



HM TREASURY

Banking Act 2009

**Special resolution regime:
Code of Practice**

November 2010



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Code of Practice

Presented to Parliament pursuant to
sections 5 and 6 of the Banking Act 2009

November 2010



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Introduction

1.1 The Banking Act 2009 (the Act), covering England, Scotland, Northern Ireland and Wales, strengthens the UK's statutory framework for financial stability and depositor protection.

1.2 The Act puts in place a permanent special resolution regime (SRR), providing the Financial Services Authority (FSA), Bank of England and the Her Majesty's Treasury (the authorities) with tools to protect financial stability by effectively resolving banks and building societies that are failing, while protecting depositors, taxpayers and the wider economy.

1.3 This Code of Practice, issued in accordance with sections 5 and 6 of the Act, supports the legal framework of the SRR, and provides guidance as to how and in what circumstances the authorities will use the special resolution tools. In particular, it sets out guidance on the use of:

- the **three stabilisation options**: transfer to a private sector purchaser, transfer to a bridge bank and transfer to temporary public sector ownership;
- the **bank insolvency procedure**, which facilitates the Financial Services Compensation Scheme (FSCS) in providing prompt payout to depositors or transfer of their accounts to another institution; and
- the **bank administration procedure**, for use where there has been a partial transfer of business from a failing institution.

1.4 The Treasury has issued this Code having consulted the FSA, the Bank of England and the FSCS in accordance with section 6 of the Act. The Code is laid before Parliament on 22 November 2010.

2

Overview of the Code

2.1 This Code of Practice provides guidance on the use of the SRR set out in Parts 1-3 of the Act. The SRR provides the authorities with a permanent set of tools to deal with banks and building societies in circumstances in which their failure has become highly likely. It consists of:

- the three **stabilisation options**: transfer to a private sector purchaser, transfer to a bridge bank and transfer to temporary public sector ownership;
- the **bank insolvency procedure**; and
- the **bank administration procedure**.

2.2 The special resolution tools may be used by the authorities to resolve a failing banking institution,¹ and include powers to take bank holding companies into temporary public ownership, if necessary.

Contents of the Code

2.3 In accordance with section 5 of the Act, this Code sets out guidance on:

- how the special resolution objectives are to be understood and achieved;
- the choice between different resolution options;
- the information to be provided in the course of a consultation under this Part (i.e. information to be provided as part of any consultation between the authorities and the giving of advice between one authority and another);
- the giving of advice by one relevant authority to another about whether, when and how the stabilisation powers are to be used;
- how to determine whether Condition 2 in section 7 is met (this condition stipulates that, before a banking institution can be placed in the SRR, the FSA must have determined that it is not reasonably likely that action will be taken by or in respect of the institution that will enable it to satisfy its threshold conditions);
- how to determine whether the test for the use of stabilisation powers in section 8 is satisfied (i.e. how the Bank of England will determine the public interest test for the use of the bridge bank and private sector purchaser stabilisation options will be satisfied);
- sections 63 and 66 (general continuity obligations); and
- compensation that may be payable as a result of the use of the SRR.

¹ In describing the use of the statutory powers under the SRR (Chapters 3-11), the Code uses the general term 'banking institution' to refer to a bank, building society or bank holding company, except where otherwise stated.

2.4 Sections 12 and 13 also require the inclusion in the Code of certain matters relating to the governance of bridge banks and temporary public ownership. The Code therefore describes the legal powers under the Act, including the legal constraints on the authorities. This element of the Code expands on the Explanatory Notes that were published with the Act and the explanatory memoranda that are published with the relevant statutory instruments made under Parts 1-3: it describes the legally binding provisions of Parts 1-3.

The authorities' regard to the Code

2.5 The authorities are legally obliged to have regard to the Code under section 5(4) of the Act.

2.6 The Treasury considers that one of the primary purposes of the Code is to provide a clear guide, for banking institutions and the financial markets, to how the authorities will seek to achieve the special resolution objectives and how the SRR powers may be used in practice. Therefore, in addition to describing the legal powers, the Code also sets out the authorities' policy approach to using these powers. The authorities must 'have regard' to these statements of policy intention (under section 5(4) of the Act) when exercising the SRR powers. The statements of policy intention in the Code should therefore provide a greater insight into how the authorities would expect to act in order to achieve the special resolution objectives.

2.7 The Code should be viewed as a guide to the most likely use of the powers. The resolution tools may be exercised in a range of ways, provided these are consistent with the special resolution objectives. So while the authorities must have regard to it they are not necessarily bound to adopt an approach set out in the Code where circumstances arise which mean that the alternative approach better meets these SRR objectives.

Revising and maintaining the Code

2.8 The Treasury will update the Code on a periodic basis, in the light of evolving experience. The Treasury will consult the Bank of England, FSA and the FSCS on any changes. In making material changes to the Code the Treasury will also consult the Banking Liaison Panel, which has a statutory remit to advise the Treasury on the Code of Practice under section 10(2)(b) of the Act.

2.9 When a revised Code is issued, the Treasury will lay a copy before Parliament as soon as is practicable.

Banking Liaison Panel

2.10 The Banking Liaison Panel will advise the Treasury on certain matters relating to the SRR. The remit and terms of reference of the panel will be published, and will include advising the Treasury on the effect of the SRR on banking institutions, persons with whom they do business, and the financial markets.

2.11 The Treasury expects the Panel to take a particular interest in providing advice in relation to the operation of the safeguards provided by and under the Act in relation to partial property transfers and on this Code.

2.12 Summaries of the proceedings of meetings of the Banking Liaison Panel will be published, subject to considerations of commercial and market confidentiality.

3

Special resolution objectives

3.1 Section 4 of the Act provides for the special resolution objectives, 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).

Matters to be considered in having regard to the objectives

3.2 Specific terms used within the objectives are not generally 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).

3.3 Therefore, this Code provides further explanation as to how the objectives may be achieved by outlining the factors that the authorities may consider to be relevant in applying them.

Stability of the financial systems of the UK

3.4 The term “stability of the financial systems of the UK” refers to the stable functioning of the systems and institutions (including trading, 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.

3.5 By virtue of section 4(9) of the Act, the reference to the stability of the financial systems of the UK includes in particular a reference to the continuity of banking services. Continuity of banking services is relevant not only for the protection of depositors under objective 2, but has wider relevance to the stability of the financial systems of the UK.

3.6 The intention of the first objective is to (a) recognise the wider systemic risks posed by the potential or actual failure of a banking institution or group of companies containing a banking institution; and (b) require the authorities to have regard to the likely systemic impact of their actions (including a decision not to act) when considering whether to use a SRR tool.

3.7 The authorities will have regard to ensuring that the transfer powers are not exercised in a manner that is likely to harm financial stability. As part of this, in transferring rights and obligations that confer a particular status (for example, as a settlement or clearance bank), the authorities will seek to ensure that this status is not transferred to an unsuitable entity.

3.8 In carrying out a resolution, the authorities will seek, where possible, to minimise operational disruptions to critical market infrastructure. Where appropriate, this may involve

liaising with the relevant parties in order to understand the different risks and stresses associated with the timing of resolution actions and market openings; and taking steps to minimise disruptions which may arise where the failed institution is a member of a payment system.

Public confidence in the stability of the banking systems

3.9 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 institutions’ deposit liabilities exceed the liquid assets they hold at any one time.

3.10 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 continue to be available; (c) problems (or perceived problems) in one institution will not extend to other institutions (contagion); and (d) if an institution does fail, systems exist to protect the interests of depositors.

3.11 The intention of the second objective is to provide that the authorities have regard to the need to act so that a failing institution will be resolved in a manner that protects and enhances public confidence in the banking system as a whole.

Protection of depositors

3.12 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 systems (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.

3.13 Under the Act such protection can be delivered in different ways. For example by (a) facilitating fast payout to eligible depositors up to the compensation limit under the FSCS (or arranging a bulk transfer of accounts) through the bank insolvency procedure; or (b) facilitating continuity of banking services through the stabilisation options provided in the SRR.

3.14 Effective depositor protection is particularly important in the case of deposits protected by the FSCS. Protection of these deposits, including prompt access to them, is also likely to be conducive to the realisation of a number of other SRR objectives such as protecting and enhancing public confidence in the banking systems. However, the use of the SRR may also offer protection to other types of depositor and non-depositor creditors if necessary to meet the special resolution objectives.

Protection of public funds

3.15 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 duty of the authorities, and particularly the Treasury, to protect public funds in taking decisions with implications for public funds.

Avoiding interference with property rights

3.16 The term “avoiding interfering with property rights in contravention of a Convention right” refers in particular to holders of property rights in a failing banking institution. This can include the institution itself, its shareholders (or, in the case of a building society, members), creditors, counterparties, or other third parties. Such persons may hold property in the failing institution, or have a right of control over such property, or both. 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 and Article 14, prohibition of discrimination) may also be relevant. The inclusion of this objective acknowledges the importance ensuring that any interference with the Convention rights is in the public interest and proportionate.

Balancing the objectives

3.17 Neither the Act, nor this Code, ranks the SRR objectives. Under section 4(10) of the Act, the objectives are to be balanced as appropriate in each case. This provision recognises 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

3.18 The special resolution objectives in the Act serve two purposes:

- they reflect 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.

3.19 This means that the authorities must consider the effect of their likely actions (including inaction) and assess them in light of the objectives. This applies to the exercise of all powers under Parts 1, 2 and 3 of the Act.

3.20 The sole exception to this requirement relates to a determination made by the FSA, under section 7(2) and (3) of the Act, that an institution is failing or is likely to fail to satisfy the threshold conditions within the meaning of the Financial Services and Markets Act 2000 (FSMA) that that it is not reasonably likely that action will be taken to enable the bank to satisfy those conditions. These decisions will be taken in the context of the FSA's objectives under FSMA.

3.21 In exercising the powers under Parts 1, 2 and 3, the authorities will also, as is the case with any public body in the exercise of its functions, necessarily have regard to restrictions and conventions of public law, in particular the requirement for the authorities to act reasonably and to have respect for the rule of law and principle of legal certainty. The authorities must also act in accordance with common law principles of procedural fairness when exercising the SRR tools.

3.22 Following actions taken under the SRR, the authorities shall make a public statement 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.

3.23 However, it should be noted that it may not be possible to divulge certain information; for example, information the release of which would threaten financial stability or confidence in the banking systems will not be made available by the authorities in any public statement.

4

Roles of the Authorities

4.1 The resolution of failing banking institutions will involve 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.

4.2 As set out in section 7 of the Act, the FSA will be responsible for making the determination that a banking institution is failing (or is likely to fail) to satisfy its threshold conditions, and that it is not reasonably likely that action will be taken by or in respect of the institution that will enable the institution to meet those conditions. The FSA will also be responsible for the authorisation of a bridge bank and ongoing supervision of institutions in the SRR.

4.3 The Bank of England will be responsible for the operation of the SRR, including the decision on which of the SRR tools to use, and its implementation (with the exception of the power to take an institution into temporary public ownership). The Bank of England will also remain responsible for the provision of liquidity support, which uses the Bank of England's balance sheet.

4.4 The Treasury will be responsible for decisions with implications for public funds, for ensuring the UK's ongoing compliance with its international obligations, and for matters relating to the wider public interest. The Treasury will also be responsible for the temporary public ownership tool. The Treasury will also exercise a number of the ancillary powers under the SRR (particularly those where Parliamentary scrutiny is required), including the power to modify the law and powers in relation to compensation.

4.5 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 payout to eligible depositors. Further, under section 171 of the Act the FSCS may be a contributor to the cost of the SRR.

4.6 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 by the Bank of England. For both a depositor payout or account transfer, or for any contribution to SRR costs, 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.

4.7 A Memorandum of Understanding between the authorities outlines how the authorities will coordinate with each other before and during the resolution of an institution.

5

General and specific conditions for choosing the SRR tools

SRR tools

5.1 The Act provides the Bank of England and the Treasury with the following stabilisation options for resolving a failing institution:

- in the case of bank or building society, transfer by the Bank of England of the banking institution or some or all of its business to a private sector purchaser;
- in the case of a bank or building society, transfer by the Bank of England of some or all of its business to a bridge bank; and
- in the case of a bank, building society or holding company of a bank, transfer by the Treasury of the institution into temporary public ownership.

5.2 As set out below, bringing a bank holding company into temporary public ownership is only likely to occur when other options are considered to be inadequate. Temporary public ownership is the only tool that can be used in respect of bank holding companies.

5.3 Each of the three stabilisation options is achieved through the exercise of one or more of the “stabilisation powers”, which are the powers to effect the transfer of shares and other securities or property, rights and liabilities, by operation of law. These stabilisation powers include the onward and supplemental transfer powers, which are discussed in paragraphs 6.2-6.12 of this Code.

5.4 The Act also provides the FSA and the Bank of England with the ability to apply to the court for a bank insolvency order to wind up a banking institution 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.

5.5 The Bank of England can also apply for a bank administration order to facilitate the transfer of part of a failing banking institution’s business to a private sector purchaser or bridge bank.

Determining that the regulatory pre-conditions are satisfied

5.6 A stabilisation power may be exercised in respect of a banking institution only if the FSA is satisfied that the conditions set out in section 7 of the Act have been met. The first condition is that the FSA determines that the institution is failing, or is likely to fail, to satisfy the threshold conditions.

5.7 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 banking institution that would enable it to satisfy the threshold conditions.

5.8 Section 7 requires that a bank could only enter the SRR at a point where it is clear that there is no realistic prospect that it will be able to continue as an authorised deposit-taker. Other than in the case of an unforeseen or very rapid failure, the authorities will, in practice, have undertaken contingency planning and sought commercial solutions to address the problems of

a failing institution, such as a commercial sale, prior to the FSA reaching a decision that the conditions for use of the SRR powers have been satisfied.

5.9 This determination is a regulatory matter for the FSA, which will be undertaken in line with its existing statutory objectives under FSMA 2000. Before determining whether it is reasonably likely that action will be taken by or in respect of the institution that will enable it to satisfy the threshold conditions, the FSA must consult the Bank of England and the Treasury.

5.10 The threshold conditions represent the minimum conditions that a firm is required to satisfy, and continue to satisfy, in order to have permission to undertake regulated activities. In making this determination, the FSA are required to discount financial assistance provided by the Treasury or Bank of England disregarding ordinary market assistance offered by the Bank on its usual terms. The concept of 'ordinary market assistance' contained in section 7(4)(b) does not create a new 'hard-edged' legal definition. The Bank of England provides banks with a spectrum of assistance in all types of different circumstances. Whether or not financial assistance from the Bank of England constitutes "ordinary market assistance... on its usual terms" will depend on a combination of factors, including the terms of the Bank's operation, the circumstances of the bank receiving liquidity from the Bank, and conditions in the relevant markets in which the firm was, or would otherwise be, seeking to access funding. Furthermore, these factors may vary during the period that any assistance is given. The provision does not imply whether a particular facility is, for all banks using it, "ordinary market assistance" or not.

5.11 The FSA Handbook contains rules and guidance relevant to an authorised firm. In particular, the "COND" sourcebook 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 (for example competent and prudent management, conducting business with integrity and in compliance with proper standards). The FINMAR sourcebook contains guidance on assessing Condition 2 under section 7(3) of the Banking Act.¹

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

5.12 Under section 8 of the Act, the Bank of England may only exercise a stabilisation power if 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.

5.13 The Bank of England must consult the Treasury and the FSA before making this determination and deciding how to proceed. In determining whether to proceed with the bank insolvency procedure, the Bank of England will also consult with the FSCS.

5.14 The three public interest conditions may overlap (to a greater or lesser degree) depending on the particular circumstances of the banking institution and the wider circumstances of the financial system as a whole.

¹ The handbook is available from the FSA website (<http://fsahandbook.info>)

5.15 The test of “necessity” is a high one, and the Bank of England and the Treasury will necessarily have regard to public law restrictions, the authorities regard to the special resolution objectives and the duty to act compatibly with the Convention rights.

5.16 The assessment must seek to 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 of England will take into account not only the implications of losses but also the consequences of lack of continuity of depositor services. While particular importance is attached to the protection of FSCS eligible 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 bank insolvency procedure to facilitate rapid FSCS payout to eligible depositors, or a transfer of their accounts to another institution.

5.17 If, having had regard to the public interest test, the Bank of England determines that it is necessary to exercise one of the SRR tools, the Bank of England will need to consider as a practical matter which of the tools it will be possible to use; and further, whether use of the tool would be compatible with the Bank of England’s legal obligations and the special resolution objectives.

The choice between the tools

5.18 In choosing between the resolution tools, the Bank of England will consider the relative merits of the stabilisation options and the bank insolvency procedure given the circumstances. There are, however, some general considerations that may be taken into account. Some of these are detailed below.

5.19 Resolution by way of the bank insolvency procedure may be the option that best meets the special resolution objectives where the most appropriate outcome would be the winding up of the failed institution’s affairs in the interests of creditors as a whole, and prompt FSCS payouts to eligible depositors or the bulk transfer of their accounts to another institution. The BIP is the default option unless the public interest considerations weigh in favour of an exercise of a stabilisation option. It is also generally important for market discipline that firms – including banks and building societies – should not be immune from failure.

5.20 Resolution by way of a transfer to a private sector purchaser is generally likely to be the resolution option that best meets the special resolution objectives if it can be effected in a cost effective way. It provides the flexibility for both whole-bank and part-bank solutions, and for a swift and certain transfer. It does, however, require a willing purchaser in order for it to be effective.

5.21 Resolution by way of a transfer to a bridge bank may be appropriate where an immediate private sector sale is not possible, and where a stable platform is needed to prepare for and effect the onward sale of all or part of the bank to a private sector purchaser.

5.22 Temporary public ownership is generally likely to be the least preferred option, and involves the Treasury taking control and ownership of a failing banking institution through the transfer of shares, in order to provide a stable platform for restructuring. Temporary public ownership may be the most suitable resolution option if, for example, the Treasury has provided a failing institution with a significant amount of public money in order to stabilise it prior to its entry into the SRR. The option may also be exercised where it is necessary to resolve or reduce a serious threat to the stability of the UK’s financial systems. This is the only option available in relation to a holding company of a bank.

5.23 A key determinant of the practicality of implementation will be the amount and quality of information available to the authorities on the balance sheet and operations of the banking institution and on any interests of third parties.

5.24 Further issues which the authorities 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 banking institution, including whether a whole institution sale is viable;
- the likely speed of FSCS payout to eligible depositors, and the method by which this would be achieved under the bank insolvency procedure;
- the feasibility of effecting a partial transfer 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, including consideration of State Aid issues; and
- the time available to implement a private sector sale, including for due diligence by potential purchasers.

5.25 Before determining which of the stabilisation options to use, the Bank of England must consult the FSA and the Treasury.

5.26 If the Treasury notifies the Bank of England that they have provided financial assistance in respect of a banking institution for the purpose of resolving or reducing a serious threat to financial stability, a different public interest condition must be satisfied before the Bank of England can exercise its stabilisation powers. This test is that the exercise of the power is necessary to protect the public interest. The Treasury will lead in judging that this public interest condition is met but the Bank of England will still lead in deciding that an exercise of a particular stabilisation option best protects that public interest.

Specific conditions for temporary public ownership

5.27 Under section 9, if the Treasury believe that an institution should be taken into temporary public ownership, specific conditions for this tool must be met in addition to the general condition relating to the failure to meet the threshold conditions. The specific condition is 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
- protect the public interest, where the Treasury have provided financial assistance in respect of the banking institution for the purpose of resolving or reducing a serious threat to the stability of the financial systems of the UK.

5.28 Temporary public ownership is the only tool that can be used in respect of bank holding companies. There are specific considerations relevant to bank holding companies, which are outlined in paragraphs 5.39-5.45 of this Code.

Specific conditions for entering the bank insolvency procedure

5.29 Under section 96, an application to the court for a bank insolvency order may be made on one of three grounds:

- that a banking institution is insolvent, i.e. it is unable, or is likely to become unable, to pay its debts;
- that winding up the banking institution 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 banking institution would be fair and in the public interest (Secretary of State only).

5.30 The general conditions also apply to the bank insolvency procedure. Therefore, before the Bank of England or the FSA makes an application to the court for a bank insolvency order, the FSA must be satisfied that the conditions set out in section 7 of the Act have been met.

Specific considerations relevant to building societies

5.31 Under sections 84-88, the stabilisation options can also be applied to building societies.

5.32 Building societies have different corporate structures to banks. Individuals who have a share account or a mortgage with a building society are members and therefore have certain rights including rights to vote (with some limited exceptions) and receive information.² Each member of a building society has one vote, regardless of how much money they have invested or borrowed, or how many accounts they hold. Further, building society shares are not like company shares. Generally, shares in a building society can be withdrawn by investors in line with the society's rules and terms of issue. So, they are more like deposits. For these reasons, some of the SRR tools need to be tailored to building societies.

5.33 The private sector purchaser and bridge bank stabilisation options are broadly the same for building societies as they are for banks. However, the temporary public sector ownership stabilisation option for building societies is different to that for banks. This is because, given the ownership structure for building societies, it would not be possible to effect public ownership of a building society through a share transfer.

5.34 The Act therefore provides the Treasury with the power to take a building society into temporary public ownership through cancelling private membership rights and becoming a member of the society in question either by transferring all deferred shares, such as PIBS (Permanent Interest Bearing Shares, a special type of long-term, interest-bearing investment in a building society) to the Government or by issuing new deferred shares to Government on the building society's behalf.

5.35 The effect of taking a building society into temporary public ownership will be that customers lose voting and other membership rights but their savings and mortgages will be unaffected. Under section 86 these "former members" may be given a right to participate in the distribution of any surplus on the winding up of the society, once all creditors and any remaining members of the society had been paid in respect of their liabilities and shares.

Building societies and insolvency set off

5.36 Where a creditor petitions for the insolvency of a building society, section 90D of the Building Societies Act 1986 requires that they give the FSA and the Bank of England two weeks' notice of the petition to enable them to consider whether to apply for a building society insolvency order, or to exercise a stabilisation power under Part 1 of the Banking Act.

² Minors do not have voting rights, and societies can require shareholding members to hold at least £100 in shares to enjoy voting rights. Mortgage holders in subsidiaries of a building society will not have membership rights in the society itself, unless they also have a share account or mortgage directly with the society.

5.37 When considering whether to use an SRR tool in respect of a failing building society, the authorities will have regard to the benefits of ensuring that if a building society is to enter liquidation proceedings, it is done under the building society insolvency procedure (BSIP), rather than under the Insolvency Act 1986.

5.38 In particular, the authorities will have regard to the fact that the Building Society Insolvency (England and Wales) Rules and the Building Society Insolvency (Scotland) Rules introduce statutory provision for mutual credit and set-off to apply in the BSIP, whereas other insolvency proceedings do not make this provision for building societies.

Specific considerations relevant to bank holding companies

5.39 Under section 82, where it is necessary, the Treasury may bring the holding company of a banking institution into temporary public ownership.

5.40 A bank holding company may only be taken into temporary public ownership if the FSA is satisfied that a bank in the group satisfies the general conditions set out in section 7. The Treasury must also be satisfied that it is necessary to take action for the purposes specified in the specific conditions for temporary public ownership set out in section 9, to resolve or reduce a serious threat to the stability of the financial systems of the UK or to protect the public interest where financial assistance has been provided.

5.41 In determining whether it is necessary to take action in relation to the holding company, the Treasury will consider whether action in relation to the bank alone would be sufficient for the purposes specified in section 9.

5.42 Only the Treasury is able to exercise the power to take a bank holding company into temporary public ownership. In taking a decision to exercise the temporary public ownership tool in relation to a holding company, the Treasury will balance the interests of relevant parties against the public interest in resolving the difficulties caused by the failing bank.

5.43 Although holding company temporary public ownership is an option involving the whole of the holding company, partial transfers of the company's property may be carried out by the Treasury in onwards or other subsequent transfers to private sector purchasers. The limitations on partial property transfers provided for in sections 47, 48 and 60 of the Act, and secondary legislation made under them (and described in Chapter 7 of this Code), will also apply to bank holding companies.

5.44 The Treasury's legislative powers with respect to non-bank entities within the group are restricted. The full range of onward transfer powers (including the partial transfer powers discussed above) only apply to banks in the group and the holding company itself.

5.45 It is considered highly unlikely that circumstances would arise under which it would be possible or desirable for the Treasury to take a holding company into public ownership, where that holding company did not have a close connection with the operation of the bank or where the primary activities of the holding company were not closely related to financial services.

Announcement of tools

5.46 When publicly announcing any action to exercise the stabilisation options or initiate the bank insolvency procedure, the Bank of England will explain the grounds on which it considers that the conditions for the exercise of the tool (set out in section 8 or, for the bank insolvency procedure, section 96) are met.

5.47 When publicly announcing any action to take a banking institution into temporary public ownership the Treasury will explain the grounds on which it considers that the one of the

conditions set out in section 9 (or, in the case of a holding company, the conditions in section 82) are met.

5.48 It should be noted that it may not be possible to divulge certain information where, for example, its release would threaten financial stability or confidence in the banking systems.

6

Ensuring that resolutions are effective

6.1 There are a number of supplementary and ancillary powers that may be needed to ensure that resolutions are effective. This Code provides further information on powers are covered by sections 63-70 (continuity obligations), 26-31 (supplemental, reverse and onward share transfers), 42-46 (supplemental, reverse and onward property transfers) and 75 (power to change law).

Bridge Bank and Private Sector Purchaser: Supplemental, reverse and onwards transfers

6.2 The Bank of England may make supplemental, reverse or onward transfer instruments in relation to property or securities. Supplemental transfers allow further transfers of property or securities from the original owner to a bridge bank or private sector purchaser. Reverse transfers provide for property to be moved back from a bridge bank to the previous owner, subject to certain restrictions. Onward transfers allow for the bridge bank's property or shares in the bridge bank to be transferred to a private sector purchaser or a Treasury- or Bank of England-owned company. These powers increase the chances of a private-sector solution, reducing the barriers to an onward sale.

6.3 This may become necessary, for example, if additional details come to light about the nature of the transferred securities, property or business, after the initial transfer, which would effect the saleability of the bridge bank, or the achievement of the SRR objectives more widely. The Bank of England must consult with the Treasury and the FSA before making any of these types of transfer instrument.

6.4 The general and specific conditions of SRR intervention do not apply to these transfer instruments as they form part of the continuing resolution, and the authorities will already have determined that the conditions have been met by the failing banking institution on its entry into the SRR.

6.5 However, these tools can only be used in a manner consistent with the SRR objectives, and the general public law responsibilities governing the action of public bodies. In particular, where these further transfers interfere with property rights, the Bank of England must be satisfied that the action is in the public interest and is proportionate to the public interest aim being pursued.

6.6 Furthermore, such transfers can only be conducted in accordance with the safeguards for partial property transfers provided for in secondary legislation made under sections 47, 48 and 60 of the Act.

6.7 These considerations also apply to the Treasury, in its exercise of supplemental, reverse and onwards transfers, as described in the next sections.

TPO: Supplemental, reverse and onwards transfers

6.8 Where a banking institution has been taken into temporary public ownership, the Treasury may make supplemental and reverse transfers of securities. Supplemental transfers provide for transfers of further classes of securities from the holders of those securities to public ownership.

Reverse transfers provide for property to be moved back from public ownership to the original holders.

6.9 The Treasury may also effect an onward transfer of the shares or business of a bank in temporary public ownership. These powers increase the chances of a private-sector solution, reducing the barriers to an onwards sale of a bridge bank or a bank in temporary public ownership.

6.10 These subsequent transfers may become necessary, for example, if additional details come to light about the nature of the transferred securities or business after the initial transfer. As with all other forms of transfer, the Treasury must consult with the Bank of England and the FSA before making the order.

Powers in relation to holding companies in temporary public ownership

6.11 Under section 82, the Act provides for powers in relation to holding companies in temporary public ownership, similar to those for banks in temporary public ownership. These are limited in important respects. In particular, the Treasury's powers in respect of non-bank entities within the group are limited in that the full range of onward transfer powers only applies to deposit-takers in the group and the holding company itself. The Treasury may:

- make an onwards share transfer or reverse share transfer of the securities issued by the failing bank or another bank within the group;
- make an onward share transfer or reverse share transfer of the securities of the bank holding company; and
- make an onwards property transfer of the property of the bank holding company, a bank or another bank within the group (including property which takes the form of securities, for example shares held in a subsidiary undertaking).

6.11.1 However, it is not otherwise possible under the Act for the Treasury to transfer the shares or property of any non-bank subsidiaries within the group. Resolution of these parts of the group (i.e. their return to the private sector) will therefore need to be undertaken via normal commercial routes.

