Special resolution regime:

safeguards for partial property transfers

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Special resolution regime: safeguards for partial property transfers

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1 Introduction and overview

The financial crisis and the Authorities' response

1.1 The recent period of sustained disruption in global financial markets, starting in the United States in the summer of 2007, and continuing ever since, has had a widespread impact on financial markets, financial services firms and economies across the world.

1.2 Many forces came together to set the stage for the current crisis, including:

- low interest rates, both short and long term, contributing to an extended global credit boom
- a search by investors for higher returns;
- the use of increasingly complex products, often ultimately linked to mortgages, to meet those demands; and
- bonus-driven pursuit of short-term profit in global financial institutions, compounded by shortcomings in regulation, most obviously in the US sub-prime mortgage market.

1.3 In short, investors were over-paying for risky assets, and a bubble had formed. As American sub-prime mortgages defaulted, asset prices linked to them fell. The shock was profoundly felt and quickly transmitted across countries. And so the collapse of the US sub-prime market became the catalyst for a global financial crisis.

1.4 In the UK, the most visible consequences of this crisis have been the difficulties faced by a number of banks. The Government has undertaken a range of actions to ensure the stability of the financial system, to protect ordinary savers, depositors, businesses and borrowers, and to protect the interests of taxpayers. The Treasury, the Bank of England (the Bank), and the Financial Services Authority, (together, the 'Authorities') and the Financial Services Compensation Scheme (FSCS) have taken decisive action, both with regard to specific firms, and the system as a whole, including:

- steps to resolve difficulties with specific failing banks, such as Northern Rock and Bradford & Bingley;
- the FSA's supervisory enhancement programme and other reviews, including of liquidity regulation and remuneration;
- the increase to £50,000, by the FSA, of the deposit protection limit of the FSCS; and
- the introduction of the Banking Bill, to provide a permanent regime for ensuring that banks are less likely to fail, and to deal with the consequences if they do.

1.5 On 8 October 2008, the Government announced comprehensive measures to ensure stability in the UK financial system. The measures address all of the key issues:

- access to liquidity via an expansion of the Bank of England's Special Liquidity Scheme to provide up to £200 billion to banks;
- strengthening banks' capital via Government purchase of shares, with £37 billion of capital injected into three major UK banks; and
- providing confidence in bank funding, via a Government credit guarantee scheme on banks' eligible debt issuance, up to around £250 billion.

1.6 Recognising that the current banking crisis is a global problem, one affecting not just banks in the UK, but all around the developed and, increasingly, the developing world, the UK is leading international efforts to stabilise the global financial system and reform it for the future. It is now recognised that the international financial regulatory architecture and international institutions were inadequate to deal with the level of risk building up within the system.

1.7 G7 Finance Ministers have agreed, therefore to implement a detailed package of measures, recommended by the Financial Stability Forum, to strengthen global financial stability for the future; and there is now a growing consensus on the Prime Minister's proposals for a reformed international architecture for global coordination and surveillance relating to the risks in the international financial system.

The Banking Bill

1.8 As noted above, a key part of the Authorities' response has been the new Banking Bill, legislation to provide for a new, permanent framework for dealing with banks before and after they experience financial stress. The Bill was introduced into Parliament on 7 October 2008 and had its Second Reading in the House of Commons on 14 October.

1.9 The Government has secured cross-party support for this Bill, and is working to secure its passage through Parliament by 20 February 2009, when key provisions of the emergency legislation (the Banking (Special Provisions) Act 2008) used to resolve Northern Rock, Bradford & Bingley, Heritable and Kaupthing expire under the sunset provisions of that Act.

1.10 Alongside the recent actions taken to resolve the crisis, as described above, the Banking Bill introduces significant changes to the framework for banking oversight and financial stability, aimed at addressing five core high-level objectives:

- strengthening the stability and resilience of the financial system;
- reducing the likelihood of individual banks facing difficulties;
- reducing the impact if, nevertheless, banks do get into difficulties;
- ensuring effective protection for depositors, through the FSCS, in the rare circumstances where banks to fail; and
- strengthening the Bank of England, and ensuring effective coordinated actions by authorities, both in the UK and internationally.

1.11 In developing this legislation over the last twelve months, the Authorities have consulted widely on a range of measures to improve financial stability and depositor protection, most notably through the following discussion papers and consultation documents:

- 'Banking reform – protecting depositors' (October 2007);
- 'Financial stability and depositor protection: strengthening the framework' (January 2008)
- 'Financial stability and depositor protection: further consultation' (July 2008)
- 'Financial stability and depositor protection: special resolution regime' (July 2008)

The special resolution regime

1.12 The most fundamental change provided for in the Banking Bill is the introduction of a new special resolution regime (SRR), to enable the Authorities to resolve failing banks and building societies[1] in the UK within the scope of the SRR (hereafter, 'banks') in a more orderly manner. All the Authorities have important roles to play in the SRR:

- the Bank will be the lead organisation in the implementation of the SRR, taking the decisions on which resolution tools (other than temporary public ownership) to use with respect to a failing bank;
- the FSA will decide whether a bank should enter the SRR (principally by judging whether the bank has breached, or is likely to breach, its regulatory 'threshold conditions', and that it is not reasonably likely that action taken by or in respect of the bank will enable the bank to satisfy the threshold conditions); and
- the Treasury will retain control of any decisions that involve the commitment of public funds (actual or contingent), and will decide on other issues properly reserved to the Government.

1.13 The SRR provides the Authorities with several options for resolving a failing bank, including:

- the private sector purchaser (PSP) stabilisation option, effected through a transfer of shares or property to a PSP;
- the bridge bank stabilisation option, effected through a transfer of property from a failing bank to a bridge bank (a new company owned by the Bank of England);
- the temporary public ownership (TPO) stabilisation option; effected through a transfer of shares to the public sector, and;
- the bank insolvency procedure (BIP), a new insolvency procedure designed to facilitate the liquidation of the failing bank and a fast payout for protected depositors, or a transfer of their accounts.

Partial transfers

1.14 Within these SRR options, the property transfer powers (Clauses 30-43 in the Banking Bill) provide the Authorities with the flexibility to split a bank. This option would be most likely used for the purposes of transferring the 'good' part of a failing bank's business to a 'newco' - either a PSP or a bridge bank. In either case a 'residual bank' ('resco') would be left behind, containing any un-transferred assets and liabilities.

1.15 Property transfer powers provide considerable flexibility to the Authorities in dealing with a failing bank, as they can be used to stabilise and support only those parts of the bank's business that require intervention to protect financial stability, banking confidence and depositors. Such 'partial transfers' potentially enable resolutions that are less expensive for the funders of the resolution - the taxpayer, and under proposals in the Bill, the FSCS – than resolutions carried out on a 'whole-bank' basis. Forms of partial transfers have been used successfully several times recently, including in the cases of Bradford & Bingley, Heritable and Kaupthing.

1.16 In 'Financial stability and depositor protection: special resolution regime' (the SRR consultation), the Authorities published detailed proposals on partial transfers, in order to gauge stakeholder reaction to the usefulness and implications of such powers. The SRR consultation

[1] A power is also taken to apply the SRR to credit unions, if this is deemed appropriate: clause 76.

included proposals for safeguards to address the potentially negative effects of unfettered partial transfers, and consulted on safeguards to protect:

- set-off and netting arrangements, based on a 'qualifying financial contracts' model;
- structured finance arrangements; and
- security interests, excluding certain types of 'floating charges'.

1.17 Stakeholder reaction has, as with prior consultations, focused on the risks and costs associated with partial transfers. Broadly, while stakeholders understand and support the policy aim sought by the Authorities, they continue to raise concerns that unrestricted, or insufficiently restricted, partial transfers could have negative consequences for UK banks and financial markets. These concerns include higher funding costs, and higher requirements for regulatory capital, ultimately resulting in a loss of competitiveness.

1.18 These potential consequences flow from possible disruption to set-off and netting agreements and security interests, and the possibility that creditors of a failed bank find themselves worse off after a partial transfer than they would have been under had the whole bank gone into an insolvency procedure.

1.19 Therefore, since the publication of the SRR consultation, the Government has sought additional legal and financial advice and stakeholder input. The Government has responded to stakeholder concerns by accepting the need to strengthen the partial transfer safeguards to address market concerns, while retaining appropriate flexibility for the Authorities to ensure that the objectives of protecting financial stability can be achieved.

1.20 The Government has set up a permanent 'expert liaison group' (ELG) to inform the development of these partial transfer safeguards in secondary legislation and in the code of practice. The ELG is made up of representatives from the major trade bodies and from financial services firms and practitioners, with a membership providing for the relevant financial and legal expertise. The ELG has already met to consider the proposals contained in this document, and to advise on the initial proposals for the suite of safeguards being proposed by the Government.

1.21 The Government will continue to work closely with the ELG throughout the consultation process. The Banking Bill will be amended by the Government to include provision for this group of expert advisers, placing it on a formal statutory footing.

Summary of the Government's proposals for safeguards

1.22 This document sets out the Government's current detailed proposals for delivering adequate safeguards for consultation and poses questions for stakeholders on the various issues discussed.

1.23 Where appropriate, the document also presents draft secondary legislation relating to the safeguards proposed. A draft code of practice for the SRR (as provided for by clause 5 of the Banking Bill), is also presented for consultation.

1.24 The Government proposes a range of safeguards to be put in place through secondary legislation. These are:

- safeguards to protect set-off and netting, structured finance, and security arrangements, as initially proposed in the SRR consultation, and now strengthened in the light of consultation responses (these safeguards will be made under clause 43 of the Banking Bill);

- a new third-party compensation mechanism to provide for minimum compensation to creditors left in a residual company, so that they will be no worse off than they would have been in a whole-bank liquidation (as provided for in clause 55 of the Bill); and
- narrowly defined restrictions on the scope of certain types of partial transfers, (provided for in clause 42 of the Bill).

1.25 The Government is also consulting on the proposal to place general guidelines restricting the scope of partial transfers in the code of practice.

Strengthened safeguards for set-off and netting

1.26 Set-off and netting arrangements are widely used by commercial counterparties to offset their liabilities to each other, helping them to manage credit risk and minimise their regulatory capital requirements.

1.27 Stakeholders have indicated that, without restrictions, partial transfers could disrupt these arrangements, either directly, by interfering with the contractual arrangements themselves, or by allowing for the transfer of some, but not all, of a counterparty's financial contracts otherwise subject to set-off and netting arrangements ('cherry-picking') with a bank in the SRR. This could lead to counterparties having to account for their credit exposure to a bank on a gross rather than net basis (including for the purposes of regulatory capital), as the contracts that count in their favour could be transferred to the newco.

1.28 To avoid the negative effects that could flow from this unintended consequence of the proposed legislation – including increased cost of capital for UK banks, and higher regulatory capital requirements - the Authorities proposed in the consultation document *Financial stability and depositor protection: special resolution regime* a safeguard to preserve the effectiveness of set-off and netting in the UK based on protection for 'qualifying financial contracts' (QFCs). QFCs would be protected from 'cherry-picking' from under any set-off or netting arrangement to which they were subject, while non-QFCs would not.

1.29 However, stakeholder and expert feedback received on the consultation has indicated that the QFC concept as presented would not assuage market concerns. Set-off and netting agreements could still be disrupted, as a netting agreement could incorporate non-QFC contracts. Stakeholders have argued for a stronger safeguard, and the Authorities have accepted the need to address these concerns.

1.30 The Government is therefore proposing that all contracts covered under set-off or netting agreements (including bespoke agreements as well as those made under industry standard forms) be protected from disruption in a partial transfer, subject to a range of carve-outs clearly defined in secondary legislation.

