

# **The UK approach to resolution of failed banks – recent experience and issues**

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# The Northern Rock failure, 2007-08

- NR grew balance sheet 6 times from 1998-2007 in **rapid expansion** primarily funded through wholesale markets.
- Growing **funding crisis** in August-September 2007, NR unable to raise new short-term funds or roll over existing loans, forced to seek financial support from Bank of England.
- **No possibility for authorities to seize control** of NR for as long as it continued ostensibly to meet regulatory capital requirements.
- First **UK bank retail run** for over 140 years – depositors withdrew 20% of deposits over 4 days. Outflows did not stop even when UK Government guaranteed deposits.
- Three options: corporate **insolvency**; private **sale**; or **nationalisation**.
- In February 2008 **NR nationalised**, using emergency legislation to pass Banking (Special Provisions) Act



# The Banking (Special Provisions) Act 2008

- Act enabled UK Treasury to carry out **directed transfers** of business of a failed bank
- Debate in Parliament on whether to limit Act to NR or **extend to other bank failures**: Government opted for latter course, subject to **one-year sunset clause**
- Act subsequently used in two main cases:
  - **Bradford and Bingley**, Sept 2008: UK Government took bank into temporary public ownership and immediately transferred deposits and branches to Abbey National (UK subsidiary of Santander)
  - **Icelandic banks' operations in UK** (Kaupthing Edge and Heritable Landsbanki), Oct 2008: UK Government froze UK assets of Icelandic banks, funded transfer of £3bn of UK retail deposits to ING Direct and placed remaining UK businesses of both banks into administration



# Resolutions of NR and B&B, 2008-12

- NR **restructuring** 2008-09 with view to repaying Government loans
- NR split into **good bank** and **bad bank**, 1 January 2010
- **NR bad bank** (NR Asset Management plc) and **B&B** combined under single holding company wholly owned by UK Government, March 2010
- **Combined bad bank** (UK Asset Resolution Ltd) to focus on orderly run-down of closed mortgage book and repayment of Government loans and creditor claims over 10-15 year period
- Chancellor announces **sale process for NR good bank**, June 2011
- **Four exit options** explored for NR good bank: sale of whole bank; deposit sale/loan book run-down; IPO; and remutualisation
- **NR good bank sold** to Virgin Money, 1 January 2012



# Recapitalisations of major UK failed banks, 2008

- **Resolution of Royal Bank of Scotland**
  - RBS Group **largest bank in world** by assets in 2008
  - Ill-timed acquisition of **ABN Amro** in 2007, huge rights issue in 2008
  - UK Government **recapitalised bank**, October 2008
  - UK Government sold RBS emergency insurance on assets via **Asset Protection Scheme (APS)**, early 2009
  - RBS now **82% owned by UK Government**, which paid c £45bn for stake.
- **Resolution of HBOS/Lloyds Banking Group**
  - HBOS **largest UK mortgage lender** in 2008
  - Following severe liquidity strain, **HBOS acquired by Lloyds-TSB** to form Lloyds Banking Group (LBG), September 2008
  - UK Government subsequently **recapitalised LBG** and sold it emergency insurance on assets via **APS**
  - LBG now **39% owned by UK Government**
  - LBG required to divest **600 branches** to comply with EU State Aid requirements



# Market-wide temporary initiatives to support UK bank recapitalisations, 2008-09

- **Asset Protection Scheme (2009):** provided participating institutions with protection against future losses on assets in exchange for a fee and legally binding agreements to increase lending to creditworthy businesses and households.
- **Credit Guarantee Scheme (2008):** provided guarantees on short- to medium-term debt issued by eligible banks, in return for a commercial fee.
- **Special Liquidity Scheme (2008):** allowed financial institutions to swap with Bank of England high-quality but temporarily illiquid assets for more easily tradeable assets.
- **Other Bank of England liquidity facilities:** permanent Discount Window Facility introduced in 2008 and extended to wider range of assets subsequently.



# UK Special Resolution Regime (SRR)

- Introduced under **Banking Act**, February 2009
- **Bank of England** becomes lead resolution authority
- **Triggers for SRR** are regulatory determinations by FSA that (1) bank no longer meets threshold conditions for authorisation; and (2) it is not reasonably likely that bank will once again meet threshold conditions after remedial action
- **Objectives** are to protect: (1) UK financial stability; (2) confidence in UK banking sector; (3) depositors; (4) public funds; and (5) avoid interfering with property rights in manner inconsistent with ECHR
- Bank will seek to **achieve objectives** in a manner that preserves continuity of access to systemically important functions of failed bank, while seeking to avoid risks to UK taxpayer



# Why was the SRR necessary?

NR failure demonstrated that corporate insolvency law is inappropriate for banks because:

- (1) No account taken of **confidence** effects
- (2) Not based on **public policy** objectives
- (3) Insolvency-based **trigger** is too late
- (4) Does not ensure **continuity** of access to critical economic functions
- (5) Takes no account of special position of bank **depositors**





# UK SRR toolkit

- (1) Directed transfer of part or all of bank's business to one or more **private sector purchasers (PSPs)**
- (2) Directed transfer of part or all of bank's property to temporary **bridge bank**
- (3) Placing bank into **temporary public ownership (TPO)**
- (4) Liquidation of bank in manner that fully protects insured depositors through either rapid payout of accounts or transfer of accounts to another bank – **bank insolvency procedure (BIP)**
- **Different conditions apply to different tools:** BIP to be used in non-systemic cases; PSP/Bridge Bank tools only possible in public interest; TPO a last resort if only that can mitigate serious threat to UK financial stability



# Creditor safeguards in the SRR

- Mainly to protect creditors whose claims are left behind in a partial property transfer (PPT), where that part of bank not transferred is placed into a special insolvency procedure – **bank administration procedure (BAP)**
- **Secured creditors** protected because resolution authority not allowed to separate collateral from claim
- **Netting and set-off agreements** must be maintained in resolution
- **“No cherry picking”** rule means financial contracts with given counterparty subject to netting agreement must all be either transferred or all left behind
- **“No creditor worse off safeguard”** ensures no creditor is worse off than in whole-bank liquidation, eg through compensation if appropriate



# Applications of the SRR (1)

- **Dunfermline Building Society** (March 2009)
  - Largest building society in Scotland
  - Expansion into **non-core areas**, eg commercial real estate and loans, buy-to-let
  - Resolved through **3-way split**:
    - (1) deposits, branches and core residential mortgage portfolio transferred to **Nationwide**;
    - (2) social housing loans transferred to **bridge bank** (subsequently also sold to Nationwide in July 2009);
    - (3) rest of business, including commercial loans, acquired mortgages, subordinated debt and treasury assets put into version of **bank administration procedure**.



# Applications of SRR (2)

- **Southsea Mortgage and Investment Company** (June 2011)
  - Very small bank failure (250 depositors and £7.4mn deposits)
  - Bank's failure clearly not systemic so **placed into BIP** and bank liquidator appointed
  - Liquidator worked with Financial Services Compensation Scheme to **pay out insured deposit claims** up to limit of £85,000
  - **Uninsured depositors** not fully protected
  - Liquidator now working to **liquidate assets**



# Enhancements needed to UK SRR to implement FSB Key Attributes

- Scope of SRR transfer powers needs to extend to **other financial institutions** whose failure could be systemic
- SRR needs to extend to **branches** in UK of (non-EU) foreign banks
- SRR toolkit needs to include explicit **bail-in tool**
- SRR statutory objectives need to pay due regard to implications for **financial stability in other countries**
- Short **stay on exercise of early termination rights** with respect to financial contracts held by counterparties of failed bank needs to be introduced
- **EU Recovery and Resolution Directive** will deliver many of these reforms
- UK Government also taking independent action through **Financial Services Act 2012** and **Banking Reform Bill 2013**



# Financial Services Act 2012

- Mainly about the **new regulatory arrangements** in the UK, eg replacement of FSA by Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA)
- But also **extends resolution powers** to:
  1. Investment firms (IFs)
  2. Parent and affiliated companies of banks/IFs
  3. Central counterparties (CCPs)
- **New statutory objectives** in banking SRR to protect client assets in resolution and minimise adverse effects on institutions that support operation of financial markets
- **Secondary legislation** will define precise application of extended powers and creditor safeguards (eg to companies that are “financial in nature”)



# Banking Reform Bill 2013

- Mainly about implementation of proposals of Independent Commission on Banking (Vickers) relating to **separation** of retail and wholesale banking activities
- Paves way for PRA to introduce **primary loss absorbency capacity** (PLAC) requirements of up to 17% of RWAs on UK ring-fenced banks and UK G-SIBs
- **PLAC** to consist of equity plus junior and senior debt with residual maturity exceeding 1 year
- Will introduce insured **depositor preference** in UK
- Can be used to make further **extensions of resolution or special administration powers** to other UK financial institutions, eg insurance companies and non-CCP financial market infrastructures such as payment and settlement systems



# Types of cross-border resolution strategy: (1)

## single point of entry

- **Whole group resolution** led by home authorities
- Best example is **top-down bail-in**, where shareholders and creditors of holding company or top operating company suffer losses
- **Subsidiaries of holdco or top opco** are recapitalised through writing down claims of holdco/top opco on subsidiaries
- Avoids need for **operating subsidiaries** in home and key host jurisdictions to enter resolution
- Reduces **incentives of host authorities to seize local assets** and use them to satisfy claims of local creditors
- FDIC and Bank of England have published **joint paper** on SPE resolution strategies, December 2012





# Types of resolution strategy: (2) multiple point of entry

- G-SIFI is **split up** through resolution procedures applied by home authority and key host authorities to multiple parts of group
- Best example: **regional break-up**
- Likely to be coordinated by **home authority** but with subsidiaries in host jurisdictions subject to resolution tools exercised by host authorities
- **Creditors of subsidiaries** in home and key host jurisdictions may be bailed in or otherwise suffer losses
- **Resolution tools** applied to different parts of the group need not be the same and could include options such as bail-in, use of bridge bank, transfer of business and wind-down
- Requires **close cooperation between home and host authorities** to avoid competing resolution or insolvency proceedings and ring-fencing of assets



# Conditions for effective SPE strategies

- Mechanisms to ensure **losses of operating subsidiaries are transmitted up the group** to be borne first by external shareholders and creditors of holding company (mirrors their structural subordination in insolvency)
- Enough external (non-deposit) claims on group **issued at holding company or top operating company level** to provide sufficient loss-absorbing capacity
- All **intra-group claims to be subordinated** to external claims issued by op subs
- Reasonable certainty that home authorities would **allow resources generated by recapitalisation at holding company level to be down-streamed** within group



# Conditions for effective MPE strategies

- **Group can be divided** into two or more constituent parts without significant cessation of critical economic functions
- **Degree of legal, financial and operational separation** within the group – may require changes to the way groups are structured
- **Robust service level agreements** to ensure continuity of essential services across entities subject to resolution
- **Cooperation between home and key host authorities** to avoid competing insolvency proceedings being triggered in which assets are ring-fenced

