14*, 'Depositor protection' at www.bankofengland.co.uk/publications/pages/news/2014/125.aspx.

Protections for financial arrangements

36 The use of stabilisation tools could, in theory, affect certain types of existing financial arrangements in a manner that undermines their original purpose. For example transactions that rely on netting and set-off, collateral and certain other capital market and financial market arrangements are protected and must be respected in resolution. This is to ensure that arrangements whose purpose is to reduce the counterparty's loss in the event of a default by the firm are preserved in a resolution. This set of safeguards effectively ensures that the authorities cannot 'cherry pick' when using the stabilisation tools, for example transfer some contracts subject to a netting, set-off or capital markets arrangement with a given counterparty, while leaving others behind.⁽¹⁾

The 'no creditor worse off' safeguard

37 The regime also requires that no shareholder or creditor will be left worse off after the use of stabilisation tools than they would have been had the whole firm been placed into an insolvency proceeding. A 'no creditor worse off' (NCWO) valuation of the firm at the point of resolution is subsequently prepared by an independent valuer, appointed by HMT, in order to check whether any shareholders or creditors have received less from the resolution than they would have recovered from an insolvency. Where there is a shortfall, shareholders and/or creditors are entitled to compensation to close the gap. This compensation must be financed by the industry. The NCWO safeguard assures creditors that their ranking in the creditor hierarchy will be respected and that the losses they will be exposed to when stabilisation tools are used will either be less than, or at worst the same as, in insolvency. The Banking Act Code of Practice outlines the arrangements for compensation in more detail.

Use of public funds

38 The resolution regime aims to ensure that public funds are not put at risk in resolving the failing firm or its successors. The tools and powers are specifically designed to ensure that shareholders and unsecured creditors meet the cost of firm failure. Moreover, resolution planning is conducted on the assumption that no public funds will be available to cover the losses of creditors and shareholders in resolution.

39 Despite this, temporary access to public funds may still be needed in some circumstances. They may, for example, be required as a loan to the FSCS, where the FSCS has been asked to support a transfer or payout of protected deposits. Such funds, including interest on them, would be expected to be repaid from recoveries in the insolvency and/or from levies on the industry.

40 In the unlikely case where the resolution objectives would not be met using any of the regime's stabilisation tools, and where at least 8% of the balance sheet as valued at the point

of resolution has already been exposed to loss, the BRRD permits the use of public funds to stabilise the firm. This may occur if the government decides to inject equity into a failing firm or take it into temporary public ownership. These tools are only available as a last resort, where a serious threat to financial stability cannot be avoided by other measures or where necessary to protect existing public funds. The decision to use them is made by the government, subject to approval from the European Commission (EC) under the State aid framework.⁽²⁾ Further details on the use of public funds are set out in Annex 1.

Role of insolvency

41 Where the public interest test outlined above is not met, firms may be put into a modified form of insolvency procedure, providing they hold protected deposits or client assets (or both). The alternative procedures, which vary according to the type of firm concerned, are discussed below. Where the firm holds neither protected deposits nor client assets, it would be placed into ordinary insolvency.

Banks and building societies

42 The bank insolvency procedure involves putting the whole bank into an insolvency process designed to allow for rapid payment of deposits protected by the FSCS (up to the limit of £85,000) or the transfer of the accounts of protected depositors to a viable bank. In the case of a building society, the building society insolvency procedure would be used. The bank insolvency procedure was used in June 2011, when the Southsea Mortgage and Investment Company failed.⁽³⁾

43 These modified procedures require the insolvency practitioner appointed to manage the wind-down of the firm to prioritise either the transfer of protected depositors' accounts to another deposit-taker or to facilitate a payout to protected depositors by the FSCS. In both cases, the FSCS provides funding and becomes a creditor in the insolvency, 'standing in the shoes' of protected depositors. The FSCS will levy the industry to meet the costs of a payout or transfer.

44 If necessary, the FSCS may borrow from the government where its own funds are insufficient at the point when the payout or transfer takes place. These funds would be repaid subsequently. The FSCS will make a claim in the insolvency to recover these costs, which helps to reduce the impact on its levypayers.

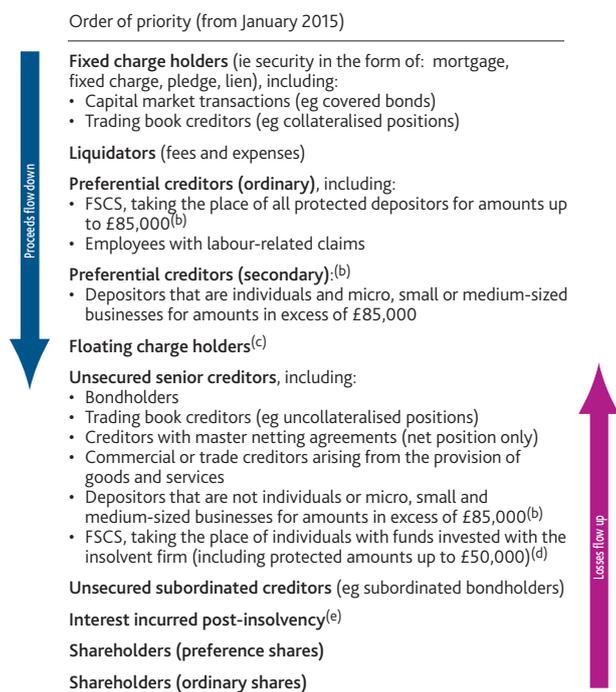
(1) The Bank is permitted to depart from this safeguard in certain circumstances, for example in order to ensure individuals and SMEs continue to have access to their deposits by facilitating their transfer. A detailed discussion of safeguards is set out in Davies, G and Dobler, M (2011) 'Bank resolution and safeguarding the creditors left behind', *Bank of England Quarterly Bulletin*, Vol. 51, No. 3, pages 213–23 available at www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb110302.pdf.

(2) See http://ec.europa.eu/competition/state_aid/overview/state_aid_procedures_en.html.

(3) Further details can be found at www.bankofengland.co.uk/publications/Pages/news/2011/060.aspx.

45 The BRRD makes deposits protected by EU guarantee schemes and deposit guarantee schemes themselves (including the FSCS) 'super-preferred'. This means that in insolvency the FSCS has the first unsecured claim in the estate, along with other preferred creditors, and is likely to recover more of its costs than under the previous creditor hierarchy. Deposits from individuals and micro, small and medium-sized enterprises that are higher than the protected amount of £85,000, are preferred to other senior unsecured liabilities but not super-preferred. **Figure 3** sets out the creditor hierarchy that applies from 1 January 2015.

Figure 3 Insolvency creditor hierarchy^(a)



(a) Proceeds recovered through an insolvency are used to meet the claims of creditors in the top row first, with any excess being passed down to meet claims of creditors in the second row, and so on. Any losses arising from a shortfall between proceeds and creditor claims are incurred firstly by shareholders, and then pass up the creditor hierarchy until they are fully absorbed. Creditors within a row are treated equally (rank 'pari passu').

(b) Amendments to existing creditor hierarchy introduced by the Bank Recovery and Resolution Directive.

(c) Floating charges that constitute financial collateral arrangements or collateral security (pursuant to the UK Financial Collateral Arrangements Regulation and the Financial Markets and Settlement Finality Regulations) rank senior to preferential creditors and liquidators' fees and expenses.

(d) Some smaller businesses are also protected by the FSCS for investment business up to £50,000.

(e) Ranking for all statutory interest from the date of the winding-up order until a final dividend is declared or all proved debts have been paid — unless otherwise specified by contract.

46 Once protected deposits have been dealt with by payout or transfer, the firm is wound up in the normal course of an insolvency process.

47 A payout is likely to mean a temporary interruption in access to deposits, as depositors wait to receive payment, usually by cheque, from the FSCS. The FSCS seeks to make a payout within seven days for the majority of depositors. In each case the insolvency practitioner will work with the FSCS to facilitate timely payout or transfer, and will be reliant upon information from the failed firm in order to carry out that task.⁽¹⁾

Investment firms

48 The special administration regime for investment firms (SAR) is available for the whole firm to be placed into an insolvency proceeding. In the SAR, the administrator of a failed investment firm has certain objectives, including the return of client money or assets as soon as is reasonably practicable and ensuring timely engagement with market infrastructure bodies and the authorities. The administrator also has the normal insolvency objective to rescue the firm as a going concern or wind it up in the best interests of creditors.

49 The PRA or FCA can direct the administrator to prioritise one or more of the SAR objectives. This might be considered necessary if this would be in the interests of the stability of the financial systems, or the maintenance of public confidence in the stability of the financial markets, of the United Kingdom.⁽²⁾

Firms with deposits and client assets

50 Some firms that fail may have both deposits protected by the FSCS and client assets (including client money). In these circumstances, although the administrator must immediately begin to work on the objectives relating to client assets, the special objectives for depositors take precedence. This means that the administrator must work with the FSCS to ensure that protected deposits are either paid out or transferred to another financial institution.

(1) To support fast payout, firms are required to maintain a 'single customer view', showing the total protected amount per customer. Changes to the requirements placed on firms to facilitate payout or transfer in resolution are included in *PRA Consultation Paper CP20/14*, 'Depositor protection' available at www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp2014.pdf.

(2) The special administration regime for investment firms was the subject of an independent review in 2013. See HMT (2014) 'Final review of the Investment Bank Special Administration Regulations 2011', available at www.gov.uk/government/uploads/system/uploads/attachment_data/file/271040/PU1560_SAR.pdf.

Part 2 Conducting a resolution

51 This part of the document explains the key stages of a resolution transaction in greater detail, focusing on the use of stabilisation tools. The detail set out in these sections, and in this document, is intended to give greater clarity over how the Bank is likely to approach a resolution. The Bank retains the ability to exercise its discretion when deciding how best to resolve a firm in pursuit of the objectives of the resolution regime, based on the facts at the time.

52 There are three key phases to any resolution, as described below and illustrated in **Figure 4**:

- **stabilisation phase**, in which the provision of critical economic functions is assured, either through transfer to a solvent third party or through bail-in to recapitalise the failed firm;
- **restructuring phase**, during which any necessary changes are made to the structure and business model of the whole firm or its constituent parts to address the causes of failure; and
- **exit from resolution**, where the Bank's involvement as a resolution authority in the failed firm and any successor firms comes to a close.

53 The use of stabilisation tools is likely to involve a number of separate transactions that will be carried out by the Bank using its powers under the Act. These are similar in effect to existing corporate transactions, and follow similar principles. For example, they could include a transfer of business from the failed firm to a willing purchaser, akin to an acquisition.

Or they could involve the replacement of debt instruments with shares to recapitalise the firm, akin to a debt-for-equity swap, followed by the launch of a restructured business.⁽¹⁾

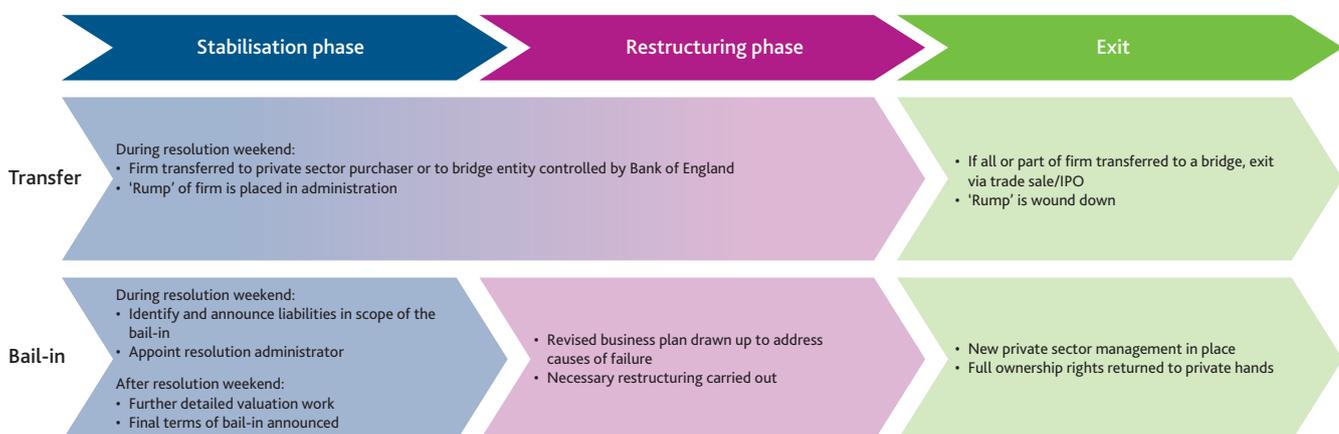
54 Unlike existing corporate transactions, the resolution authority is empowered to act without seeking the consent of shareholders, creditors or the existing management of the firm. This feature of the regime recognises that the firm has failed and is designed to ensure that action can be taken quickly and effectively. As part of the process, the Bank will expect to remove senior management considered responsible for the failure of the firm and appoint new senior management, as necessary, to any continuing parts of the failed firm not transferred directly to a purchaser.

III Stabilisation phase

55 For a firm that has entered resolution, the Bank will decide which of the stabilisation tools should be used in order to secure the appropriate degree of continuity of the firm's critical economic functions. The firm will need to be stabilised, either through use of the tools designed to facilitate a transfer of some, or all, of the firm, or through use of the bail-in tool. In either approach there will need to be some form of loss absorbency available to the resolution authority at the point of resolution, so that solvency can be restored.

56 In either approach it is likely that liquidity will need to be provided to the firm in resolution, for example if external funding sources are not available to the firm in resolution. This may be under the terms of the Bank's published schemes,

Figure 4 Stages of resolution



(1) For a more complete discussion of the parallels, see Gracie, A (2012), 'Resolution through the lens of corporate restructuring', available at www.bankofengland.co.uk/publications/Documents/speeches/2012/speech583.pdf.

as set out in the 'Red Book',⁽¹⁾ or may be on a bilateral, individually-tailored basis to ensure that the financial stability objectives of the resolution are achieved. Any liquidity provided would need to comply with the EC's State aid framework.

57 As part of the stabilisation, the Bank will aim to ensure that a firm's existing arrangements for accessing payment systems, clearing and settlement systems and central counterparties — the essential components of the financial market infrastructure — remain intact. (This includes any services provided by the failing firm to its customer banks.) This supports the goal of an orderly resolution, by minimising any disruption to existing transactions.

58 In most complex cases, it will be advantageous for the authorities to have up to 48 hours outside normal market hours to conduct the initial transactions. This is often referred to as the 'resolution weekend'. It will not always be essential to have an actual weekend — the amount of time required will depend on the amount of advance planning that has been carried out and the speed of the firm's failure. If a firm meets the conditions for entry into the resolution regime mid-week, resolution will begin at that point.