1.31 The Government believes that this option offers the industry the certainty it requires, as all contracts will be covered unless they have been explicitly excepted, while also providing the Authorities, and in particular the Bank, with appropriate flexibility to execute partial transfers in pursuit of the statutory special resolution objectives (clause 4 of the Banking Bill).

1.32 Further detail on this option is set out in Chapter 2.

Strengthened safeguards for security interests and structured finance

Security interests

1.33 A security interest is the interest a lender has in property of the party to whom they have lent on a secured basis ('collateral'). If disruption of security interests during a partial transfer is

possible, then counterparties will have no legal confidence that they can enforce against the collateral on which their loans are secured. This would have serious negative consequences for UK banks' cost of capital.

1.34 The SRR consultation made clear that the Authorities do not intend that partial transfers should interfere with secured liabilities and associated collateral. The Authorities proposed, therefore, that they would transfer liabilities to newco *with* the related collateral, or not at all. However, a concern was noted that 'floating charges' over all, or substantially all, of a bank's assets, if respected in the same way, could seriously compromise the Authorities' ability to execute partial transfers. Consequently, a carve-out for such 'floating charges' was considered.

1.35 The Government now proposes that a safeguard to protect security holders should be included in the secondary legislation, and is consulting on the position that the safeguard should be comprehensive, including all floating charges. The Government believes that the extra certainty this position will give to the market outweighs the small risk that banks would start granting such wide-ranging floating charges to counterparties. The ELG has noted that the FSA could use existing regulatory tools to prevent a bank granting wide-ranging charges, if this was felt to be necessary.

Structured finance

1.36 The term 'structured finance' refers to a broadly defined set of financial arrangements; examples include securitisation products and covered bonds. If the interconnecting parts of structured finance arrangements could be subject to disruption due to a partial transfer, serious damage could be caused to this important type of finance in the UK.

1.37 Recognising this risk, the Authorities made clear in the SRR consultation that they did not intend to expose structured finance arrangements to potential disruption during a partial transfer. In line with this, the Government proposes an explicit safeguard protecting structured finance arrangements from disruption, to be provided for in an Order made under clause 43 of the Bill.

1.38 Further detail on safeguards relating to security interests and structure finance is presented in Chapter 3.

New third party compensation safeguard

1.39 A major concern of counterparties is that, in the event of a partial transfer, creditors remaining in the residual bank may be left worse off as a result of the Authorities' decision to transfer 'good' assets to the newco. While provision is made in the Bill to provide compensation, where appropriate, for ECHR purposes (via compensation scheme orders, third party compensation schemes and the Bank Resolution Fund (clauses 44 to 53)), this compensation may not meet the policy aim of providing creditors remaining in the residual company with certainty that they will be no worse off than they would have been in the counterfactual of a whole-bank liquidation. This could have a negative impact on the banking sector as firms may be less willing to transact with UK banks.

1.40 Therefore, the Government has proposed a safeguard that aims to ensure that creditors remaining in the residual bank will be no worse off after a partial transfer compared to the hypothetical counterfactual of a 'whole-bank' insolvency. Clause 55 provides a power for the Treasury to make Regulations that require a third party compensation scheme Order (TPCO) to ensure that the objective of "no creditor being worse off" (NCWO) is delivered.

1.41 The NCWO process requires the counterfactual calculation of the result of a whole-bank insolvency, in which the dividend, if any, due to each creditor from the counter-factual insolvency estate of the bank would be calculated. This figure would then be compared to the

actual dividend payable to the creditors on the winding up of the residual bank. Any shortfall would be met by way of a payment under a TPCO.

1.42 The Government proposes that the regulations require that the process of calculating the counterfactual and assessing the shortfall should be undertaken by an independent valuer.

1.43 Further detail on this safeguard is set in Chapter 4.

New restrictions to the scope of partial transfers

1.44 The SRR consultation also raised the possibility that the Authorities would issue guidelines setting out the limits of the scope of partial transfers to three types of partial transfer:

- transfer of the deposit book only, to ensure protection and continuity of service for depositors;
- a transfer to facilitate a pre-agreed PSP resolution; and
- a transfer to 'sanitise' the balance sheet of a failing bank by separating good and bad assets.

1.45 The Treasury will place these guidelines into the code of practice for the SRR. Additionally, the Government has introduced an enabling power into the Bill, to allow for such scope restrictions to be made, in future, in secondary legislation (under clause 42 of the Bill). The Government does not, however, intend to make an Order restricting scope at this time.

1.46 In light of recent events in the financial markets, it has become apparent that preserving the flexibility of the Authorities is crucial . While recent partial transfers have involved the deposit books of failing banks such as Bradford & Bingley, they have, for example, also involved the transfer of related assets such as branches.

1.47 The Government is therefore consulting on a range of considerations around scope restrictions, including:

- whether the adoption by the Authorities of the NCWO safeguard provides counterparties with sufficient comfort that they will not be left any worse off than if the assets had not been transferred, and the bank wound-up whole;
- whether the inclusion of stronger set-off and netting and security safeguards will provide counterparties with sufficient certainty around their potential exposure; and
- whether, at some future point, the Government should reconsider the inclusion of scope restrictions in secondary legislation.

1.48 However, the Government proposes to amend the Banking Bill to permit in certain circumstances reverse transfers (transfers back to the residual bank). In the case of reverse transfers, the Treasury consider that it may be appropriate to use the powers provided in clause 42 to specify a restriction on reverse transfers. This is not a generalised restriction, but relates to the exercise of partial transfer powers in specific circumstances. These restrictions should give key counterparties greater certainty of their position in circumstances when property has already been transferred to a newco.

1.49 Further detail on these proposals is set out in Chapter 5.

Code of practice

1.50 Clause 5 of the Banking Bill confers a power on the Treasury to issue a code of practice ("the code") on the Authorities' use of the stabilisation powers, the bank insolvency procedure and the bank administration procedure as set out in parts 1, 2 and 3 of the Banking Bill.

1.51 Further detail on the contents of the code of practice is presented in chapter 6.

Next steps

The consultation period closes on **Friday 9th January 2009**. Chapter 7 provides more detail on how you can respond to this document.

2 Set-off and netting

Introduction

2.1 Set-off and netting arrangements are used by commercial counterparties to offset their liabilities to each other. Many bank counterparties rely on these arrangements to manage their risk profiles. They are widely recognised and provide one of the principal mechanisms by which banks and bank counterparties address credit risk and attempt to reduce their regulatory capital requirements.

2.2 UK law has generally respected set-off and netting arrangements without restriction, including in insolvency proceedings. Without restrictions, partial transfers could disrupt these arrangements by allowing the Authorities (principally, the Bank of England) to transfer some, but not all, of a counterparty's financial contracts which would otherwise have been set-off and netted from a bank subject to the SRR regime.

2.3 The Authorities have presented general proposals for partial transfers in previous consultations. Stakeholders and experts have indicated their concerns over the effects of insufficiently restricted partial transfers. They have indicated that counterparties could have to account for their credit exposure to a bank on a gross, rather than on a net, basis, as the contracts that count in their favour may be transferred to the newco. Another effect highlighted was that a UK bank and its counterparties may not be able to obtain 'clean' legal opinions on the effectiveness of their set-off and netting agreements. Clean legal opinions are necessary for UK banks and their counterparties to account for their exposure on a net basis for regulatory capital purposes.

2.4 . Stakeholders argued that these effects would potentially have several negative market consequences for UK banks, corporates, and for the UK markets:

- increased cost of capital for a UK banks – counterparties would demand a higher risk premium to reflect their higher gross exposure to credit risk. Counterparties would also have to hold more regulatory capital to cover their exposure to a UK bank, making transactions less viable, and therefore counterparties less keen to lend;
- higher regulatory capital requirements – UK banks can take account of effective set-off and netting to reduce their own regulatory capital requirements. In addition, many bank counterparties are themselves subject to regulatory capital requirements. If these arrangements could not qualify for recognition for favourable regulatory capital treatment, any regulated UK bank would have to hold much larger amounts of capital against its exposure;
- evasion and events of default – counterparties and UK banks might re-structure their arrangements to ensure that partial transfers could not be easily applied to their business. Counterparties may seek to alter 'events of default' in their contracts to apply at earlier stages, before the SRR is triggered. If this happened, a bank that was getting into trouble might find that it is more readily abandoned by its counterparties, making the use of the SRR more likely; and

- potential adverse affect on commercial competitiveness – the effectiveness of set-off and netting arrangements in the UK has been identified as giving a competitive advantage to the UK relative to other jurisdictions.

2.5 As a result, the Government has committed to providing a safeguard to preserve the effectiveness of set-off and netting in the UK, while preserving as much flexibility as possible for the Authorities to execute partial transfers.

The SRR consultation and stakeholder responses

2.6 In the SRR consultation, the Authorities proposed a safeguard based on certain 'qualifying financial contracts' (QFCs). QFCs would have included, for example, derivatives contracts such as futures and swaps. Only QFCs would be protected from cherry-picking[1]. The primary benefit of this approach is that it would give the Authorities considerable flexibility to split up a failing bank.

2.7 However, stakeholder and expert feedback received since the publication of the SRR consultation has indicated that the QFC concept as presented would be subject to evasion and gaming, and that it would not assuage market concerns. Set-off and netting agreements could still be disrupted, as a netting agreement could incorporate non-QFC contracts. Furthermore, there is a risk that such an approach would skew the market in favour of the QFCs with uncertain effects in the medium to long term[2].

2.8 Stakeholders have argued for a stronger safeguard, and the Authorities have accepted the need for this.

Proposed safeguard – broad protection with specific carve-outs

2.9 The expert liaison group (ELG), set up to advise the Government on the secondary legislation for partial transfer safeguards, has proposed an approach that involves protecting all contracts of any sort that contain netting provisions, but with specific 'carve-outs' for necessary exceptions. The Government proposes that this option should be implemented through secondary legislation made under clause 43 of the Banking Bill.

2.10 The key issue under this option will be the exact form and scope of the exceptions from the broad protection provided by the carve-outs. The Government is proposing a range of exceptions under this option, and is consulting on whether these are appropriate, and whether other carve-outs should be added.

2.11 The first carve-out proposed will have an effect such that, if contracts not governed by foreign law (which may not be transferable) are covered under a netting agreement, their presence will not stop the Authorities transferring to newco the remainder of the (non-foreign) contracts covered to newco[3]. The intention behind this carve-out is to ensure a transfer can be made even where non-transferable foreign law contracts are covered by a netting agreement.

2.12 The second proposal is for a carve-out covering claims arising in relation to debt securities issued by the failed bank, such as bonds, medium-term notes and commercial paper. It is the case that counterparties generally do not tend to expect these claims to be included in set-off and netting calculations. However, if such claims were not 'carved out', and instead included in set-off and netting calculations, it would have the effect of raising subordinated debt securities

[1] This approach is used in the United States, although this reflects the different approach taken more generally to set-off and netting in that jurisdiction.
[2] For example, the existence of QFC regulations could block future financial innovation – counterparties might not wish to develop and use new products which could fall outside the regulations.
[3] Foreign property defined as property outside the UK or rights and liabilities under foreign law – which might not be transferable under the SRR.

issued by the failing bank to a higher insolvency ranking than was intended, because such claims would be set-off fully against any other (possibly unsubordinated) claim the failing bank might have against the relevant counterparty. For these reasons, similar debt securities issued by the failing bank's counterparty would also be 'carved out' of the safeguard.

2.13 Third, the Government proposes a carve-out to include, to the extent that such claims would ever be covered by a netting agreement, claims that are crucial to the preservation of banking continuity in a partial property transfer, such as retail deposits, mortgages and other loans, as well as liabilities other than financial contracts in the ordinary course of business, e.g. trade debts and litigation claims (non-financial contracts, etc).

