HM Treasury

Financial Services (Banking Reform) Bill

Government Amendments: Bail-in

Briefing for Peers **October 2013**

Bail-in

The Government agreed with the recommendations of the Independent Commission on Banking and, more recently, the Parliamentary Commission on Banking Standards that bail-in powers should be brought in to enable the authorities to impose losses on a failing bank's creditors. This is an important component in the Government's reforms to tackle the "too big to fail" problem and help ensure that UK taxpayers are not in future required to shoulder the burden of failing banks.

In other industries, when a company fails, it enters insolvency. Its creditors have a claim in that insolvency, and how much they get back is determined by their position in the creditor hierarchy, and the level of losses in the firm (i.e. how much money there is available to share between the creditors).

For large banks, and certain other financial institutions, it is not possible to allow them to fail and enter insolvency. This is because of how interconnected the banking system is (the insolvency of one bank can cause widespread problems in the financial markets) and because of the essential services they provide to a wide range of customers and other industries. Disruption to these services could have serious repercussions for the economy.

In the past, this has meant that when large banks failed, they were bailed out by the taxpayer, often at huge cost. The purpose of the bail-in tool is to offer an alternative to insolvency which will expose creditors to the losses incurred by the bank, while ensuring that the bank can continue to operate and provide essential services to its customers. Moreover, exposing creditors to the costs of failure in this way should sharpen their incentives to curb excessive risk-taking by banks.

Bail-in involves shareholders of a failing bank being divested of their shares, and creditors of the bank having their claims cancelled or reduced to the extent necessary to restore the bank to financial viability. The shares can then be transferred to affected creditors as appropriate by way of a proxy for compensation. Alternatively, where a suitable purchaser is identified, the shares may be transferred to them, with the creditors instead receiving as appropriate compensation in some other form.

This approach will help ensure that creditors of the failed bank, rather than the taxpayer, will meet the costs of failure. Bail-in will also ensure that the failed bank can continue to operate and provide essential services to its customers, by restoring the bank to viability through recapitalising it. This limits disruption to the bank's customers and maintains public confidence in the banking system.

These clauses will introduce a bail-in tool by amending the Banking Act 2009 for the purposes of introducing a new stabilisation option – the bail-in option – which is to be available to the Bank of England as lead resolution authority. The bail-in option will be available in relation to failing banks and investment firms. It will also be available, with any necessary modifications, to building societies using a power to make such modifications as are necessary using secondary legislation. This will also involve commencing the powers in the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (commonly known as the "Butterfill Act") relating to the creditor hierarchy for building societies, in order to bring it into line with that of banks.

The conditions for use of the bail-in option are the same as those for the existing stabilisation options set out in the Special Resolution Regime – firstly, the regulator must determine the bank is failing or likely to fail; secondly, that it is not reasonably likely that any other action can be taken by or in respect of the bank to avoid its failure; and thirdly the Bank of England determines that it is in the public interest to exercise the bail-in power.

The bail-in option includes the power to cancel or modify the terms of contracts (the power to make "special bail-in provision") in a resolution scenario for the purposes of reducing or deferring the liabilities of the bank under resolution. Liabilities can also be converted into different forms; for example a debt instrument may be converted into an equity instrument.

Certain liabilities will be excluded from the scope of the power to make special bail-in provision. The Bank of England will not be able to use this power in relation to:

- deposits covered by the Financial Services Compensation Scheme (FSCS) or an equivalent overseas scheme;
- liabilities to the extent they are secured (i.e. any unsecured portion of a claim against the bank is within the scope of the power to make special bail-in provision unless it falls within the scope of another excluded liability);
- client assets, including client money;
- liabilities with an original maturity of less than seven days which are owed to a credit institution or investment firm (save in relation to credit institutions or investment firms which are banking group companies in relation to the bank);
- liabilities arising from participation in a designated settlement system and owed to such systems, or to operators or participants in such systems;
- liabilities owed to central counterparties recognised by the European Securities and Markets Authority (ESMA) in accordance with Article 25 of Regulation (EU) 648/2012;
- liabilities to employees or former employees in relation to accrued salary or other remuneration (with the exception of variable remuneration);
- liabilities owed to employees or former employees in relation to rights under a pension scheme (with the exception of discretionary benefits); and
- liabilities to a creditor arising from the provision of goods or services (other than financial services) that are critical to the daily functioning of the bank's operations (with the exception of creditors that are companies which are banking group companies in relation to the bank).