Continuity obligations

6.12 Where it is necessary to use a stabilisation option in respect of an individual banking institution that forms part of a group of companies, the general continuity obligations will apply (see sections 63 to 70 of the Act).

6.13 Group companies will be obliged under the continuity obligations to provide services and facilities that the Bank of England or Treasury considers are required to enable the acquirer of the transferred business to operate it effectively. This general duty, however, is subject to a right to receive reasonable consideration (see section 63(4) and 66(4)).

6.14 A general continuity obligation will arise following a transfer automatically, by operation of law.

6.15 In addition, it may be appropriate to impose special continuity obligations. These obligations will be restricted to ensuring that necessary services and facilities continue to be provided in order to ensure that what part of the business is transferred can continue to be operated effectively.

6.16 The special obligations provide powers to create, modify or cancel contracts and confer or impose rights and obligations between a transferee and the group companies of a residual bank and the residual bank itself – but only in relation to services and facilities required to operate the banking business effectively. As far as is reasonably practicable, provision will be made to ensure that providers receive reasonable consideration for any services provided.

6.17 For example, where there is a pre-existing funding arrangement, continuity obligations may provide for that arrangement to be continued to prevent cash flow from being disrupted while new funding arrangements are being put in place. Section 64(3) provides that the Bank of England shall aim to preserve or include provision for reasonable consideration and any other provision which would be expected in arrangements undertaken between two parties dealing at arm's length. In addition, subsection (4) provides that the powers under subsection (2) may be exercised only in so far as the Bank of England thinks it necessary to ensure the provision of such services and facilities as are required to operate the transferred business effectively, and that the Treasury must consent to the exercise of this power. These measures ensure that providers will not be placed under a disproportionate burden as a result of being subject to special continuity obligations.

6.18 The Bank of England may only exercise these powers with Treasury consent, and Ministers will assess the broad public interest of the particular situation.

Power to change law

6.19 Where necessary for the purpose of enabling the powers of Part 1 of the Act to be used effectively, the Treasury may exercise its power under section 75 of the Act to modify legislation. This power may be used in respect of both primary and secondary legislation, and the provisions of common law.

6.20 The power may only be used to facilitate or in connection with the use of one the stabilisation options. The power may be used in two ways:

- to make a specific amendment to a piece of legislation for the purposes of making the resolution of a specific banking institution effective. Generally, such an amendment would only apply to that banking institution or a related institution (e.g. a group company). It would not generally apply to any other banks, or any other banking institutions; or
- to make an amendment to legislation that is applied to all resolutions or a class of resolutions carried out under the SRR. This would then apply in each resolution where the Bank of England or the Treasury used a stabilisation tool

6.21 Examples of legislative provisions that may need to be disapplied in a resolution are provisions on shadow directorship under the Companies Act or on liabilities for connected or associated persons under the Pensions Act. The power can be used retrospectively if this is necessary or desirable for giving effect to the particular exercise of a power under the Act. However in using the power, the Treasury must have regard to the fact that it is in the public interest to avoid retrospection. The Treasury will also necessarily have regard to existing public law restrictions, in particular the requirement on the Treasury to have respect for the rule of law and legal certainty. In addition the Treasury must have regard to the special resolution objectives and act compatibly with the Convention rights. Thus the power could not be used for purposes unconnected with the use of the powers under the Act, for example to change the law for wider public policy objectives.

6.22 The power cannot be used to amend the Act itself, or any standing secondary legislation made under it. The power can be used in relation to an instrument or order made in the exercise of a stabilisation power, including transfer orders and instruments.

6.23 In general, exercise of the power to change law will be approved in advance by Parliament under the draft affirmative resolution procedure. Where the Treasury consider it to be necessary to make an order without prior Parliamentary approval, the 28-day procedure will be used. Under this procedure, the order can be made and brought into force immediately but will cease to have effect 28 days later unless approved by both Houses of Parliament.

6.24 The Banking Liaison Panel has a statutory right to provide advice on use of the power to change law. However, this does not include a right to provide advice on an exercise of this power that is carried out in connection with or to facilitate a particular use (proposed or actual) of a stabilisation power.

Using section 75 to amend a transfer order or transfer instrument

6.25 A section 75 order may be used to amend a transfer instrument or order. Unlike a typical commercial merger and acquisition process, the timetable for carrying out due diligence and preparing the legal documentation is likely to be compressed into a few weeks or even days and the direct channels of communication with the management of a failing bank are necessarily limited to ensure confidentiality and avoid premature disclosure. In some circumstances, it may therefore become necessary or desirable to use a section 75 order to amend a transfer instrument or order (with or without retrospective effect), for example:

- in the event of further information coming to light that results in a transfer instrument incorrectly reflecting the commercial terms of the transfer; or
- where it is necessary to make a change to avoid a transferee inadvertently being in breach of a law or regulation.

6.26 The authorities will make every effort to ensure that transfer instruments and orders are drafted accurately to reduce the likelihood of recourse being had to the power under section 75 for this purpose and that it is only where there are serious difficulties that consideration will be given to an amendment made in exercise of this power.

Box 6.A: Example – use of section 75 in the resolution of the Dunfermline Building Society

In the resolution of the Dunfermline Building Society, The Amendments To Law (Resolution Of Dunfermline Building Society) (No. 2) Order 2009 (2009/1805), made under section 75 amended the Property Transfer Instrument to change the definition of “commercial loan”.

The definition of “commercial loan” was intended to exclude Dunfermline Building Society’s commercial property portfolio (of approximately £660m) from the transfer of part of Dunfermline’s business to Nationwide Building Society. The legal effect of the definition as originally drafted in the Property Transfer Instrument, however, was to transfer a significant proportion of this commercial property portfolio and a small number of social housing loans to Nationwide. The loans transferred were not included in the transaction agreed between HM Treasury, the Bank of England, and Nationwide and had been managed in the period following the resolution on the assumption that they had not been transferred to Nationwide.

The power under section 75 was therefore exercised to correct the definition of “commercial loan” to reflect the agreement reached by the various parties to the resolution. The correction was made with retrospective effect which means that the Property Transfer Instrument is to be treated as having included the correct definition from the time at which it was made.

Conversion and delisting

6.27 Section 19 can be used when the Bank of England makes a share transfer instrument to a private sector purchaser, or the Treasury makes a share transfer order to exercise temporary public ownership. Section 19 allows the instrument or order to convert securities into another form or class of security of another type. But in contrast to the Banking (Special Provisions) Act 2008 (which is no longer in force for future bank resolutions), section 19 does not allow the authorities to alter a class of securities by simply modifying specific terms of securities. The authorities will use the powers available in the Banking Act as appropriate in the particular circumstances of the case in order to achieve the special resolution objectives.

6.28 Where the property rights of third parties are affected by provisions of a transfer instrument or order to the extent that it appears to the Treasury that those parties have suffered compensatable interferences in their property rights, the Treasury will make provision in a third party compensation order for compensation to be assessed.

Termination rights and events of default

6.29 Section 38 allows the Bank of England (or HMT in the case of an onward property transfer from TPO) to make provision for a transfer to be disregarded for the purposes of determining whether a default event right applies. Section 22 makes similar provision in the case of the share transfer powers. A transfer of property or shares under the Banking Act powers could result in the triggering of an event of default (for example, change of control of the bank), allowing counterparties to exercise termination rights. The purpose of the power is therefore to ensure that the effectiveness of a transfer of a bank’s business is not undermined through the termination of key contracts.

6.30 The provisions do not prevent the operation of default clauses generally, for example related to assets or solvency: rather, they prevent the making of the order or instrument and its operation from being a specified event which could enable a counterparty to exercise their default event rights.

Uses of section 22 and section 38

6.31 The purpose of the powers is therefore to ensure that the effectiveness of a transfer of a bank's business or shares is not undermined through termination of key contracts. Examples of how the power could be used are:

- to ensure operational continuity. For example, termination of IT and service contracts could make it very difficult for the transferee to take on and manage effectively business transferred from the failed bank: contracts may need to be renegotiated, potentially with new counterparties, with no guarantee that similar terms could be arranged; replacing a supplier may be impracticable or ineffective.
- to maintain financing arrangements. For example, to facilitate a transfer to a private sector purchaser it might be desirable to keep financing contracts current so the purchaser could be certain as to which assets and liabilities are being transferred. In this scenario, balancing the special resolution objectives will include considering the right of the finance provider not to be locked into facilities with a new counterparty to whom they may not wish to lend (for example, because of risk concentration concerns).

Limitations

6.32 Sections 22(5) to (8) and 38(5) to (8) can be used to ensure that the effect of a property transfer instrument is not undermined by activation (automatic or otherwise) of a default event provision. However, use of section 22 or 38 must be appropriate given the specific conditions that necessitate the use of a stabilisation option and having regard to the balancing of the special resolution objectives (in particular, regard for financial stability and for Convention rights under Objectives 1 and 5); and it must be justifiable in accordance with the principles of administrative law.

6.33 The provisions of sections 22 and 38 cannot be used to override financial collateral agreements, which are protected by the Financial Collateral Arrangements Directive, and which in broad terms must be allowed to take effect in accordance with their terms.

6.34 These criteria place a material restriction on the use of section 38 and section 22 and will require the Bank or HMT to balance the risks of allowing counterparties to retain the power to terminate contracts against the extent of the potential interference with contractual rights and the stability implications on markets if this power is used in a certain way. It is possible to conceive circumstances in which it would be reasonable to apply the section 22 or 38 power to contracts to which the bank is not itself a party, for example a contract between a supplier of IT services and intermediary dealing directly with the bank itself. Equally, it is possible to conceive of contracts which would be unlikely to meet this legal test, for example if the power were applied to the terms of credit default swaps to which the failed bank is not party but is the reference entity.