Resolutions involving a transfer

59 The Bank can take a number of different approaches to stabilising the firm using transfer tools, depending on the complexity of the firm and the market conditions at the point of failure. The key alternatives are:

- transfer of a whole firm to a private sector purchaser;
- transfer of part of the firm — its critical economic functions such as deposit-taking — to a purchaser, backed by good-quality assets;
- temporary transfer of all or part of the firm to a bridge bank, backed by good-quality assets in preparation for an onward sale (via transfer to a purchaser or an initial public offering);
- any part of the firm not transferred to a purchaser or bridge bank, such as poor-quality assets and remaining liabilities, would be placed into administration or into an asset management vehicle.

60 The transfer to a purchaser would generally be effected through an auction process over a 'resolution weekend', unless it were necessary to forgo an auction on financial stability grounds or to complete the transaction speedily. The transfer of a whole firm to a purchaser has some advantages. It avoids the complexities of maintaining continuity of services when splitting the firm apart in resolution, for example separating deposits that are protected by the FSCS from those to be left behind in administration.

61 In the absence of an appropriate purchaser willing to acquire the whole firm at the point of failure, the Bank can choose to transfer only the liabilities associated with the failed firm's critical economic functions — such as protected deposits — to a purchaser, backed by good-quality assets. Those assets and liabilities that are not linked to critical functions and do not improve the chances of achieving a sale would be left behind and dealt with in insolvency.

62 If a purchaser cannot be found immediately, a bridge bank⁽²⁾ can be used to maintain the critical economic functions of a failed firm on a temporary basis, while the poor-quality assets and loss-bearing liabilities are again left behind in insolvency. The primary objective of a bridge bank is to facilitate the sale of the business to one or more purchasers. It is inherently a temporary measure, and should only operate for as long as is needed to arrange a sale or an initial public offering.

63 The steps involved in a case where a combination of the transfer tools is used are illustrated in a stylised numerical example in Box 2.

Executing a transfer

64 A transfer will be given effect through one or more transfer instruments finalised by the Bank during the resolution weekend. Transfer instruments set out which parts of the business have been transferred and to whom — for example to one or more purchasers and/or a bridge bank. A court order would also be prepared to place the remainder of the business into administration.

65 At the end of the weekend, the Bank will announce:

- that the firm has entered resolution, on either the Sunday evening or the Monday morning (depending on the nature of the business);
- the nature of the resolution strategy being carried out — in this case a transfer — and the destination of the various parts of the business of the firm;
- that the firm's core functions will continue without disruption and that those depositors and investors protected by the FSCS continue to be protected (as always); and
- that the firm will open for business on Monday morning.

(1) See Bank of England (2014), *The Bank of England's Sterling Monetary Framework*, available at www.bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf.

(2) Although the term 'bridge bank' is used in the legislation, in practice the tool is available whether the failed firm is a bank, building society or investment firm.

Box 2 Stylised example of a transfer

This example illustrates how transfer tools could be used to resolve a failing institution and protect critical economic functions.

Panel A shows a stylised bank balance sheet for a firm that has entered resolution following a £10 reduction in the value of its assets. Of the firm’s assets, £260 are identified as high-quality assets, with £30 being low-quality assets. In this example, it is assumed that the critical economic function being protected is the £120 deposit book, located in the £248 of ‘other liabilities’.

Panels B and C show how the bank would be split up. High-quality assets, ‘other liabilities’ — including the deposit book — and £3 of senior liabilities are transferred to a purchasing bank in panel B. The acquiring bank could be another private sector bank, or potentially a bridge bank.

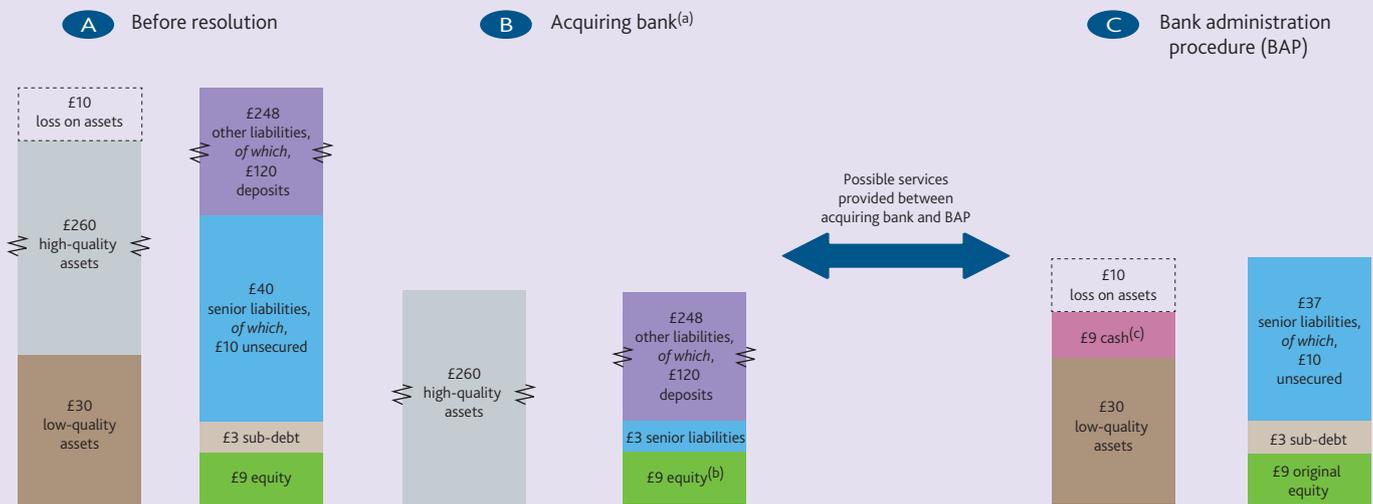
Panel C shows that the remaining low-quality assets, original equity, subordinated debt (‘sub-debt’) and senior liabilities not transferred are left behind in a bank administration procedure. Services may be provided from the residual bank in administration to the acquiring bank, and *vice versa*.

Creditors in the administration would receive proceeds from the eventual sale of the transferred assets and liabilities, and from the £30 in low-quality assets.

In this example, it is likely that the original equity holders, and £1 of the subordinated debt holders, would not receive full recovery of their claims. The final recovery will depend upon the proceeds of the sale, since any excess value will accrue to the administration procedure, and the proceeds of disposal of the low-quality assets.

The transferred assets and liabilities would have a net asset value sufficient to meet capital requirements (assumed here to be the same as for the bank before it entered resolution). This would either support the sale to a private sector purchaser, or provide capital if the business was transferred to a bridge bank.

Following resolution, HMT would appoint a valuer to provide an independent assessment of the ‘no creditor worse off’ value of the firm at the point it entered resolution. If any creditor is worse off than their position would have been in insolvency, they would be entitled to compensation.



Note: block sizes not to scale.

(a) The acquiring bank may be a private sector purchaser or a bridge bank.
 (b) Equity provided by the excess in net asset value transferred to the acquiring bank.
 (c) Cash is from sale of the equity in the new bank, sale of which provides compensation to creditors in the BAP.

66 The availability of transfer options will depend upon a number of factors. The degree of interest from potential purchasers will be determined by: the nature of the difficulties at the firm, for example whether the losses have arisen in multiple business lines or are confined to a limited area; the ease with which the firm can be valued, for example the proportion of hard-to-value or illiquid assets in the balance sheet; and prevailing market conditions at the time.⁽¹⁾

67 In a transfer of business, the acquirer would need to demonstrate that the threshold conditions necessary for PRA or FCA authorisation of the acquired or merged business are met. For example, the purchaser would need to demonstrate compliance with capital requirements during the resolution process and be capable of having a credible business plan once the transfer has occurred. In a transfer of shares, the acquirer would need to seek approval for any change in control from the PRA or FCA.

