HM Treasury

Transposition of the Bank Recovery and Resolution Directive

July 2014

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1 Introduction

1.1 The Bank Recovery and Resolution Directive (BRRD) entered into force on 2 July 2014. The Directive establishes a common approach within the EU to the recovery and resolution of banks and investment firms.

1.2 The Directive includes:

- A requirement for all deposit-takers and significant investment firms to have in place recovery plans for the institution or the group it is part of, designed to ensure that firms have credible plans in place to recover their financial position following a stress; and that the authorities could manage their failure in an orderly way.
- The establishment of resolution authorities, with responsibility for planning for and managing the failure of banks and investment firms, and with the necessary tools to manage the failure of banks. This includes a bail-in tool, which allows the resolution authority to write down or cancel debt in a failing firm, and convert it in to equity.
- A requirement to ensure that 8% of a bank's liabilities are used to absorb losses and recapitalise a failing bank before public funds can be used to absorb losses.
- Co-operation between the authorities in different Member States in order to effectively plan for and manage the failure of firms which operate across borders.
- Protection for depositors – deposits covered by Deposit Guarantee Schemes (such as the FSCS) are excluded from bail-in and will also be preferred liabilities. The introduction of depositor preference will ensure that these deposits, and the deposits of natural persons and SMEs, will be senior to other unsecured liabilities of the bank in the event of insolvency.
- A framework for cooperating with third countries on resolution planning.
- The establishment of resolution financing arrangements which will help ensure that the resolution tools can be used effectively. The Directive allows the UK to use the existing bank levy as the resolution financing arrangement.

1.3 The entry into force of the BRRD represents an important step forward in ensuring that the EU effectively addresses the risks posed by the banking system.

1.4 In transposing the BRRD, the Government will build on the UK's current systems and powers. The Bank of England will therefore be the UK resolution authority, in accordance with its current role in the Banking Act. The PRA and the FCA will carry out the functions of the competent authority specified in the Directive, many of which they currently undertake. And the Treasury will be the competent ministry, performing any functions specified in the BRRD.

1.5 The scope of the Directive covers credit institutions, 730k investment firms[1], certain financial institutions[2], and financial holding companies, mixed financial holding companies and mixed-activity holding companies. Following the expansion of the Special Resolution Regime (SRR) by the Financial Services Act 2012 to add sections 81B – 81D and once the Banking Act 2009 (Banking Group Companies) Order 2014 comes into force[3] all of these types of firm will be within the scope of the SRR except for mixed-activity holding companies. These are not within scope of the BRRD resolution actions if the credit institution or investment firm is a subsidiary of an intermediate holding company, as outlined in Article 33(3) BRRD.

1.6 An impact assessment has been prepared and will be published shortly on the gov.uk website.

1.7 Member States are required to adopt and publish the necessary laws and regulations to transpose the Directive by 31 December 2014, and to apply them from 1 January 2015. They have the option of delaying the application of the bail-in measures until 1 January 2016 at the latest.

1.8 This consultation seeks views on key aspects of transposition, particularly in areas where a policy choice remains in implementation. It does not attempt to cover all aspects of transposition. Where the consultation document expresses the Government's views, these are preliminary views and are subject to further consideration of the legal requirements of the BRRD.

1.9 Draft legislation on some aspects of transposition is included as an annex to this consultation. This is intended to assist respondents in considering the policies outlined here. Drafting is at an early stage and will be subject to revision – both as a result of this consultation, and as further consideration is given to the requirements of the Directive. The drafting has not been approved by the Office of the Parliamentary Counsel and is provided for illustrative purposes.

1.10 Responses are requested by **28 September 2014**. The Government cannot guarantee that responses received after this date will be considered.

1.11 This document is available electronically at www.gov.uk/treasury. You may make copies of this document without seeking permission. Printed copies of the document can be ordered on request from the address below.

1.12 Responses can be sent by email to brrd.transposition@hmtreasury.gsi.gov.uk. Alternatively, they can be posted to:

BRRD Transposition, Resilience and Resolution Team, HM Treasury, 1 Horse Guards Road, London SW1A 2HQ

1.13 When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make clear who the organisation represents and, where applicable, how the views of members were assembled.

Confidentiality

1.14 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

[1] As defined in point (2) of Article (1) of Regulation (EU) No 575/2013 (the Capital Requirements Regulation) and subject to the initial capital requirement laid down in Article 28(2) of Directive 2013/36/EU (the Capital Requirements Directive)

[2] i.e. financial institutions that are subsidiaries of credit institutions or investment firms, or of financial holding companies

[3] http://www.legislation.gov.uk/uksi/2014/1831/pdfs/uksi_20141831_en.pdf

1.15 If you would like the information that you provide to be treated as confidential, please mark this clearly in your response. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

1.16 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.

2 Recovery and resolution planning

2.1 The BRRD requires that all institutions that are not part of a group subject to consolidated supervision draw up and maintain **recovery plans,** which set out actions that the firm could take to restore its financial position following a significant deterioration of its financial situation.

2.2 The recovery planning requirements in the BRRD are broadly in line with the existing UK regime requiring UK banks and building societies and PRA-designated investment firms to draw up recovery plans.

2.3 The Directive also requires that for groups subject to consolidated supervision, the Union parent undertaking draw up and submit a recovery plan for the group as a whole. Parent undertakings in this context include financial holding companies and mixed financial holding companies. This group recovery plan must be assessed and approved by the management body of the parent undertaking and submitted to the consolidating supervisor. The parent undertaking must demonstrate to the consolidating supervisor that the group recovery plan meets the relevant requirements. In order to implement these requirements, the Government will grant the PRA and the FCA additional rule-making powers over parent undertakings for the purposes of group recovery plans. This will enable the PRA and FCA to make rules requiring financial holding companies and mixed financial holding companies to prepare group recovery plans, to comply with the requirements in the Directive, and to submit the group recovery plan to the consolidating supervisor – whether that is the UK supervisor or another EU supervisor (in cases where the UK supervisor is not the consolidating supervisor).

2.4 The PRA and FCA will be consulting on changes to their rules on recovery plans in order to implement the BRRD. In doing so, they will have regard to the principle of proportionality – which is particularly relevant for small 730k firms which are unlikely to be considered systemic in the event of their failure.

2.5 Although the Bank of England prepares **resolution plans** for all credit institutions and certain investment firms, there is currently no requirement for them to do so in legislation. Therefore, in transposing the Directive, the Government will make secondary legislation that will include a requirement for the Bank of England, as the resolution authority, to develop resolution plans in line with the requirements of the BRRD. Article 10 (4 & 7) of the BRRD establishes requirements for the contents of resolution plans of institutions, and Article 12 (3) expands these requirements to groups. The European Banking Authority (EBA) has been mandated (in Articles 10 and 12) to develop draft Regulatory Technical Standards (RTS) on the content of resolution plans for institutions and for groups.

2.6 The Financial Services and Markets Act 2000 (FSMA), which currently includes a reference to "resolution plans" in s. 137K, will be amended. What is currently referred to as a "resolution plan" is in fact information provided by the firm itself, to enable the Bank of England and the Treasury to plan for the possible use of any of their resolution powers. This information is now commonly referred to as a "resolution pack", so s. 137K FSMA will be amended to use this term, with corresponding amendments for ss. 137M and 137N. "Resolution plan" will be used as described by Article 10 BRRD.

2.7 The BRRD allows for the resolution authority to collect this information directly or through the competent authority. The "resolution pack" information will continue to be collected by the competent authority – that is the PRA or the FCA – and passed on to the Bank of England. In order to enable the PRA and FCA to collect information in relation to banking groups, the Treasury will commence s.192JB of FSMA (as amended by the Financial Services (Banking Reform) Act 2013), which grants the appropriate regulator the power to make rules requiring a qualifying parent undertaking to make arrangements that would allow or facilitate the exercise of the resolution powers in relating to the parent undertaking or any of its subsidiaries.

2.8 However, the Government also intends to give the Bank of England two new information-gathering powers in relation to Articles 11 and Article 63(1)(a) BRRD, to enable the Bank of England to require information directly from firms. The power to collect information in accordance with Article 11 is not expected to be used frequently – as set out above, the competent authority will continue to collect information for the purposes of preparing resolution plans. This information gathering power is therefore a back-stop power which will enable the Bank of England to request specific information not included in the resolution pack. It will also be available in to support active contingency planning as a firm moves towards possible failure.

2.9 Article 15 of the BRRD also requires resolution authorities to assess the **resolvability** of an institution – that is, the extent to which it is feasible and credible to resolve it in a way that protects systemically important functions without severe systemic disruption and without use of public funds. This resolvability assessment process will serve several purposes. First, it will require the resolution authority to assess whether the liquidation of the institution or group is feasible and credible in a manner which is consistent with the public interest. If it is judged that resolution action is not necessary in the public interest, the institution should be considered resolvable through liquidation in accordance with normal insolvency procedures. Second, for firms where resolution action is judged necessary in the public interest, it will also provide assurance of the quality of resolution plans and strategies, and ensures that resolution authorities assess whether their strategies are feasible and credible. And third, the assessment identifies impediments to the implementation of resolution strategies which should be addressed through the procedure provided in Article 17 of the BRRD. As a result, secondary legislation will place a requirement on the Bank of England to carry out such resolvability assessments of credit institutions and investment firms. The EBA has been mandated to develop draft RTS on the matters and criteria which resolution authorities should apply in the assessment of resolvability.

3 Removing impediments to resolvability

3.1 The BRRD requires that the resolution plans be credible and feasible. For the resolution plan to be considered credible and feasible, it may be necessary for financial institutions to remove impediments to orderly resolution, which have been identified by the resolvability assessment conducted by the Bank of England. This may involve changes to the legal, operational and financial structure of credit institutions and investment firms or their business activities.

3.2 Where the Bank of England, as resolution authority, in its assessment of the resolvability of an institution or group identifies substantive impediments to liquidation in normal insolvency proceedings or to the feasible and credible implementation of resolution powers, Article 17 of the BRRD sets out procedural and substantial rules requiring the reduction or removal of these impediments.

3.3 In accordance with Article 15, or Article 16 in the case of groups subject to consolidated supervision, the Bank of England will consult the competent authority regarding its determination of whether there are substantive impediments to the resolvability of a firm. The Bank will notify the firm in writing of any substantive impediments they have identified, and the firm will have an opportunity to address these impediments.

3.4 The Bank of England will be given a power to direct institutions and qualifying parent undertakings to take specific actions in order to address or remove impediments to resolvability, in the event that the firm's proposals are considered inadequate. A number of the powers in Article 17 must be exercisable in relation to a financial holding company, mixed financial holding company or mixed-activity holding company. The Government's initial view is the powers should only extend to mixed-activity holding companies where its subsidiary institutions are not held directly or indirectly by an intermediate financial holding company. This is in line with the provision in Article 33 of the BRRD which states that resolution actions for the purpose of group resolution must be taken in relation to the intermediate financial holding company, and not the mixed-activity holding company. The Bank of England will have the power to require a mixed-activity holding company to establish an intermediate financial holding company.

3.5 The measures to address impediments to resolvability form part of the Union framework creating adequate resolution tools to effectively deal with unsound or failing credit institutions. Article 17(5) provides the authorities with a non-exhaustive range of powers to remove firm impediments to resolvability in advance of failure, which may be used if measures proposed by firms are insufficient to ensure resolvability. In selecting the appropriate measure to remove the impediments, resolution authorities have wide discretion. The Bank will consult the competent authority before using its powers by discussing its proposals and enabling the competent authority to provide representations which the Bank will take into account when exercising its powers.

3.6 The measures outlined in Article 17(5) can be organised under three broad headings (structural, financial and information related) based on the nature of the impediment the measure may be used to remove. See Table 3.A for more details.

3.7 To support the consistent use of Article 17(5) measures across Member States, the EBA is mandated in Article 17(9) to develop guidelines specifying further details on the measures and the circumstances in which each measure may be applied.

Right of appeal and enforcement

3.8 Article 85 of the BRRD requires that there is a right of appeal against a decision to take a crisis prevention measure, as defined in Article 2(1)(101), which includes a requirement to remove impediments to resolvability. The Government supports this and intends to legislate for an appeal process, modelled on the right of appeal to the Tribunal in respect of the use of own-initiative powers under s. 55Y of FSMA.

3.9 The Government does not intend to implement the option for Member States in Article 85(1) of requiring *ex ante* judicial approval of crisis prevention measures or crisis management measures.

3.10 It will be necessary to ensure that there are appropriate mechanisms in place to ensure that any requirements placed on firms can be effectively enforced. This could be done by giving the Bank of England a direct enforcement power, or by delegating enforcement to another entity – i.e. the PRA or the FCA.

3.11 The Government is considering giving the Bank of England a direct enforcement power over firms in relation to resolution. This would be modelled on the current enforcement powers of the PRA, FCA and the Bank (as regulator of CCPs) under FSMA with analogous safeguards and procedures drawn from FSMA. This would ensure that the authority responsible for imposing the requirement has responsibility for enforcing it and firms would deal with one authority for both the setting of the requirement and its enforcement. However, it would also involve firms dealing with different parties for the enforcement of supervisory decisions and for decisions related to resolution and resolvability.

3.12 The Government is therefore seeking views on the most appropriate way to ensure that these powers can be enforced.

Box 3.A: Removing impediments to resolvability

1 Do you agree that the powers to remove impediments to resolvability should only extend to mixed-activity holding companies where its subsidiary institutions are not held directly or indirectly by an intermediate financial holding company, with the exception of the power to require a mixed-activity holding company to establish an intermediate financial holding company?

2 Do you agree with the proposal to model the right of appeal on s. 55Y of FSMA?

3 Should the Bank of England be given a direct enforcement power in relation to resolution?

4 Do you have any comments on the features of that enforcement power? Do you agree that it should be modelled on the current enforcement powers of the PRA, FCA and Bank under FSMA?

Table 3.A: Table

Category	Powers in Article 17(5)
Structural Art 17(5)(a)	Requiring the institution to revise any intra-group financing arrangements or review the absence thereof, or draw up service agreements (whether intra-group or with third parties) to cover the provision of critical functions
Structural Art 17(5)(g)	Requiring changes to legal or operational structures of the institution or group entity so as to reduce complexity in order to ensure that critical functions may be legally and economically separated from other functions through the application of the resolution tools
Structural Art 17(5)(h)	Requiring a parent undertaking to set up a parent financial holding company in a Member State or a Union parent financial holding company
Structural Art 17(5)(k)	Where an institution is the subsidiary of a mixed-activity holding company, requiring that the mixed-activity holding company set up a separate financial holding company to control the institution, if this is necessary in order to facilitate the resolution of the institution and to avoid the application of the resolution tools and powers specified in Title IV having an adverse effect on the non-financial part of the group
Financial Art 17(5)(b)	Requiring the institution to limit its maximum individual and aggregate exposures
Financial Art 17(5)(d)	Requiring the institution to divest specific assets
Financial Art 17(5)(e)	Requiring the institution to limit or cease specific existing or proposed activities
Financial Art 17(5)(f)	Restricting or preventing the development or sale of new or existing business lines or products
Financial Art 17(5)(i)	Requiring an institution or parent undertaking to issue liabilities eligible for bail in
Financial Art 17(5)(j)	Require an institution, or an entity referred to in points (b), (c) or (d) of Article 1, to take other steps to meet the minimum requirement for own funds and eligible liabilities under Article 39, including in particular to attempt to renegotiate any eligible liability, additional Tier 1 instrument or Tier 2 instrument it has issued, with a view to ensuring that any decision of the resolution authority to write down or convert that liability or instrument would be effected under the law of the jurisdiction governing that liability or instrument
Information Art 17(5)(c)	Impose specific or additional information requirements relevant for resolution purposes

4 Intra-group financial support

4.1 Articles 19 – 26 of the BRRD relate to agreements between entities within the same financial group, for the provision of financial support by one or more group entities to a credit institution or investment firm in the same group when it meets the conditions for early intervention, as set out in Article 27. Other intra-group agreements will not be affected.

4.2 Any such agreements will be subject to review by the competent authorities. If not prohibited by the relevant competent authorities, the agreement must be submitted to shareholders for approval.

4.3 In the event that a party to the agreement subsequently meets the conditions for early intervention, the agreement may be activated. In order for financial support to be provided under the agreement, the conditions set out in Article 23 of the BRRD must be met. The decision to provide intra-group financial support is taken by the management body of the entity providing the support. However, the competent authority may oppose the provision of financial support if, in the view of the authority, the conditions specified in Article 23 are not met.

4.4 The Government will provide the PRA and FCA with additional powers over financial holding companies, mixed financial holding companies and mixed-activity holding companies in order to enable them to impose rules relating to intra-group financial support agreements, and to require that these entities notify them if they intend to provide support. The Government therefore intends to broaden the PRA and FCA's powers in these two contexts to include mixed-activity holding companies and seeks comments on that change to the financial institutions prescribed by HMT in SI 2013/165 for the purposes of the definition of 'qualifying parent undertaking' in section 192B of FSMA.

5 Early intervention

5.1 The BRRD requires that competent authorities have the ability to intervene in a firm that is experiencing a rapid deterioration in its financial condition and is therefore at risk of failing, in order to attempt to reverse the decline and avoid failure.

5.2 Article 27 of the BRRD lists the actions that a competent authority must be able to take in these circumstances. It includes the power to require the firm to undertake one or more of the actions in the firm's recovery plan. The competent authority may also require the management of the firm to take a number of actions designed to address the difficulties the firm is facing – for example, by requiring the firm to attempt to negotiate a restructuring of its debt, or to require changes to the firm's business strategy or structure. It also includes a number of powers to enable these actions to be enforced – for example, requiring the firm to draw up plans, or convening a meeting of shareholders.

5.3 The Government considers that the UK is already largely compliant with these requirements, primarily through the powers in s. 55L and s. 55M of FSMA to require authorised firms to take a specific action. The competent authority must have the power to require the removal and replacement of senior management, which the Government considers the UK is largely compliant as a result of the approved persons regime. For those members of the senior management who are not covered by the approved persons regime, the Government considers that the prohibition power in s. 56 FSMA is adequate to meet the requirements of the BRRD.

5.4 However, it will be necessary to introduce a new power for the competent authority (the PRA or FCA as applicable) to itself convene a meeting of shareholders should the management fail to do so, when the conditions for early intervention are met – as required by Article 27(1)(c).

5.5 Article 28 of the Directive requires Member States to ensure their regulators have the power to remove and replace the board of directors and senior management of an institution, if it encounters serious financial difficulties or persists in operating unlawfully, and use of early intervention powers (described in Article 27 BRRD) has not been sufficient to reverse the position.

5.6 To implement this article the Government proposes to insert a new standalone power in part 4A of FSMA to allow the PRA or the FCA to require an institution to remove members of its board, or senior managers directly accountable to its board, when the conditions laid down in Article 28 BRRD are met.

5.7 Such a power has far-reaching consequences for individuals and must be subject to a reasonable procedure. In order to ensure the power is used fairly and compatibly with the ECHR, the power will be subject to procedural provisions, including rights of appeal.

5.8 In accordance with Article 28, following the removal of the management, in whole or in part, the institution may appoint new management, subject to the approval of the competent authority. The Government expects the approval process to be similar to that for the approved persons regime.

5.9 In accordance with Article 29, the competent authority will also be given a power to appoint a temporary administrator, which may be used where the power under Article 28 is deemed

insufficient. The procedural requirements relating to the appointment of a temporary administrator will be transposed into UK law via regulations that amend FSMA.

Box 5.A: Early intervention

5 Do you agree that the power to require the removal of the senior management should be interpreted as relating to those managers directly accountable to the Board?

6 Resolution objectives and general principles of resolution

6.1 The BRRD sets out the resolution objectives in Article 31. When applying the resolution tools and powers, resolution authorities must have regard to the resolution objectives, and act in the way that will best achieve the resolution objectives.

6.2 Similarly, the Banking Act sets out the special resolution objectives in s. 4. It requires the relevant authorities (the Bank of England, PRA, FCA and the Treasury, as appropriate) to have regard to the special resolution objectives when using the stabilisation powers, or considering their use.

6.3 Although Article 31 BRRD only refers to the resolution authority's need to have regard to the resolution objectives, the Government intends to retain the scope of s. 4 which requires that all Authorities must have regard to the special resolution objectives. Although the Bank of England, as the resolution authority, will have primary responsibility for exercising the resolution tools and powers, and considering their use, the involvement of other authorities merits the inclusion of them in s. 4.

6.4 The Government's view is that the BRRD resolution objectives and the existing special resolution objectives in the Banking Act are well aligned. In order to ensure consistency, s. 4 of the Banking Act will be updated, following the copy-out principle where appropriate.

6.5 The proposed changes are reflected in Table 5.A below. The wording of the Banking Act has been aligned more closely with that of the BRRD. The Government proposes to retain the wording which defines an objective to "protect and enhance the stability of the financial system", rather than using the BRRD phrase "to avoid a significant adverse effect". This stronger wording is consistent with the aims of the BRRD.

6.6 The Government also proposes to retain a specific objective to protect the *public confidence* in the stability of the financial system. This is implied in the BRRD resolution objectives, since public confidence is necessary to avoid contagion in the system.

6.7 The Government proposes to maintain the current Objective 5 in the Banking Act. Although it is not listed as a resolution objective in Article 31, it is a principle of EU law that all Directives and their transposition they respect fundamental rights. This is explicitly set out in Recital 130 of the Directive. The Government feels that it is appropriate to maintain this as a special resolution objective.

6.8 The BRRD refers to the protection of "client funds and assets". "Client funds" is not a defined term in the BRRD, nor in the Markets in Financial Instruments Regulation (MIFIR) or the Markets in Financial Instruments Directive (MIFID). "Client assets" is defined broadly in the Banking Act to include client money. The Government is therefore of the opinion that the current wording in the Banking Act, which refers to client assets, is sufficient.

6.9 The Government does not anticipate that these changes to the special resolution objectives would result in a material change in the way the Authorities approach resolution of an institution or decide on the appropriate course of action. The changes are undertaken to ensure sound implementation and promote market certainty.