2.14 The fourth carve-out would enable the Authorities to transfer to newco any liabilities that constitute some or all of a counterparty's claims against the bank.[4] This carve-out would benefit the counterparty, who would be able to enforce the claim against the solvent newco without needing to wait for recovery of its claim in the resco's insolvency. It would also allow the Authorities to transfer liabilities of the bank that needed to be supported to meet the SRR objectives quickly and without adversely affecting a counterparty's net exposure[5].

2.15 The Government will also consider adding other carve-outs that may be necessary to ensure sufficient flexibility, while still delivering sufficient certainty to the market. Consultation responses on this point are being sought.

2.16 The Government's clear intention is to protect contracts relevant for regulatory capital purposes from the threat of disruption under a partial transfer. Therefore this consideration will outweigh any of the carve-outs listed above.

2.17 Overall, this option is framed in order to offer the market certainty on set-off and netting. Except for the contracts excepted under the carve-outs, counterparties would have certainty that their relationship with the failed bank would be transferred whole, or not at all, and that their set-off and netting calculations would not be disrupted.

2.18 This certainty will not, however, prevent the Authorities (principally the Bank) from carrying out partial transfers outright. The carve-outs would deliver flexibility for the Authorities to execute the most likely forms of partial transfers, and reduce the likelihood of the Authorities having to execute a partial transfer only on a strict 'counterparty by counterparty' basis in all circumstances.

Other options considered

2.19 In addition to the proposal put forward above, which as noted has been developed in consultation with the ELG, the Government has considered a number of alternative approaches to providing a broad protection for set-off and netting agreements. This section sets out these alternatives, and the reasons the Government does not intend to proceed with them. The Government would welcome stakeholder views on these alternatives, and on the Government's analysis of their suitability.

Safeguard based on 'industry master netting agreements'

2.20 This option involves protecting from disruption only those contracts written under widely recognised 'industry master netting agreements' (IMNAs), but not contracts written under any

[4] The effect of the transfer of counterparty claims would be to reduce the counterparty's net claim against the insolvent resco by allowing the counterparty to enforce the counterparty claim against the solvent newco.

[5] The counterparty's on-going analysis of its net exposure to the bank would continue on the assumption that there was no disruption to netting. The counterparty would know that the carve-out could only be relied upon to reduce its net position and so any uncertainty would only be on the upside.

other 'bespoke' netting agreements[6]. The safeguard would also have been subject to the carve-outs listed above, for the same reasons, and would have continued to ensure that any contracts relevant for regulatory capital purposes would have been protected. While it would potentially provide a reasonable balance between flexibility for the Authorities and certainty for the market, the Government has identified a number of problems with this approach.

2.21 First, all counterparties modify IMNAs in practice, to reach a mutually acceptable final agreement. This creates a significant difficulty in terms of how the boundary between industry standard and bespoke agreements would be drawn. In practice, it is likely that any contracts that are presently written under a 'bespoke' netting agreement could very easily be re-written under a suitably modified IMNA. As a result, as counterparties could be expected to take action to ensure that their set-off and netting position would be protected, it is likely that the IMNA safeguard would have resulted in the same policy outcome as the proposed broad safeguard, with the downside of causing considerable market disruption.

2.22 Second, IMNAs can include 'sweeper' provisions that allow for the results of the netting of the contracts written directly under the IMNA to be netted against any other liabilities and credits that two counterparties may have with each other. This creates a further boundary issue, as if the sweeper is respected, contracts that the Authorities had intended to leave unprotected under 'bespoke' netting agreements, would in fact be protected if an IMNA was present. Again, this could lead to potential evasion and market disruption.

Protecting contracts relevant for regulatory capital

2.23 This option would involve protecting only those contracts relevant for regulatory capital calculations. This would address the regulatory capital element of stakeholders concerns, while providing the Authorities with flexibility to transfer contracts not covered by regulatory capital requirements.

2.24 However, there are considerable practical and technical problems with this approach; for example, the difficulty of dealing with regulatory capital rules in different jurisdictions. Indeed substantial numbers of important counterparties to UK banks are not subject to regulatory capital requirements at all, and therefore would not receive any protection, and be exposed to gross credit risk. Furthermore, as not all contracts used in netting agreements would be covered, this option would not give the market sufficient credit risk certainty.

Protection of all contracts containing netting provisions

2.25 This option would offer maximum set-off and netting protection and certainty to the market. However, the Government believes that such an approach (without appropriate carve-outs) would be too restrictive, as partial transfer could only be executed solely on the basis of transferring property 'counterparty by counterparty'. Such a wide safeguard could potentially reduce the attractiveness of partially transferred property to a private sector purchaser (PSP) and may prevent the Authorities from taking actions that might be necessary in certain circumstances. These actions are enabled under the Government's preferred option.

Breach of the Safeguard

2.26 The Government proposes that if the Authorities are notified that a property transfer is in breach of this safeguard, the Authorities must or remedy that breach.

[6] Master agreements allow all contracts written under them to be set-off against each other. There may also be a higher-level master agreement that allows the net results of several different master agreements to be netted together. A key example of an IMNA is the International Swaps and Derivatives Association (ISDA) master netting agreement.

Draft Order

2.27 Please see the complete draft Order in Annex A, in particular section 3.

Box 2.A: Consultation questions

1. Do you agree that there should be a broad 'catch-all' set-off and netting safeguard, with appropriate carve-outs?
2. Do you have any views on the likely effectiveness of this safeguard?
3. Do you agree with the proposed 'carve-outs'?
4. Do you agree with the proposed actions to be taken following a breach of this safeguard?
5. Do you have any views on how the safeguard is framed in the draft Order?
6. Are there any practical considerations (for example around the operation of events of default) that the Government will need to address to ensure that the set-off and netting safeguard works as planned?

3 Security interests and structured finance

Security interests

3.1 A security interest is the interest a lender has in the property ('collateral') of the party to whom they have lent on a secured basis.[1] If disruption of security interests during a partial transfer was possible, then counterparties could have no confidence in their ability to enforce against the collateral their loans were secured on, if needed. This would result in serious negative consequences for UK banks' cost of capital and general ability to operate.

The SRR consultation and stakeholder responses

3.2 The SRR consultation consulted on the position that the Authorities do not intend that partial transfers should interfere with secured liabilities and associated collateral. The Authorities proposed that they would transfer liabilities to newco *with* the related collateral, or not at all. However, the concern that 'floating charges' over all, or substantially all, of a bank's assets, if respected in the same way, could seriously compromise the Authorities' (principally, the Bank's) ability to execute partial transfers, was noted. Consequently, a carve-out for such 'floating charges' was considered. However, the SRR consultation also noted the fact that banks have rarely granted such charges in the past, and that very few exist in the UK market at present.

3.3 To some extent, feedback indicated that stakeholders and others shared the concern that there was a possibility that banks might start to grant wide-ranging floating charges over their assets if floating charges over all, or substantially all, of a bank's assets were not carved out of the safeguard.

3.4 This action might give greater comfort to a bank's counterparties and perhaps allow it to obtain cheaper funding (or, in a situation in which a given bank was getting into difficulties, any funding at all)[2]. Stakeholders have noted the possibility that if this happened (whether during 'normal' times or shortly before the SRR was triggered), the Authorities' flexibility to execute a partial transfer might be significantly reduced. This feedback might support a safeguard that omitted floating charges over all or substantially or of a bank's assets.

3.5 However, expert legal opinion has continued to indicate that it may not be possible to define a clear carve-out for floating charges over 'substantially all' of a bank's assets in a way that would be workable or give sufficient legal certainty. Several stakeholders have also suggested that commercial and practical realities may actually make it unlikely that banks would start to grant wide-ranging floating charges. Additionally, the ELG has noted that regulatory action by the FSA could be used to prevent a bank granting such a charge, should this be felt appropriate.

3.6 The Government does not intend to take forward the legislative option by attempting to carve out wide-ranging floating charges from the safeguard at this time.

[1] For example, a mortgage lender has a security interest in a house on which they have granted a secured loan. Where a liability is secured on a specific asset belonging to the borrower, the security interest is known as a 'fixed charge'. Where a liability is secured over a certain value of undefined and potentially changing assets, the security interest is known as a 'floating charge'.

[2] It is recognised that banks may grant a wide-ranging floating charge over their assets if a bank takes emergency assistance from the Bank of England.

Proposed safeguard: protecting all security interests without exception

3.7 The Government proposes, therefore, that a safeguard preventing the disenfranchisement of security holders should be included in the secondary legislation, and that the safeguard should be comprehensive, including all floating charges, even those over all, or substantially all, of a bank's assets. The Government believes that the value of the extra certainty this position will give to the market outweighs what would, in all likelihood, be a small chance that banks will start granting wide-ranging floating charges to counterparties.

3.8 The safeguard will re-state the existing legal requirement to respect the integrity of security interests covered by the Financial Collateral Directive (FCD). The safeguard will cover those interests covered by the FCD only, rather than the wider range of interests covered by the implementation of the FCD in the UK. However, ELG has raised the point that in a number of areas it may be desirable to include the UK regulatory protections (which go beyond the EU minimum) within the scope of this safeguard. The Government is therefore consulting on this point.

Breach of the Safeguard

3.9 The Government proposes that if the Authorities are notified that a property transfer is in breach of this safeguard, the Authorities must remedy that breach.

Draft Order

3.10 Please see the complete Order in Annex A, in particular section 4.

Box 3.A: Consultation questions

7 Do you agree that this safeguard should encompass all charges?

8 Do you agree that the likelihood of banks beginning to grant wide-ranging floating charges over their assets (whether in 'normal' conditions, or under stress) is low?

9 Do you have any other views on how the issues related to floating charges and SRR flexibility could be addressed?

10 What are your views on the Government's proposal to restrict the observance of EU law to the strict Directive definitions? Are there elements of the UK implementation of the relevant EU laws that the Government should consider protecting in the safeguard?

11 Do you agree with the proposed actions to be taken following a breach of this safeguard?

12 Do you have any views on how the safeguard is framed in the draft Order?

13 Are there any practical considerations (for example around the operation of events of default) that the Government will need to address to ensure that the security safeguard works as planned??

Structured finance

3.11 The term 'structured finance' refers to a broadly defined set of financial arrangements; examples include securitisation products and covered bonds. If the interconnecting parts of structured finance arrangements could be subject to disruption due to a partial transfer, serious damage could be caused to this important type of finance in the UK.

3.12 Recognising this risk, the Authorities made clear in the SRR consultation that they do not intend to expose structured finance arrangements to potential disruption during a partial transfer. In line with this, the Government proposed an explicit safeguard protecting structured finance arrangements from disruption, to be provided for in regulations made under Clause 42 of the Bill.

Proposed safeguard: no disruption to structured finance arrangements

3.13 The Government continues to believe that partial transfers must not threaten the integrity of structured finance arrangements. These arrangements will be safeguarded. The ELG has suggested that this intention can best be met by including a specific term in the draft Order protecting set-off, netting and security interests. The Government is therefore consulting on whether this is necessary, and how the protection might be drafted in the Order.

3.14 The Government has not included any drafting on this point in the draft Order. It welcomes comments from respondents as to how any such additional safeguard could be drafted.

Box 3.B: Consultation questions

14 Do you agree with the Government's position that 'structured finance' arrangements should not be subject to possible disruption in a partial transfer situation?

15 Do you think that an additional explicit term protecting 'structured finance' arrangements from disruption is required in the Order?

16 If this is necessary, do you have any suggestions for how this term might be framed in a sufficiently powerful but flexible way as to provide legal certainty and avoid damage to the Authorities' ability to execute a partial transfer?

4 Third-party compensation

4.1 A major concern of counterparties is that, in the event of a partial transfer, the creditors remaining in the residual company may be left materially worse off as a result of the transfer of 'good' assets to the newco. Stakeholders have argued that this position, if left unaddressed, might have a negative impact on the banking sector as businesses may be less willing to transact with UK banks.