68 The FSCS also has a role in a transfer that uses stabilisation tools. It can be required to provide a contribution to the cost of resolving the failed firm, including by contributing to recapitalisation costs or making payments which provide capital to the bridge bank or purchaser, up to the amount that it would otherwise have incurred on a payout, after recoveries.

69 As an example, FSCS contributed to the costs of the resolution of Dunfermline Building Society in March 2009. This firm was resolved using a combination of the transfer of some of the business to a willing buyer, the temporary transfer of other parts of the business to a bridge bank, with the remainder being placed into a building society administration procedure.⁽²⁾

Resolutions involving a bail-in

70 The size and complexity of most global banks and investment firms greatly increases the difficulty of rapidly separating critical economic functions from the rest without causing systemic disruption. For such large firms, a transfer of part or all of the business is likely to be difficult to achieve during a short period, such as a resolution weekend. This has led to the development of the concept of bail-in, although as a stabilisation tool, it is available for any firm where use of an insolvency procedure would not meet the resolution objectives. That is, where the public interest test is met.

71 Bail-in stabilises a failing firm by ensuring that the interests of existing shareholders are cancelled, diluted or transferred, and the claims of unsecured creditors are written down sufficient to absorb the losses incurred. Creditor claims are converted into equity to recapitalise the firm. This ensures that the essential functions of the firm can continue, without any need to split up the firm immediately.

72 Where possible the bail-in will be carried out in a holding company of the failing firm, for example, where a group issues debt to external investors from a holding company. This would allow losses to be absorbed and the firm to be recapitalised without the operating companies themselves needing to enter resolution. This should help to maintain the critical functions located in those operating companies.

73 Following a bail-in, the firm in resolution (or a successor firm) will continue to be authorised and regulated by the PRA and by the FCA (as market conduct regulator, and in the case of many investment firms, prudential regulator). Each will assess whether the firm complies with their threshold conditions and other regulatory requirements in the usual way.

74 Bail-in can be used to ensure that the firm or its successor is able to meet regulatory capital requirements, paving the way for it to operate once again under private ownership and control. This will in general be achieved by providing creditors with compensation that corresponds to the net asset value of the firm following the write-down of liabilities — to cover any losses — during the bail-in. That compensation will be allocated in accordance with the creditor hierarchy in insolvency.

Executing a bail-in

75 There are four core elements to a bail-in within the UK resolution framework:

- the run up to a resolution, where preparations are put in place for the resolution weekend;
- the bail-in period, including the resolution weekend;
- the announcement of final bail-in terms and compensation arrangements; and
- restructuring of the firm after bail-in.

76 In the run up to a resolution, the Bank would create a draft resolution instrument which will give legal effect to the bail-in, including the write-down and/or conversion of outstanding regulatory capital instruments. As part of this preparation, the Bank will identify those liabilities which are within scope for the bail-in, for example shares, subordinated debt and unsecured senior creditors.

77 During the resolution weekend, the Bank would confirm which liabilities are within scope of the bail-in, for example shares plus subordinated debt, or shares plus subordinated debt plus senior unsecured debt. The FCA may suspend

(1) Further discussion of the importance of valuation in resolution is provided in Annex 2.

(2) Further information available at www.bankofengland.co.uk/archive/Documents/historicpubs/news/2009/030.pdf.

trading in those instruments. One way of executing the bail-in would be for the Bank to transfer the legal title of the shares to a third-party commercial bank appointed by the Bank to act as a depositary bank. The Bank is also likely to appoint a resolution administrator, acting under the Bank's direction.

78 At the end of the weekend, the Bank will announce:

- that the firm has entered resolution, probably on the Sunday evening (prior to the re-opening of Asian financial markets);
- the nature of the resolution strategy being carried out — in this case a bail-in without any immediate changes to the structure and functioning of the firm — and the liabilities that will be affected;
- that the firm's core functions will continue without disruption and that those depositors and investors protected by the FSCS continue to be protected (as always); and
- that the firm will open for business on Monday morning, providing information on the expected financial strength of the firm.

79 The depositary bank would hold the shares on trust until they can be distributed to former bondholders or other creditors identified as being entitled to compensation, once the final terms of the bail-in are announced. This period would need to be as short as possible, while allowing sufficient time to ensure that the valuation, on which write-downs are based, is robust.

80 During this period, further detailed valuation work will be undertaken by the authorities so that the resolution administrator can announce the final terms of the write-down of liabilities within scope of the bail-in as soon as possible. One method of balancing the need to provide creditors with continued access to their claims while trading in the liabilities within scope of the bail-in has been blocked, is to issue instruments known as 'certificates of entitlement'. This mechanism would enable former creditors to be provided with shares or other instruments in due course, with the relevant depositary bank maintaining legal title until the final valuation is complete. (See Annex 3 for more detail.)

81 Once the valuation work is complete, the terms of bail-in will be announced, including the terms on which the certificates of entitlement will be exchanged for shares in the firm. The resolution administrator will continue to exercise voting rights on behalf of the former creditors until a sufficient number have come forward to claim their shares (at least a majority) or a set time period has passed. Depending on the

number of shares issued, formal approval of a change in control may be needed.

82 In line with the 'no creditor worse off' safeguard, any shareholders and creditors directly affected by the resolution must not be left worse off than if the whole firm had been placed into insolvency. Creditors may be compensated with shares or other securities in the resolved firm in order to ensure that the NCWO safeguard is not breached. Given the timings involved, robust valuations of the assets and liabilities of the firm, and the expected equity in the firm once it has been resolved are crucial factors in ensuring these principles are met. (Further details of the valuations required are set out in Annex 2.)

83 The steps outlined above are illustrated in a stylised example in Box 3.

Role of asset management vehicles

84 The BRRD requires the United Kingdom to provide the resolution authority with an asset separation tool. The tool gives the Bank the power to transfer assets, rights and liabilities of a firm to an asset management vehicle (AMV).⁽¹⁾ Strictly speaking, the asset separation tool is classed as a stabilisation tool, but unlike the other stabilisation tools it can only be used in conjunction with another stabilisation tool.

85 The BRRD specifies that an AMV must be wholly or partially owned by the authorities and must manage the assets transferred to it with a view to maximising their value through eventual sale or orderly wind-down. It can only be used if liquidating the assets using normal insolvency proceedings would have adverse effects on financial markets.

86 The asset separation tool could support both transfer and bail-in resolutions. In a transfer, the tool could be used to transfer poor-quality assets to the AMV, reducing the risk profile of the remaining firm, which may help to improve market interest and the likelihood of a sale. In a bail-in, the tool could be used to support a rapid restructuring after the firm has been stabilised, by separating out the business lines that caused failure, improving the viability of the recapitalised firm.

IV Restructuring phase

87 Once the firm has been stabilised, either through bail-in or transfer, the next stage will be to consider what restructuring of the firm will be required in order to address the causes of failure and restore confidence in it. The extent of restructuring required will depend upon the causes and consequences of

(1) Asset management vehicles are used by HMT to manage the gradual exit from government ownership of the outstanding mortgage books of the former Northern Rock and Bradford & Bingley. Further information can be found at www.ukar.co.uk.

Box 3 Stylised example of a bail-in

This example illustrates how a bail-in could be used to recapitalise a failing bank and allocate losses across different creditor classes.

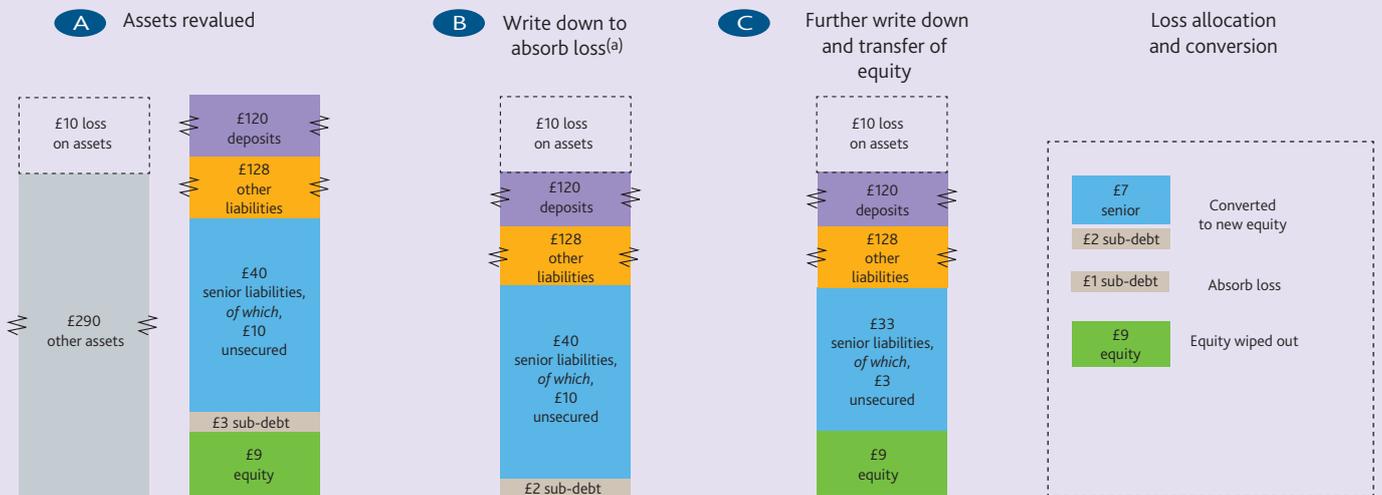
Panel A shows a stylised bank balance sheet for a firm that has entered resolution following a £10 reduction in the value of its assets. The PRA will have to set the firm's new capital requirement; it has been assumed (for simplicity) that the firm will need to be recapitalised to the same level as was required before the firm entered resolution.

Panels B and C show the liability side of the balance sheet and break down the bail-in transaction into two phases. In the example, existing shares are transferred to a third party depository. Panel B shows that all of the equity and some of the subordinated debt ('sub-debt') liabilities are written down to the extent necessary to absorb the loss. Panel C shows a conversion of the remaining subordinated debt and also of part of the senior unsecured creditors to create sufficient net asset value to meet the PRA's capital requirement. The shares transferred to the third party depository are then allocated to those creditors written down in Panel C.

In this example, the outstanding equity is completely written down to absorb the losses, and £1 out of the £3 of subordinated debt in issue is written down. The equity stake is then allocated between the remaining subordinated debt holders and senior unsecured creditors as part of the process shown in panel C.

The amount of equity allocated to subordinated debt and senior unsecured creditors will be determined with reference to an equity valuation, to estimate the value of the shares being allocated, and an insolvency valuation, which estimates the value creditors would have received in insolvency. The Bank must ensure that no creditor would be worse off than they would have been if the whole firm had been placed in insolvency. Based on these valuations, the Bank will determine what proportion of the shares should be allocated to different classes of creditors. For example, if the equity value is estimated at significantly above the value of senior debt bailed in, then some value could be allocated to subordinated creditors.

As with a transfer, if any creditor is worse off than they would have been in insolvency, they would be entitled to compensation following resolution. This would be assessed by an independent valuer appointed by HMT.



Note: block sizes not to scale.

(a) Shares are transferred to the Bank of England during the write-down.

failure. Were the losses caused by a single rogue trader or specific market shock, or did they result from widespread problems with the business model? Did they occur in only one business line or many? Did the circumstances of the failure reveal pervasive problems with the risk management of the firm?

88 Any restructuring plan will need to ensure that critical economic functions are maintained. And market confidence will need to be restored in order to avoid a flight of counterparties and to enable the firm to access funding markets at a sustainable price. In the case of a bail-in, the Bank will require a resolution administrator or one or more directors of the firm under resolution to submit a business reorganisation plan. This reorganisation plan would cover the group as a whole, and would be sent by the Bank to the relevant supervisors and to authorities hosting other parts of the group.

89 The reorganisation plan would provide, among other things, a diagnosis of the factors and problems that caused the failure of the firm, a description of the measures aimed at restoring the long-term viability of the firm, and a timetable for carrying out those measures. The measures may include:

- the reorganisation of the activities of the group;
- a withdrawal from loss-making activities;
- sale or transfer of assets or business lines; and
- a restructuring of existing activities to restore competitiveness.

90 The restructuring that takes place after the firm has been stabilised is designed to address the causes of failure, will take time and is likely to require the firm to have sufficient capital in excess of its minimum regulatory requirements. Therefore, it is essential that the expected costs of restructuring the firm are taken into account when determining the extent of the bail-in that will be required. The proposed restructuring plan will have implications for the valuation of the specific business line(s) captured, as well as the franchise value of the firm as a whole. This effect on the bail-in valuation will need to be included when announcing the final terms of the bail-in and the resulting scale of the write-down and/or conversion required. (See Annex 2 for more detail.)

91 With a bridge bank, the restructuring effectively takes place over the resolution weekend, when critical functions (such as retail deposit liabilities) are transferred to the bridge

bank backed with supporting assets. Shares, debt and other unsecured liabilities remain in a bank administration procedure, along with unwanted or poor-quality assets.

92 For critical functions and other business transferred to a bridge bank, an initial public offering, private share sales or portfolio sales are likely to be the most feasible ways of ensuring that the bridge bank is only temporary. Some additional restructuring may be required to facilitate one or more of these options.

V Exit from resolution

93 Identifying the route for the Bank to bring its involvement with an individual firm to a close is a key part of the resolution. The regime's tools support the objective that firms will either cease to exist — they may be put into insolvency, wound down or be absorbed by a new owner — or that they will be restructured and able to operate without official liquidity support when the resolution has been completed.

94 The precise route out of resolution will be shaped by the nature of the intervention that has taken place. Where all or part of a business is sold to a private sector purchaser, the exit is clear. Where a bridge bank is used, it must be a bridge to a more permanent arrangement — exit is likely to be through an onward sale to a private sector purchaser or an initial public offering. Similarly, where all or part of a business is put into administration or insolvency, the administration or insolvency procedure will run its course. And, where the asset separation tool is used, the objective of this is to ensure that certain assets of the firm are disposed of in an orderly fashion.

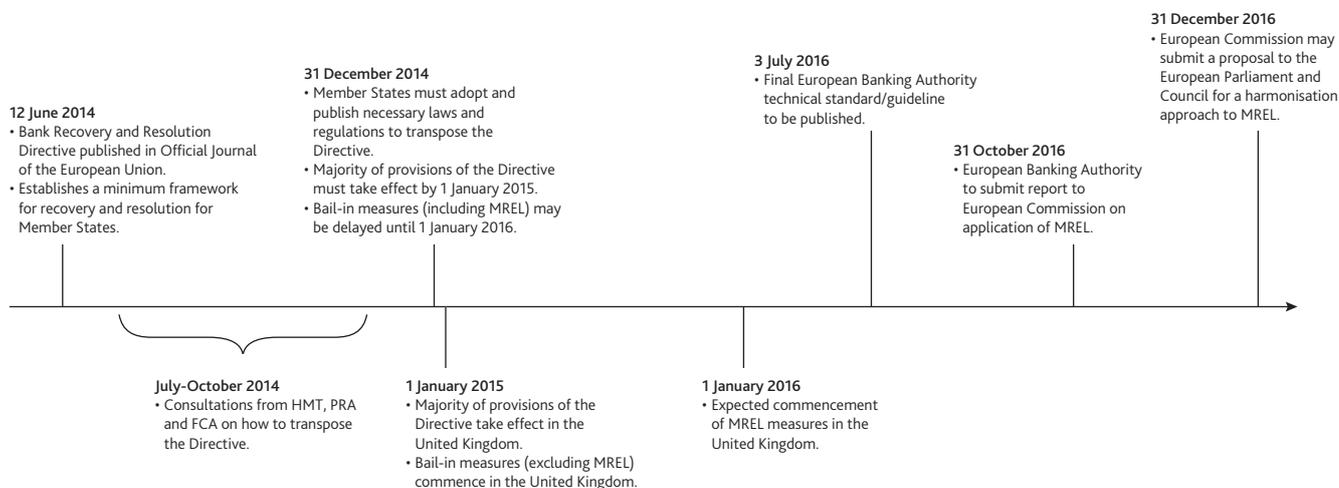
95 Where the bail-in tool is used to recapitalise an existing firm, it is essential that the causes of the firm's failure are addressed directly. Restructuring the firm is likely to be a critical part of this process. Some parts of the business may need to be wound down or sold, but the remaining business may also need to be restructured. The bail-in absorbs the losses and recapitalises the failed firm. It therefore provides the stability to evaluate the firm's strategy and to carry out any restructuring that may be required.

96 The goal of ensuring that the firm can operate unsupported means that the firm must be recapitalised to a level that is sufficient to restore market confidence and allow the firm to access private funding markets. This means that the level of capital held by the firm is likely to need to be higher than the minimum required for authorisation by the relevant supervisor.

Annex 1

Overview of the Bank Recovery and Resolution Directive

Timeline



The Bank Recovery and Resolution Directive (BRRD) was published in the Official Journal of the European Union in June 2014. It establishes a European framework for the recovery and resolution of banks and large investment firms and complies with the Financial Stability Board's international standard for effective resolution regimes (the Key Attributes).⁽¹⁾ It must be transposed into national law by 31 December 2014.⁽²⁾

The BRRD sets out the roles and responsibilities for firms, supervisors and resolution authorities prior to resolution (recovery and resolution planning), as a firm begins to weaken (early intervention tools) and in resolution (resolution tools). It also sets out a framework for co-operation between Member States so that they may plan for and manage the failure of firms that operate across borders within the European Union; and provides for co-operation with resolution authorities outside the European Union.

The United Kingdom is required to equip the resolution authority with resolution powers and tools so that it may take steps to preserve the critical economic functions of a bank or investment firm in resolution and expose existing holders of its liabilities to loss, without needing to put public funds at risk. It also sets out steps that must be taken post-resolution — including the restructuring of firms and providing compensation to certain creditors where they have been treated worse in resolution than they would have been had the firm been put into insolvency.

Scope of the BRRD

The following types of financial institutions are within scope of the BRRD:

- credit institutions, that is those firms licensed to take deposits from the public and extend loans, such as banks and building societies;
- '730k investment firms', that is those investment firms that deal as principal and must have initial capital of €730,000 (as defined under the Capital Requirement Regulation (575/2013));
- certain financial institutions (those that are subsidiaries of credit institutions or investment firms, or of financial holding companies); and
- financial holding companies, mixed financial holding companies and mixed activity holding companies.

All these types of firms are already within the scope of the UK resolution regime. Where the subsidiaries of a mixed-activity holding company are held directly or indirectly by an intermediate financial holding company, any action required to resolve the group will be taken at the level of the intermediate financial holding company, not the mixed-activity holding company.

Member States must establish a resolution authority. The Bank will be the UK resolution authority, in accordance with its current role in the Banking Act 2009, and will have a number of new powers and responsibilities prior to resolution.

(1) For the latest version, see FSB (2014), 'Key attributes of effective resolution regimes for financial institutions', available at www.financialstabilityboard.org/publications/r_141015.pdf.

(2) See HMT (2014), 'Transposition of the Bank Recovery and Resolution Directive', available at www.gov.uk/government/consultations/transposition-of-the-bank-recovery-and-resolution-directive; and PRA Consultation Paper CP13/14, 'Implementing the Bank Recovery and Resolution Directive', www.bankofengland.co.uk/pradocuments/publications/cp/2014/cp1314.pdf.

These are: requiring information from firms for resolution planning; assessing resolvability of firms; requiring the removal of barriers to resolvability; setting the minimum requirement for own funds and eligible liabilities (MREL) for individual firms; and assessing the second condition for resolution (that there is no reasonable likelihood that a firm will no longer be failing or likely to fail).

Under the BRRD the triggers for resolution will remain broadly unchanged. However the Directive introduces a mandatory write-down of regulatory capital instruments at the point of non-viability (PONV). This means that common equity (CET1), additional Tier 1 (AT1) and Tier 2 (T2) that qualify as regulatory capital instruments must absorb losses, up to the extent required to meet the resolution objectives, before or together with the use of any of the resolution tools.

Although it is possible that a PONV write-down alone could restore a firm to viability, where the losses are limited and the business model remains sound, our expectation is that it would generally be applied at the same time as the relevant resolution tools.

Additional tools

The majority of the resolution tools set out in the BRRD are already available under the UK regime. However two new tools are introduced: an asset separation tool and a public equity support tool.

The asset separation tool, which may only be used with another resolution tool, will enable the Bank to transfer the assets, rights and liabilities of an institution to an asset management vehicle which is wholly or partially owned by public authorities. The asset management vehicle will manage assets transferred to it with a view to maximising their value through eventual sale or orderly wind-down.

The public equity support tool equips Member States with the power to contribute to the recapitalisation of firms in exchange for CET1, AT1 or T2 instruments. This tool is controlled by HM Treasury and there are limitations on its use, in addition to those relating to the use of stabilisation tools.

Requirement for loss-absorbing capacity

The BRRD also introduces, in MREL, the concept of a minimum requirement for loss-absorbency, which aims to ensure that all firms have adequate total loss-absorbing capacity, including sufficient liabilities that could credibly be exposed to loss in resolution. All EU banks and investment firms within scope of the BRRD will be subject to an MREL, which will be set on a firm-by-firm basis according to criteria set out in the Directive, from 1 January 2016 at the latest.

The BRRD prohibits early termination of financial (and other) contracts as a result of entry into resolution or application of

the resolution tools, provided that the substantive obligations of the financial contracts, including payment and delivery obligations, and provision of collateral, continue to be met. To achieve this, the relevant elements of the Financial Collateral Arrangements Directive (FCAD) are amended by the BRRD. This will allow existing provisions in the Banking Act 2009 to be effective for instruments covered by FCAD and provides a comprehensive mechanism for ensuring that termination rights are not automatically triggered by resolution.

Resolution funds

Member States must establish resolution funds of at least 1% of deposits that are protected by their national Deposit Guarantee Scheme (DGS). These must be financed by industry through a risk-based *ex-ante* levy system and supplemented by additional levies after resolution as necessary. In the United Kingdom this requirement is met through the existing levy on deposit-takers.

These resolution funds may be used only to the extent necessary to ensure the effective use of the resolution tools for the following reasons:

- to guarantee the assets or liabilities of the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
- to make loans to the institution under resolution, its subsidiaries, a bridge institution or an asset management vehicle;
- to purchase assets of the institution under resolution;
- to make contributions to a bridge institution or an asset management vehicle;
- to pay compensation to shareholders or creditors; and
- to lend to resolution funds of other Member States on a voluntary basis.

The Directive also permits resolution authorities to wholly or partially exclude a liability from bail-in in exceptional circumstances and, if this is the case, the resolution fund may be used in lieu of the write-down or conversion of the excluded liability.

Resolution funds are not designed to be directly loss-absorbing. The BRRD requires that at least 8% of the total liabilities of a firm in resolution, including own funds, must be exposed to loss before resolution funds or public funds can be used to absorb losses and recapitalise a firm (for example by making a contribution to the institution in resolution instead of creditors that have been exempted from bail-in). Use of resolution funds is also subject to EU State aid rules and requires approval by the European Commission.

In the United Kingdom, resolution planning will be conducted on the basis that there will be no access to the resolution financing arrangements or other sources of public funding, and that losses will be absorbed by shareholders and unsecured creditors of the firm.

Powers over branches

In line with the Key Attributes, the BRRD requires Member States to have powers over incoming branches of firms based in countries outside the European Economic Area ('third countries') so that they may support a third-country resolution. As a fall-back, Member States must also have powers to act independently in relation to incoming third-country branches. These fall-back powers are only available in limited circumstances, for example where it is necessary to protect domestic financial stability or where a third-country resolution would discriminate against local creditors.

Changes to the creditor hierarchy

The BRRD introduces mandatory preference in the creditor hierarchy for EU and non-EU deposits from individuals and

micro, small and medium-sized businesses that exceed the deposit protection limit of €100,000 (£85,000). It also introduces mandatory 'super-preference' for deposits protected by EU DGS, such as the Financial Services Compensation Scheme (FSCS) in the United Kingdom, for amounts below €100,000 (£85,000). This means that in insolvency the FSCS is in the most senior class of unsecured creditors.

Supporting guidelines and standards

The European Banking Authority (EBA) is required to produce a series of binding technical standards and guidelines in relation to various parts of the BRRD. It may also exercise powers of binding mediation (the power to intervene definitively where Member States disagree) in a number of areas, but not in relation to the exercise of the resolution tools themselves. The BRRD also requires the EBA to establish an internal resolution committee, comprised of representatives of EU national resolution authorities, to manage these tasks.

Annex 2

Valuations in resolution

Valuations are critical for any resolution. A successful resolution will require valuations that are timely, accurate, realistic, reliable and credible with the market. This will mitigate risks such as misallocation of assets/liabilities to a bridge bank, unnecessarily exposing unsecured creditors to bail-in, or exposing the authorities to increased compensation and/or litigation risks, which in turn increase the risk that use of industry funds will be required. Valuations perform a number of functions, including:

- providing an up-to-date estimate of the financial position of the firm;
- allowing the authorities to quantify future expected losses that should be addressed through resolution;
- providing an estimate of the value of the firm after resolution has taken place; and
- informing the extent to which losses will fall on different shareholders and unsecured creditors, and quantifying the size of any compensation that may be due to those shareholders and creditors.

Together these valuations help inform the authorities' view on whether the firm is failing or likely to fail and, if so, the appropriate resolution strategy. The approach of the Bank of England (Bank) to valuation is set out below, recognising that, under the terms of the Bank Recovery and Resolution Directive valuations are conducted by independent valuers. Guidance and technical standards on valuation being prepared by the European Banking Authority are likely to result in some changes to this valuation framework.

The range of valuations required to support resolution can broadly be divided into three discrete time periods (see **Figure A**).

Prior to resolution

In the period prior to resolution, the Bank will appoint an independent valuer to conduct a valuation to inform the decision of the Prudential Regulation Authority or the Financial Conduct Authority on whether the firm is failing or likely to fail. This is expected to be based on the firm's updated accounting balance sheet with appropriate regulatory capital adjustments.

Concurrently, the independent valuer will prepare indicative estimates of the other resolution valuations described below. These valuations, along with other considerations, will inform the decisions over whether the firm should enter resolution and over which resolution tools to use.

During resolution

During resolution, the authorities will require a valuation of the firm's assets and liabilities to estimate the scale of the losses of the firm that need to be addressed. This valuation would take into account factors that are excluded from an accounting valuation such as: the nature of the resolution tool that will be used; the losses expected; the plans to restructure the firm once it has been stabilised (for example, following bail-in); and the costs of this restructuring.

At this stage the authorities will also require an estimate of the value of the firm's equity, post-resolution. This represents the value that will be available to be allocated to creditors as compensation (following a bail-in, for example) or distributed to creditors (such as the proceeds of a sale to a private sector purchaser, for example).

The authorities will use the final asset and liability valuation and the equity valuation, which together comprise the 'exchange valuations', to inform the terms of resolution. That might encompass the equity allocated to subordinated debt and senior unsecured creditors in a bail-in, or the allocation of assets and liabilities to a bridge bank.

Post resolution

Once the firm has left resolution, two further independent valuations will be commissioned by HM Treasury (HMT) where a stabilisation tool has been used. The purpose of these valuations is to protect the interests of the shareholders and creditors affected by the resolution, by ensuring that no relevant creditor is worse off (NCWO) than they would have been if the whole firm had entered insolvency.

HMT will therefore appoint an independent expert to prepare:

- an estimate of the financial outcome for each class of creditor based on a hypothetical insolvency of the whole firm at the date of resolution; and
- an assessment of the actual financial outcome for each class of shareholder and creditor as a result of the resolution.

If the independent expert concludes that a relevant creditor would have received a better outcome from insolvency than they actually received from resolution, that creditor would be entitled to compensation.

While the final asset and liability, equity and NCWO valuations will be completed during and post resolution, as described above, the independent valuers will begin work on indicative valuations in the period before a resolution takes place, where this is possible. These early-stage valuations would be used, alongside the accounting valuation, to inform the choice of resolution tool, develop potential resolution

strategies, and make an assessment of the compensation risk of the different strategies.

Key concerns for the authorities

Valuations will be the cornerstone of critical decisions taken during a resolution, including:

- the determination of the assets and liabilities to be transferred to a bridge bank;
- the exchange terms for a bail-in or a sale of business; and
- the level of recapitalisation required that is adequate, but not excessive.

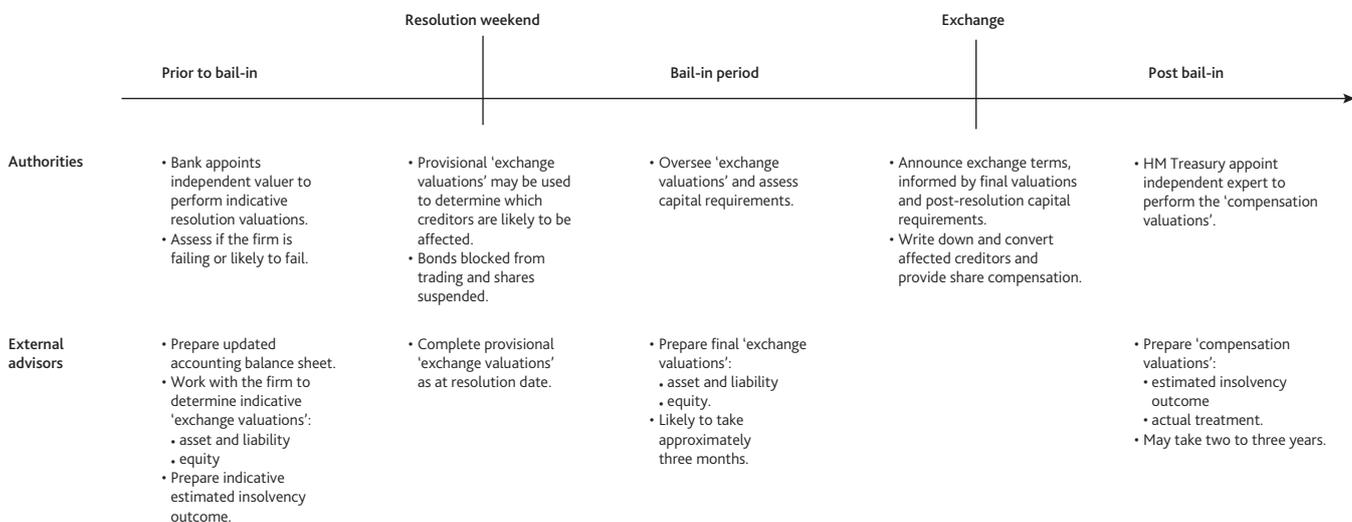
High-quality valuations will also support financial stability in a crisis, by providing greater certainty to counterparties and the wider financial market as to the scale of losses and the proposed approach to resolution.

Significant work will be required in advance of any failure so that firms can assist in achieving these objectives. Work is

being carried out to develop frameworks for valuation that are robust and flexible: that is, these can be provided at the speed likely to be required during a resolution, reflect the size and global complexity of the firms concerned, and are capable of accommodating the inherent uncertainties involved in resolution.

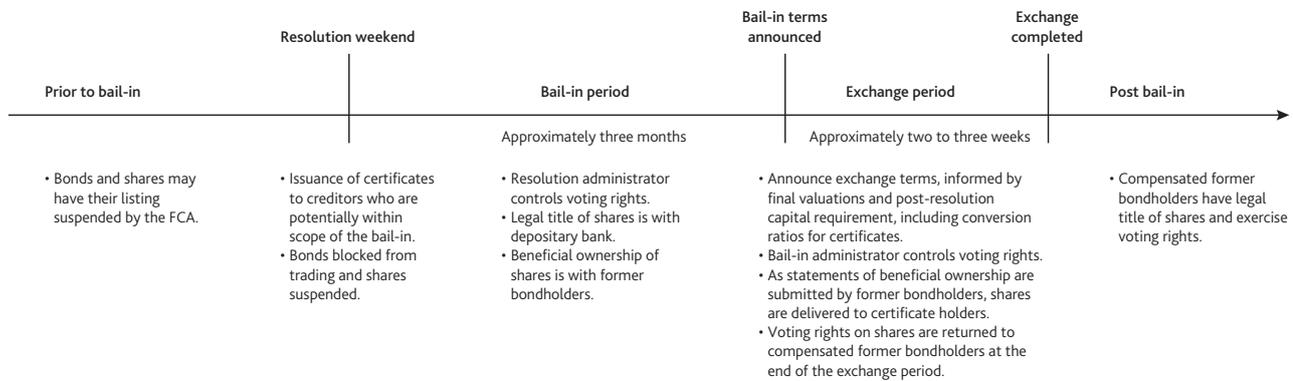
Valuation work will need to be co-ordinated across jurisdictions, to support the resolution of the largest global firms. These firms will have a home authority (where the firm is head-quartered) and host authorities (where a firm has subsidiaries). The valuation work required to resolve these firms is expected to be more complex, for example due to the size and breadth of their activities, their interconnectedness across the financial system, and the challenges for authorities in co-ordinating valuations under different accounting, capital and regulatory requirements. The authorities expect to continue to work closely with these firms, and each other, to develop robust valuation frameworks.

Figure A



Annex 3 Bail-in mechanism

Stylised timeline for a bail-in



Principles underpinning the bail-in mechanism

There are several steps involved in conducting a bail-in. In the interests of ensuring that the technical complexity of the transaction does not unintentionally detract from the overall purpose of the resolution, certain principles have underpinned the development of the mechanism. It has been designed to:

- reflect the potential right of investors to compensation as a result of resolution;
- allow time to process any necessary regulatory approvals;
- enable compensation to be given to those who are entitled to compensation, but are unable to claim; and
- provide for the sale of any potential right to compensation, at all times throughout the resolution process.

To achieve this, the Bank of England (Bank) expects to use 'certificates of entitlement' (certificates). These will be issued by the firm to investors holding a liability that is potentially within scope of the bail-in. The certificates will be allocated based upon relevant groupings of liabilities. They represent a potential right to compensation, should the investor be entitled to such compensation under the 'no creditor worse off' safeguard.

Resolution weekend

The certificates are issued over the resolution weekend, with the existing shares transferred to a third-party depositary bank (appointed by the Bank) to be held in trust on behalf of the certificate holders. The shares remain in issuance throughout the resolution period, although the listing may be suspended.

It is possible that, should a firm enter resolution, there will be no equity value remaining. On that basis, the original shareholders of the failed firm would not receive certificates.

At this point all liabilities potentially within scope of the bail-in will be blocked from trading.

Bail-in period

Following the resolution weekend, the Bank and its advisors will prepare the equity valuation (see Annex 2). During this phase, immediately after the resolution weekend, legal title to the shares would sit with the depositary bank, while the former creditors would be given beneficial ownership of the shares. The resolution administrator will control the voting rights of all shares from the point the shares are transferred to the depositary bank until they are transferred to their new owners, but will not have legal or beneficial ownership of the failed firm.

Bail-in terms announced

Once the valuation work has been completed, the Bank will announce the terms of exchange. This will specify the ratio of shares due to each class of certificate holder. At this point write-downs will be applied to those liabilities which have been bailed in, and the blocks on trading would be lifted.

Statements of beneficial ownership will need to be completed by all those entitled to compensation. On receipt of that statement, the depositary bank will ensure any compensation is reflected in the holder's account.

The authorities will need to review the claims and evaluate the equity stake due to each claimant. Where this stake is of a sufficient size to require approval under the 'change in control' regime, approval will need to be obtained before the equity is distributed.

Completion of exchange

After the terms of exchange are announced, voting rights will be transferred from the resolution administrator to the new equity owners once either:

- 51% of the equity has been returned to private hands; or
- a set time period has elapsed (expected to be at least 2–3 weeks).

The resolution administrator will continue to control voting rights for any unclaimed shares, until those shares are returned to private ownership or unclaimed shares are sold into the market. Holders who are not able to take delivery of shares, such as institutional investors with contractual mandates that prevent them from holding shares, will then receive any proceeds of the sale.

Trading of certificates

At issue, the certificates will be assigned an International Securities Identification Number. These certificates may be

traded throughout the resolution. The certificates represent an entitlement to whatever compensation may become due.

Simple cases

The above description assumes that the size of the loss, and the recapitalisation requirement of the firm post-resolution, is not known at the resolution weekend. If these are known, it is possible that the certificates may be issued alongside the terms of exchange, and thus the process outlined above would take place more quickly. In this case, statements of beneficial ownership could be issued at the resolution weekend, and certificates could be exchanged for shares almost immediately.