6.35 The Bank of England and the Treasury will have regard to ensuring that transfer instruments and orders only disapply events of default to the extent necessary for the purposes of addressing the threats to the public interests which are posed by the failing institution, having regard to the special resolution objectives.

The effect of a property transfer instrument on property held on trust

6.36 Section 34 provides that a transfer of property, rights and liabilities by property transfer instrument takes place by virtue of the instrument, and that such a transfer takes effect regardless of any restrictions. Under section 34(7) a property transfer instrument may make provision about property held on trust.

6.37 However, the Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 makes express in respect of section 34(7) that a relevant partial transfer may only remove or alter the terms of a trust to the extent necessary or expedient to transfer the legal or beneficial interest of the banking institution in the property held on trust to the transferee or to transfer any powers, rights or obligations of the banking institution in respect of the property held on trust.

6.38 The authorities will act consistently with this limitation where a property transfer instrument is used to transfer all (rather than part) of the property of a failing bank: the powers under section 34(7) will not be used except to the extent necessary to facilitate the transfer of property held on trust, any trust property held by the bank to the custody of the new trustee, and where relevant, the bank's role as trustee in respect of any property; and the authorities will also take steps to ensure, wherever possible that all property held subject to any particular trust will be transferred together.

7

Partial transfers and safeguards

Partial transfers

7.1 The property transfer powers (sections 33-48) provide the flexibility to transfer just some, but not necessarily all, of the property of a failing institution. The Bank of England (or following temporary public ownership, the Treasury) will exercise the power to effect a partial transfer when they believe that this approach will best meet the special resolution objectives.

7.2 The most likely use for this power is to transfer the 'good' part of an institution's business to a new entity – either a private sector purchaser or a bridge bank – with a 'residual bank' left behind, containing any assets and liabilities that are not transferred.

7.3 It is also possible to exercise the power to move certain liabilities and 'bad' assets to a bridge bank leaving the residual company solvent.

7.4 The authorities recognise the significant potential for partial property transfers to interfere with vital market interests including set-off and netting arrangements and security interests. The Act provides that limits may be placed on the ability of the Bank of England or the Treasury to make partial property transfers. Such limits are set out in secondary legislation, as set out in Chapter 7 of this Code.

Bank administration procedure

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

7.6 Therefore, the Act provides that the Bank of England may make an application to the court for a bank administration order.

7.7 The bank administration procedure is a new insolvency procedure created to deal with an insolvent residual bank following a partial transfer. It is largely based on existing insolvency provisions, specifically the administration procedure as set out in Schedule B1 to the Insolvency Act 1986. It is designed to ensure that any essential services and facilities that cannot be immediately transferred to a bridge bank or private sector purchaser will continue to be provided, for a period of time.

7.8 The bank administration procedure imposes on the bank administrator an objective to ensure the supply of essential services and facilities to the transferee. To this end, the bank administrator will have unique statutory objectives: firstly, to provide support to a private sector purchaser or bridge bank in relation to the transferred business; and secondly to rescue the residual bank as a going concern or wind up its affairs in the best interests of creditors.

7.9 By obliging the residual bank to continue to provide services to the transferee, the bank administration procedure is intended to increase the likelihood of a successful resolution of a failing banking institution's business.

7.10 Once the Bank of England considers that it is no longer necessary for the residual bank to continue to provide support services, the procedure will continue in a similar way to an ordinary administration although to keep down costs, maximise returns to creditors, and to protect the interests of creditors by providing for a full-range range of outcomes, some of the existing powers of a liquidator have been built in to the procedure.

Safeguards for partial property transfers

7.11 Partial property transfers under the Act are subject to restrictions imposed by secondary legislation that certain types of contractual arrangement are adequately protected, thereby mitigating any negative market consequences to banking institution creditors and counterparties. These legislative safeguards are intended to continue to allow the flexibility to execute a bank partial transfer where necessary. The Treasury will keep the safeguards under review.

7.12 The safeguards for partial property transfers are set out in The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (referred to as the 'Safeguards Order'), The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 and The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009.

7.13 The Safeguards Order is kept under review by the authorities, in particular where specific concerns may arise that an activity analogous to those otherwise protected by explicit safeguards itself falls outside the safeguard order.

Safeguard for set-off and netting arrangements

7.14 The Safeguards Order provides broad protection for set-off and netting arrangements, ensuring that property included under a counterparty's set-off and netting arrangement with a bank may not be "split up" through the exercise of a property partial transfer. However, in order to allow the flexibility to carry out partial transfers in the interests of financial stability and depositor protection, the Order features a number of carve outs from this protection ('excluded rights' and "excluded liabilities"). These include excluded rights and liabilities in connection with:

- deposits held in a class or brand of account mainly used or marketed to depositors eligible for compensation under the Financial Services Compensation Scheme ("FSCS"); (this includes most individuals and some small businesses); and
- subordinated debt issued by the failing bank or the failing bank's counterparty.

7.15 In addition, the Order provides that where a transfer order or instrument has purported to respect the safeguard for netting and set-off, the fact that some of the property being transferred is foreign property, and so may not have been effectively transferred, does not give rise to a breach of the safeguard.

Protection for secured liabilities

7.16 This safeguard protects financial collateral and other secured arrangements to which the bank in SRR is party. It provides that where the bank or its counterparty has a security interest over an asset securing a liability owed to it by the other party, the charged asset may not be "split up" from this liability under a partial transfer. In this way, counterparties can continue to be confident that they will be able to have recourse to collateral assets over which they have taken security.

Protection for structured finance arrangements

7.17 There is a safeguard for financial arrangements broadly covered by the term “structured finance”. These arrangements are referred to in the order as “capital markets arrangements” and refer to, for example, covered bonds, and securitisation vehicles. The safeguard provides that partial property transfers may not interfere in the operation of such arrangements to which a bank is party by transferring some, but not all, of the relevant property, rights or liabilities.

Targeted protections for termination rights under financial contracts (that are relevant for set-off and netting)

7.18 The safeguards provide certainty for counterparties that a partial property transfer will not prevent them from calling events of default in relation to specified financial instruments, or set-off, netting or title transfer financial collateral arrangements.

Protection for default rules of clearing houses and investment exchanges and market contracts

7.19 The safeguards protect the operations of important central market counterparties, such as clearers and settlement houses, from possible disruption under a partial property transfer. For example, clearing house “default rules”, which are given legal force by Part VII of the Companies Act 1989, are given explicit protection.

Restrictions on reverse partial transfers

7.20 The Act allows for the use of transfer powers to transfer property, rights and liabilities from certain entities (including a bridge bank) back to the residual bank. However, the safeguards prevent the Bank of England or the Treasury from transferring back certain types of property, rights and liabilities. Broadly speaking, the restriction applies to property, rights and liabilities acquired or created by the transferee after the transfer, assets that subsequently become liabilities and financial instruments, loans and deposits. This safeguard is provided to ensure that those transferred to the new company can have confidence in their position.

Community law

7.21 The Safeguards Order sets out some specific protections, which are outlined in this section. In addition to this, the safeguards include an express bar on action in contravention of Community law.

7.22 In keeping the effectiveness of the safeguards order under review, the authorities have regard to the fact that certain protections provided by the order may depend solely on the application of the bar on action in contravention of Community law. Where specific and significant areas of legal uncertainty are identified arising from the absence of an express provision in the Safeguards Order, the Treasury will consider whether it would be more appropriate to provide a tailored safeguard which specifically protects the activity.

Continuity obligations

7.23 The safeguards include a prohibition on use of the powers to provide for continuity of intra-group services and facilities in a way that would contravene the key safeguards provided for in the Safeguards Order.

'No creditor worse off' provisions

7.24 The safeguards include a requirement to establish third party compensation arrangements with regard to ensuring that no pre-transfer creditor is worse off than they would have been had the institution gone into insolvency.

7.25 The 'no creditor worse off' provisions are established by regulations made under section 60 of the Banking Act 2009, and are kept under review by the authorities. The Regulations provide that where there has been a partial transfer, the compensation scheme order or resolution fund order must include a third party compensation order, which

- must provide for the appointment of an independent valuer;
- must provide for the valuer to assess the treatment that the pre-transfer creditors of the failing bank, that was subject to a partial transfer, would have received had the transfer powers not been exercised and the whole bank been put into insolvency (the "insolvency treatment");
- must provide for the valuer to assess the treatment which such creditors have received, are receiving or are likely to receive if no compensation (or further compensation) is paid (the "actual treatment").

7.26 If the independent valuer determines that there is a difference between the insolvency treatment and the actual treatment and a creditor in such a situation had been made worse off than they would have been had the bank entered insolvency, the valuer must consider whether compensation should be paid to that creditor and, if so, the amount of compensation payable. In assessing the amount of any compensation the valuer would be obliged to follow the mandatory principles specified in the regulations. These include the principle that no financial assistance would have been provided to the bank by the Bank of England or the Treasury after the time at which the transfer took effect. In addition, other valuation principles may be specified by the Treasury in the third party compensation order in accordance with regulation 10 of the regulations referred to in paragraph 7.25. Such principles may include a requirement for the valuer to assume that certain property would have been sold for a specified price.

7.27 Further detail about the compensation provisions is set out in detail in Chapter 10.

Remedies for breaches

7.28 Remedies in the event of a breach of a safeguard are set out in the secondary legislation. The authorities are under a statutory duty to comply with the safeguards, and this duty is unaffected by the existence of such remedies. The remedy provisions exist to provide certainty to the market as to the outcome should the safeguards be inadvertently contravened.

7.29 The authorities consider that the provision of certainty is relevant to achievement of special resolution objectives 1, 2 and 5. And further, the authorities will necessarily have regard to restrictions and conventions of public law, in particular the requirement on Government of respect for the rule of law and legal certainty.

7.30 The remedies apply where any person considers that a partial property transfer has been made in contravention of any provision of this Order and that as a result his property, rights or liabilities have been affected. The authorities will require parties who believe that the Order has been contravened to provide a notification:

- specifying the provision of this Order which is alleged to have been contravened and the manner in which that contravention has occurred;

- identifying the property, rights or liabilities to which the alleged contravention relates; and
- providing other such information as the relevant authority may reasonably require. In particular, this is likely to include information how a party's property, rights or liabilities have been affected by the contravention.

7.31 If the relevant authority considers that the matters raised in the notice are of such complexity that it is impracticable to take a decision about the remedy for the breach within 60 days of receipt of the notice, the relevant authority may extend the period by no more than a further 60 days. In such cases the relevant authority must inform the party of the duration of the extension, within 60 days of receipt of the notice. In practice, the timetable will be dependent on the complexity of the resolution.

7.32 The authorities will make use of all regulatory and supervisory information available to them to avoid breaching the safeguards order, including any relevant information available in the failed firm's recovery and resolution plan.

8

Governance arrangements for bridge banks

8.1 Bridge banks are defined in section 12 of the Act.

Bridge bank objectives

8.2 A bridge bank is intended to be a short-term operation, until appropriate private sector solutions can be arranged and implemented.

8.3 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.

8.4 Insofar as the pursuance of that objective is not compromised, the Bank of England 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).

8.5 It may also not be appropriate in circumstances where only a small part of the failed bank's business has been transferred to the bridge bank. Paragraphs 8.13-8.17 of this Code provide further guidance on this point.

8.6 In some circumstances, it may not be feasible for some or all of a bridge bank's business to be transferred to a private sector purchaser (for example, in a case where bad assets have been transferred to a bridge bank). 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.

8.7 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.

Contents of property transfer instruments

8.8 Section 33 of the Act describes the provisions that 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. Section 33(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."

8.9 Where it is envisaged that the bridge bank will be in operation for a period in which longer-term operational management decisions will need to be taken, the Treasury are likely to impose a management duty on the Bank including a requirement to minimise costs.

8.10 The Bank of England shall take steps to specify appropriately in the given circumstances which property, rights and liabilities of a failing banking institution have been transferred.

8.11 Once a property transfer instrument is made, the Treasury shall lay a copy in the Houses of Parliament.

Establishment

8.12 The Bank of England shall establish or acquire an incorporated company to which property, rights and liabilities will be transferred. The Bank will work with the FSA to arrange appropriate authorisations where necessary to carry on the relevant regulated activities. The company will need to comply with authorisation requirements on an ongoing basis and will be subject to FSA supervision.

Nature of the shareholder relationship

8.13 A bridge bank when it is established or acquired will be a company limited by shares that is wholly owned by the Bank of England.

8.14 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, a bridge bank might go through a number of phases, and the key phases include:

- the stabilisation phase, immediately following the transfer; and
- the sale / purchase phase, where the Bank manages the bridge bank on a conservative basis while working with one or more private sector purchaser to transfer the business.

8.15 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.

8.16 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.

8.17 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 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

8.18 The articles of association of a bridge bank will provide for the company regulations governing the relationship between the Bank of England (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

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

8.20 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.

8.21 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, and having regard to relevant regulation and legislation.

8.22 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 of England.

8.23 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

8.24 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, and provide continuity of banking services.

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

8.26 In its role as shareholder, the Bank of England shall work with the board of directors to decide on how the bridge bank should be operated. A business plan will be required for authorisation purposes. 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 of England, who shall ensure that it meets the Bank of England'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

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

- the provision of section 80(1) of the Act (a "bridge bank report");
- the provision of section 80(5) of the Act (a "specific report"); and
- any other reports as agreed between the directors of the bridge bank and the Bank of England.

Bridge bank report

8.28 Under section 80 of the Banking Act 2009, the Bank is required to report to the Chancellor about the activities of the bridge bank and under section 80(2) is required to submit the first report as soon as is reasonably practicable after the period of one year from the date of the first transfer to the bridge bank. This obligation to produce a report exists whether or not the bridge bank exists for a whole year. As soon as a section 80(2) report is submitted, the Chancellor must lay the report in Parliament.

8.29 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 that the bridge bank is in existence. Such reports shall include:

- the management accounts of the bridge bank;
- a report on the activities of the bridge bank over the year;

- a report on the costs of advisers engaged by the bridge bank; and
- how the Bank of England is intending to achieve the bridge bank objectives.

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

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

Specific report

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

Other reports

8.33 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 of England 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 of England shall make arrangements to provide for regulatory reporting appropriate to the activities undertaken by the bridge bank.

8.34 Whilst there will be a presumption towards applying the same requirements as another bank of that type and size when determining these arrangements, the Bank of England will take into account the size and nature of the bridge bank's activities, the risk of competitive distortions, the length of time since creation, the foreseeable life of the bridge bank, and the need for information for financial stability purposes. The decision to remove reporting requirements will be kept under review and is likely to be driven by particular events and apply for a finite period.

Disposal and onward transfer

8.35 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 as soon as possible after the initial transfer of property to a bridge bank.

8.36 In each case, the Bank of England 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 of England shall take account of the special resolution objectives (section 4 of the Act). It shall also work with the FSA to ensure that the acquiring party is suitable for taking on the bridge bank's business.

8.37 Following this process, the Bank of England 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 FSMA) or by exercising the onward transfer powers provided in the Act, either by making a bridge bank share transfer instrument (section 28) or an onward property transfer instrument (section 40).

8.38 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 12). However, this would only occur if it best met the bridge bank objectives.

9

Governance arrangements for institutions in temporary public ownership

9.1 Temporary public ownership is described in section 13 of the Act.

Temporary public ownership objectives

9.2 The objectives of an institution in temporary public ownership will reflect the special resolution objectives. Where possible, the intention shall be to return the business of the bank to the private sector in a manner that maintains financial stability and protects depositors and the taxpayer while acting in a way that promotes competition.

Contents of share transfer orders

9.3 Section 16 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.

9.4 The Treasury shall take steps to specify appropriately which securities of a failing institution have been transferred.

The nature of institutions in temporary public ownership

9.5 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.

9.6 Provision will be made as to the relationship between the Treasury (in its capacity as shareholder) and the directors of the company. As shareholder, the Treasury will have the power to exercise normal shareholder rights.

9.7 Immediately following the transfer of securities and for the initial 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. If a bank is likely to remain in public ownership for longer than a short period (to be determined on a case by case basis), the Treasury shall set out for the directors objectives as to 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.

9.8 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.

9.9 This business plan shall be presented to the Treasury, who shall ensure that it meets the Treasury's objectives for the banking institution.

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

9.11 In many cases, it will be appropriate for the Treasury to develop and implement an investment strategy for disposing of the investments in an orderly way.

9.12 Insofar as the banking institution carries on relevant regulated activities, the FSA shall continue to authorise and regulate it where appropriate.

Arm's length management of institutions in temporary public ownership

9.13 In circumstances where an institution is likely to remain in public ownership for longer than a short period, the Treasury may seek to put in place arrangements to operate the bank at arm's length, for example through UK Financial Investments Limited (UKFI), which is an arm's length company wholly owned by the Government.¹

9.14 The UKFI Investment Mandate, available from the UKFI website, describes

- the scope of UKFI's decision-making responsibilities with respect to its management of the Investments, the Loan Arrangements and the Guarantee Arrangements;
- the extent to which decision-making requires the prior approval of HM Treasury before being taken or implemented; and
- the anticipated dialogue between UKFI and HM Treasury in relation to UKFI's 1.1 responsibilities under this Investment Mandate.

9.15 In such circumstances, the Treasury may set out objectives for UKFI's directors as to how the Government's holdings should be managed. It is likely that these objectives would include protecting and creating value with due regard to the special resolution objectives. The Treasury shall also take steps to ensure that the bank is operated in a manner that does not distort competition.

Disposal of institutions in temporary public ownership

9.16 Sale of the institution in temporary public ownership may be carried out through normal commercial means, or existing statutory mechanisms. However, the Treasury may alternatively make an onward share transfer, by order (under section 28), or onward property transfer, by order (under section 45). These may be more expeditious and therefore command more confidence than a transfer through existing commercial or statutory processes. The powers to make such orders provide for swift and effective transfer to a private sector purchaser, maximising the commercial opportunities and minimising risks to the purchaser.

9.17 Where an institution in temporary public ownership is being managed at arm's length by a separate body, it will be the responsibility of the arm's-length body, with appropriate consultation with the Treasury, to develop and execute an investment strategy for disposing of the investments in an orderly and active way.

¹ Further information is available from the UKFI website (www.ukfi.gov.uk)

Reporting

9.18 The Treasury shall make arrangements to ensure that a bank in temporary public ownership reports on a similar basis to other commercial banks. This includes regulatory reporting appropriate to the activities undertaken by the bank. In addition section 81 of the Act requires the Chancellor of the Exchequer to report to Parliament on an annual basis about the activities of a bank in temporary public ownership.

10

Financial Services Compensation Scheme

10.1 The Financial Services Compensation Scheme (FSCS) is the scheme established by the Financial Services Authority (FSA) to compensate customers of authorised financial services firms when those firms are in default (i.e. unable, or likely to be unable, to satisfy claims against them).

Role of the FSCS in the bank insolvency procedure (BIP) and building society insolvency procedure (BSIP)

10.2 The BIP provides for the orderly winding up of a failed bank and to facilitate rapid FSCS payments to eligible claimants or a transfer of such accounts to another financial institution. The BSIP makes similar provision for building societies.

10.3 The bank liquidator or building society liquidator will have specific statutory objectives:

- to work with the FSCS to enable prompt payouts to eligible depositors or to facilitate the bulk transfer of accounts to another institution; and
- to wind up the affairs of the failed bank in the interests of creditors as a whole.

10.4 The authorities are committed to making changes to the UK deposit guarantee scheme to provide eligible depositors¹ with access to at least a material proportion of their funds within a target of seven days, with any balance payable within the following few days. The authorities and the FSCS will have a key role in the early stages of the proceedings to oversee and work with the bank liquidator to ensure that this objective can be met.

10.5 Section 102 of the Act provides that the initial liquidation committee (made up of the Bank of England, the FSA and the FSCS) must advise the bank liquidator as to whether to pursue a bulk transfer of accounts or to work with the FSCS to enable prompt payments to eligible depositors. Section 123 makes provision for the funding of compensation payments to eligible depositors or a transfer of accounts by the FSCS, requires the bank liquidator to provide information to the FSCS and allows the FSCS to participate in court proceedings relating to a bank insolvency order.

FSCS contribution to SRR costs

10.6 Sections 214B, 214C and 214D of the Financial Services and Markets Act 2000 allow the Treasury to require the FSCS to contribute to the cost of using the special resolution regime to resolve a failing bank or building society. This contribution is limited to the amount that the FSCS would have had to pay out if it had instead gone into default without any Government intervention, less any recoveries that the FSCS would have made from the insolvency of the failed bank. Such amount will include the costs that would have been incurred in funding a pay-out.

¹ Subject to some exceptions, for example beneficiary accounts, dormant accounts, accounts in legal dispute and accounts subject to international sanctions

10.7 Costs that have been incurred by the authorities in the resolution (including cost of funding) can be charged to the FSCS. The legislation provides for the net costs of the resolution to be independently verified.

10.8 The FSCS contribution to SRR costs is capped at the amount that would have been paid had the failed firm had gone into insolvency, and industry will have to pay out no more than it would have had to pay if the Government had not intervened. The legislation provides for the appointment of a valuer to calculate the amounts the FSCS would recover from the bank under a hypothetical insolvency and ensures that the cap on the FSCS's contribution is reduced to reflect this calculated recovery.

10.9 Whilst the authorities do not have a specific objective to minimise costs charged to the FSCS, it should be noted that the FSCS is, in any event, protected by the cap on its contributions which ensures that the industry will have to contribute no more than it would have had to pay if the Government had not intervened. Furthermore, the statutory requirement on the authorities to have regard to protecting public funds is likely to result in the authorities sharing the FSCS's interest in maximising recoveries for creditors of an insolvent bank. The authorities are accountable through Parliament to the wider public for the way that they have gone about achieving the special resolution objectives.

11

Compensation

11.1 Sections 49-62 of the Act make provision for the compensation measures that must or may be put in place by the Treasury following an exercise of the stabilisation powers. Provision is made for three types of orders: compensation scheme orders, resolution fund orders and third party compensation orders.

11.2 These measures are designed to ensure that appropriate provision for compensation is made to secure the compatibility of the actions of the authorities under the SRR with Article 1 Protocol 1 of the European Convention on Human Rights ("A1P1"). A1P1 provides that the right of a person (such as a bank or a shareholder) to the peaceful enjoyment of his own property should only be interfered with where that interference is proportionate and a balance is struck between wider public interests and the protection of a person's interests in his property. In order to strike a balance between public and private interests where property has been transferred compulsorily (for example, as a result of an exercise of the share transfer powers) it is appropriate to make provision for compensation to be paid which is normally required to be an amount reasonably related to the market value of the property in question.

11.3 In addition, in the case of partial property transfers, further measures have been put in place to ensure that pre-transfer creditors of a bank are left in no worse position as a result of the exercise of the transfer powers than they would have been in had the powers not been exercised and the bank had gone into insolvency. The safeguards for creditors and counterparties have been put in place in response to the concerns of industry that partial property transfers may prejudice their rights and interests.

Nature of the compensation measures to be put in place following an exercise of the stabilisation options

11.4 Where the Bank of England has effected a transfer of shares or business to a private sector purchaser in accordance with section 11(2) of the Act, the Treasury must make a compensation scheme order (section 50(2)). In the case of a transfer of business to a bridge bank the Treasury must make a resolution fund order (section 52(2)).

11.5 Where the Treasury has transferred a failing bank into temporary public ownership, the Treasury may make either a compensation scheme order or a resolution fund order (section 51(2)).

11.6 In addition, where any of the stabilisation options have been effected the Treasury may make a third party compensation order which establishes a scheme for paying compensation to third parties (persons who are not transferors). Where a partial property transfer has been effected the Treasury must make a third party compensation order in accordance with the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 (S.I. 2009/319).

Compensation scheme orders

11.7 A compensation scheme order may either:

- deem an amount of compensation to be payable to the transferors (i.e. the persons whose shares have been transferred, or in the case of a property transfer, the failing bank), or
- establish a scheme for assessing the compensation, if any, payable to the transferors.

11.8 Where the Treasury consider that the process for the disposal of the shares or business of a failing bank has established the market value of the shares or business (for example an auction process prior to the transfer), the Treasury is likely to deem any amount paid by the purchaser to be the compensation payable. In these circumstances it would be inappropriate for an independent valuer to be appointed under a compensation scheme order to establish the value of the business or shares because a market process had already done so.

11.9 Alternatively, the Treasury may provide for the appointment of an independent valuer to assess the value of the shares or business immediately before the transfer was effected (see further paragraph 28). Examples of this arrangement exist in relation to Northern Rock plc and Bradford & Bingley plc, the shares of which were transferred into temporary public ownership by the Treasury in exercise of powers conferred on the Treasury by the Act's predecessor, the Banking (Special Provisions) Act 2008 (see the Northern Rock plc Compensation Scheme Order 2008 (S.I. 2008/718) and the Bradford & Bingley plc Compensation Scheme Order 2008 (S.I. 2008/3249)).

Resolution fund orders

11.10 Rather than providing for the appointment of an independent valuer to assess any compensation payable following an exercise of the stabilisation powers, a resolution fund order provides for the transferors (the residual of the failing bank in the case of property transfers or the shareholders in the event of a share transfer) to receive a contingent economic interest in the proceeds of resolution in specified circumstances and to a specified extent.

Bridge banks

11.11 Where some or all of the business of a failing bank has been transferred to a bridge bank the resolution fund arrangements provide that the residual of the failing bank is to receive the proceeds achieved from the sale or disposal of that business. As the residual bank is likely to be in an insolvency procedure, the net proceeds of the resolution will constitute an asset of the insolvency estate to be applied for the benefit of creditors in accordance with normal insolvency priorities.

11.12 A resolution fund order has been made following the transfer of some of Dunfermline Building Society's business to a bridge bank discussed in the case study below.

Temporary public ownership

11.13 Where a failing bank has been transferred into temporary public ownership, a bank resolution fund order will provide for the former shareholders to receive any proceeds of the resolution of the bank in temporary public ownership, for example, any consideration paid by a private sector purchaser to acquire the shares from the Treasury.

11.14 However, it may not be appropriate for the Treasury to put in place a bank resolution fund order in relation to a failing bank that has received a significant amount of public financial assistance or where it is anticipated that the Treasury will be unable to make disposals for some time following the initial transfer. In such circumstances, the Treasury would make a compensation scheme order.

Costs of resolution

11.15 The proceeds of resolution may be calculated net of any resolution costs. For example, such costs could include the costs of financial assistance – including loans or guarantees provided from or backed by public funds during the course of the resolution. This is to ensure that the taxpayer receives a suitable return for public funds that have been invested or put at risk in the bank during the course of the resolution. “Costs” may also include administrative costs such as advisers fees incurred in relation to, or in consequence of, the transfer of the shares or business and the incorporation or authorisation of a bridge bank.

11.16 The authorities do not intend to profit from a resolution of a failing firm. Typically, Compensation Scheme Orders, Resolution Fund Orders and Third Party Compensation Order will specify:

- Treasury’s right to retain discretion over payments made to the Bank of England and the Treasury from the bank resolution fund. Where the Treasury determines that costs may be deducted from the fund, an independent person will be required to certify that the costs have been reasonably incurred by the authorities;
- that costs which may be deducted from the fund relate only to certain costs incurred in connection with the bridge bank and not to other costs incurred in connection with a resolution; and
- that an independent valuer must be appointed to certify that any costs to be deducted from the fund are certified as having been reasonably and properly incurred by the authorities.

11.17 The resolution fund order may also include provision for the determination of any disputes about the application of its provisions.

Management duties

11.18 The Treasury may specify in a resolution fund order that the resolution authority, the Bank of England or the Treasury, is required to maximise the proceeds available for distribution (a “management duty”). However, the management duty must be complied with only in so far as compatible with the pursuit of the special resolution objectives (section 4), and compliance with the Code of Practice under section 5.

11.19 It is likely that a duty will be imposed in cases where it is anticipated that a bridge bank or a bank in temporary public ownership will be under the control of the relevant authority for a period of time in which longer-term operational management decisions will need to be taken.

Third party compensation orders

11.20 The Treasury has the discretion to provide for a third party compensation order in a compensation scheme order or a resolution fund order (sections 51(3) and (4)) to make provision for the assessment of any compensation payable to persons other than transferors, such a commercial counterparts of a bank.

11.21 Generally the order will provide for the appointment of an independent valuer to assess the compensation, if any, payable to certain parties whose property rights have been affected by virtue of provision made in a transfer instrument or order, for example, those parties whose termination rights are modified by virtue of the application of sections 22 or 38 of the Act (see the case study below for a brief discussion of the way an independent valuer may approach this task).

Third party compensation scheme orders in the case of partial property transfers- the “No creditor worse off safeguard”

11.22 Where a partial property transfer is effected the Treasury must make provision for a third party compensation order in accordance with the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 (S.I. 2009/319), which establish the “no creditor worse off” safeguard to compensate pre-transfer creditors of a bank (defined in section 60(3)(b) of the Act). This measure is intended to reassure commercial counterparties of a bank who are creditors that their position (as compared to that on the insolvency of the whole bank had the authorities not effected a transfer) will not be seriously prejudiced as a result of the transfers of property from the residual bank. This measure applies to all pre-transfer creditors whether or not left behind in a residual bank.

11.23 The safeguard provides that, in the event of a partial transfer, the Treasury must make provision for an independent valuer to be appointed to assess the treatment the pre-transfer creditors would have received had the bank entered into insolvency immediately before the transfer was effected (“the insolvency treatment”) and to compare this with the treatment the creditors have received as a result of the transfer (“the actual treatment”). The insolvency treatment is calculated on a counter-factual basis, with an independent valuer modelling what would have happened had the transfer not been made in accordance with any principles specified by the Treasury in the third party compensation order. Compensation must then be paid to pre-transfer creditors (or to persons to whom these claims have been assigned) to the extent that the actual treatment is worse than the insolvency treatment.

11.24 The independent valuer may also require the Treasury to pay interim compensation before the actual treatment has been finally established (for example the winding up of a residual company may take a long period of time so it may not be possible for the actual treatment of a creditors to be established for several years after a transfer is effected) where appropriate having regard to the merits of ensuring that the creditor receives compensation in a timely manner. A more detailed discussion of the third party compensation arrangements is set out in the case study below.

Onward and reverse transfers

11.25 Where the Treasury or the Bank of England exercise onward and reverse transfer powers, the Treasury may make compensation scheme or resolution fund orders (section 53(2)).

Independent valuer

11.26 A compensation scheme, resolution fund or third party compensation order may provide for an independent valuer to be appointed to perform certain functions. Sections 54 to 56 make provision for safeguarding the independence of the valuer. For example:

- The valuer must be appointed by a person appointed by the Treasury. This person may be an individual or a panel of persons selected by the Treasury. In previous resolutions, a panel has been appointed to select the independent valuer from any applications received following the publication of an invitation for applicants on the Treasury’s website. A number of criteria will be relevant for an applicant to be considered for appointment as valuer, including the ability to demonstrate independence from Government and interested parties, freedom from conflicts of interest, professional skills and experience, particularly in relation to the valuation of complex companies, ability to carry out a high profile public process and also value for money.

- A monitor must be appointed to oversee the operation of the arrangements from remuneration and payment of allowances for independent valuers.
- The valuer may only be removed from office by a person appointed by the Treasury on the grounds of incapacity or serious misconduct.

11.27 To ensure that independent valuers have the power necessary to obtain all information reasonably required to conduct his or her functions, the Treasury can confer a power on valuer to apply to the court for an order requesting any information reasonably required for those purposes to be supplied to the independent valuer.

Appeals against determinations of the independent valuer

11.28 An independent valuer will be required to set out his or her determinations as to the compensation, if any, payable in assessment notices.

11.29 Consistent with provision made for the independent valuers appointed for the purposes of the Northern Rock plc, Bradford and Bingley plc and Dunfermline Building Society compensation arrangements, we envisage the following provisions would be made in exercise of the power conferred by section 55(6):

- a. The Treasury or any person affected by a determination of the independent valuer set out in an assessment notice would be able to require the independent valuer to reconsider his or her determination and must set out his or her revised determination in an a revised assessment notice.
- b. If the Treasury or any person affected by a determination set out in a revised assessment notice are dissatisfied with the determination, they may refer the matter to the Tribunal and the Tribunal may remit the matter to the independent valuer for further consideration.

Valuation principles

11.30 Where the Treasury provide for an independent valuer to be appointed, they may specify the valuation principles to be applied by the valuer in determining the amount of compensation payable (section 57). These may require, for example, the valuer to apply or not to apply specified methods of valuation, assess values or average values, take specified matters into account. Valuation principles may also require or permit the valuer to make certain assumptions, for example, that the banks has had a permission under Part 4 of the Financial Services and Markets Act 2000 varied or cancelled and that it is unable to continue as a going concern, is in administration or is being wound up. The Treasury will consider whether to specify these assumptions on a case-by-case basis.

11.31 However, in determining any amount of compensation payable an independent valuer must disregard financial assistance that was, or could have been, provided by the Bank of England or the Treasury (disregarding ordinary market operations offered by the Bank on its usual terms) (section 57(3)). The authorities consider that there are extremely strong public interest justifications for each of these assumptions. For example, it would be entirely inappropriate for the assessment of any compensation payable to former shareholders of a bank that has been transferred into temporary public ownership, to include the value in the distressed bank created by public financial assistance.

Box 11.A: Case study: Dunfermline Building Society

On 30 March 2009, the Bank of England exercised its powers under the Act to transfer some of the property, rights and liabilities (“business”) of Dunfermline Building Society (“Dunfermline”) to:

- Nationwide Building Society; and
- a bridge bank (wholly owned and controlled by the Bank of England).

This action was taken to protect depositors and to safeguard financial stability and the transfers were effected by virtue of the Dunfermline Building Society Property Transfer Instrument (“the Transfer Instrument”). Following these transfers Dunfermline was placed into building society special administration.

The Act required the Treasury to make:

- a compensation scheme order because the Bank of England effected a transfer of Dunfermline’s business to a private sector purchaser (in this case Nationwide) (section 50(2) of the Act);
- a resolution fund order because the Bank of England transferred some of this business to a bridge bank (section 52(2)); and
- a third party compensation as the Bank of England effected two partial property transfers (sections 50(4) and 52(4)).

In accordance with these obligations the Treasury made the Dunfermline Building Society Compensation Scheme, Resolution Fund and Third Party Compensation Order 2009 (S.I. 2009/1800) (“the Compensation Order”), which combined these orders into one instrument, which provides for the appointment of an independent valuer to perform the functions referred to in article 4 of that Order. Detailed provision for the independent valuer is made in the Dunfermline Building Society Independent Valuer Order 2009 (S.I. 2009/1810) (“the Independent Valuer Order”). The Explanatory Memoranda to the Orders provide a detailed explanation of the various provisions of the Orders. However, a general overview is provided below:

Compensation scheme

It was determined that no compensation was payable to Dunfermline in respect of the business assets and liabilities transferred to Nationwide as the Treasury was satisfied that the auction process put in place by the Bank of England effectively established the market price.

Resolution fund

As the powers under Part 1 of the Act were exercised for the first time to effect the resolution of Dunfermline, the arrangements put in place in relation to this resolution (see Part 4 of, and Schedule 2 to, the Compensation Order) may be taken as something of a precedent for the way in which the resolution fund arrangements work (although of course the Treasury could exercise their powers under the Act to make such provision as they consider to be appropriate in any subsequent resolutions).

The Treasury is required to establish an account at the Bank of England to be known as the Dunfermline Resolution Account (“the Account”), which is the resolution fund. Although the authorities may have an interest in the monies in the Account for the purposes of recovering any cost incurred in connection with bridge bank aspect of the resolution, it would be inappropriate for the monies in the Account to be treated as public funds as the principal beneficiary is Dunfermline. As such, the Account must be held in the name of an

independent person (“the Account Holder”) appointed by the Treasury (paragraph 1(2) of Schedule 1 to the Order).

The Bank of England (as the owner of the bridge bank and lead resolution authority) must pay monies into the Account in specified circumstance (see paragraph 3 of Schedule 1 to the Order), for example any consideration received following the sale of the shares of the bridge bank or following the sale of the business transferred to the bridge bank.

Payments out of the Account may only be made by the Account Holder on the direction of the Treasury (paragraph 4 of Schedule 1 to the Order) and the Treasury may only direct payments to be made to specified persons. In the case of the Dunfermline resolution, payments to the Bank of England or the Treasury may only be made for the purpose of reimbursing the authorities for certain costs and following certification by an independent valuer that the costs have been reasonably and properly incurred (see paragraphs 5 and 7 of the Schedule).

Third party compensation

Article 9 of the Compensation Order specifies the arrangements to be put in place for the assessment of compensation payable to third parties. The detailed arrangements are set out in Schedule 2 to the Order.

Third parties affected by provisions of the transfer instrument

An independent valuer is required to assess the amount of any compensation payable to third parties whose default event provisions were affected by the application of section 38(6) of the Act. The independent valuer may put in place whatever procedure he or she considers appropriate for the purposes of identifying those parties and for the purposes of assessing the compensation, if any, payable. However, the independent valuer must take into account any diminution in the value of a person’s property or right or any increase in liability on that person.

“No creditor worse off” provisions

Part 3 of the Schedule makes provision for the “no creditor worse off safeguard”. Under these arrangements an independent valuer is required to determine the compensation, if any, payable to the pre-transfer creditors of Dunfermline (defined in section 60(3)(b) of the Act) (article 9(3) of, and Part 3 of Schedule 2 to, the Compensation Order) as discussed in §§23ff. This requires the independent valuer to assess the treatment the pre-transfer creditors would have received had Dunfermline entered into insolvency immediately before the Transfer Instrument was made (“the insolvency treatment”) and to compare this with the treatment the creditors have received (e.g. on being transferred to Nationwide or to the bridge bank, or in special administration of Dunfermline) (“the actual treatment”).

The independent valuer has a discretion to determine that the Treasury must make interim payments to pre-transfer creditors before the determination of the actual treatment of the pre-transfer creditors has been made (paragraph 11 of Schedule 2 to the Compensation Order).

Where the independent valuer has determined that the Treasury must make interim payments, the independent valuer must determine what, if any, balancing payments are required to be paid to ensure that the pre-transfer creditors receive the relevant amount of compensation, if any, assessed to be payable under the “no creditor worse off” arrangements (paragraph 12 of Schedule 2 to the Compensation Order).

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