The SRR consultation and stakeholder responses

4.2 The SRR consultation set out that adequate provision would be made in the Bill to provide compensation, where appropriate, for European Convention on Human Rights purposes. This is achieved via the Bank Resolution Fund (BRF) in Clause 53 of the Bill, which provides that surplus proceeds of the sale of some or all of the bridge bank's property should return to resco and its creditors, less the costs of the resolution.

4.3 However, stakeholders have noted that this compensation may not be enough to meet the policy aim of providing creditors remaining in the residual company with the certainty that they will be no worse off than they would have been in the counterfactual of a whole-bank liquidation, possibly leading to the negative impacts noted above.

Proposed safeguard: third party compensation

4.4 Therefore, the Government has proposed a safeguard that aims to ensure that creditors remaining in the residual company will be no worse off after a partial transfer compared to the hypothetical counterfactual of a whole-bank liquidation. Clause 55 provides a power for the Treasury to make regulations about third party compensation scheme Orders (TPCOs), to ensure that the objective of "no creditor worse off" (NCWO) is delivered.

4.5 The NCWO process requires the counterfactual calculation of the result of a whole-bank insolvency, by which the dividend due to each creditor (if any) from the hypothetical insolvency estate of the bank would be calculated. This figure would then be compared to the actual dividend payable to the creditors on the winding up of the residual bank. Any shortfall would be met by way of a payment under a TPCO.

4.6 Clause 55 enables the Treasury to specify provision which must be included in a TPCO in the case of a partial property transfer. The Regulations attached in Annex B contain a number of provisions which are mandatory - i.e. which must always be included in a TPCO in the case of a partial property transfer (see regulations 3-6). Clause 55 also allows the Treasury to specify provisions which may be included in a TPCO. In the latter case, it would be for the Treasury, in making the TPCO in relation to a particular bank following the exercise of an SRR tool, to determine whether the "optional" provisions set out in the Regulations were appropriate. Regulation 7 sets out the optional provisions, which relate to valuation principles.

4.7 The Government proposes that the Regulations require the following process to be implemented by a TPCO.

4.8 The calculation will be determined by an independent valuer, who will be appointed in accordance with the provision set out at clause 49. The independent valuer will be appointed by

an independent person appointed by the Treasury for this purpose. Provision is made in the Bill in clauses 49-51.

4.9 It is proposed that independence of the valuer will be safeguarded in the following ways as set out in clauses 49-51:

- The independent valuer will not be appointed directly by the Treasury;
- The remuneration and expenses of the independent valuer, although paid by the Treasury, will be monitored by an independent third party;
- The independent valuer may only be removed from office by the appointing person on the grounds of incapacity or serious misconduct; and
- The independent valuer will be able to determine his own day-to-day procedure in conducting the valuation exercise.

4.10 In calculating the counterfactual outcome for counterparties to the failed bank (which by triggering the SRR has therefore failed to meet the threshold conditions with no reasonable likelihood that action taken by or in respect of the bank will enable it to satisfy those conditions), the Government proposes that the independent valuer will be required to assume:

- that the partial property transfer had not been made and that no partial property transfer would have been made in relation to the bank;
- that no financial assistance would have, after the time at which the partial property transfer took place, been provided by the Bank or the Treasury to the bank

4.11 The Government proposes to outline certain provisions which the Authorities can, in relation to a particular exercise of an SRR tool, require the independent valuer to take into account, including;

- a TPCO may specify that the valuer must assume that Business X from within the failing bank was sold for £ Y, (this is especially likely to be appropriate if such a sale did indeed happen from the newco after a partial transfer);
- that specified methods of valuation, for example, should or should not be applied (this might include whether a whole-bank wind-up would have involved a fire sales of assets)

4.12 The independent valuer shall:

- have regard to any valuation principles specified by the Treasury (clause 52).
- disregard actual or potential financial assistance provided by the Bank of England or the Treasury (disregarding ordinary market assistance).

4.13 The regulations will require a TPCO to provide that the independent valuer must have regard to the desirability of ensuring that creditors receive compensation in a timely manner (including via the provision of interim NCWO payments 'on account').

4.14 At the suggestion of the ELG, the Government will consult directly with valuation professionals in the accounting sector to benefit from their expertise in finalising this safeguard.

Draft Regulations

4.15 Please see the complete Regulations in Annex B.

Box 4.A: Consultation questions

17 Do you agree with the need for the NCWO safeguard?

18 Do you have any views on the process stated above, or on the assumptions we suggest that an Independent Valuer should work under?

19 Do you have any concerns over the likely effectiveness of the safeguard Regulations as they are presently framed?

20 Do you have any views on how the Regulations could be better framed?

5 Restriction of scope

Introduction

5.1 As discussed in previous chapters, while recognising the policy intention behind partial property transfers, stakeholders have focused their consultation response on the risks associated with unfettered powers to exercises such transfers. Stakeholders have expressed concerns that their rights as counterparties would be compromised in unpredictable ways. In general, these concerns can be summarised as relating to the risk of creditors being left behind in resco, while many of the bank's 'good' assets are transferred away, leaving them worse off.

5.2 The SRR consultation therefore raised the possibility that the Authorities would issue guidelines on the scope of partial transfers, limiting their exercise to a number of key scenarios. The aim of these guideline limitations would be to give the market more clarity about what property could be transferred in a given situation, and therefore allow a counterparty to estimate the value of 'good' assets likely to be transferred in a partial transfer, and therefore their likely position in any insolvency distribution.

The SRR consultation and stakeholder responses

5.3 The SRR consultation proposed the following framework for partial transfers, with guidelines setting out the intention for the exercise of partial transfers to be limited to three scenarios:

- transfer of the deposit book only, to ensure protection and continuity of service for depositors;
- a transfer to facilitate a pre-agreed PSP resolution; and
- a transfer to 'sanitise' the balance sheet of a failing bank by separating good and bad assets.

5.4 Stakeholder response on these specific proposals has been limited. However, stakeholders have generally made the point that safeguards provided through a non-statutory code of practice are not sufficiently strong to address their concerns around loss of legal certainty and the attendant consequences which could result.

5.5 The Government has responded to this feedback in two ways: first, as discussed in preceding chapters, by strengthening the specific safeguards for netting, security and structured finance arrangements which will be provided for in secondary legislation. Secondly, by including in the Banking Bill a clause (clause 42) which allows any scope restrictions to be made in secondary legislation, rather than the code of practice.

Proposed safeguard (1): guidelines in the code of practice

5.6 While the Banking Bill provides the Government with the power to make regulations limiting the scope of partial transfers, the Government does not intend to do so at this time, for the reasons set out below.

5.7 Firstly, the adoption by the Government of the NCWO safeguard should remove counterparties' need to calculate their likely position after a partial transfer of property (e.g. of

assets to back a transferred deposit book). Counterparties should have comfort that they will not be left any worse off than if the assets had not been transferred, and the bank wound-up whole. In addition, the inclusion of stronger set-off and netting and security safeguards should also make counterparties surer of their exposure.

5.8 Secondly, in light of recent events in the financial markets, it has become apparent that preserving the flexibility of the Authorities is crucial . While recent partial transfers have involved the deposit books of failing banks such as Bradford & Bingley, they have, for example, also involved the transfer of related assets such as branches and systems. It is not clear what form of partial transfers may be appropriate in the future.

5.9 Therefore, the Government proposes to include guidelines on the scope of partial transfers in the code of practice, in line with the original proposals in the SRR consultation. Further information on the proposed guidelines is set out in the chapter 6. However, the Government does propose to use its powers in clause 42 to introduce a narrow restriction on the exercise of certain specific types of partial transfer. These are discussed in the next section.

Box 5.A: Consultation questions

21 Do you agree that there should be no general restriction of scope safeguard in secondary legislation given the other legislative safeguards that the Government is proposing?

22 Do you think there are other scope restrictions that would help give the industry certainty without unnecessarily reducing the Bank's flexibility to execute a partial transfer?

Supplemental and reverse transfers

5.10 Supplemental transfers involve further transfers of property, rights and liabilities ("property") or securities between a transferor and a transferee. They provide further flexibility to the Authorities following the exercise of a stabilisation option. For example, if the Bank of England chose to effect the bridge bank stabilisation option, then a supplemental transfer of property could be made from the residual bank to the bridge bank.

5.11 Supplemental transfers involving the further transfer of property or securities are important because the Authorities may have to intervene at extremely short notice to resolve a serious threat to financial stability. This may mean that it is not feasible to carry out detailed due diligence on the nature of property or securities transferred. It may subsequently transpire that a further transfer is required in order to make the initial transfer fully effective.

5.12 In the SRR consultation, the Authorities proposed that the Bank of England should have the power to effect supplemental transfers between a residual bank and a bridge bank, but not between a residual bank and a private sector purchaser. The Authorities also proposed that the power to transfer property back to a residual bank (a reverse transfer) should be restricted to exclude liabilities. Stakeholder responses to this consultation predominantly focussed on the need for any safeguards made in relation to partial transfers to also apply to these transfers. Providing this was the case, respondents did not generally express strong views about the flexibility to make supplemental and reverse transfers.

5.13 The Government is now proposing to make amendments to the Banking Bill to increase the flexibility of the Authorities to make such transfers. Alongside this, the Government is consulting on a new safeguard with respect to reverse property transfers. It should also be noted that all of the safeguards proposed and discussed in this document would apply to supplemental and

reverse transfers. For example, the protection provided to netting arrangements would have to be respected in any supplemental property transfer.

Proposed amendments to the Banking Bill

5.14 The Banking Bill as introduced provides for a limited form of supplemental transfers. They are constrained to either a supplemental property transfer from a residual bank to a bridge bank, or a supplemental share transfer to temporary public ownership. Thus supplemental transfers are limited to public sector transferees. However, in the light of recent experience, the Government considers it appropriate to broaden this flexibility. As such, the Government is proposing to amend the provisions of the Bill to provide that supplemental share and property transfers may be made to a private sector purchaser.

5.15 Reverse transfers provide for the converse of supplemental transfers. That is, a reverse property transfer provides for property, rights and liabilities to be moved back to the original failing bank. And a reverse share transfer provides for securities to be transferred back to their original holders. As introduced, the Bill does not allow for reverse transfers.

5.16 As noted above, in the light of recent experience the Government considers it appropriate to increase flexibility. To this end, the Government is proposing an amendment to the Bill in order to provide the flexibility to make a reverse transfers of property and shares. This flexibility is likely to be valuable as, for example, where an initial transfer has been made to a bridge bank, it provides the Bank of England with the means to optimise the balance sheet of the bank. Assets could be moved from a bridge bank to the residual bank if a particular class were to suffer a significant deterioration in quality and hence become undesirable for potential purchasers.

5.17 Further, as noted above, the time and information available prior to taking control of a failing bank may not be sufficient to allow detailed due diligence of every part of a bank's business. It is possible that due diligence carried out following a property transfer to a bridge bank may reveal certain property which potential purchasers may not wish to acquire.

5.18 It is not intended that these powers should be capable of reversing a transfer of property or securities from a private sector purchaser, however. The potential to exercise such powers would be likely to interfere with arrangements to sell banking business to private sector purchasers.

Proposed safeguard (2): narrow restrictions on reverse transfers

5.19 Alongside these amendments to the Banking Bill, the Government is therefore proposing a new safeguard restricting the exercise of reverse transfers. To balance the advantages of the reverse property transfers with the need to ensure confidence in a bridge bank, the Government proposes that secondary legislation made under clause 42 (restriction of partial transfers) should define what property, rights and liabilities should be protected from being transferred back.

5.20 At this stage, the Government expects that these items might include retail deposits, wholesale deposits, other loans to the bank, financial contracts (for example, securities contracts, derivative contracts, commodities contracts, forward contracts, repurchase contracts, swap agreements, margin lending agreements and master agreements) and some other forms of liability.

5.21 This is because of the need to preserve confidence in a bridge bank. If, for example, it was possible for the Bank of England to transfer a liability-holder from a bridge bank to the residual bank, that creditor may not be willing to continue to do business with the bridge bank. If a bridge bank's creditors do not have confidence in the entity to which they have been transferred, then this may be detrimental to the success of the resolution.

5.22 The Government is consulting on this proposal. It should be noted that this safeguard is at an earlier stage of development than others, and draft secondary legislation has not yet been prepared. The Government will continue to work with the ELG in developing this safeguard, and consult more widely, as appropriate, in due course (subject to the wider legislative timetable).

Box 5.B: Consultation questions

23 Do you agree that there should be restrictions placed on reverse property transfers?

24 Do you agree that the restriction should take the form of a list of property which cannot be transferred under reverse property transfer powers?

25 If so, what property should be protected from being transferred back?

6 Code of practice

6.1 Clause 5 of the Banking Bill confers a power on the Treasury to issue a code of practice ("the code") on the Authorities' use of the stabilisation powers, the bank insolvency procedure and the bank administration procedure as set out in parts 1, 2 and 3 of the Banking Bill. The code will be issued by the Treasury following consultation with the FSA, Bank of England and the Financial Services Compensation Scheme (FSCS). Once issued, the Treasury will lay a copy of the code before Parliament as soon as reasonably practical.

Draft code of practice

6.2 The code cannot be finalised until after the Banking Bill receives Royal Assent but the Government has produced an early draft of the code to inform both the debate on the Banking Bill and to receive input from external stakeholders on its measures. The Government is therefore consulting on the draft code in Annex C, which includes the following sections:

- **explanation of the SRR objectives:** the draft code provides further explanation of both the meaning and intention behind the SRR objectives;
- **how the objectives should be balanced:** the draft code notes that the objectives are deliberately not ranked, recognising that the relative weighting and balancing of objectives will vary according to the particular circumstances of each failure, including both (a) circumstances specific to the failing institution; and (b) general circumstances relating to the wider financial system;
- **the regard the Authorities should have to the code:** the draft code notes that following actions taken under the SRR, the Authorities should make public statements explaining (a) how they have acted with regard to the SRR objectives; and (b) how they have balanced the objectives against each other;
- **explanation of the roles of the Authorities in the SRR:** including the role of the FSCS in the SRR and the link between the code and the memorandum of understanding, which will be revised by the Authorities in due course;
- **explanation of how the Authorities will judge that the general and specific conditions are met:** in this regard, the draft code refers to other relevant texts, such as the FSA handbook, where appropriate;
- **factors to be considered when choosing the SRR tools:** including, for example, the likelihood of finding a private sector purchaser; the likely saleability of assets and liabilities of the failing bank or building society including whether a whole bank or building society sale is viable and at a reduced cost to public finances; and the likely speed and method of insured depositor payout by the FSCS in the bank insolvency procedure;
- **procedure for announcement of the SRR tools**: the draft code notes that when publicly announcing any action to exercise the stabilisation tools or the bank insolvency procedure the Bank of England should explain why it considers that the conditions for the exercise of the tool (set out in clause 8 or, for the bank

insolvency procedure, clause 83 of the Bill) are met. The same should apply when Treasury announces any action to take a bank into temporary public ownership; and

- governance arrangements for bridge banks and banks in temporary public ownership: the draft code provides further guidance on (amongst other things) the objectives, operating or management strategy reporting requirements that the Bank of England or Treasury should have with a bridge bank or a bank in temporary public ownership respectively.

Additional sections of the code

6.3 It is likely that the Government will add further sections to the final code of practice. In particular, as stated in chapter 5 of this document, the Government is consulting on its proposal that the code provide guidelines on the likely scope of the exercise of partial transfer powers. This section of the code will be drafted in light of responses received to the consultation questions on this issue. However, as set out in chapter 5, the Government's intention is that the guidelines should cover the broad areas presented in the SRR consultation:

- transfer of the deposit book only, to ensure protection and continuity of service for depositors;
- facilitating a pre-agreed partial private sector solution (for example, where two parties have already been engaged in negotiations for a business transfer); and
- sanitising the bank's balance sheet by separating out parts that had significantly deteriorated in quality or would otherwise be expected to reduce appreciably the attractiveness of the bank to a private sector purchaser.

6.4 Depending on stakeholders' response, and the advice of the ELG, the code will include further details defining each of these particular set of circumstances. The Government will balance the need to provide detail in the code against the important need to maintain a degree of flexibility, so as not to constrain the ability of the Authorities (in particular, the Bank of England) to act in appropriate cases in support of the overall SRR objectives.

6.5 It is also proposed that the code should cover other issues arising from provisions of the Banking Bill. These include, for example:

- the operation of the continuity of services provisions for group companies (as outlined in clauses 57 to 60 of the Bill); and
- the operation of the bank insolvency procedure and bank administration procedure (as outlined in parts 2 and 3 of the Bill).

6.6 In these areas, the Government is awaiting scrutiny and debate within Parliament on the relevant clauses in the Banking Bill before drafting provisions of the code.

Box 6.A: Consultation questions

26 The Government is seeking general views on the draft code attached in Annex C and requesting suggestions for other issues under parts 1, 2 and 3 of the Banking Bill that it should cover.

7 How to respond

7.1 This consultation document is available on the HM Treasury website at www.hm-treasury.gov.uk. For hard copies, please use the contact details below.

7.2 The Government invites responses to the issues raised and the proposals in this consultation document. **Responses are requested by Friday 9 January 2009**, during which time the Government will continue to engage with relevant stakeholders.

7.3 Please ensure that responses to the consultation document are sent in before the closing date. The Government cannot guarantee to consider responses that arrive after that date.

7.4 Responses should be sent by email to:

banking.reform@hm-treasury.gov.uk

7.5 Alternatively, they can be posted to:

Banking Reform consultation responses
Banking Reform Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

7.6 When responding, please state whether you are responding as an individual or on behalf of an organisation.

Confidentiality

7.7 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). If you want the information that you provide to be treated as confidential, 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 that 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.

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

Code of practice for written consultation

7.9 This consultation process is being conducted in line with the code of practice for written consultation (www.cabinetoffice.gov.uk/regulation/code.htm) which sets down the following criteria:

- consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy;
- be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses;
- ensure that your consultation is clear, concise and widely accessible;
- give feedback regarding the responses received and how the consultation process influenced the policy;
- monitor your Department's effectiveness at consultation, including through the use of a designated Consultation Co-ordinator; and
- ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

7.10 If you feel that this consultation does not fulfil these criteria, please contact:

Angela Carden
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

angela.carden@hm-treasury.gov.uk

A Safeguards order

Draft Order laid before Parliament under section 42(5) of the Banking Act 200, for approval by resolution of each House of Parliament.*

DRAFT STATUTORY INSTRUMENTS

200* No.

BANKS AND BANKING

The Banking Act 200* (Restriction of Partial Transfers) Order 200*

Made - - - -	***
Coming into force - -	***

The Treasury, in exercise of the powers conferred by sections 43 and 234 of the Banking Act 200***(a)**, make the following Order:

Citation, commencement and interpretation

1.—(1) This Order may be cited as the Banking Act 200* (Restriction of Partial Transfers) Order 200*.

(2) This Order comes into force at the same time as section 8 of the Act (private sector purchaser and bridge bank) comes into force.

(3) In this Order—

"the Act" means the Banking Act 200*;

"the Bank" means the Bank of England;

"banking institution" means –

(a) a bank (within the meaning of Part 1 of the Act);

(b) a building society (within the meaning of section 119 of the Building Societies Act 1986(**b**)); or

(c) if an order has been made under section 76 of the Act applying section 8 of the Act to credit unions (within the meaning of section 31 of the Credit Unions Act 1979(**c**) or, in Northern Ireland, Article 2 of the Credit Unions (Northern Ireland) Order 1985(**d**)), a credit union;

"the Financial Collateral Directive" means Directive 2002/47/EC of the European Parliament and of the Council on financial collateral arrangements(**e**);

"partial property transfer" has the meaning given in section 42(1) of the Act;

"Regulated Activities Order" means the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001(**a**)).

(**a**) 200* c.*.
(**b**) 1986 c.53.
(**c**) 1979 c.34.
(**d**) SI 1985/1205 NI 12.
(**e**) OJ L168, 27.6.02, p.43.

Application of this Order

2. This Order (apart from article 4) does not apply to a partial property transfer where the only property, rights or liabilities of a banking institution which are not transferred are foreign property (within the meaning of section 36(2) of the Act).

Set-off and netting

3.—(1) Subject to paragraphs (3) and (4), a partial property transfer to which this Order applies may not provide for the transfer of some, but not all, of the protected rights and liabilities between a particular person ("P") and a banking institution.

(2) For the purposes of paragraph (1), rights and liabilities between P and a banking institution are protected if they are rights and liabilities of P which P is entitled to set-off or net under an agreement so long as they are not excluded rights or excluded liabilities.

(3) Paragraph (1) does not apply if the only protected rights and liabilities which are not transferred are foreign property (within the meaning of section 36(2) of the Act).

(4) Paragraph (1) does not apply if only liabilities of the banking institution to P are transferred.

(5) For the purposes of paragraph (2), it is immaterial whether—

(a) the arrangement which permits P to set-off or net rights and liabilities also permits P or the banking institution to set-off or net rights and liabilities with another person; or

(b) P's right to set-off or net is exercisable only on the occurrence of a particular event.

(6) In paragraph (2)—

"excluded rights" means rights—

(a) which relate to a deposit (within the meaning of article 5 of the Regulated Activities Order(**b**)) made by P with the banking institution;

(b) which relate to a regulated mortgage contract (within the meaning of article 61 of Regulated Activities Order(**c**)) between the banking institution and P;

(c) which arose otherwise than in the course of the banking institution entering into a contract in the course of carrying on its business as a banking institution;

(d) which relate to securities issued by the banking institution or by P;

(e) [ ],

and "excluded liabilities" shall be interpreted accordingly;

"set-off arrangements" and "netting arrangments" have the meanings given in section 43 of the Act.

(7) For the purposes of paragraph (c) of the definition of "excluded rights", contracts entered into by the banking institution with the principal purpose of securing the supply of services (other than the provision of credit) or of goods (other than cash or a specified investment within the meaning of section 22 of the Financial Services and Markets Act 2000, read in conjunction with the Regulated Activities Order) are to be treated as having been entered into by the banking institution otherwise than in the course of carrying on its business as a banking institution; this paragraph also applies for the purposes of the definition of "excluded liabilities".

Financial collateral

4.—(1) A partial property transfer may not provide for—

(a) the transfer of some, but not all, of the protected rights and liabilities between a particular person ("P") and a banking institution; or

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(**a**) SI 2001/544.
(**b**) Amended by SI 2002/682.
(**c**) Amended by SI 2001/3544.

(b) protected liabilities owed by a financial institution to P to be transferred unless the financial collateral used as security in respect of those liabilities is also being transferred.

(2) For the purposes of paragraph (1), rights and liabilities between P and a banking institution are protected if they are rights and liabilities which are the subject of a financial collateral arrangement, within the meaning of the Financial Collateral Directive, to which that Directive applies.

(3) For the purposes of paragraph (2), the Financial Collateral Directive is to be treated as applying to financial collateral arrangements where—

(a) one of the parties to the arrangement is a person mentioned in Article 1(2)(e) of the Directive; or

(b) the financial collateral to be provided under the arrangements consists of shares of a kind specified by article 1(4)(b) of the Directive.