These liabilities have generally been excluded either because they would not be exposed to losses in insolvency (for example deposits covered by the FSCS and client assets) or because subjecting these liabilities to special bail-in provision would be likely to destabilise the bank or the wider financial system, and therefore be counter-productive.

With the exception of those creditors whose claims constitute "excluded liabilities", the exercise of powers in the course of a bail-in should in general respect the creditor hierarchy and the principle of equal treatment of equally ranking creditors. Therefore, shareholders should be completely divested of their shareholdings before subordinated creditors are exposed to loss. Senior creditors should only experience losses where the subordinated debt has been exhausted. And creditors in the same class should experience the same level of loss. The Bank of England will have the flexibility to depart from these principles – for example, if it is not possible to bail-in a particular liability within a reasonable timeframe or where there are concerns that bailing in a liability or set of liabilities would have a significant negative impact on financial stability. Wherever the Bank does so, it must explain the reasons for doing so in a report to the Chancellor, which will be laid before Parliament.

Following the exercise of the bail-in option the Treasury is required to put in place compensation arrangements, as is the case for the existing stabilisation options, and regulations will be made making clear that a "no creditor worse off" safeguard is to apply in relation to resolutions using the bail-in tool (i.e. so as to provide that no shareholder or creditor should be left worse off as an exercise of the bail-in powers than they would have been had the stabilisation option not been deployed and the bank had gone into insolvency).

Following a bail-in, it is important that the reasons for the bank's failure are understood, to ensure lessons are learnt. The Bank of England will therefore have the power to require that a business reorganisation plan is drawn up by, or in respect of, the bank. This plan will identify the reasons and factors that led to the failure of the firm, and set out a plan for addressing them.

The Government will be consulting on a number of important issues relating to these new powers – in particular:

- **Extending the powers to building societies:** The bail-in provisions will be applied to building societies with modifications set out in secondary legislation. The Government intends to develop this in parallel to the final stages of the Bill, and will consult with industry on the detail of that order.
- **Updating the Code of Practice:** The Code of Practice under section 5 of the Banking Act 2009 provides guidance as to how and in what circumstances the authorities will use the stabilisation options. It will be updated to reflect the new bail-in option, following a consultation with the Banking Liaison Panel (section 10 of the Banking Act 2009) and taking into account any views raised with us by the wider industry.
- **Safeguards for protecting financial arrangements:** The amendments will give the Treasury the power to make an order restricting the exercise of the bail-in powers in cases involving protected arrangements – i.e. security interests, title transfer collateral arrangements, set-off and netting arrangements (this power is similar to the power in relation to partial property transfers- see section 48 of the Banking Act 2009). The Treasury will be consulting on the matters to include in this important order during the passage of the Bill.
- **"No Creditor Worse Off" regulations**: The amendments will give the Treasury the power to make regulations about compensation arrangements following the use of the bail-in powers. The Treasury will consult on the regulations, and in particular how to reflect the desirability of ensuring that pre-resolution shareholders and creditors do not receive less favourable treatment that they would have had the bank entered into insolvency.

It has long been the Government's intention to introduce bail-in powers. We are introducing the clauses at this stage of the Bill because, at the time of its passage through the Commons, we did not have the necessary clarity about the design of the bail-in tool to be included in the European Directive establishing a framework for the recovery and resolution of credit institutions and investment firms, commonly referred to as the Bank Recovery and

Resolution Directive (BRRD)[1]. The BRRD will introduce bail-in across Europe, and we did not want to introduce a tool domestically that would have been out of step with it. We have played a leading role in developing a credible and effective bail-in regime as part of the BRRD – negotiations have progressed to a sufficiently advanced state that we are confident that we can now bring forward a bail-in tool without risking having to adapt to a radically different regime when the Directive is implemented.

Further Enquiries

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2. For access to publications please go to http://www.gov.uk/government/policies/creating-stronger-and-safer-banks

[1] Further details of the proposal can be found at http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm