HM Treasury

Bank Resolution (Recapitalisation) Bill

Cost-Benefit Analysis

July 2024

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Chapter 1

Bank Resolution (Recapitalisation) Bill: summary

Background

1.1 On 11 January 2024, HM Treasury published a consultation outlining proposals to enhance the Special Resolution Regime for banking institutions – hereafter referred to as the "resolution regime". The government published both a response to that consultation and introduced the Bank Resolution (Recapitalisation) Bill to Parliament alongside publication of this cost-benefit analysis.

1.2 The resolution regime, introduced in the wake of the Global Financial Crisis, provides a number of powers to the Bank of England (the Bank) to manage the failure of financial institutions safely, limiting risks to financial stability, public funds and the economy.

1.3 The government's proposal, as set out in the government's response to the consultation and in the Bank Resolution (Recapitalisation) Bill, is primarily designed to provide the Bank, as the UK's resolution authority, with more flexibility in how it manages the failure of small banks.[1] Whilst these institutions would normally be expected to be placed into insolvency when they fail, the period of banking stress in Spring 2023, and in particular the failure of Silicon Valley Bank (SVB), demonstrated that it may sometimes be in the public interest to use the Bank's resolution powers to manage the failure of a small bank. Resolution action can carry risks to public funds, since these banks – unlike larger institutions – are not required to hold a portion of their own equity and debt above minimum capital requirements to support their resolution.

1.4 This proposal therefore intends to enhance the Bank's powers to deal with a situation where resolution of a small bank is justified in the public interest in a way that limits the risks to public funds. To achieve this, the Bank Resolution (Recapitalisation) Bill amends the Financial

[1] For the purposes of this cost-benefit analysis, the phrase "small banks" or "smaller banks" refers to the population of banks and building societies which are not required to hold a portion of equity and debt (known as the Minimum Requirement for Own Funds and Eligible Liabilities (MREL)) above minimum capital requirements. Noting that the expectation is that the mechanism would generally be used to support the resolution of small banks, the government considers it appropriate for the mechanism to be, in principle, applicable to any banking institution within scope of the resolution regime.

Services and Markets Act 2000 to allow funds sourced from the banking sector to be provided by the Financial Services Compensation Scheme (FSCS) to the Bank of England upon request. The funds would be able to be used when the Bank of England uses its powers to transfer a failing small bank to a Bank of England-owned Bridge Bank or commercial buyer ("transfer powers"). Funds drawn from the FSCS would be used either to meet recapitalisation costs ahead of selling a failing small bank to a commercial buyer, or to meet the recapitalisation and operating costs of placing a small bank into a Bridge Bank. The FSCS would recover any funds provided through *ex-post* levies on the banking sector. As a result, this FSCS funding would limit the need for these costs to be met from public funds.

Strategic case for proposed approach

1.5 As mentioned in paragraph 1.2, the UK first implemented the resolution regime through the Banking Act 2009, following the Global Financial Crisis. The regime was last used to resolve Silicon Valley Bank UK ('SVB UK'), the UK subsidiary of the US firm SVB which collapsed in March 2023. The Bank of England used its powers under the Banking Act to facilitate the sale of SVB UK to HSBC, delivering good outcomes for financial stability, customers and taxpayers. All of SVB UK's customers were able to continue accessing their bank accounts and other facilities without disruption, and all deposits remained safe, secure and accessible. In doing so, the Bank ensured the continuity of banking services and maintained public confidence in the stability of the UK financial system.

1.6 Whilst the case of SVB UK demonstrated the effectiveness and robustness of the resolution regime, the government believes there is a case for a targeted enhancement to give the Bank of England greater flexibility to manage the failure of small banks effectively.

1.7 It is worth noting that small banks are typically expected to be placed into insolvency, under the Bank Insolvency Procedure (BIP), and are not expected to meet the conditions that must be satisfied for the Bank of England's resolution powers to be used. These conditions include whether exercise of the powers is necessary and in the public interest (having regard to a set of resolution objectives). Under the BIP, upon entering insolvency, the FSCS compensates eligible depositors for account balances up to £85,000 per depositor within seven days, with higher limits for temporary high balances. This compensation is funded through a levy on industry, as well as recoveries from the estate of the failed firm.

1.8 The government's view is that, in some cases of small bank failure (as demonstrated by SVB UK), the public interest and resolution objectives, particularly in respect of continuity of banking services, may be better served by the use of the stabilisation tools than the BIP. Reflecting this, while there is still a role for the BIP, there is value in ensuring that certain existing resolution tools can be applied to small banks in a way that achieves good outcomes for financial stability while also protecting taxpayers.

1.9 If, in future, a small bank were to require resolution action, as part of taking this approach, the failed bank may need additional capital, for example to meet minimum capital requirements for authorisation or to cover the costs of restructuring. At present, these costs may at least initially have to be borne by taxpayers as the Treasury would be the only available source of funds to meet these costs. This is due to the fact that, unlike larger banks, small banks are not required to maintain additional resources above minimum capital requirements – known as the minimum requirement for own funds and eligible liabilities (MREL) – that can be used to absorb losses and provide for recapitalisation. A key aim of the Bank Resolution (Recapitalisation) Bill, therefore, is to strengthen the protections for public funds where a small bank is placed into resolution instead of insolvency.

1.10 Overall, the government judges this as a necessary set of reforms in order to ensure the regime continues to effectively limit risks to financial stability and taxpayers.

Chapter 2
Policy overview

Policy objectives

2.1 In using the powers under the resolution regime, the Bank of England has to have regard to the special resolution objectives.[2] These objectives help determine whether taking resolution action is in the public interest. The Bank of England would therefore be required to have regard to these objectives when deciding whether to use the new enhancement. The government notes that there are some resolution objectives that may be especially important in relation to the use of this enhancement:

a) **ensure continuity of banking services and critical functions in the UK** – in the context of this enhancement, a key objective would be to preserve immediate continuity of access to deposits and banking services for customers;

b) **protect depositors covered by the FSCS** – which relates to the objective above; and

c) **protect public funds** – the intention of the enhancement is to ensure public funds are less exposed to risk in the event of a small bank failing.

2.2 In addition, the government considers a key merit of this enhancement is to enable the Bank of England to deploy a solution which avoids additional upfront costs for the banking sector in advance of a firm failure.

How the government's approach meets these objectives

2.3 The government's final policy, as set out in the response to the consultation and the Bank Resolution (Recapitalisation) Bill, is to amend legislation to allow funds from the FSCS to be provided to the Bank of England upon request, to support the resolution of a failing small bank.

2.4 The key elements of the proposal are:

- Where a failing small bank meets the required tests for resolution action, the Bank would be able to use its powers to transfer the firm to a Bridge Bank or commercial buyer. As now and as set out in the

2 Banking Act 2009, s4

Banking Act 2009 and the Special Resolution Regime Code of Practice, the Bank would still be required to ensure that shareholders and creditors bear losses when a bank fails, including by writing down regulatory capital.

- The Bank Resolution (Recapitalisation) Bill amends the Financial Services and Markets Act 2000 to allow funds provided by the FSCS to cover the following costs during a resolution:
    - the costs of recapitalising the failed bank;
    - the operating costs of a Bridge Bank; and
    - Treasury and Bank of England costs in relation to the resolution, including legal and other professional expenses, costs of valuation and other associated costs.

- The Bank would have some discretion over how to achieve the recapitalisation, but it is expected this would be implemented via the issuance of new shares.

- The Bill also allows the FSCS to recover its costs on an *ex-post* basis through levies on the banking sector. Levies on the sector are subject to an annual cap set by the Prudential Regulation Authority (PRA) based on what it assesses as affordable for the sector, which currently stands at £1.5 billion.

- Where FSCS is not able to raise sufficient funds itself at the point of a failure, the FSCS could make a request to borrow from the Treasury through the National Loans Fund. The FSCS would subsequently recoup any funds provided through levies on the banking sector after the event. As above, levies would be subject to the annual cap set by the PRA.

- In the event that the failing small bank requires liquidity provision, this would be provided by the Bank of England under the terms of its existing resolution liquidity framework.

2.5 The diagram at Figure 2.A sets out a simplified version of how the policy may be utilised in practice.

Figure 2.A Simplified diagram of enhancement

2.6 The policy set out in the Bill and the government's response to the consultation represents an extension of the existing regime in two important ways.

2.7 Firstly, it mirrors the framework for paying out depositors when a small bank is placed into insolvency, utilising the FSCS in the same way and taking a similar FSCS funding approach by imposing *ex-post* costs on the banking sector[3]. As a result, it would not impose additional upfront financial costs on the banking sector in advance of a firm failure compared to an insolvency. Moreover, it would utilise the FSCS's existing operational capacity and infrastructure to provide the funding.

2.8 Secondly, it does not make significant changes to the resolution regime as a whole, as the decision-making framework for managing a bank failure – including the public interest test and conditions for taking action – would remain unchanged as set out in the Banking Act 2009.

2.9 In totality, the Bill delivers the intended policy objectives in a number of important ways:

- It ensures that, where necessary, access to deposits and banking services can be maintained immediately following a small bank failure.
- If FSCS funds are needed to recapitalise the failed bank and meet the other costs set out above, the quantum of those funds could be said to equate to the quantum of public funds potentially saved.
- It avoids imposing additional upfront costs on the banking sector by only raising funds on the sector on an *ex-post* basis. Moreover, it displaces the costs that would otherwise have been incurred by the FSCS had the small bank been placed into insolvency.
- It also meets HM Treasury's objective of ensuring the stability of the macro-economic environment and financial system, necessary for enabling strong, sustainable and balanced growth. Furthermore, it aims to avoid value destruction associated with bank insolvency, mitigating risks to the economy and economic growth.

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[3] One point of difference in funding approach is that credit unions will be exempt from contributing to the costs of the new mechanism. The government notes that credit unions currently contribute only 0.24% of total FSCS levies. Therefore, any impact on the calibration of levies for the rest of the sector as a result of exempting credit unions from contributing towards costs for the new mechanism would be negligible. As such, the exemption of credit unions has not been factored into the subsequent analysis.

Chapter 3

Cost-benefit assessment

Summary

3.1 The costs and benefits associated with managing a bank failure will always be highly case-specific. In addition, instances of bank failure have been rare since the financial crisis. As a result, any cost-benefit analysis requires a high degree of judgement. Reflecting the proposed design of this set of resolution reforms the government notes the following key points:

- In most cases, the nominal value of a small bank's capital requirements is significantly lower than that of its covered deposits. This means the upfront implied costs for levy payers of recapitalising a failed bank would normally be lower than those for a payout to covered depositors in an insolvency.
- When comparing the lifetime costs of the mechanism outlined in the Bank Resolution (Recapitalisation) Bill to those in the counterfactual of an insolvency, as well as the upfront costs, a number of other factors must be taken into account and some assumptions made. In particular, the extent to which the banking sector would be levied in-year, noting this would be a judgement for the PRA to take at the time based on what is affordable for the sector; any interest payments on FSCS borrowing; any proceeds from the sale of the bank in resolution; and any funds recovered from the estate of the failed bank in insolvency.
- The government expects that lifetime costs for levy payers will generally be lower when the funding mechanism outlined in the Bank Resolution (Recapitalisation) Bill is used rather than insolvency and a depositor payout. This reflects a combination of the lower nominal level of funding needed to achieve recapitalisation relative to paying out FSCS covered deposits, and the resulting interest cost.
- However, this does not necessarily mean the new mechanism would have a lower direct cost in all circumstances. This is one reason why the new mechanism provides an additional option for the Bank of England but is not expected to be used by default. When determining whether to deploy its resolution powers, in its capacity as resolution authority, the Bank of England would take into account affordability as part of its assessment against the resolution conditions in pursuit of the statutory resolution objectives.
- In addition, the government also notes these reforms are justified by wider, indirect public policy benefits. Resolution can only be justified

if in the public interest, meaning the Bank of England would only use the new mechanism if it had determined that it was overall better for depositors, the financial sector, taxpayers and the UK economy than the counterfactual of insolvency.

3.2 These points are discussed further in the remainder of this paper.

Potential costs to the banking sector – FSCS levies

3.3 As noted, an important element of the government's policy design is that costs to the banking sector are levied on an *ex-post* basis. This means that any costs are contingent, since they would only arise in the event of a failing bank requiring resolution (and recapitalisation as part of that resolution). This means there will be no new upfront costs in terms of levies arising from these reforms.

3.4 Equally, it is important to note that, in practice, the recapitalisation amount for an individual specific failing bank may be less than or greater than the equivalent of its minimum capital requirement. This is because the actual amount required would be dependent on the quantum of losses recognised at the point of resolution (and consequently the extent of capital depletion), the resources available to write down, and the amount of capital required to secure continuous PRA authorisation of and ongoing market confidence in the bank.

3.5 For the purposes of this assessment, it is assumed the recapitalisation amount of a failed bank would be equal to minimum capital requirements.[4]

3.6 It is estimated that the median recapitalisation cost for a failed small bank is c.£50 million. In addition, the government has also considered an illustrative scenario where the largest 3 small banks (in terms of total assets) failed simultaneously, for which the recapitalisation costs are estimated to be c.£2.5 billion under the new mechanism.[5] As above, this illustrates that the precise costs could vary widely depending on the scenario.

3.7 These recapitalisation costs would be levied on all Deposit Guarantee Scheme members with the exception of credit unions. Other than this credit union exception, this is similar to the approach currently taken for FSCS levy contributions in a bank insolvency. As now, the annual cap on FSCS levies for the banking sector would

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[4] Minimum capital requirements of banks are calculated based on PRA regulatory data as at end 2023. All figures in this and subsequent sections are based on Bank of England, FSCS and HM Treasury calculations.

[5] Calculated based on banks' total capital requirements as at end 2023. This assumes total interest expenses of 17% of the capital borrowing by FSCS, in line with the total interest incurred on FSCS borrowing following the Global Financial Crisis. This is a highly conservative estimate: the total interest incurred under the new mechanism is likely to be lower, given the much smaller initial borrowing requirement and that repayment would be likely to be completed much faster.

continue to be set by the PRA and currently stands at £1.5 billion. Moreover, costs to individual firms would be calibrated in a comparable way to FSCS levy contributions for depositor pay-outs in insolvency.

3.8 In order to meet the recapitalisation costs, consistent with how it currently funds compensation to covered depositors in an insolvency, the FSCS may need to borrow funds. If these are lower than £1.5 billion, these would likely be met through its commercial borrowing arrangements with lenders; if higher than £1.5 billion, the FSCS would be able to request a loan from the National Loans Fund. In both cases, levy contributions would be required to meet both the principal of a loan and any interest payments charged to the FSCS by either commercial lenders or HM Treasury.

Comparison to insolvency

3.9 The main counterfactual for most small banks would be the use of the bank (or building society) insolvency procedure. Therefore, the relative cost between the two options will be a function of:

- the implied amount of FSCS funding required to either recapitalise a firm or to make payouts to covered depositors;
- the amount of recoveries made either from the eventual sale of the firm to a private sector purchaser (in resolution) or from the estate of the failed firm (in insolvency);
- the amount of interest charged on any relevant FSCS borrowing.

3.10 As noted above, it is estimated that the median recapitalisation costs to resolve a failed small bank are c.£50 million. Taking FSCS protected deposits data in going concern as a proxy for deposit pay-outs at the point of failure, the median firm in terms of total capital requirements in the small bank population would be subject to c.£470 million of covered deposit FSCS pay-outs.

3.11 In the case of the three largest small banks (by total assets), the recapitalisation costs would be c.£2.5 billion under the new mechanism. Using the same approach this would imply c.£22 billion of covered deposit FSCS pay-outs.[6] These figures do not take into account any cash outflows during the stress period preceding a bank's failure.[7]

3.12 Overall, the government expects that, in the vast majority of cases, the implied nominal value of recapitalisation will be significantly lower than the value associated with deposit pay-outs.

3.13 However, as noted, it is then necessary to consider some variable factors that may affect the lifetime cost of the different options. In particular, any money recovered from the estate of a failed bank either

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[6] Protected deposits data was provided by the FCA and is as at end 2022. Guidance sent to firms when requesting protected deposits: FSCS class A (SA01) - deposit (fca.org.uk).

[7] Although not a scenario that is considered probable, it has been provided to give a sense of scale in various scenarios and to avoid solely providing analysis based on one firm, in order to offer a richer view of the data.

in insolvency or via a sale in resolution, and then any interest payments on FSCS borrowing to fund a pay-out.

3.14 Starting with the former, monies recovered from a failed firm are case-specific and will depend on the conditions of failure and the business model of the firm. As such, there would be a high degree of uncertainty estimating this in advance. As a reference, in the Global Financial Crisis, the FSCS paid out £20.9 billion and recovered £20 billion from the estates of the relevant failed banks, which suggests that c.96% of compensation costs were ultimately recovered.[8] FSCS levies covered the £0.9bn shortfall and £3.5 billion in interest.[9]

3.15 If one were to extrapolate from the data above and apply it to the case where the three largest small banks by total assets had failed, then assuming that 96% of £22 billion of deposit pay-outs was recovered, this would correspond to a c.£933 million shortfall which would be covered by FSCS levies.[10]

3.16 In a case where the new mechanism was used instead of insolvency, the concept of recoveries in insolvency would be less relevant. Instead, the expectation is that the Bank of England would seek to sell the failed firm (either immediately at the point of resolution or after a period of time in a Bridge Bank). Under the government's proposals the proceeds of any sale would then be used to repay any funding provided by the FSCS to recapitalise the firm. It is not possible to reliably estimate this in advance, given the mechanism has not been used before. However, in principle the government expects that the rate of recoveries under insolvency and a sale price under resolution would likely be correlated. This reflects the fact that a firm with a stronger underlying asset quality should be more attractive to purchase.

3.17 There are a number of important uncertainties. The historical experience of bank failure has demonstrated that insolvency typically results in an additional deterioration in the value of a bank's assets, i.e. deadweight loss. This additional cost accrues because insolvency typically results in a sale of some assets below their book value, and the destruction of any additional value that the bank may have had as a going concern. This point is addressed in the section on indirect costs and benefits.

3.18 Finally, as noted above, there would still need to be payment from the levy to cover any interest expenses. As an example, if one were to extrapolate from the data above and assume that c.17% of £22 billion of deposit pay-outs was paid out for interest expenses, this would correspond to c.£3.7 billion in interest. This would increase if, as now, interest costs were higher than they were in the period of very low

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[8] It is worth caveating that, since then, depositor preference has been introduced, with FSCS subrogating for super-preferred creditors.

[9] Source: FSCS closes book on 2008 banking crisis.

[10] The figures cited here have been rounded.

interest rates following the Global Financial Crisis of 2008. Overall, this would imply the cost of deposit pay-out in a case where the three largest small banks (by total assets) failed would be c.£4.6 billion (depending on the level of recoveries), while it would be c.£2.5 billion under the new mechanism.

Case study

3.19 As above, costs to the banking sector via levies would likely vary significantly depending on the scenario and a variety of factors. An illustrative case study can be used to show how these potential costs might fall under both resolution (under the new mechanism) and insolvency (under a depositor payout), using a bank with £8 billion in covered deposits.[11]

3.20 In the resolution scenario, a recapitalisation amount of £640 million is provided immediately by the FSCS. The FSCS receives this funding through its commercial borrowing arrangements, with the banking sector subsequently levied and repayment to commercial lenders made within 3 months. As such, the full recapitalisation amount is realised in year 1, in addition to any interest charges incurred under the borrowing facility. The FSCS would face further estimated operational and administration costs including for legal support and communications. Most of these costs would be realised in year 1 with negligible costs after this.

3.21 In the insolvency scenario, it is assumed that there is a similar FSCS repayment profile to that of the bank failures of 2008, where industry is predominantly levied for interest costs, although this would be a judgement made by the PRA at the time. Consequently, in this example the principal amount borrowed would be repaid by recoveries, which are assumed to reach 100% over a 10-year period.

3.22 As such, in addition to the much larger borrowing needed under an insolvency in this scenario, the cost profile is also extended over a longer period than under resolution. This results in greater interest rate charges over the lifetime of the policy. £558 million of this interest is paid in year 1 with the rest paid between years 2 and 10.

3.23 Further, the same operational and administrative costs incurred under resolution in year 1 would also be incurred under an insolvency, in addition to internal and external costs related to claims processing, legal advice and recoveries from the estate of the failed bank, which would continue to some extent in following years.

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[11] Analysis is subject to a number of broad assumptions around the size of payout, complexity and profile of recoveries. General assumptions include: interest charges are based on a rate of SONIA plus 1.75%, although this is variable. SONIA is assumed to be 0.2% above Bank rate which is assumed to reduce over 10 years to 3.7%. It also includes conservative assumptions around cost recoveries under resolution (i.e. no recoveries) with more favourable assumptions under insolvency, and as such demonstrates a worst-case scenario for a resolution scenario.

3.24 As a result, in this case the lifetime cost for use of the new mechanism would be lower than that of a pay-out in insolvency (£648 million in resolution vs c.£2.1 billion in insolvency), as it would not incur equivalent interest rate charges in future years.

3.25 It should be noted that the repayment profile could be quicker than it was for the bank failures of 2008, as the FSCS now benefits from its super-preferred status in the creditor hierarchy when the rights of covered depositors are subrogated to it in insolvency. In the case of a relatively swift insolvency process, it could instead be assumed that interest only accrues to year 4. In this case these costs would still be higher than through the use of the new recapitalisation mechanism, just by a lesser amount (£1.24 billion).[12]

3.26 As mentioned above, it is worth noting that historical experience demonstrates that insolvency typically results in an additional deterioration in the value of a bank's assets. This is because insolvency can result in a sale of assets below their book value, and the destruction of any additional value that the bank may have had as a going concern. One could therefore argue that a failing bank's assets' value may be preserved to a greater extent under resolution, particularly in a scenario where the failing bank is transferred to a Bridge Bank, as in such a case the continuity of access to all critical functions and core business lines of the failed bank would be maintained before its potential eventual sale. In addition, there may also be substantial benefits in terms of confidence in the banking sector or the financial system as a whole. Taking these factors into account may therefore affect the cost estimates above, though this has not been factored into the modelling itself.

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[12] All figures in this case study are presented in Net Present Value terms by having a standard discount rate of 3.5% per annum applied to them, in accordance with the principles set out in The Green Book published by HM Treasury.

Figure 3.A : Illustrative case study

Resolution (new mechanism)[13]		**Insolvency (depositor pay-out)**[14]	
Borrowing to fund recapitalisation (assuming sale proceeds are nil)	£635m	Principal repayment of borrowing to fund £8bn compensation payments (assuming 100% recoveries)	£0
Interest	£11m	Interest cost to fund £8bn compensation payments	£2.075bn
Administrative costs	£3m	Administrative costs	£8m
Total Lifetime Cost	**£648m**[15]	**Total Lifetime Cost**	**£2.083bn**

3.27 Notwithstanding this, there are potential scenarios where a Bank Insolvency Procedure may involve lower direct levy costs, for instance if a certain business model is capital intensive but has relatively few covered deposits; or where a recovery process can be undertaken very swiftly. In this context it is important to note the new mechanism is not intended to replace the Bank Insolvency Procedure (BIP), and any decision to deploy stabilisation powers would remain subject to the resolution conditions, including the public interest test, as now. The BIP remains an important part of the toolkit for dealing with the failure of small banks, and the Bank of England would need to judge that the wider costs and benefits justified the use of the new mechanism at the time of its use.

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[13] Resolution model assumptions: a recapitalisation amount of 8% of total deposits. FSCS borrows from its commercial facility, which is assumed as immediate with firms levied straight away and repayment made within 3 months. No recovery or repayment is assumed.

[14] Insolvency assumptions: a payout of £8bn with 10% of deposits deemed excluded from the payout due to being ineligible of uncovered. Borrowing from both commercial facility and the National Loans Fund is assumed to be £8bn and is repaid using recoveries only. Assuming a similar recovery profile to 2008 failures (c.100% recovery over 10 years) this results in gradual repayment of the loan over a 10-year period. We have not taken into account the potential impact of covered depositors super-preferred status in the creditor hierarchy, which would be subrogated to FSCS in a bank insolvency, which was introduced following the Global Financial Crisis.

[15] Where the figures do not sum, this is due to rounding.

Other potential costs to the banking sector – resolution planning & familiarisation

3.28 This policy introduced by the Bill is primarily intended for small banks that are not required to maintain MREL above minimum capital requirements. These firms are generally subject to different *ex-ante* requirements on preparing for resolution than large banks (e.g. firms with a preferred strategy of bail-in). The impact of any future changes would be considered by the Bank or PRA as part of the usual policymaking process.

3.29 The government has also considered familiarisation costs concerning the legislation. Given this is a modest enhancement to the existing resolution regime, the government does not expect these to be material.

Potential costs to the FSCS

3.30 The FSCS will incur some minor operational and administrative costs in deploying the mechanism set out in the Bank Resolution (Recapitalisation) Bill. However, these are estimated to be slightly lower than the equivalent costs that would be incurred in the insolvency counterfactual.

Potential costs to the Bank of England and PRA

3.31 The Bank is already required to undertake certain resolution planning processes and we assume that any changes to related processes arising from the reforms set out in the Bank Resolution (Recapitalisation) Bill would be incorporated into existing processes and use existing resources. As such, it is assumed that the enhancement should not create significant additional operational costs. Similarly, it is assumed that any changes to PRA rules to implement the enhancement would not create significant costs since this can be achieved using existing resources.

3.32 In addition, the costs imposed for transferring a failing bank into a Bridge Bank can vary and will depend on the amounts that will be drawn (plus interest) under the liquidity facilities from the Bank, the tax liability to HMRC as well as the fees charged by the appointed advisors who may provide management and other services to the Bridge Bank on both the operational side and in relation to the sale process.

3.33 For reference, in the case of Dunfermline Building Society – a firm with a total balance sheet size of c.£365 million at the time of its transfer to a Bridge Bank (30 March 2009) – a total of c.£19 million was paid to the Bank to repay the drawn amount plus interest under the Bank's liquidity facility, c.£309,000 was paid to HMRC as a tax liability and c.£3 million was paid in operating costs and professional fees. The Bank

charged no fee for the service that it provided but recovered costs of c.£7,000.[16]

Potential indirect economic costs and benefits

3.34 The government has also considered whether there would be broader, indirect costs and benefits arising from the new mechanism.

3.35 The main source of indirect costs is likely to be that in the event of failure industry will need to contribute funds via an FSCS levy which could instead be used to support lending. As the examples set out above demonstrate, the exact volume would depend on the size of the firm that needed resolution and its associated capital requirement.

3.36 The PRA sets an annual cap of £1.5bn in levies for the banking sector (and any amount above that would require drawing on the National Loans Fund). Therefore, if the new mechanism is used, there would be a cost to the banking sector to supply the relevant capital which could in turn reduce the amount of capital available for lending to the real economy. For example, £1.5 billion of capital could potentially support around £30 billion of real economy lending based on sector wide average risk weights.[17]

3.37 As explained further below, this is one reason the government has pursued an *ex-ante* funding option, as the potential effect on lending will only crystallise when a bank fails, rather than as under other options (such as via a prefunded arrangement).

3.38 However, the potential for indirect costs needs to be set in the context of both the relevant counterfactual and potential indirect benefits.

3.39 As noted in earlier sections, it is anticipated that use of the new mechanism would generally have a lower set of levy costs for the sector than insolvency. This means that the incremental additional indirect cost of the mechanism relative to the main counterfactual may be negative or neutral, depending on the circumstances.

3.40 Even where that is not the case, the Bank of England as resolution authority would have ultimately judged that resolution is in the public interest by reference to its broader resolution objectives. There are three specific points to note:

- As the Bank of England has set out previously, insolvency can be highly disruptive both for the estate of the firm concerned, through generating additional deadweight losses, and for its customers and creditors such as uncovered depositors. For instance, for many it

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[16] Source: [Report under Section 80(1) of the Banking Act 2009 on the Dunfermline Building Society (DBS) Bridge Bank, July 2010 (bankofengland.co.uk).]

[17] Based on Bank calculations as at end 2023.

would imply a near immediate cessation of certain banking services.[18]

- In turn, any significant period of disruption could cause a wider loss of confidence in the banking system (as seen internationally during the period of banking sector turmoil in 2023), creating a broader set of negative economic and financial consequences.
- The new mechanism also further reduces an implicit risk to public funds, which would otherwise be deployed to support the provision of public services.

3.41 While it is not possible to quantify these effects with certainty, the government is confident that the overarching structure of the resolution regime means the new mechanism would only be deployed where the wider economic and financial benefits proportionately justify a set of costs, and as noted in the consultation response, would ask the Bank of England to publicly justify a chosen approach.

Comparison to alternative options

3.42 There are a number of alternative options that could be pursued to achieve the policy objectives. These are set out in the following paragraphs, as well as the government's assessment of the costs / benefits of these options compared to the policy option being pursued.

Setting MREL requirements for small banks

3.43 The Bank of England sets requirements on individual firms that it expects to require resolution action to maintain additional equity and debt above its minimum capital requirements, which can then be used to meet certain costs that arise if they fail. This is known as the minimum requirement for own funds and eligible liabilities (MREL).

3.44 The indicative thresholds for these requirements are total assets above £15-25 billion or total transactional accounts above 40,000-80,000, as the Bank of England expects that firms above these thresholds are more likely to require stabilisation through resolution powers, for example because of the potential disruption their failure could carry or the potential impact on contagion.

3.45 The Bank of England could decide to alter this policy and require small banks to hold additional capital or eligible liabilities above minimum capital requirements.

3.46 Under reasonable assumptions, it is likely that the new mechanism would be cheaper for small banks, on average, than being required to maintain MREL.[19] The interest expense or cost of issuing

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[18] MREL Discussion Paper, Bank of England (2020).

[19] Aggregate estimates based on small banks' 2023 capital requirements. These may change over time. For banks maintaining capital significantly in excess of their minimum capital requirements, the need to maintain additional MREL resources would be lower than banks operating relatively closer to their minimum capital requirements.

MREL could be achieved either by issuing subordinated debt liabilities or, if that were not possible, increasing equity. In practice, small banks have limited or no access to debt capital markets to issue MREL-eligible debt to investors, and would therefore likely need to meet MREL requirements with equity.

3.47 Even if access to debt capital markets were possible, for this to be cheaper for small banks it is assumed that the average interest expense of issuing subordinated debt would need to be lower than recent examples of issuances by larger banks subject to an MREL above minimum capital requirements. Similarly, raising equity would most likely be more expensive.

Mutualised pre-fund

3.48 The government's proposal involves raising costs from the banking sector *ex-post*, i.e. after a failure has occurred. The direct alternative to this option would be to consider establishing a mutualised fund to be built up in advance and drawn on in the event of resolution. The effect of this option would be to provide a contingency fund for use in any future failures that might require additional capital resources. The EU's Banking Union has built up such a contingency fund, the Single Resolution Fund, that has now reached its target size of €78bn.[20]

3.49 A pre-fund could be built up in a range of ways, from charging the banking sector as a whole to limiting payments to small banks only. The exact design of a pre-fund could vary the potential costs for individual banks and therefore how these could compare to alternative options. However, for the purposes of this assessment, it is assumed that the maximum *ex-ante* costs to individual banks of a pre-fund would be equal to the *ex-post* contributions under the new mechanism, since any contributions would likely continue to be subject to the annual levy cap set by the PRA, to remain affordable for the sector.

3.50 A key consideration is that costs under a pre-fund would not be contingent and would therefore have a direct impact on banks before a resolution takes place. As a consequence, it would have the effect of reducing the amount of capital each individual contributing bank has to absorb losses and support productive lending and investment.

3.51 Moreover, building up a mutualised fund of sufficient magnitude in advance to be drawn on in the event of resolution could take a significant amount of time. As an illustration, if only small banks were in scope to pay, it would take an estimated 12 years to build a fund sized at £1.5 billion.[21] The time taken would increase to 16 years for a £2 billion fund and 24 years for a £3 billion fund. In the event that all banks were

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[20] Single Resolution Fund: no expected contribution in 2024 as target level reached | Single Resolution Board (europa.eu).

[21] We have assumed that the maximum contribution small banks would make is their current maximum annual contribution to the FSCS levy, which in aggregate currently totals c.£130 million.

in scope to pay, the time to build up a fund would decrease to 1 year for a £1.5 billion fund, 2 years for a £3 billion fund and 4 years for a £6 billion fund.[22]

3.52 The government notes that, depending on the calibration, building up a mutualised fund over a period of time would leave depositors and the taxpayer exposed for longer to the risks the government is seeking to mitigate through the new mechanism. It took the EU's Banking Union 8 years to build up its Single Resolution Fund to its target size of 1% of covered deposits.

Limiting scope of payments to small banks

3.53 Finally, an alternative way of designing the new mechanism would be to limit the payment liability to small banks only, rather than require all Deposit Guarantee Scheme members (apart from credit unions) to pay.

3.54 As with other options, the assumption is that small banks' levy contributions would need to remain capped in line with the current FSCS levy limits set by the PRA, in order for these payments to remain affordable.

3.55 As a result, it is assumed that the practical effect of this option would be to limit the amount that FSCS could feasibly levy in aggregate from £1.5 billion to c.£130 million. The government judges this would provide an insufficient amount of funding in the range of worst-case scenarios.

3.56 Consequently, it would become more likely that the FSCS would need to request to borrow from the National Loans Fund to meet any recapitalisation needs, which would then be repaid over a number of years. As noted elsewhere in this assessment, this could have the effect of increasing the overall payment liability for banks to account for interest payments over a longer period of time.

Conclusion

3.57 Estimating the impact of the new mechanism has inherent challenges, as bank failures are rare and each is highly case-specific. Critically, under the *ex-post* funding model, no costs are incurred until a bank failure occurs. That is fundamentally different to both the options of a mutualised pre-fund or setting MREL requirements for small banks.

3.58 More broadly, the main counterfactual to the use of the mechanism delivered by the Bank Resolution (Recapitalisation) Bill is insolvency.

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[22] These estimates include all firms that are currently subject to the FSCS levy, which includes credit unions. The calculation methodology used the FSCS levy-based approach, where the maximum contribution from all firms is £1.5 billion per year.

3.59 While use of the new mechanism would have some implications and cost impact for the sector, the government considers the policy design to be proportionate, considering the public policy benefits.

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