Secured liabilities

5.—(1) This article applies where the banking institution and a person ("P") have entered into an arrangement under which the banking institution's liability to P is secured against the property or rights of that banking institution (except where the arrangement is of a kind described commercially as "title transfer security" arrangements); and it is immaterial that—

(a) the liability is secured against all or substantially all of the property or rights of the banking institution; or

(b) the liability is secured against specified property or rights.

(2) A partial property transfer may not transfer the property or rights of the banking institution against which its liability to P is secured unless the banking institution's liability to P is also transferred.

Effect of partial property transfers in breach of this Order

6.—(1) This article applies where any person considers that a partial property transfer has been made in breach of any provision of this Order.

(2) A person who considers that a partial property transfer has made in breach of a provision of this Order may give notice to the Bank.

(3) The notice under paragraph (2) must—

(a) be in writing;

(b) specify the provision of this Order which is alleged to have been breached;

(c) specify the manner in which that breach has occurred.

(4) Within [30] days of receipt of a notice under paragraph (2), the Bank must –

(a) if it agrees that a provision of this Order has been breached in the manner specified in the notice given under paragraph (2), take the steps specified in paragraph (5);

(b) if it agrees that a provision of this Order has been breached but does not agree that the breach has occurred in the manner specified in the notice given under paragraph (2), take the steps specified in paragraph (6);

(c) if it does not agree that a provision of this Order has been breached, take the steps specified in paragraph (7).

(5) [The steps are to remedy the breach identified in the notice.]

(6) [The steps are to take such steps as the Bank thinks fit to remedy the breach it has identified.]

(7) [The steps are to give reasons to the person as to why it considers that no provision of this Order had been breached.]

Name
Two of the Lords Commissioners of Her Majesty's Treasury

Date

EXPLANATORY NOTE

(This note is not part of the Order)

B 'No Creditor Worse Off' Regulations

Draft Regulations laid before Parliament under section 55(7) of the Banking Act 200, for approval by resolution of each House of Parliament.*

DRAFT STATUTORY INSTRUMENTS

200* No.

BANKS AND BANKING

The Banking Act 200* (Third Party Compensation Arrangements for Partial Transfers) Regulations 200*

Made - - - -	***
Coming into force - -	***

The Treasury, in exercise of the powers conferred by sections 55 and 234 of the Banking Act 200***(a)**, make the following Regulations:

Citation, commencement and interpretation

1.—(1) These Regulations may be cited as the Banking Act 200* (Third Party Compensation Arrangements for Partial Transfers) Regulations 200*.

(2) These Regulations come into force at the same time as section 8 of the Act (private sector purchaser and bridge bank) comes into force.

(3) In these Regulations—

"the Act" means the Banking Act 200*;

"the Bank" means the Bank of England;

"banking institution" means –

(a) a bank (within the meaning of Part 1 of the Act);

(b) a building society (within the meaning of section 119 of the Building Societies Act 1986(**b**)); or

(c) if an order has been made under section 76 of the Act applying section 8 of the Act to credit unions (within the meaning of section 31 of the Credit Unions Act 1979(**c**) or, in Northern Ireland, Article 2 of the Credit Unions (Northern Ireland) Order 1985(**d**)), a credit union;

"partial property transfer" has the meaning given in section 42(1) of the Act;

"pre-transfer creditor" has the meaning given in section 55(3)(b) of the Act;

"third party compensation order in relation to a partial property transfer" has the meaning given in regulation 3(1).

(**a**) 200* c.*.
(**b**) 1986 c.53.
(**c**) 1979 c.34.
(**d**) SI 1985/1205 NI 12.

Application of these Regulations

2. These Regulations do not apply to a partial property transfer where the only property, rights or liabilities of a banking institution which are not transferred are foreign property (within the meaning of section 36(2) of the Act).

Appointment of independent valuer

3.—(1) A third party compensation order made in the case of a partial property transfer to which these Regulations apply ("a third party compensation order in relation to a partial property transfer") must include provision for a person ("an independent valuer") to be appointed to determine—

(a) whether pre-transfer creditors generally or any class of pre-transfer creditors should be paid compensation; and

(b) if compensation should be paid, what amount is to be paid,

(and, in accordance with section 54(3)(a) of the Act, sections 49 and 50 shall apply to the independent valuer appointed in accordance with this paragraph).

(2) Regulations 4 to 6 make provision which must be included in a third party compensation order in relation to a partial property transfer; regulation 7 contains provision which may be included in such an order.

Mandatory provisions – assessment of insolvency treatment

4.—(1) A third party compensation order in relation to a partial property transfer must include the provisions made by this regulation, subject to the need to make any modifications which are necessary to ensure that the provision applies effectively to the particular partial property transfer.

(2) The independent valuer must assess the treatment ("the insolvency treatment") which pre-transfer creditors would have received had the banking institution been would up immediately before the partial property transfer took place.

(3) The independent valuer must assess the treatment ("the actual treatment") that pre-transfer creditors have received, are receiving or are likely receive (as the case may be) if no further compensation is provided for.

(4) If the independent valuer considers that, in relation to pre-transfer creditors generally or in relation to any class of pre-transfer creditor, the actual treatment assessed in accordance with paragraph (3) is less favourable than the insolvency treatment assessed in accordance with paragraph (2), the independent valuer must determine that compensation be paid to pre-transfer creditors or a particular class of pre-transfer creditors (as the case may be).

(5) The amount of compensation payable under paragraph (4) must be determined by the independent valuer by reference to the difference in treatment identified in accordance with paragraph (4) and on the basis of the fair and equitable value of that difference in treatment.

Mandatory provisions – valuation principles

5.—(1) A third party compensation order in relation to a partial property transfer must include the provisions made by this regulation, subject to the need to make any modifications which are necessary to ensure that the provision applies effectively to the particular partial property transfer.

(2) In making the assessment of the insolvency treatment required under regulation 4(2), the independent valuer must make the following assumptions—

(a) that had the partial property transfer not been made, the banking institution would have been wound up immediately before the partial property transfer took place;

(b) that the partial property transfer had not been made and that no partial property transfer would have been made in relation to the banking institution;

(c) that no financial assistance (within the meaning of section 3 of the Act) would have, after the time at which the partial property transfer took place, been provided by the Bank or the Treasury to the banking institution.

Mandatory provisions – interim payments

6.—(1) A third party compensation order in relation to a partial property transfer must include the provisions made by this regulation, subject to the need to make any modifications which are necessary to ensure that the provision applies effectively to the particular partial property transfer.

(2) The independent valuer may determine that payments should be made to pre-transfer creditors (or a class of pre-transfer creditors) on account of compensation to be payable under the third party compensation order.

(3) The independent valuer may make such a determination at any time before the determination under regulation 4(5) has been made.

(4) Once the determination under regulation 4(5) has been made, the independent valuer must determine what payments are appropriate to ensure that the pre-transfer creditor receives the amount of compensation determined under regulation 4(5) (and no more than that amount).

(5) Subject to paragraph (6), the independent valuer may make such provision as to payments on account as he thinks fit (including a requirement that payments be made in instalments).

(6) Payments on account must be made subject to the following conditions—

(a) that the acceptance of such a payment by the pre-transfer creditor reduces any obligation (whether in existence at the time of the payment or not) on the Treasury or Financial Services Compensation Scheme (as the case may be) to pay compensation to the pre-transfer creditor by the amount of the payment on account;

(b) that, where the independent valuer, in accordance with paragraph (4) determines that the pre-transfer creditor should make a balancing payment to the Treasury or Financial Services Compensation Scheme (as the case may be), the pre-transfer creditor is liable to pay that amount.

(7) In considering whether to require payments on account to be made in accordance with this regulation, the independent valuer must have regard to the merits of ensuring that pre-transfer creditors receive compensation in a timely manner.

Optional provisions – valuation principles

7.—(1) A third party compensation order in relation to a partial property transfer may make any of the following provisions.

(2) In making the assessment of the insolvency treatment required under regulation 4(2), the independent valuer must assume that property specified in the order (or property of a class specified in the order) would have been sold for a price specified in the order or calculated by reference to criteria specified in the order.

(3) In making the assessment of the insolvency treatment required under regulation 4(2), the independent valuer must assume that property specified in the order (or property of a class specified in the order) would have been treated in a specified manner.

Name
Two of the Lords Commissioners of Her Majesty's Treasury

Date

EXPLANATORY NOTE

(This note is not part of the Regulations)

C Code of practice

DRAFT

Special Resolution Regime: code of practice

In accordance with section 5 of the Banking [Act] 2008 ("the Act"), this code of practice ("the code") provides guidance on how, and in what circumstances, the Authorities (HM Treasury, the Financial Services Authority and the Bank of England) will use the special resolution regime powers in Parts 1, 2 and 3 of the [Act] to resolve a failing bank or building society.[1]

The code is issued by HM Treasury ("the Treasury"), in accordance with section 6 of the [Act], in consultation with the Financial Services Authority ("the FSA"), the Bank of England ("the Bank") and the Financial Services Compensation Scheme ("the FSCS"). A copy of the code will be laid before Parliament as soon as is practicable after it is issued.

Under the [Act] the Authorities must have regard to this code when implementing:

- **The stabilisation options (Part 1, Sections 14, 15, 25, 26, 26, 28, 72, 30, 39, 40 and 41);**
- **The bank insolvency procedure (BIP) (Part 2); and**
- **The bank administration procedure (BAP) (Part 3)**

The Treasury will update the code on a periodic basis, in the light of evolving experience.

[1] The [Act] also provides the Government with the power to extend the SRR tools to credit unions should that be appropriate.

Part 1: Special resolution regime (SRR) objectives

1. Section 4 of the [Act] states that the special resolution objectives are as follows:

- Objective 1 is to protect and enhance the stability of the financial systems of the UK;
- Objective 2 is to protect and enhance public confidence in the stability of the banking systems of the UK;
- Objective 3 is to protect depositors;
- Objective 4 is to protect public funds; and
- Objective 5 is to avoid interfering with property rights in contravention of a Convention Right (within the meaning of the Human Rights Act 1998).

Definition of terms within the objectives

2. Specific terms used within the objectives are not defined by the Act. The objectives set out in the [Act] are context-specific and neither they nor the terms within them can be defined in an exhaustive or definitive manner. In addition, the specific relevance and application of the objectives may change over time (for example, as the threats to financial stability change over time).

3. Therefore, this code provides further explanation as to the meaning of the objectives by outlining the factors that the Authorities may consider to be relevant in applying them.

4. The term “stability of the financial systems of the UK” refers to the stable functioning of the systems and institutions (including payment and settlement infrastructure) supporting the efficient operation of financial services and markets for purposes including capital-raising, risk-transfer, and the facilitation of domestic and international commerce in addition to day-to-day banking operations.

5. The intention of the first objective is to (a) recognise the wider systemic risks posed by the potential or actual failure of any institution, or group of institutions; and (b) to require the Authorities to have regard to the likely systemic impact of their actions (including a decision not to act) when implementing a SRR tool.

6. The term “public confidence in the stability of the banking systems” refers to the crucial role that public confidence has in maintaining the stable and efficient operation of financial services and markets. The confidence of the general public is of particular significance in maintaining stability in a banking system based on a fractional reserve model, whereby banks’ deposit liabilities exceed the liquid assets they hold at any one time.

7. Public confidence has a number of dimensions. For example, it refers to the expectation that (a) deposits will be repaid in accordance with their terms; (b) normal banking services will be continuously available; (c) problems (or perceived problems) in one bank or building society will not extend to other

banks (contagion); and (d) if a bank or building society does fail, systems exist to protect the interests of depositors.