Bank Insolvency Procedure and Bank Administration Procedure

6.10 These changes will also apply to authorities when using, or considering the use of, the bank insolvency procedure or the bank administration procedure.

Table 6.A: Comparison of the BRRD resolution objectives, the current Banking Act special resolution objectives, and the proposed special resolution objectives following implementation of the BRRD

BRRD resolution objectives	Banking Act special resolution objectives	Amended Banking Act special resolution objectives, post transposition
(a)To ensure the continuity of critical functions	Objective 1 – to protect and enhance the stability of the financial systems of the UK	Objective 1 - to ensure the continuity of banking services in the UK and of critical functions.
(b)To avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline	Objective 1 – to protect and enhance the stability of the financial systems of the UK Objective 2 – to protect and enhance public confidence in the stability of the banking systems of the UK Objective 7 – to minimise adverse effects on institutions that support the operation of financial markets	Objective 2 – to protect and enhance the stability of the financial systems of the UK, in particular by – • preventing contagion (including contagion to market infrastructures such as investment exchanges and clearing houses), and • maintaining market discipline. Objective 3 – to protect and enhance public confidence in the stability of the financial system of the United Kingdom.
(c)To protect public funds by minimising reliance on extraordinary public financial support	Objective 4 – to protect public funds	Objective 4 – to protect public funds, including by minimising reliance on extraordinary public financial support
(d)To protect depositors covered by [DGSD] and investors covered by [ICSD]	Objective 3 – to protect depositors	Objective 5 – to protect: • depositors to the extent that they have deposits covered by a deposit guarantee scheme under Directive 2014-49/EU, and • investors to the extent that they have investments covered by an investor compensation scheme under Directive 97/9/EC
(e) To protect client funds and assets	Objective 6 – to protect client assets	Objective 6 – which applies in any case in which client assets may be affected, is to protect those assets
	Objective 5 – To avoid interfering with property rights in contravention of a Convention right	Objective 7 – to avoid interfering with property rights in contravention of a Convention right

Resolution objectives for Central Counterparties

6.11 The Financial Services Act 2012 amended the Banking Act to extend it to Central Counterparties (CCPs), with certain modifications. These modifications included changes to the special resolution objectives when using the stabilisation powers in relation to a CCP, or considering their use.

6.12 Where applicable, the amendments to the special resolution objectives will also apply to CCPs. But the current modifications will be broadly maintained – in particular, any objectives which were to be ignored for the purposes of CCP resolution (because they are not applicable) will continue to be ignored and any objectives specific to CCP resolution will be maintained.

The general principles of resolution

6.13 Article 34 of the BRRD sets out the general principles governing resolution. Resolution authorities must act in accordance with the principles when applying the resolution tools and exercising the resolution powers.

6.1 These principles are general, and are specified as in more detail as requirements elsewhere in the Directive. The Government therefore considers that these principles are reflected in current legislation (or will be following the transposition of other parts of the Directive, as described in this consultation) and therefore that it is not necessary or appropriate to set these principles out separately in legislation. The Government is considering implementing them through the Code of Practice to provide further clarity.

Box 6.A: Resolution objectives and the general principles of resolution

6 Do you have any comments on the proposed changes to the special resolution objectives?

7 Conditions for entry into resolution

7.1 Article 32 sets out the conditions that must be met in order to place a firm into resolution. Sections 7, 8 and 8A will be amended to align the conditions for resolution in the Banking Act with those required by the BRRD.

7.2 The conditions for resolution as set of the in the BRRD are:

1 A determination has been made that the firm is failing or likely to fail;

2 Having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures, including measures by an IPS, or supervisory action, including early intervention measures or the write down or conversion of relevant capital instruments...taken in respect of the institution would prevent the failure of the institution within a reasonable timeframe.

3 A resolution action is necessary in the public interest.

7.3 Conditions 1 and 2 relate closely to the general conditions set out in section 7 of the Banking Act. Currently, the PRA determines whether Conditions 1 and 2 are met in the case of credit institutions and PRA-designated investment firms, and the FCA makes the determination for FCA-regulated firms. Before determining whether or not Condition 2 is met, the PRA or FCA, as applicable, must consult the Bank of England, the PRA or FCA as applicable, and the Treasury.

7.4 Article 32 of the BRRD permits either the competent authority or the resolution authority to make the determination that Condition 1 is met. Whichever authority is designated for that purpose, they must consult the other in making that determination. The Government intends to keep the current UK practice, with the competent authority determining whether or not Condition 1 is met.

7.5 Under the BRRD, the resolution authority must determine whether or not Condition 2 is met. Therefore, s. 7 of the Banking Act will be amended so that the Bank of England is responsible for determining whether or not Condition 2 is met. Before making that determination, the Bank of England will be required to consult the PRA, FCA and Treasury.

7.6 The Bank of England will continue to be responsible for determining whether the public interest test (Condition A in both s. 8 and s. 8A) is met. As is the case currently, the Bank must consult the PRA, FCA and the Treasury before making this determination and deciding how to react.

Group treatment

7.7 For banking groups, losses may originate in an operating entity, but the group resolution plan may involve resolution at a different part of the group – in particular, at the level of the holding company. This has the advantage of avoiding the need to take a resolution action in respect of an operating entity, which can create difficulties by, for example, requiring the bail-in of operating liabilities, or lead to service disruption.

7.8 Article 33 of the BRRD sets out the conditions for entry into resolution in such cases. It is necessary to make special provision for this in the Directive, because the entity being resolved

may not, in itself, be failing or likely to fail. For example, if a holding company has a number of subsidiaries, one of which is failing, then the resolution authority may wish to bail in the holding company.

7.9 Article 33(2) permits resolution authorities to take an action in relation to a holding company when the resolution conditions (as outlined above) are met with regards to one or more subsidiaries and the holding company. A resolution authority may also take an action in relation to a holding company when it is not failing, but one or more subsidiaries meet the conditions for resolution, and their failure threatens the group as a whole. This is consistent with the provisions in s. 81B and s. 81BA of the Banking Act, both of which require that an institution in the group be failing or likely to fail. The Government does not consider it necessary to implement a separate power for situations where the holding company is also failing, because the condition precedent (that a subsidiary institution is failing or likely to fail) will be met. Therefore no further implementation is necessary to comply with this requirement, apart from the enactment of the Banking Act 2009 (Banking Group Companies) Order 2014.[1]

7.10 To facilitate resolution at the level of the holding company and in line with Article 33(4) BRRD, the Banking Act will be amended to provide that the resolution authority of the subsidiary institution and the resolution authority of the holding company may jointly agree that the write-down and conversion of any intra-group liabilities (by contract or otherwise) shall be disregarded for the purpose of determining whether the conditions for resolution are met in respect of the subsidiary institution or of the holding company.

7.11 It will also be necessary to implement the power to resolve a UK holding company when one or more of its subsidiary institutions in another jurisdiction are failing. The Bank of England will be given a power to resolve a UK holding company where a third country resolution authority has determined that a subsidiary institution in its jurisdiction meets the conditions for resolution. Following notification from the third country resolution authority, the Bank of England will determine whether the public interest test like that in s. 8 or 8A (as appropriate) is met.

7.12 Where the ultimate parent is a mixed-activity holding company, and the subsidiary institutions are held directly or indirectly by a financial holding company, Article 33(3) requires that resolution actions for the purposes of group resolution are undertaken at the level of the intermediate financial holding company (or lower) and not in relation to the mixed-activity holding company. This is reflected in the existing Banking Act 2009 (Banking Group Companies) Order 2014[1] and therefore no further implementation is necessary.

Box 7.A: Conditions for entry into resolution

7 Do you have any comments on the proposed changes to the conditions for entry into resolution?

[1] http://www.legislation.gov.uk/uksi/2014/1831/pdfs/uksi_20141831_en.pdf

8 Valuation

8.1 The Directive requires that valuations are conducted for the purposes of resolution (Article 36) and to assess whether shareholders and creditors affected by bail in or partial property transfers would have received better treatment if the institution under resolution had entered into normal insolvency proceedings (Article 74).

8.2 The objectives of Article 36 include informing the determination of whether the conditions for resolution or write down of capital instruments are met, informing the decision on the application of the resolution powers, and ensuring that any losses on the assets of the institution are fully recognised at the moment resolution tools are applied. Additionally, it requires that for a valuation to be considered definitive, the resolution authority must ensure a fair, prudent a realistic valuation is carried out by a person independent from any public body, including the resolution authority. But, in certain circumstances where an independent valuation may not be possible (e.g. due to the urgency in circumstances) the Directive permits the use of a provisional valuation with a buffer for additional losses.

8.3 Article 74, valuation of difference in treatment from insolvency, provides certain shareholders and creditors with protection, under the No Shareholder or Creditor Worse Off principle, in that it seeks to identify where the actions taken by the resolution authority may have resulted in a worse outcome than normal insolvency proceedings. This valuation will be distinct for the valuation in Article 36 and will be conducted by an independent person as soon as possible after resolution action(s) have been effected.

8.4 The Directive requires the EBA to draft RTS about the independence of the valuer for Articles 36 and 74, and permits EBA to draft RTS to specify the methodology for assessing the value of the assets and liabilities of the institution, the separation of the valuations under Articles 36 and 74, the methodology for calculating the buffer for additional losses in the provisional valuation and the methodology for assessing the treatment shareholders and creditors would have received under normal insolvency proceedings. The EBA is expected to consult on these in due course.

9 Special manager

9.1 Article 35 of the BRRD requires that resolution authorities have the power to appoint a special manager that replaces the management body of the institution under resolution. The special manager shall have all the powers of the shareholders and the management body of the institution, but may only exercise such powers under the control of the resolution authority.

9.2 Article 63 of the BRRD sets out the minimum list of powers that resolution authorities must have in order to apply the resolution tools effectively. These powers include:

- The power to take control of an institution under resolution and exercise all the rights and powers conferred upon the shareholders, other owners and the management body of the institution under resolution; and
- The power to remove or replace the management body and senior management of an institution under resolution.

9.3 Article 72 further specifies that, in order to take a resolution action, resolution authorities must be able to exercise control over an institution so as to "operate and conduct the activities and services of the institution under resolution with all the powers of its shareholders and management body". This control may be exercised "directly by the resolution authority or indirectly by a person or persons appointed by the resolution authority".

9.4 The special manager power can therefore be seen as a sub-set of Articles 63 and 72, as it allocates the management powers to a specific person and sets a time limit on these powers.

9.5 The Government considers that the existing powers in ss. 20, 36A, 48N BA implement these obligations. They permit the Bank of England to remove, appoint or vary the service terms of the directors of the institution under resolution. The directors are the 'management body' for UK banks. In addition, s. 48I of the Banking Act, as amended by the Financial Services (Banking Reform) Act 2013, allows the Bank of England to appoint a bail-in administrator, and to confer on it functions related to control of the institution under resolution. The powers that the Bank could give to the bail-in administrator are equivalent to those envisaged under the BRRD. Therefore, the Government considers that the UK complies with the special manager requirements in relation to the bail-in tool.

9.6 Where there is a partial transfer to a private sector purchaser or a bridge bank, then the "residual bank" may be placed into the Bank Administration Procedure (BAP). Under the BAP a bank administrator is responsible for the management of the company's assets and undertakings. The BAP imposes on the bank administrator an objective to ensure the supply of essential services and facilities to the transferee. To this end, the bank administrator should, first, provide support to a private sector purchaser or bridge bank in relation to the transferred business and, second, rescue the residual bank as a going concern or wind up its affairs in the best interests of creditors. The Government considers that the amount of control that the Bank of England has over the administrator is adequate to fulfil the requirements of the special manager in relation to the BAP.

9.7 Article 72(4) RRD requires the Government to ensure that "resolution authorities shall not be deemed to be shadow directors or de facto directors under national law." The Government intends to implement along the lines contained in the instrument used for the resolution of Dunfermline SI 2009/814[1].

Box 9.A: Special manager

8 Do you feel that any changes to the Bank's ability to control an institution under resolution would be useful?

[1] http://www.legislation.gov.uk/uksi/2009/814/article/7/made

10 Asset separation tool

10.1 The majority of the resolution tools in the BRRD are present in the Banking Act. The exceptions are the asset separation tool and the equity support tool (see Chapter 13).

10.2 The asset separation tool is described in Article 42 of the BRRD. Resolution authorities must have the ability to transfer the assets, rights and liabilities of an institution to an asset management vehicle – a vehicle created for the purpose of receiving these assets, rights and liabilities and wholly or partially owned by public authorities. The purpose of the asset management vehicle is to manage assets transferred to it with a view to maximising their value through eventual sale or orderly wind down.

10.3 Therefore, the Banking Act will be amended to add a new stabilisation options – the asset separation tool. The asset separation tool will enable the Bank of England to use property transfer powers to transfer assets, rights and liabilities of a failing bank to an asset management vehicle. A minor amendment will be made to the bridge bank tool to reflect the purpose described in Article 40(2)(b) BRRD of maintaining access to critical functions and selling the institution under resolution.

10.4 A draft of these amendments is included in the annex.

10.5 The specific conditions for use of the asset separation tool will be those specified in section 8 of the Banking Act – i.e. the same as those for the private sector purchase, bridge bank and bail-in options. However, in line with the BRRD, there is an additional condition that the asset separation tool may only be used in conjunction with another tool. The asset separation tool may therefore be used in conjunction with any of the other stabilisation options, including bail-in. This condition is specified in draft section 8ZA of the Banking Act, as set out in the annex.

10.6 Any consideration paid by the asset management vehicle in respect of assets, rights or liabilities acquired directly from the institution under resolution shall benefit the institution under resolution (subject to using it to recover expenses of the resolution as permitted by Article 37(7) BRRD). The appropriate consideration would be determined on an individual basis at the time of resolution, with reference to the valuation principles specified in Article 36 BRRD. In particular, Article 36(4)(g) states that losses of the assets of the institution should be fully recognised at the moment the resolution tools are applied.

10.7 The Government proposes allowing for an "onward asset management vehicle" in the same way that an "onward bridge bank" is possible under section 12 of the Banking Act.

Disposal of the asset management vehicle

10.8 Article 42(3) of the BRRD specifies that an asset management vehicle must manage the assets transferred to it with a view to maximising their value through eventual sale or orderly wind down. The draft tool allows for both of these possibilities.

10.9 While it is not necessary to allow for an initial share transfer (since the asset management vehicle is only for the purposes of assuming certain assets or liabilities of the firm, not the whole firm), draft sections 17 and 18 of the Order make amendments to Sections 30 and 31 of the

Banking Act to allow the Bank of England to make asset management vehicle share transfer instruments and asset management vehicle reverse share transfer instruments in order to transfer shares of the asset management vehicle, for example if it is to be sold as a whole. This is modelled on sections 30 and 31 of the Banking Act, which relate to bridge bank share transfer instruments and bridge bank reverse share transfer instruments.

10.10 The BRRD specifies that the asset management vehicle must be "wholly or partially owned by one or more public authorities". It is anticipated that the Bank of England will initially own the asset management vehicle. The asset management vehicle could be sold (through a share transfer) and transferred, in whole or in part, to another public authority or to a private third party.

10.11 If the ownership were fully transferred to a private third party via a sale, then the vehicle would cease to be an asset management vehicle for the purposes of the Banking Act, and would re-enter the private sector.

Interaction with the Bank Administration Procedure

10.12 Part 3 of the Banking Act provides for a bank administration procedure (BAP) to be applied following a partial property transfer. This procedure may be required in the event of a partial transfer of a banking institution's business to a bridge bank or private sector purchaser. Where a partial transfer of property takes place, the 'residual bank' (the part left behind) may be insolvent. Despite being insolvent, it may be vital that the residual bank continues to provide services and facilities to the purchaser or bridge bank where these are required to enable the transferred business to be operated effectively. For example, it might be impossible to transfer certain business assets or service contracts as part of the initial arrangements. These items may be vital for the successful operation of the transferred business.

10.13 Therefore, the Banking Act provides that the Bank of England may make an application to the court for a bank administration order under s. 143BA.

10.14 The bank administration procedure is a new insolvency procedure created to deal with an insolvent residual bank following a partial transfer. It is largely based on existing insolvency provisions, specifically the administration procedure as set out in Schedule B1 to the Insolvency Act 1986. However, it imposes an additional Objective on the bank administrator, which is 'support for commercial purchaser or bridge bank' and which takes precedence over the normal administration objective. It is designed to ensure that any essential services and facilities that cannot be immediately transferred to a bridge bank or private sector purchaser will continue to be provided, for a period of time.

10.15 The BAP will remain in place for partial property transfers to a private sector purchaser or bridge bank. There may be cases where it would be useful for the remainder of the institution to continue to provide services to the asset management vehicle for a period of time. Therefore, the Government proposes that the BAP be extended to cover partial property transfers to an asset management vehicle.

Box 10.A: Asset Separation Tool

9 Do you agree with the proposal to allow for an "onward asset management vehicle"?

10 Do you agree that it should be possible to use the Bank Administration Procedure with the Asset Management Vehicle, so that the remainder of the bank that is placed into administration can provide services to the Asset Management Vehicle?

11 Do you have any other comments on the suggested approach to transposing the Asset Management Vehicle?

11 Bail-in

11.1 The Financial Services (Banking Reform) Act 2013 amended the Banking Act 2009 to include a bail-in stabilisation option. This legislation is yet to be commenced. It was closely based on the BRRD, which was in draft at the time. However, there are a number of differences between it and the final BRRD text. Some amendments will therefore be required to fully transpose the BRRD.

11.2 The Government recently consulted on the secondary legislation necessary to complete the domestic bail-in legislation. A number of responses to that consultation argued against the commencement of the bail-in powers ahead of BRRD transposition. They highlighted the uncertainty that this would cause for firms and market participants, who would have to prepare for one regime and then make certain changes in order to adapt to the BRRD requirements when they came into force.

11.3 The Government has taken these views into account and now no longer intends to commence the domestic bail-in legislation before BRRD transposition. The Government will make any amendments necessary to the bail-in legislation in order to transpose BRRD, and commence the legislation on 1 January 2015, in a way that is fully compliant with the BRRD.

11.4 This means that the UK will not take advantage of the option provided for in the BRRD of delaying the application of the bail-in provisions until 1 January 2016. The Government feels that a comprehensive and effective bail-in tool is essential in ensuring that banks can be resolved without recourse to public funds, and to address the implicit guarantee that large banks are currently seen to benefit from.

11.5 Indeed, following the Commission's proposal for a bail in tool in BRRD in 2012 and introduction of the bail-in powers in the Financial Services (Banking Reform) Act 2013, markets will have been preparing for introduction. The Government considers it unlikely that firms would benefit significantly from delaying the introduction, since the necessary legislation must be laid by 31 December 2014, and any costs associated with the introduction of the bail-in powers (primarily through the increased cost of senior unsecured debt) are likely to be realised by 1 January 2015, to the extent that they are not already reflected in the cost of this debt.

11.6 Therefore, the Government sees little benefit or delaying the implementation of the bail-in powers, and proposes to commence the bail-in legislation on 1 January 2015, with the exception of the provisions relating to a Minimum Requirement for Eligible Liabilities (MREL), and the requirement in Article 55 BRRD to include a contractual clause in liabilities governed by third country law (see below).

Scope of the bail-in powers – excluded liabilities

11.7 The Directive requires a broad scope bail-in tool, with defined exclusions. This is consistent with the approach taken in the amendments to the Banking Act, which specifies a list of excluded liabilities in section 48B(8).

11.8 A number of minor amendments are needed in order to ensure that this the list of excluded liabilities in section 48B(8) is consistent with that in Article 44(2) of the BRRD.

11.9 In particular, it is necessary to remove deposits covered by non-EEA deposit guarantee schemes from the list of excluded liabilities by changing the definition of "protected deposits". The introduction of depositor preference – which grants a second tier preference to deposits which would be covered were they not made through a third country branch – will mitigate the effect of this change, making it very much less likely that such deposits would be bailed-in in practice.

11.10 It is also necessary to amend the exclusion for liabilities arising from participation in designated settlement systems and CCPs, as the exclusion in the BRRD is more limited. The BRRD exclusion is limited to "liabilities with a remaining maturity of less than seven days, owed to systems or operators of systems designated according to Directive 98/26/EC [Settlement Finality Directive] or their participants and arising from the participation in such a system".

11.11 The BRRD protection is therefore limited to liabilities with a remaining maturity of less than seven days, and only applies to systems designated under the Settlement Finality Directive (SFD). It does not extend to non-EU CCPs which are not designated under the SFD. It is therefore necessary to amend our legislation to align with the BRRD. The Commission is currently considering what to include in its proposed directive on CCP recovery and resolution, and any comments in relation to CCPs could be made to the Commission and taken up in that negotiation.

11.12 The Directive also requires that liabilities to tax and social security authorities be excluded, provided that they are preferred under national law. Since liabilities to HMRC are not preferred under UK law, these liabilities will not be excluded from the bail-in tool.

11.13 Finally, it is necessary to exclude liabilities to Deposit Guarantee Schemes arising from contributions in accordance with Directive 2014/49/EU, the Deposit Guarantee Scheme Directive. This will apply only to liabilities under the recast 2014 Directive, and therefore does not apply to the legacy costs which are currently being collected through FSCS levies.

Pension liabilities

11.14 The Directive specifies that liabilities to employees and former employees are excluded from bail-in, with the exception of the variable component of remuneration unless subject to a collective bargaining agreement. This exclusion also covers pension liabilities. In response to our earlier consultation on bail-in, some concerns were raised about whether this exclusion extended to liabilities to pension schemes, rather than directly to employees.

11.15 The Government is clear that the intention of the Directive is to exclude liabilities to pension schemes, since it is unusual in the UK for a firm to have pension liabilities directly to the employee. This is confirmed by Recital 70, which states that *"In order to honour pension entitlements and pension amounts owed or owing to pension trusts and pension trustees, the bail-in tool should not apply to the failing institution's liabilities to a pension scheme".* Therefore, it is proposed to amend s. 48B to make this clear.

11.16 The Government understands the reference to the 'variable component' of remuneration to refer to performance-related bonus payments, and this interpretation is confirmed by Recital 70, which specifies that the bail-in tool will apply to *"liabilities for pension benefits attributable to variable remuneration"*. The Government is still considering what implementation is required, but intends to ensure that pension trustees are able to reduce their liability to pensioners to the extent that any 'variable component' of remuneration is bailed in.

11.17 Following all of these changes, the list of excluded liabilities would therefore read as follows:

1 liabilities representing protected deposits;

2 any liability, so far as it is secured;

3 liabilities that the bank has by virtue of holding client assets;

4 liabilities with an original maturity of less than 7 days owed by the bank to a credit institution or investment firm;

5 liabilities with a remaining maturity of less than 7 days arising from participation in designated settlement systems and owed to such systems or to operators of, or participants in, such systems;

6 liabilities owed to an employee or former employee in relation to salary or other remuneration, except

   a variable remuneration that is not regulated by a collective bargaining agreement, and

   b variable remuneration of material risk takers as referred to in Article 92(2) of Directive 2013/36/EU.

7 liabilities owed as the employer under an occupational pension scheme

8 liabilities owed to creditors arising from the provision to the bank of goods or services (other than financial services) that are critical to the daily functioning of its operations.

9 liabilities owed by the bank to the scheme manager of the Financial Services Compensation Scheme (established under Part 15 of the Financial Services and Markets Act 2000) in relation to levies payable by virtue of section 213(3)(b) [or (4)] of that Act [other than historical liabilities arising prior to the adoption of the Directive 2014/49/EU[1]].

Liabilities with no fixed maturity

11.18 In response to the earlier consultation on the bail-in powers, several responses questioned whether liabilities with no fixed maturity, which are callable on demand, would be included within the definition of liabilities with an original or remaining maturity of 7 days. The Government's proposes that if a liability has no fixed maturity and is callable at any point, with less than 7 days' notice, then it will fall within the definition of a liability with an initial or remaining maturity of less than 7 days.

Box 11.A: Bail-in – excluded liabilities

12 To the extent that liabilities in relation to pension benefits attributable to variable remuneration must be within scope of the bail-in powers, do you agree that it should be possible for the pension trustee to reduce his liability to the beneficiary accordingly? Do you have any comments on how this could be achieved?

13 Do you agree that liabilities with no fixed maturity and which are callable at any point with less than 7 days' notice should fall within the definition of a liability with an original or remaining maturity of less than 7 days?

14 Do you have any other comments on the proposed changes to s. 48B?

[1] Drafting to be finalised.

Exceptional discretionary exclusions from bail-in

11.19 Article 44(3) permits resolution authorities to exclude or partially exclude certain liabilities when exercising the bail-in tool, if certain conditions are met. The liability may be excluded or partially excluded where any of the following conditions are met:

- It is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority;
- The exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions;
- The exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union; or
- The application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.

11.20 The Government views this flexibility as essential for ensuring that the bail-in tool is effective.

11.21 The decision on which liabilities to exclude will rest with the Bank of England at the point of resolution. They will consider the liabilities of the firm in question, and whether any of the criteria specified in Article 44(3) are applicable.

11.22 The Government proposes that these discretionary exclusions are included as a new category of "excluded liability" as set out in the draft Order.

Contractual recognition of bail-in

11.23 Article 55 of BRRD relates to liabilities within the scope of the bail-in powers but governed by the law of a third country. It requires that any such liabilities issued or entered into after implementation (and not subject to the exclusion in Article 55(1)) include a contractual term which states that the liability may be subject to the write-down and conversion powers and where the creditor agrees to be bound by any actions of the resolution authority in relation to the liability.

11.24 The Government is supportive of this approach, which will ensure that debt issued in third countries or subject to the law of third countries will be available to contribute to the loss absorbency of an institution. This is particularly important for eligible liabilities, as defined in Article 45.

11.25 The PRA's and FCA's existing powers under s.137G and s. 137D FSMA respectively are sufficient to enable them to impose such a requirement on institutions. Following the commencement of s.192JB of FSMA (as amended by the Financial Services (Banking Reform) Act 2013), they will also be able to ensure that qualifying parent undertakings comply, by making rules requiring a qualifying parent undertaking to make arrangements that would allow or facilitate the exercise of the resolution powers in relating to the parent undertaking or any of its subsidiaries.

11.26 However, the PRA's and FCA's existing powers do not currently extend to mixed-activity holding companies. The Government's initial view is that it is not appropriate to extend this

requirement to mixed-activity holding companies, where its subsidiary institutions are held directly or indirectly by an intermediate financial holding company. Imposing such a requirement on these companies would be disproportionate given the provision in Article 33 of the BRRD which states that resolution actions for the purpose of group resolution must be taken in relation to the intermediate financial holding company, and not the mixed-activity holding company.

11.27 Therefore, the Government proposes to extend the scope of the rule-making power to mixed-activity holding companies only where the subsidiary institutions are not held by an intermediate financial holding company. If the subsidiary institutions are held by an intermediate financial holding company, then this requirement will not apply.

11.28 The Government considers that complying with such a requirement will impose a cost on firms. There will also be EBA RTS that, in accordance with Article 55(3), will relate to the contents of the term required. Therefore, the Government is considering whether to apply the extension to the existing rule-making powers to mixed-activity holding companies, where the subsidiary institutions are not held by an intermediate financial holding company, from 1 January 2016.

Minimum requirement for eligible liabilities (MREL)

11.29 Article 45 (1) of BRRD requires Member States to ensure that institutions meet, at all times, a minimum requirement for own funds and eligible liabilities (MREL). MREL is calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution, and will be set on a firm-by-firm basis. Derivative liabilities should be included in the total liabilities on the basis that full recognition is given to counterparty netting rights.

11.30 Article 45 (6) of the Directive sets out a minimum list of criteria on the basis of which MREL should be determined. The EBA is required to draft regulatory standards (RTS) to further specify these criteria by June 2015. The EBA is also required to submit a report to the Commission by 31 October 2016, on the basis of which the Commission will decide whether a legislative proposal would be necessary for a harmonised application of MREL across all EU firms. The discussion on MREL is also closely tied to the Financial Stability Board's (FSB's) work on adequacy of global systemically important financial institutions' (G-SIFIs) loss absorbing capacity in resolution.

11.31 Although the Directive's provisions must be transposed by 1 January 2015, the application of the provisions that implement Section 5 on bail-in, which includes the rules about MREL, may be delayed until 1 January 2016. The Government is considering delaying the application of MREL until 1 January 2016, the latest date at which it can be applied due to the fact that that some significant policy developments are expected between now and 1 January 2016 on the issue as a result of the FSB's work on the adequacy of globally systemic banks' loss-absorbing capacity. The Government anticipates imposing a duty in subordinate legislation on the Bank of England to set MREL from 2016. In order to comply with the requirement to complete the necessary legislation by 31 December 2014, the Government is considering transposing the Directive's minimum requirements into UK law without further specifying them at this stage. Following any international agreement on the issue of a requirement for loss-absorbing capacity, this legislation could be updated as necessary prior to commencement.

11.32 The Government therefore confirms that it will not be laying the Banking Reform (Loss Absorbency Requirements) Order as drafted in the consultation on secondary legislation relating to the Financial Services (Banking Reform) Act 2013.

Box 11.B: Contractual recognition of bail-in and Minimum Requirement for Own Funds and Eligible Liabilities

15 Should the regulators' powers to require the inclusion of a contractual clause regarding recognition of bail-in extend to mixed-activity holding companies where the subsidiary institutions are held by an intermediate financial holding company?

16 Should the extension of the regulators' powers to require mixed-activity holding companies to include contractual recognition provisions in accordance with Article 55, and the MREL provisions, be delayed until 1 January 2016?

Loss absorption and recapitalisation – access to the resolution financing arrangements

11.33 The BRRD will place limitations on use of industry contributions or public funds to "bail-out" a bank. The Government is fully supportive of the aim to prevent bail-outs in future, and ensure that shareholders and creditors of failing bank are fully exposed to the losses of that institution. This is very important in order to address the perceived implicit guarantee that systemic banks are seen to benefit from.

11.34 Resolution planning will be conducted on the assumption that there will be no access to the resolution financing arrangements or other sources of public funding to absorb losses or recapitalise the bank. Losses will be absorbed by shareholders and creditors of the firm.

11.35 Any use of external financing to absorb losses or recapitalise a firm will be exceptional, and only used in cases where there is a strong public interest case to do so. Therefore, the Government welcomes the requirement in the BRRD that the resolution financing arrangement may only be used to absorb losses and recapitalise a bank once shareholders and creditors have made a contribution to the loss absorption and recapitalisation equal to at least 8% of the total liabilities of the firm, including own funds.

11.36 Once that level has been reached, the resolution financing arrangements may be used to absorb up losses of up to 5% of the firm's total liabilities, including own funds. The Government anticipates that the Bank of England will inform the Treasury that a contribution equivalent to at least 8% of liabilities including own funds has been made by shareholders and creditors before public funds are made available under ss. 228 and 229 of the Banking Act.

11.37 It should be noted that 8% of a firm's liabilities, including own funds, is a very substantial amount, and exceeds the losses experienced by the majority of banks that failed or faced significant financial difficulties during the financial crisis.

11.38 Article 49 of the Directive provides that derivatives may only be bailed in on a netted basis. The Government's view is that derivatives should therefore be treated on a net basis in accordance with the relevant close out provisions for the purpose of the calculation of the total liabilities for determining the 8%. This is also consistent with the basis for MREL and the rule in Article 45(1) that "derivative liabilities shall be included in the total liabilities on the basis that full recognition is given to counterparty netting rights."

Timing

11.39 It is necessary to define the point at which the amount equivalent to 8% of the total liabilities, including own funds will be calculated. Article 44(5)(a) specifies that this must be "measured at the time of resolution action in accordance with the valuation provided for in

Article 36". "Resolution action" is defined in Article 2(1)(40) and includes the decision to place a firm in resolution, the application of a resolution tool, and the application of a resolution power.

11.40 Losses in regulatory capital that have been incurred before the point of resolution will therefore not be counted towards the 8% requirement. This includes any reduction in the value of CET1, and the conversion of any instruments that have a contractual conversion (e.g. contingent convertibles) which have a trigger which is met before the point of resolution. However, any such instruments which have not converted at the point of resolution, but are subsequently converted or have the principal amount reduced in accordance with Article 48(3) will contribute towards the 8% requirement, as will the mandatory write down or conversion of capital instruments required by Article 59 before the use of any resolution tools. Basis of the calculation for derivatives.

Group resolution

11.41 Where an institution is part of a banking group, the Bank of England may bail in the liabilities of the holding company. This may be the case when one banking subsidiary is failing, or where a number of subsidiaries are failing.

11.42 It is not immediately clear what the 8% requirement refers to in such cases. The Government considers that the most reasonable interpretation, and the one which meets the objective of ensuring that creditors are exposed to losses, is to interpret it as referring to whichever is the greater – 8% of the liabilities of the failing bank or banks, or 8% of the liabilities of the holding company and is considering implementing the provision in this way.

Firms with less than 8% of liabilities available for bail-in

11.43 It is theoretically possible that a firm will exist where it is impossible to meet the 8% requirement, due to the fact that over 92% of its liabilities at the point of resolution are excluded liabilities as defined in Article 44(2). While this may seem like an unlikely scenario, it is clearly not impossible – particularly for banks which mainly accept deposits, the majority of which are covered deposits.

11.44 In such cases as this, the Government is considering whether it is reasonable to implement this requirement by obliging the Bank of England to bail in all liabilities which are not excluded from bail-in under Article 44 before a contribution from the resolution financing arrangements is possible.

Box 11.C: Loss absorbency

17 Do you have any comments on the proposed approach to implementing the requirement that shareholders and creditors must make a contribution to loss absorption and recapitalisation equal to at least 8% of the total liabilities of the firm, including own funds, before alternative resolution financing arrangements can be accessed?

18 How should situations with a bank or investment firm where over 92% of its liabilities at the point of resolution are excluded liabilities be dealt with? Do you think that this is a realistic scenario?

12 Safeguards

Safeguards for counterparties in partial transfers

12.1 In the event that the resolution authority uses its powers to transfer some but not all of the assets, rights or liabilities of an institution under resolution, the Directive requires that Member States put in place appropriate protections for counterparties to the following instruments:

- Security arrangements, under which a person has by way of security an actual or contingent interest in the assets or rights that are subject to transfer, whether that interest is secured by specific assets or rights of by way of a floating charge or similar arrangement;
- Title transfer collateral arrangements;
- Set-off arrangements
- Netting arrangements;
- Covered bonds;
- Structured finance arrangements, including securitisations and instruments used for hedging purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to the covered bonds, which involve the granting and holding of a security by a party to the arrangement of a trustee, agent or nominee.

12.2 Articles 76 – 80 set out requirements that the protections must meet.

12.3 The Government is of the view that the existing safeguards meet these requirements with respect to partial property transfers. Section 47 BA and SI 2009/322, the *Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009* already provide appropriate restrictions on partial property transfer. Therefore, it is proposed that these be retained. The safeguard for termination rights in Article 4 of the Order will continue to prevent partial property transfers that would contravene Community law. However, Article 9 of the Order will be removed to reflect the amendments to the Financial Collateral Arrangements Directive 2002/47/EC ('FCAD') in Article 107 of the BRRD. This issue was addressed in the March 2013 consultation.

12.4 Since the asset separation tool involves the use of partial property transfers, it will be ensured that the safeguard will apply to any use of the asset separation tool.

12.5 The Government proposes to maintain the carve-outs in the *Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009* including the reference to 'excluded rights' and 'excluded liabilities' in article 3(3) relating to a retail deposit or a retail liability. This allows the transfer of retail deposits without it being necessary to transfer any assets that may be offset against those liabilities (for example, offset mortgages). The Government considers that it is important to retain this, in order to allow the transfer of a retail deposit book as a whole, including covered deposits, either to a private sector purchaser or a bridge bank.

Safeguard for protected arrangements in bail-in

12.6 Although the BRRD does not expressly address this issue, it is clear that safeguards are required in bail in as well, because they are important to ensure that bailed in creditors are not worse off than they would have been in insolvency. The Government consulted on safeguards for protected arrangements in the context of bail-in in the March 2013 consultation.

12.7 "Protected arrangements" are security arrangements, title transfer collateral arrangements, set-off arrangements and netting arrangements. The draft Order included with that consultation defined a set of "protected liabilities" to which the Order would apply.

12.8 This draft Order was designed to, among other things, meet the requirement in Article 49 of the BRRD that derivatives are closed out prior to being bailed in. As set out in the March 2013 consultation, the Government proposes extending this protection to a broader set of liabilities.

12.9 However, a number of responses to the consultation raised concerns that the list of "protected liabilities" in the draft Order was not sufficiently broad, and did not include some liabilities which could have an effect on regulatory capital requirements.

12.10 Therefore, in response to that consultation, the Government proposes adopting a different approach, where the safeguard will apply to a broad set of liabilities with certain exclusions which will be defined in the Order and will facilitate the effect use of the bail-in tool. This approach is more consistent with the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 and should provide market participants with a high degree of certainty about the treatment of different contracts.

12.11 The Government proposes that the following liabilities should be excluded from the safeguard:

- Liabilities under unsecured debt securities (including bonds and commercial paper);
- Liabilities under any capital instrument (including preference shares);
- Subordinated liabilities;
- Unsecured liabilities with an original maturity of 1 year or more, except any liabilities in relation to financial contracts;
- Unsecured intra-group liabilities, except any liabilities in relation to financial contracts;
- Liabilities related to claims for damages.

12.12 It should be remembered that, to the extent that any set-off or netting rights would have been respected in insolvency, then the calculation of any "No Shareholder or Creditor Worse Off" compensation would reflect this fact. This is the case for all liabilities, whether covered by this safeguard or not.

12.13 The Government will be publishing a summary of responses to the earlier consultation in due course, and will provide further details on the approach proposed here.

Box 12.A: Safeguard for protected arrangements in bail-in

19 Do you have any comments on the proposed safeguard for protected financial arrangements in bail-in?

No Shareholder or Creditor Worse Off

12.14 One of the most important safeguards in the BRRD is that no shareholder or creditor shall, through the exercise of the resolution powers that involve a partial property transfer or bail-in, be left in a worse position than they would have been in had the institution entered insolvency immediately before the exercise of the resolution powers.

12.15 A "No Creditor Worse Off" safeguard is included ss. 60 and60B of the Banking Act 2009, SI 2009/319, and the *Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009*. These require the appointment of an independent valuer following any use of the partial property transfer powers. The independent valuer's role is to assess the actual treatment of any creditor following the resolution action, and the treatment that the creditor would have received had the institution entered insolvency immediately before the exercise of the resolution tool. The independent valuer will then consider whether any compensation is due in order to ensure that the creditor is not left worse off than they would have been in resolution, and determine the amount of compensation necessary.

12.16 However, these Regulations currently only relate to pre-transfer creditors of the institution under resolution. The Regulations will therefore be amended to require that the independent valuer must also determine whether pre-transfer shareholders should be paid compensation, and if so how much.

12.17 Since the asset separation tool (see Chapter 10) will involve the use of the property transfer powers, any use of that tool will be covered by these compensation arrangements and therefore no further changes are needed.

12.18 Equivalent arrangements are required for bail-in. The Government consulted on draft compensation regulations in its consultation on bail-in implementation, published 13 March 2014. A summary of responses will be published shortly, but broadly, respondents were content with the proposed safeguard – although they raised questions about how the valuation would work in practice.

12.19 The Government is considering whether amendments are necessary to deal with situations where both partial property transfer and bail-in are used in the same resolution. Subject to that issue, it is proposed that the regulations are laid as previously consulted on.

12.20 The Government will give further consideration the issue of practical arrangements for the valuation, but does not believe it necessary to codify the procedure in the mandatory compensation arrangements.

13 Government stabilisation options

13.1 In addition to the resolution tools available to the Bank of England as the resolution authority, the BRRD includes two "Government financial stabilisation tools", as outlined in Articles 56 – 58.

13.2 Article 58 relates to the Temporary Public Ownership (TPO) tool, which is already available under the Banking Act. The Government is of the view that the existing TPO tool is adequate for implementation of the BRRD. The Government intends to supplement the Banking Act Code of Practice to note the requirement that it must manage the entity on a commercial and professional basis and transfer it to the private sector as soon as commercial and financial circumstances allow.

13.3 The other government financial stabilisation tool is the public equity support tool, as outlined in Article 57 of the Directive. This tool will be added to the Banking Act.

13.4 The TPO tool and Public Equity Support tool may only be used once there has been a contribution to loss absorption and recapitalisation of at least 8% of the total liabilities of the institution under resolution, in accordance with Article 37(1)(a). This limitation will be reflected in the legislation.

14 Write down of capital instruments

14.1 In order to ensure that capital fulfils its loss-absorbing function, the BRRD requires that none of the resolution tools are used before capital has absorbed losses. Article 59(3)(a) of the Directive requires that 'relevant capital instruments' are written down or converted in accordance with the procedure outlined in Article 60 before any resolution tool is used. The procedure in Article 60 requires that shares and other instruments of ownership be cancelled, transferred to bailed in creditors, or severely diluted. The EBA will prepare Guidelines on the treatment of shareholders and other instruments of ownership.

14.2 Relevant capital instruments are defined in Article 2(1)(74) as Additional Tier 1 (AT1) and Tier 2 (T2) instruments.

14.3 Relevant capital instruments must be written down and converted in accordance with the priority of claims under normal insolvency proceedings and in accordance with Article 47, 48 and 60 BRRD, to the extent necessary to satisfy resolution objectives.

14.4 If losses need to be absorbed to adequately recapitalise the firm, then AT1 must be written down, converted into CET1, or both – i.e. the principal reduced and converted into CET1 instruments. This should be done either to the extent required to meet the resolution objectives, or to their capacity, whichever is the lower.

14.5 If this action is not sufficient to meet the resolution objectives, then the principal amount of Tier 2 instruments must be written down, converted into CET1 instruments, or both as above. Again, the instruments must be done either to the extent required to meet the resolution objectives, or to their capacity, whichever is the lower.

14.6 This is reflected in Article 6 of the draft Order.

Group treatment

14.7 Article 59(3) specifies the circumstances in which the right down must occur. Where relevant capital instruments are held by a subsidiary and are recognised for the purposes of meeting own funds requirements on both an individual and a consolidated basis, then Article 59(3)(c) is designed to ensure that the relevant capital instruments are available for loss absorption in the case of failure of the subsidiary or of the wider group. This can happen where the subsidiary is not failing, but the consolidating supervisor and the appropriate authority from the Member State of the subsidiary make a joint determination that without the write-down of the relevant capital instruments held by the subsidiary, the group will no longer be viable. In such cases, the appropriate authority may consider that the failure of the parent or the group as a whole would affect the viability of the subsidiary, and therefore it is in the interests of the subsidiary and the appropriate authority to take action to return the group to viability.

14.8 Where write-down of relevant capital instruments held by a subsidiary occurs on this basis, then in accordance with Article 59(7), the instruments held by the subsidiary may not be written down to a greater extent or converted on worse terms than equally ranked capital instruments issued by the parent undertaking or another subsidiary of the group where write-down and/or

conversion is occurring on the same basis. This prevents holders of capital instruments in the "host" Member State from being disproportionately affected by a write down.

14.9 This limitation only applies in the case where the subsidiary's capital instruments are being written down in order to preserve the viability of the group, subject to Article 59(3)(c). It does not prevent holders of capital instruments of the subsidiary being converted on worse terms than equally ranked capital instruments held by the parent undertaking in circumstances where the subsidiary is itself failing, and therefore meets the conditions in Article 59(3)(a), (b) or (e) on a standalone basis.

Extent of the write-down and conversion

14.10 The BRRD requires that the relevant capital instruments are written down "to the extent required to meet the resolution objectives". This will be a matter of judgement for the Bank of England, in consultation with the PRA or the FCA as the competent authority. It should not be interpreted as simply meaning ensuring that the firm meets its regulatory minimum capital requirement. Although this will of course be an important factor, the Bank of England will have to consider the viability of the firm, the level of recapitalisation which is needed to restore market confidence, and any restructuring that the firm will undertake following the write-down. This may lead it to determine that it is necessary, in order to meet the resolution objectives, to capitalise the firm above its minimum regulatory capital requirement.

No shareholder or creditor worse off

14.11 The Government's preliminary view is that the "No Shareholder or Creditor Worse Off" safeguard does not apply to write-down of capital instruments. The safeguards described in Articles 73 to 75 only apply to partial transfers and the application of the bail-in tool, not to the write-down of relevant capital instruments. This interpretation is under discussion with the Commission.

14.12 The "No Shareholder or Creditor Worse Off" safeguard is designed as a protection against the resolution authority's discretionary use of the transfer and bail-in powers. As well as providing a level of comfort to creditors, this protects against abuses of these discretionary powers. As write-down or conversion of capital instruments is mandatory when the specified conditions are met, this safeguard is not applicable.

14.13 The Government is of the view that this is an appropriate distinction, since it is important to ensure that capital instruments do what they are designed to do: that is that they absorb losses. Since compensation payments may be made from the resolution financing arrangements, extending the safeguard to capital instruments could result in the wider industry bearing the costs of a firm's failure, rather than holders of its capital instruments.

14.14 Holders of capital instruments will of course continue to be protected by Article 1 Protocol 1 of the European Convention on Human Rights (ECHR), which entitles every natural or legal person to the peaceful enjoyment of his possessions. No-one may be deprived of his possessions except in the public interest and subject to the conditions provided for by law. This may mean that, in a specific case, holders of capital instruments may be entitled to compensation due to interference with these rights.

Box 14.A: Write-down of capital instruments

20 Do you agree with the proposed approach to implementation of the write down and conversion provisions? Do you have any comments on the draft Order?

21 Do you agree with the Government's preliminary view that the "No shareholder or creditor worse off" safeguard does not apply in relation to the write-down and/or conversion of capital instruments?

Emergency liquidity assistance

14.15 Article 59(3) of the BRRD sets out the circumstances in which resolution authorities must exercise the write down or conversion power. This includes a situation where "extraordinary public financial support is required by the institution...except in any of the circumstances set out in point (d)(iii) of Article 32(4). Point (d)(iii) of Article 32(4) is "an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution". This is often known as "precautionary recapitalisation, and is conditional upon approval under the Union State aid framework.

14.16 "Extraordinary public financial support" is defined in Article 2(1)(28) as State aid, or any support provided at a supra-national level which would constitute State aid if provided at the national level.

14.17 The Government's interpretation of this provision is that it only applies where there are losses to absorb, as the write down must follow the procedure in Article 60, which requires that instruments are reduced "in proportion to the losses". When ELA is provided to a solvent bank that does not need to absorb any losses to meet its capital requirements, then there are no relevant losses, and therefore write-down is not required. Indeed, it would be inappropriate to require the State to improve the capital position of a bank in such cases.

14.18 If State-indemnified ELA were to be provided in such a circumstance then this would remain subject to State aid approval as now. The State aid communication does not require burden sharing for a bank that receives ELA but continues to meet its capital requirements. For a bank that is failing to meet its capital requirements, ELA may be provided for up to two months before burden sharing is required, during which time the bank will attempt to recover its capital position. In such cases, ELA is provided to provide the bank with liquidity to enable it to keep operating while it attempts to recover its capital position, not to provide additional capital. The Government considers that the BRRD should be interpreted similarly where a bank fails to meet its capital requirements but has a recovery plan underway and repays the ELA within two months.

14.19 The Government is discussing this interpretation with the Commission and other Member States. Following this interpretation, the Government does not consider it would be necessary to place any requirement in legislation for write down to occur upon the receipt of State-indemnified ELA unless it is provided to a bank that fails to meet its capital requirements and the ELA is not repaid within two months.

15 Branches of third country institutions

15.1 Title VI, Articles 93 – 98, of the BRRD deals with relations with third countries. Article 94 requires Member States to give resolution authorities the powers to support the resolution of a third country institution with a branch or any assets located in the Member State. The Banking Act will therefore be amended to give the Bank of England the ability to support a resolution action by a home resolution authority by exercising the resolution powers in relation to:

1 Assets of a third country institution or parent undertaking located in the UK or governed by UK law;

2 Rights or liabilities of a third country institution that are booked by a UK branch, governed by UK law, or where the claims in relation to such rights and liabilities are enforceable in the UK.

15.2 The Government does not propose extending the share transfer power to UK branches, since it is unlikely to ever be effective, as the branch itself is very unlikely to have any shares in issuance.

15.3 These powers will be available where the Bank of England is acting to support a resolution carried out by the resolution authority where the firm is incorporated. This will include actions such as transferring assets located in the UK to a purchaser under a foreign equivalent of a sale of business tool, or to a bridge bank in the third country.

15.4 The Bank of England will have the right to refuse to recognise third country resolution proceedings in certain circumstances, as set out in Article 95.

15.5 Where the Bank of England refuses to recognise third country resolution proceedings, or in other circumstances where it is in the public interest to do so, Article 96 of the BRRD requires that the Bank of England has the powers necessary to act in relation to the UK branch.

15.6 The view of the Government and of the Bank of England is that such cases will be exceptional. There is significant work underway at international level, primarily through the firm-specific crisis management groups, to ensure that resolution authorities co-operate in the resolution of cross-border banks. This includes drawing up and agreeing resolution plans, and co-operation agreements which set out the roles and responsibilities of each authority.

15.7 Powers to act in relation to the UK branch of a third country institution are therefore "back-stop" powers to be used in the event that this co-operation proves ineffective, and where action is required to protect the public interest. This is consistent with the FSB's Key Attributes of Effective Resolution Regimes, which recognise the need for a fall-back strategy of independent action with respect to local operations of foreign banks in certain circumstances. This will also help reinforce the PRA's approach to supervising international banks, in cases where branches undertake critical economic functions and some of the facts related to those branches change to the detriment of the UK (e.g. if the home resolution strategy changes).

15.8 The Directive does not specify the nature of the powers that resolution authorities should have over UK branches of third country institutions when acting independently. The Government is therefore considering, and seeking views on, an appropriate set of powers which will provide the Bank of England with effective powers enabling it to act in the public interest, while also

being proportionate. The intention is to ensure that the Bank of England may use the most effective and least disruptive tool in the circumstances.

15.9 One option is to extend the set of resolution powers used to support third country resolution decisions to situations where the Bank of England is acting independently to manage the failure of a branch. This would mean that the Bank of England would have the same powers regardless of whether they were acting to support a third country resolution (as set out above) or were acting independently to resolve the branch.

15.10 The Government is considering the enforceability of such powers, in the absence of a decision under foreign law by the third country authorities, and the means by which they could effectively be applied. One example of such powers may be to allow for an initial transfer of some or all of the assets, rights and liabilities of a branch to a private sector purchaser, or to a legal entity established in the UK for the purpose of receiving the assets, rights and liabilities of the branch. That action may, in itself, be enough to achieve the resolution objectives and it would also mean that the UK entity would then be within scope of the resolution powers – allowing, for example, the bail-in of the newly created entity.

15.11 An alternative is to provide the Bank of England with a more limited set of powers which will enable it to deal with the unlikely scenario that it is necessary to act to resolve a branch independently of its home authority.

15.12 These powers could include a power to require the branch to subsidiarise (which would bring it fully within scope of the resolution regime); and enhanced liquidity coverage requirements which could be used to improve the ratio of local assets to local liabilities. The Bank could exercise these powers by directing the PRA to use their existing powers under FSMA.

15.13 In either scenario, the question of defining the assets, rights and liabilities of the branch will be key. Possible criteria could include assets located in the UK and/or governed by UK law; rights or liabilities booked by the UK branch or governed by UK law or where claims in relation to such rights and liabilities are available in relation to UK law.

Box 15.A: Powers over branches of third country institutions

22 Do you agree with the proposal not to extend share transfer powers to branches of third country institutions?

23 Do you feel that the Bank of England should have the full set of resolution powers (with the exception of share transfer powers) over branches of third country institutions when acting independently to resolve a branch?

24 If not, what powers do you feel would be appropriate, in order to ensure that the risks posed by branches of third country institutions can be addressed effectively?

25 How should the assets, rights and liabilities of the branch be defined for the purposes of resolution of a branch?

16 Resolution financing arrangements

16.1 The BRRD requires Member States to establish resolution financing arrangements for the purpose of ensuring the effective application of the resolution tools and powers.

16.2 Where certain conditions are met, the Directive allows Member States to fulfil the requirement to establish resolution financing arrangements through mandatory contributions from the banking sector which are not held in a fund controlled by the resolution authority. This acknowledges and takes into account the fact that several Member States imposed bank levies before the BRRD was proposed by the Commission, to ensure fair burden-sharing and provide incentives for banks to reduce their funding and systemic risk.

16.3 The Government is of the view that the existing UK bank levy (Schedule 19 of the Finance Act 2011) meets these conditions and has previously set out its intention to use the levy to meet the *ex ante* funding requirements in the BRRD[1]. This means that the BRRD resolution financing requirements can be met without imposing an additional upfront cost on UK institutions, and permits the Government flexibility in the use of those funds when they are not needed for resolution (as opposed to them being held in a separate fund controlled by the resolution authority).

16.4 The Government would make these funds immediately available in the event of a resolution, if they were required, in accordance with Article 100(6). The Government would then need a mechanism for replenishing the *ex ante* funding requirement and, if necessary, raising extraordinary *ex post* contributions in accordance with Article 104 of the BRRD, in the event that the *ex ante* funding is insufficient.

16.5 The Government considers it very unlikely that the *ex post* mechanism would be needed in practice. The UK authorities would ordinarily seek to ensure that shareholders and creditors bear the costs of resolution and therefore use of the resolution financing arrangements to absorb losses is not a preferred option, but a fall back. Resolution financing arrangements can only be used to absorb losses in place of creditors in bail-in once shareholders and creditors of the bank have absorbed losses or contributed towards recapitalisation to an amount equivalent to 8% of a bank's total liabilities. Furthermore, in the majority of cases, the resolution financing arrangements will not be used to directly absorb losses, but to support the resolution in other ways (for the purposes specified in Article 101), in which case it may eventually be repaid, avoiding the need to raise further contributions from industry.

16.6 However, a mechanism for replenishing the *ex ante* requirement and raising *ex post* contributions needs to be developed on a contingent basis. The Government has identified two main options.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298679/bank_levy_banding_approach_consultation_270314.pdf

Option 1 – bank levy

16.7 The first option is to use the bank levy for both purposes. This would have the advantage of avoiding the need to establish alternative arrangements for raising contributions. However, there may be some issues in using the bank levy for these purposes.

- The scope of the bank levy may be seen as misaligned with the potential beneficiaries of the resolution fund. For example, the bank levy excludes banks with chargeable equity and liabilities below £20bn, who may still pass the public interest test for resolution in the event of their failure.
- The bank levy, as a tax, may be an inappropriate mechanism for raising funds quickly and predictably from the banking sector.
- The extent to which contributions could be met through future bank levy receipts is unclear, and the Government would separately need to consider whether it is appropriate to bear the costs of the resolution financing arrangement's use in this way.

16.8 To address the first concern, it would be possible to consider options to adjust the design of the bank levy in the event that it is used to replenish the ex-ante fund requirement or fulfil the ex-post financing requirement. However, while the Government welcomes views on this point, it also recognises the additional uncertainty this could create and the potential difficulties in making temporary changes to the bank levy's design.

Option 2 – establishing alternative resolution financing arrangements

16.9 An alternative option is to establish resolution financing arrangements as outlined in the BRRD, which would be used to raise any *ex post* financing requirements and to replenish the *ex ante* funding requirement following a transfer of funds in accordance with Article 100(6).

16.10 Under this approach, contributions to the resolution financing arrangements would be required to follow the delegated act currently being developed by the Commission in accordance with Article 103(7)[2]. These contributions would be based on a firm's size (measured in terms of its total liabilities, excluding covered deposits) with a risk-adjustment that would be calculated using a variety of metrics (potentially including banks' capital ratios, leverage ratios, and the size of the balance sheet as a proportion of GDP, for example). The number of firms contributing to the financing arrangements in this scenario is likely to be greater than under the current bank levy. The Commission is currently consulting on a version that would include firms that would be unlikely to meet the public interest test for resolution.

16.11 The Government feels that it is not possible to reach a final view on the preferred option until the delegated act is finalised. The Government is aware of the consultation exercise the Commission is currently running on the delegated act, which only concerns contributions from credit institutions. Under the proposed timetable, it is hoped that firms will have the opportunity to see a final version of the delegated act before the deadline for responding to this consultation. The Government therefore welcomes views from respondents on the two options outlined above.

[2] http://ec.europa.eu/internal_market/consultations/2014/credit-institutions-contributions/docs/consultation-document_en.pdf

Box 16.A: Resolution financing arrangements

26 Should the bank levy be used to meet the *ex post* funding requirements and replace the initial contributions from the bank levy in the event they are used, or should these be repaid by establishing resolution financing arrangements which follow the Delegated Act on contributions to the resolution financing arrangements?

Use of deposit guarantee schemes in the context of resolution

16.12 Article 109 of the BRRD requires the use of Deposit Guarantee Scheme (DGS) funds to contribute to the costs arising from resolution, provided that resolution actions ensure that depositors continue to have access to their deposits.

16.13 The DGS contribution to a resolution is subject to a cap equal to the amount of losses the DGS would have had to bear, had the institution been wound up under insolvency proceedings. This cap on the DGS contribution differs when the bail-in tool is applied; in this case, the DGS is liable for the amount by which covered depositors would have been written down, had covered deposits been included within the scope of the bail-in. Following the introduction of depositor preference, this amount is likely to be small, and in some cases nil.

16.14 Sections 214B and 214C of FSMA provide for FSCS contribution to resolution costs of banks up to an insolvency counterfactual. Therefore, the Government intends to amend FSMA to reflect the different cap that will apply when using the bail-in tool.

16.15 Article 109(5) introduces a cap of a different nature –stating that the contribution should not exceed 50% of the target level of the DGS (where the target level is the amount specified in Article 10(2) of Directive 2014/49/EU, the recast Deposit Guarantee Scheme Directive, which is generally equal to 0.8% of the covered deposits of its members). However, it allows Member States to set a higher cap taking into account the specificities of the national banking sector.

Box 16.B: Use of deposit guarantee schemes in the context of resolution

27 Should the contribution of the deposit guarantee scheme should be capped at 50% of the target level of the deposit guarantee scheme, or at a higher level?

17 Depositor preference

17.1 When a bank enters insolvency, creditors of that bank are entitled to a claim on the residual assets. These are distributed according to the creditor hierarchy, which dictates the order in which these assets are distributed and in what priority. Creditors with a higher ranking are entitled to receive any recoveries in full before creditors in the class below. Within classes, creditors rank pari passu and assets are distributed evenly.

17.2 In the UK, the FSCS (the UK's Deposit Guarantee Scheme (DGS)) guarantees eligible deposits up to £85,000. In insolvency, the FSCS would pay out to eligible depositors and take their place in the insolvency proceedings for the amount equal to the payments made. This ensures disruption of depositors' access to their deposits is minimal.

Depositor Preference under the Banking Reform Act

17.3 In insolvency, preferential debts are paid out first and are listed in Schedule 6 of the Insolvency Act 1986[1]. The number of preferential debts has been reduced over the years, however the Financial Services (Banking Reform) Act 2013 added FSCS eligible deposits to this list, meaning claims from depositors of up to £85,000 rank pari passu with other existing preferential debts. Where the residual assets of the failed bank are not sufficient to meet the claims of preferential debts, they also have priority over claims secured by floating charges and are paid out of any property comprised in or subject to that charge[2]. This is in line with the recommendations made by the ICB in its final report that preferential debts should rank above floating charges[3].

Depositor Preference in the BRRD

17.4 Article 108 of the BRRD provides for changes to the creditor hierarchy with respect to deposits. It states that the following, which themselves rank equally, have a higher ranking than the claims of ordinary unsecured creditors:

- Deposits from natural persons and micro, small and medium sized businesses which are eligible for protection but exceed the coverage limit[4].
- Deposits from natural persons and micro, small and medium sized businesses that would be eligible for protection were they not made through branches located outside of the union.

[1] http://www.legislation.gov.uk/ukpga/1986/45/schedule/6
[2] Insolvency At 1986 Section 175 (2)(b)
[3] ICB Final Report Recommendations. September 2011. P.108
[4] The coverage limit is defined in article 6 if Directive 2014/49/EU (Deposit Guarantee Scheme Directive)

17.5 The BRRD extends depositor protection further by introducing a 'super preference' for covered deposits[5], preferring these above eligible deposits. Covered deposits are those which are protected by the DGS.

The Government's Approach to Implementation

17.6 To implement the depositor preference measures in the BRRD, and make related changes to the order of priority for building society members, the Treasury intends to exercise its powers under section 2(2) of the European Communities Act 1972, and section 90B of the Building Societies Act 1986(c) to amend the necessary legislation. This includes, but is not limited to, provisions relating to preferential debts in the Insolvency Act 1986 and the Insolvent Partnerships Order 1994 and the equivalent provisions in legislation in Northern Ireland and Scotland. A draft Order is set out alongside this consultation document. This is currently under discussion with the Scottish Government in order to ensure the provisions operate correctly as a matter of Scots law. Accordingly, drafting in relation to Scotland may change.

17.7 The Order will create two classes of preferential debts. Those eligible deposits which must, under Article 108 of the BRRD, be given preferential treatment by comparison with debts owed to unsecured, non-preferred creditors will become preferential debts. However, they will be "secondary preferential debts", which on insolvency will rank after "ordinary preferential debts". All existing preferential debts, including covered deposits which were made into preferential debts by section 13 of the Financial Services (Banking Reform) Act 2013 will be "ordinary preferential debts", and accordingly will be paid out before secondary preferential debts.

Floating Charges

17.8 Floating charges are securities where the underlying assets are subject to a change in value. A floating charge does not affect the ability to use the underlying asset as normal. If the holder fails to repay, or goes into liquidation, the floating charge will be crystallised and turn into a fixed charge. Upon crystallisation, the lender becomes the first creditor in line to recover its losses. The ICB recommended that guaranteed deposits should rank above floating charges in the creditor hierarchy.

17.9 With the introduction of the second tier preference, the Government believes that it is appropriate that deposits within this class (eligible deposits) also rank above floating charges. Including floating charges in the second tier preference would further increase the subordination of unsecured creditors. Floating charges relate to investment decisions made by firms who are able to assess the risk of that investment, whereas depositors are not well places to exert market discipline.

Depositor Preference and Building Societies

17.10 Building societies are owned by their members. Members of a building society either hold a share in the society (usually through a shareholding deposit account) or are a borrowing member, i.e. have a loan secured against land. Within the creditor hierarchy, members currently rank below unsecured creditors. This would mean that in insolvency, member deposits would only be paid out, after unsecured creditors had been paid out in full (although covered deposits would be paid out by the FSCS). This limits the recoveries the FSCS can make in relation to this class of deposits and places a larger contingent liability on the banking sector through FSCS levy contributions. Similarly, in a bail-in, eligible deposits are not excluded and may be bailed in before unsecured creditors.

[5] Also including deposit guarantee schemes subrogating to the rights and obligations of covered deposits

17.11 In the discussion document "The Future of Building Societies", published in July 2012, the Government stated its intention to change the building society creditor hierarchy. Consistency across banks and building societies is important for creating a level playing-field. That statement proposed to implement insured depositor preference for both banks and building societies, and take any other necessary steps to ensure consistency. Since that discussion paper was published, the BRRD requires us to introduce the two tier preference as described above, for both banks and building societies.

17.12 However, there may be some building society shareholding members that are not in scope of FSCS protection. Following the Building Societies Act 1997[6], building societies have been prohibited from raising funds from bodies corporate (except for issuing deferred shares). Before this date, it was possible for large companies to be members of building societies and some of these accounts may still exist. The Government believes there will only be a small number of these accounts, and perhaps none at all. However, if any do exist, they would not benefit from these depositor preference measures and would continue to rank below unsecured creditors.

17.13 The Deposit Guarantee Scheme Directive (DGSD), which will come into force in the UK from 3 July 2015 will extend the coverage of the FSCS to corporate deposits irrespective of size, and therefore include these pre 1997 accounts within covered deposits. However, if there are any non-SME corporate shareholder accounts, their deposits over £85,000 will still rank below unsecured creditors.

17.14 The Government proposes to ensure that any building society members' deposits that are not subject to depositor preference will rank pari passu with senior unsecured creditors. This can be achieved by exercising the powers under section 90B of the Building Societies Act 1986 (inserted by the Building Societies (Funding) and Mutual Societies (transfers) act 2007 (commonly known as the "Butterfill" Act)) to change the order of priority for this class of building society member.

Box 17.A: Depositor Preference

28 Do you agree that floating charges should rank after secondary preferential debts on insolvency? If not, what characteristics do floating charges have which make them suitable to benefit from higher protection?

29 Are you aware of any pre-1997 corporate shareholding members of a building society?

30 Should the powers under section 90B of the Building Societies Act 1986 be exercised so that any existing accounts which will not benefit from depositor preference rank pari passu with unsecured creditors?

[6] The Building Societies Act 1986. Section 8 (1)(c). Amended by the Building Societies Act 1997. Part 1 Section 9.

18 Scope of application

18.1 Members of the European Economic Area (EEA) which are not EU Member States are currently neither bound by nor required to implement the BRRD, and would only be obliged to do so following a Decision of the EEA Joint Committee to extend the BRRD to the EEA.

18.2 The Government is considering whether to include these EEA members in implementation of the cross-border provisions of the BRRD. To do so would be consistent with the implementation of the Capital Requirements Directive IV, and may be easier for firms that already produce information for regulators on that basis.

18.3 However, unless and until these EEA members which are not EU Member States implement the BRRD, some aspects of the BRRD such as binding mediation on recovery and resolution planning will not be workable with respect to those jurisdictions. Whether this matters in practice depends on the extent to which UK entities participate in group planning with entities in the EEA, or are likely to in the period before the EEA become a party to this Directive.

18.4 The Government is therefore considering how to address this issue in transposition of BRRD.

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