8. The intention of the second objective is to ensure that the Authorities have regard to the need to act so that a failing bank or building society will be resolved in a manner that enhances public confidence in the banking system as a whole.

9. The term “protection of depositors” refers specifically to the objective of protecting depositors from the effects of the failure of an institution, as an end in itself. This objective goes beyond the need to ensure public confidence in the banking system (although, as noted above, depositor protection may be an important element of such confidence), and recognises the important public policy objective of ensuring that depositors in a failed institution are adequately protected.

10. Under the [Act] such protection can be delivered in different ways. For example by (a) through the bank insolvency procedure, facilitating fast payout (or funding of an account transfer) under the FSCS to eligible depositors; or (b) facilitating continuity of banking services through the stabilisation options provided in the SRR.

11. Public policy concerns around effective depositor protection are particularly relevant in the case of retail deposits protected by the FSCS. Protection of retail depositors is also likely to be conducive to realisation of a number of other objectives such as protecting and enhancing public confidence in the banking system. However, the use of the SRR may also offer protection to other types of depositor and non-deposit creditors if necessary to meet the special resolution objectives, for example if the SRR tool chosen provides continuity of service to both retail and non-retail customers of the failing institution, through one of the stabilisation options.

12. The term “protection of public funds” refers primarily to the protection of taxpayers’ interest in the effective expenditure of public money. The intention of the fourth objective is to recognise the strong fiduciary duty of the Authorities, and particularly the Treasury, in taking decisions with implications for public funds.

13. The term “avoiding interfering with property rights in contravention of a Convention right” refers to the rights of property holders in a failing bank or building society. This can include the bank or building society itself, its shareholders or creditors, or other third parties. Such persons may hold property in the failing bank or building society or have a right of control over such property, or both. The inclusion of this objective acknowledges the importance of acting proportionately in exercising these powers. The primary Convention right at issue is Article 1 of Protocol 1 to the Convention (right to property). Other Convention rights (including Article 6, the right to a fair trial) may also be relevant.

Balancing the objectives

Neither the [Act], nor this code, ranks these objectives. This is deliberate, recognising that the relative weighting and balancing of objectives will vary according to the particular circumstances of each failure, including both (a) circumstances specific to the failing institution; and (b) general circumstances relating to the wider financial system.

Authorities' regard to objectives

14. The special resolution objectives in the [Act] serve two purposes:
    - they state the purpose of the SRR measures in the [Act]; and
    - they set out the objectives to which the Authorities must have regard when using or considering the use of their powers under the SRR.

15. This means that the Authorities must consider the effect of their likely actions (including inaction) and assess them in light of the objectives.

16. The sole exception to this rule relates to a decision taken by the FSA, under section 7 of the [Act] that the general conditions for use of the SRR have been met. This decision will be taken in the context of the FSA's objectives under the Financial Services and Markets Act 2000 ("FSMA").

17. Following actions taken under the SRR, the Authorities must make public statements explaining (a) how they have acted with regard to the special resolution objectives; and (b) how they have balanced the objectives against each other. The form that such an explanation will take will depend on the circumstances.

18. It should be noted that it will not be possible to divulge certain information, for example information the release of which would threaten financial stability or confidence in the banking system.

Part 2: Roles of the Authorities

19. The resolution of failing institutions will require intensive coordination, cooperation and information sharing between the Authorities at each stage of the decision-making process. Each of the Authorities will take lead responsibility for specified aspects of the resolution:

- As set out in section 7 of the [Act], the FSA will be responsible for taking the decision that a bank or building society is failing (or is likely to fail) to meet its threshold conditions and that it is not reasonably likely that action will be taken which will enable it to meet those conditions. The FSA will also be responsible for the authorisation of a bridge bank and ongoing supervision of institutions in the special resolution regime;
- The Bank will be responsible for the operation of the SRR, including for taking the decision on which of the SRR tools to use and their implementation (with the exception of the power to take a bank or building society into temporary public sector ownership). The Bank will also remain responsible for liquidity support; and
- The Treasury will be responsible for decisions with implications for public funds, and ensuring the UK's ongoing compliance with its international obligations and the wider public interest. The Treasury will also be responsible for the temporary public sector ownership tool. The Treasury will also exercise a number of the ancillary powers under the SRR including the power to modify the law and powers in relation to compensation.
- The FSCS will also work closely with the Authorities. Under the compensation scheme, triggered in the insolvency procedure, the FSCS has the role of delivering the payout to eligible depositors. Further, the FSCS is a potential contributor to the cost of the SRR if payout is averted. The FSCS will need to assess and prepare for the payout, and its assessment of the possibilities for payout, or account transfer, will be a relevant factor in the selection of the SRR tool. Information sharing protocols will be put in place to ensure that the FSCS has access to information relating to the failing institution and its systems at the appropriate time.

20. The revised Memorandum of Understanding between the Authorities will set out how the Authorities will communicate with each other before and during the resolution of an institution, including through the operation of the tripartite Standing Committee.

Part 3: General and specific conditions and choosing the SRR tools

SRR tools

21. The [Act] provides the Authorities with the ability to use the following stabilisation options to resolve a failing bank or building society.

- to transfer some or all of the bank or building society's business to a private sector purchaser;
- to transfer some or all of the bank's or building society's business to a bridge bank;
- to transfer the failing bank or building society into temporary public ownership.

22. Further the [Act] provides the Authorities with the ability to apply to the court for a bank insolvency procedure to wind up a bank in the interests of creditors as a whole and to facilitate a rapid FSCS payout to eligible depositors or transfer of their accounts to another institution.

23. The Bank can also apply for a bank administration procedure to facilitate the partial transfer of part of a failing bank or building society to a private sector purchaser or bridge bank.

Determining that the regulatory pre-conditions are satisfied

24. A stabilisation power may be exercised in respect of a bank or building society only if the FSA is satisfied that the conditions within section 7 of the [Act] have been met. The first condition is that the FSA determines that the bank or building society is failing, or is likely to fail, to satisfy the threshold conditions.

25. The second condition is that the FSA must also determine that, having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilisation powers that are available to exercise the stabilisation options) action will be taken by or in respect of the bank or building society that would enable the bank or building society to satisfy the threshold conditions.

26. The decision about whether the bank or building society is failing or is likely to fail to meet the threshold conditions is a regulatory matter for the FSA. But before determining whether it is reasonably likely that action will be taken by or in respect of the bank or building society that will enable it to satisfy the threshold conditions, the FSA must consult the Bank and the Treasury.

27. The threshold conditions represent the minimum conditions that a firm is required to satisfy, and continue to satisfy, in order to be given permission to undertake regulated activities, and to retain that permission.

28. The FSA Handbook contains rules and guidance relevant to an authorised firm. In particular, within the FSA Handbook, the Threshold Conditions section "COND" contains rules and guidance on the threshold conditions. There are a range of conditions, including: legal status and location of offices; the adequacy of the firm's resources (financial and non financial) in relation to the regulated activities which the firm undertakes; and suitability issues (e.g. competent and prudent management, conducting business with integrity and in compliance with proper standards).[2]

Determining that the specific conditions for exercising the SRR tools are met.

29. Under section 8 of the Act, the Bank may only exercise the stabilisation powers (that is the power to transfer a bank to a private sector purchaser or a bridge bank) satisfied that the exercise of the power is necessary having regard to the public interest in:

- the stability of the financial systems of the United Kingdom;
- the maintenance of public confidence in the stability of the banking systems of the United Kingdom; or
- the protection of depositors.

30. The Bank must consult the Treasury and the FSA in making this assessment. The Bank will also refer to the FSCS, in order to determine whether to proceed with the BIP.

31. These three public interest conditions may overlap (to a greater or lesser degree) depending on the particular circumstances of the bank or building society and the wider circumstances of the financial system as a whole.

32. The test of "necessity" is a high one. In determining whether the exercise of the power is necessary, the Bank must have regard to whether other approaches would resolve the situation.

33. The assessment must balance the short and long-term effects on financial stability, public confidence and depositor protection of different resolution options. When considering the need to protect depositors, the Bank will take into account not only the implications of losses but also the consequences of lack of access to deposits. While particular importance is attached to the importance of protecting retail depositors, at times of heightened systemic risk greater emphasis may be placed on protecting a wider range of depositors of a failing institution. At other times, the preferred option might be to use the BIP to facilitate rapid FSCS payout to eligible depositors, or a transfer of their accounts to another institution..

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[2] The *FSA Handbook* is available from http://fsahandbook.info/. The Threshold Conditions section of the handbook sets out the minimum standards for becoming and remaining authorised (reference code: COND).

Determining which SRR tool to use

34. If, having had regard to the public interest test, the Bank determines that it is necessary, to exercise one of the SRR tools, the Bank will need to consider as a practical matter which of the of the tools it would be possible to use; and further, whether use of the tool would be compatible with the Bank's legal obligations (including its obligations under international law).

35. A key determinant of the practicality of implementation will be the information available to the Bank on the balance sheet and operations of the institution and on any revealed interest of third parties.

36. Further issues which the Bank will need to take into account in determining the feasibility of different tools include:

- the existence of, or likelihood of finding, a private sector purchaser;
- the likely saleability of assets and liabilities of the failing bank or building society including whether a whole bank or building society sale is viable, and whether this would minimise the cost to the public finances;
- the likely speed of FSCS payout to eligible depositors, and method by which this would be achieved, in the BIP;
- the feasibility of adopting a partial solution, (such as the exercise a partial transfer) that is in compliance with the safeguards set out in primary and secondary legislation;
- the operational risks of managing a bridge bank and the amount of public funding that may be required to keep it operational.

37. Before determining which SRR tool to use, the Bank must consult the FSA and the Treasury.

38. If the Treasury notifies the Bank that they have provided financial assistance to a bank or building society for the purpose of resolving or reducing a serious threat to financial stability, a further public interest condition must be satisfied before the Bank can exercise the stabilisation powers of the Bank: namely, that the exercise of the power is necessary to protect the public interest. The Treasury will lead in judging that that this public interest condition is met but the Bank will still lead in deciding that an exercise of a particular stabilisation option best protects that public interest.

39. If the tool is likely to require the Treasury to make provision for paying compensation under the Act, the Bank will consult with the Treasury in estimating the amount of compensation that may be payable under the [Act] when making its assessment.

Specific conditions for temporary public sector ownership

40. If the Authorities believe that a bank or building society should be taken into temporary public sector ownership, the [Act] requires that the specific conditions for this tool must be met. The specific conditions are that the Treasury must be satisfied that such action is necessary to:
    - resolve or reduce a serious threat to the stability of the financial systems of the UK; or
    - to protect the public interest, where the Treasury have provided financial assistance in respect of the bank or building society for the purpose of preserving or reducing a serious threat to the stability of the financial systems of the UK.

41. As noted above, the test of necessity is a high one and requires consideration of whether alternative resolutions would be more appropriate.

Specific conditions for entering the BIP

42. An application to the court for a bank insolvency order may be made on one of three grounds:
    - that a bank or building society is insolvent, i.e. it is unable, or is likely to become unable, to pay its debts;
    - that winding up the bank or building society would be 'fair' (this has the same legal meaning as the phrase "just and equitable" in the Insolvency Act 1986); or
    - that winding up the affairs of the bank or building society would be fair and in the public interest (Secretary of State only).

43. In addition, before the Bank or the FSA make an application to the court for a bank insolvency order, the FSA must be satisfied that the bank or building society is failing or is likely to fail to meet the threshold conditions.

Announcement of tools

44. When publicly announcing any action to exercise the stabilisation options or the BIP the Bank should explain why it considers that the conditions for the exercise of the tool (set out in section 8 or, for the BIP, section 83) are met.

45. When publicly announcing any action to take the bank or building society into temporary public sector ownership the Treasury should explain why it considers that the condition set out in section 9 is met.

46. It should be noted that it will not be possible to divulge certain information, for example information the release of which would threaten financial stability or confidence in the banking system.

Part 4: Bridge bank and TPO governance arrangements

Bridge banks

47. Bridge banks are defined in Section 11 of the [Act].[3]

48. This section of the code of practice provides further guidance on the nature of bridge banks. It describes:
- the bridge bank objectives;
- the content of property transfer instruments;
- how a bridge bank will be established;
- the nature of the shareholder relationship;
- a bridge bank's articles of association;
- arrangements for directors;
- the operating strategy;
- reporting requirements; and
- the disposal and onward transfer of a bridge bank.

Bridge bank objectives

49. A bridge bank is intended to be a short-term operation, only existing until an appropriate private sector solution can be arranged and implemented.

50. To this end, the primary bridge bank objective shall be to facilitate the sale of a bridge bank – in whole or in part – to one or more private sector purchasers.

51. Insofar as the pursuance of that objective is not compromised, the Bank shall take steps to manage its relationship with the bridge bank at arm's length. However, an arm's length arrangement may not be appropriate if a bridge bank is only in existence for a short period of time (as is intended and envisaged). The section below, *Nature of the shareholder relationship*, provides further guidance on this point.

52. In exceptional circumstances, it may not be feasible for some or all of a bridge bank's business to be transferred to a private sector purchaser. In these circumstances, the bridge bank will either be wound up in a manner that meets the special resolution objectives and is in the interests of the remaining creditors of the bridge bank or taken into temporary public ownership.

53. It should be noted that the bridge bank objectives are subordinate to the special resolution objectives. In situations where there is a conflict between the two sets of objectives, the special resolution objectives take precedence.

11(1): "The second stabilisation option is to transfer all or part of the business of the bank to a company which is wholly owned by the Bank (a "bridge bank").

Contents of property transfer instruments

54. Section 30 of the [Act] describes the provisions a property transfer instrument may make. There are a number of options for how an instrument may describe which property, rights and liabilities have been transferred.[4]

55. The Authorities shall take steps to specify appropriately which property, rights and liabilities of a failing bank or building society have been transferred.

Establishment

56. The Bank shall establish or acquire a newly-incorporated company to which property, rights and liabilities will be transferred. The Bank will work with the FSA to arrange appropriate authorisations to carry on the relevant regulated activities.

Nature of the shareholder relationship

57. As provided by Section 11 of the [Act], a bridge bank will be a company limited by shares that is wholly owned by the Bank. .

58. The nature of the shareholder relationship with a bridge bank will vary depending on the nature of each resolution and the particular 'phase' of the resolution. In broad terms, it is envisaged that a bridge bank may go through two phases:

- the stabilisation phase, immediately following the transfer;
- the purchase phase, where the Bank works with a private sector purchaser to transfer the business while managing the bridge bank on a conservative basis.

59. In many cases the purchase phase may immediately follow the stabilisation phase. In these situations, it is likely that arm's length management may not be appropriate. The Bank would be expected to take an active role in managing the affairs of the bank, first to ensure stabilisation, and second to ensure a successful transaction.

60. However, in situations where there is expected to be a lengthy period of time prior to a sale, the Bank shall put in place an appropriate governance structure. This structure shall be based on the objective of taking steps to manage the relationship with the bridge bank at arm's length.

61. Arm's length is defined as leaving the day-to-day management of the bridge bank to its board of directors and keeping shareholder involvement at a

[4] Subsection (2) provides that "a property transfer instrument may relate to– (a) all property, rights and liabilities of the specified bank, (b) all its property, rights and liabilities subject to specified exceptions, (c) specified property, rights or liabilities, or (d) property, rights or liabilities of a specified description."

strategic level (for example, the Bank shall have an oversight role to ensure that its objectives continue to be met in the face of changing circumstances).

Articles of association

62. The articles of association of a bridge bank will provide for the company regulations governing the relationship between the Bank (in its capacity as shareholder) and the directors of the company. These articles will be based on the model articles prescribed by the Secretary of State for a limited liability company but with such modifications as are necessary or appropriate. Such modifications shall be based on what best meets the bridge bank objectives.

Directors

63. The Bank shall take steps to put in place appropriate arrangements for the management of a bridge bank.

64. As noted above, the nature of the management structure put in place will depend on the particular circumstances of the resolution. Over the period of stabilisation, the management arrangements may involve a relatively small core of directors with appropriate skills and experience. If a bridge bank is, as intended, only in existence for a short period of time, then this arrangement may remain suitable.

65. In circumstances where the bridge bank exists for a longer period of time, the Bank shall take steps to ensure the composition of the board of directors continues to remain appropriate. This may include appointing additional directors. The composition of the board will be decided by the Bank on a case-by-case basis.

66. At any time over the course of the resolution, the bridge bank's board of directors may or may not include employees of the Bank.

67. In addition, board members and senior managers performing key functions will need to be approved persons for the purposes of the FSA's regime, although there may be transitional arrangements in appropriate cases.

Operating strategy

68. The operating strategy for a bridge bank shall be decided by what best meets the bridge bank objectives. This is likely to involve the bridge bank operating on a conservative basis, to protect the franchise value of the business.

69. The Bank shall take steps to ensure that the bridge bank meets it regulatory requirements for its relevant regulated activities, including taking necessary steps to comply with relevant FSA requirements.

70. In its role as shareholder, the Bank shall work with the board of directors to decide on how the bridge bank should be operated. Where appropriate, the board shall produce a business plan setting out how the directors intend to operate the bridge bank in a manner pursuant to meeting the objectives. This business plan shall be presented to the Bank, who shall ensure that it meets the Bank's objectives for the resolution. If a bridge bank exists for only a short amount of time it may be unnecessary to go through this process.

Reporting

71. Bridge banks are covered by a number of reporting requirements. These are:

- the provision of section 70(1) of the [Act] (a "bridge bank report");
- the provision of section 70(5) of the [Act] (a "specific report"); and
- any other reports as agreed between the directors of the bridge bank and the Bank.

Bridge bank report

72. It is envisaged that a bridge bank will typically exist for less than one year: it is intended to be a short-term operation. While a bridge bank report is not required in these circumstances, the Bank shall report appropriately about the resolution.

73. In the unlikely event that a bridge bank exists after one year, the Bank must report to the Chancellor about the activities of a bridge bank. The first report must be made as soon as is reasonably practicable after the end of one year beginning with the date of the first transfer to the bridge bank. A similar report must also be made as soon as is reasonably practicable after the end of each subsequent year. Such reports shall include:

- an account of the activities of the bridge bank over the year; and
- how the Bank is intending to achieve the bridge bank objectives.

74. When compiling the report, the Bank may choose to not reveal market-sensitive information.

75. These reports to the Chancellor are supplementary to the reporting arrangements that the Bank in its role a shareholder will put in place to ensure it receives appropriate management information from a bridge bank.

Specific report

76. The contents of specific reports will be determined on a case-by-case basis, dependent on the specific request of the Treasury.

Other reports

77. In addition to bridge bank reports and specific reports, and the reporting requirements imposed on the bridge bank pursuant to the Companies Act 2006, the Bank shall consider, in each case, whether the bridge bank should have regard to any additional reporting requirements to which similar commercial banks may be subject. In addition, the Bank shall make arrangements to provide for regulatory reporting appropriate to the activities undertaken by the bridge bank.

Disposal and onward transfer

78. The primary bridge bank objective is to facilitate the sale of a bridge bank – in whole or in part – to one or more private sector purchasers. It is envisaged that a sale of business should follow soon after the initial transfer of property to a bridge bank.

79. In each case, the Bank shall establish an appropriate mechanism for selecting a preferred purchaser and agreeing on a price for the business of the bridge bank. In its assessment the Bank shall take account of the special resolution objectives (section 4 of the Banking [Act]). It shall also work with the FSA to ensure that the acquiring party is suitable for taking on the bridge bank's business.

80. Following this process, the Bank shall complete the transaction. This may be achieved through a standard commercial agreement (for example, a sale of securities, or an asset sale using the Part 7 process of the Financial Services and Markets Act 2000) or by exercising the onward transfer powers provided in the Banking Bill.[5]

81. In some circumstances it may be appropriate to transfer some or all of a bridge bank's business to a public-sector transferee, either a company wholly owned by the Treasury or an onward bridge bank (defined in section 11). However, this would only occur if it best met the bridge bank objectives.

[5] Either through making a bridge bank share transfer instrument (section 28) or an onward property transfer instrument (section 40).

Temporary public ownership

Introduction

82. Temporary public ownership is described in section 12 of the Banking [Act].[6]

83. This section of the code of practice provides further guidance on:

- the content of share transfer orders;
- the objectives for temporary public ownership;
- the nature of banks in temporary public ownership;
- the management of banks in temporary public ownership; and
- reporting requirements.

Contents of share transfer orders

84. Section 15 of the [Act] describes the provision a share transfer order may make. A share transfer order may relate to either specified securities or securities of a specified description.

85. The Authorities shall take steps to specify appropriately which securities of a failing bank have been transferred.

Temporary public ownership objectives

86. The objectives of a bank in temporary public ownership will reflect the special resolution objectives (as provided for in section 4 of the Banking [Act]). The intention shall be to return the business of the bank to the private sector in a manner which maintains financial stability and protects depositors and the taxpayer.

87. In addition, insofar as this is appropriate and reasonable, the Treasury shall seek to operate the bank at arm's length.

88. The Treasury shall also take steps to ensure that the bank is operated in a manner that does not distort competition in the UK banking system.

The nature of banks in temporary public ownership

89. The securities of a bank in temporary public ownership shall either be held by a nominee of the Treasury (for example, the Treasury Solicitor) or by a company wholly owned by the Treasury. In either case, the transferee shall be the single shareholder of the bank.

12(1): "The third stabilisation option is to take the bank into temporary public ownership."
12(2) provides that the transferee may either be "a nominee of the Treasury or a company wholly owned by the Treasury."

90. The articles of association of a bank in temporary public ownership will provide for the company regulations governing the relationship between the Treasury (in its capacity as shareholder) and the directors of the company. These articles will based either on the existing articles of association of the bank or on the model articles prescribed by the Secretary of State for a limited liability company, in each case with such modifications as are necessary or appropriate.

The management of banks in temporary public ownership

91. As shareholder, the Treasury will have the power to exercise normal shareholder rights.

92. Immediately following the transfer of securities and for the period of stabilisation, the Treasury may take a 'hands on' role in managing the affairs of the bank. However, once stabilised, the Treasury shall seek to introduce corporate governance arrangements in line with best practice as soon as is reasonably practicable. The nature of these arrangements will depend on how likely the bank is to remain in public ownership.

93. If a bank is likely to remain in public ownership for longer than a short period, the Treasury shall set out for the directors objectives for how the bank should be operated. Based on these objectives, the board shall produce a business plan setting out how the directors intend to operate the bank.

94. The plan may include:
- a commercial strategy;
- a funding plan, including arrangements for repaying any public money that has been provided;
- a risk management strategy; and
- an approach for complying with competition issues, state aid and regulatory requirements.

95. This business plan shall be presented to the Treasury, who shall ensure that it meets the Treasury's objectives for the bank or building society.

96. The Treasury shall then take an oversight role to ensure that the plan continues to meet its objectives in the face of changing circumstances.

97. Insofar as the bank or building society carries on relevant regulated activities, the FSA shall continue to authorise and regulate it in the usual manner.

Reporting

98. The Treasury shall make arrangements to ensure that a bridge bank reports on a similar basis to other commercial banks. This includes regulatory reporting appropriate to the activities undertaken by the bank.

99. As and when appropriate, the Chancellor of the Exchequer shall report to Parliament about the activities of the bank.

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