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Brexit & financial services

Banking: the bank recovery and resolution regime

Introduction

The substance of the bank recovery and resolution regime in the UK has not changed as a result of Brexit and all EU rules have been onshored in the UK. Whilst the UK is now free to diverge from those rules, no substantial change is anticipated, not least because the UK led the development and implementation of the resolution regime in the first place.

The EU Regime

The Bank Recovery and Resolution Directive ("**BRRD**")[1], which was implemented with some alterations in the UK by the Banking Act 2009 ("**the Act**", as itself subsequently amended[2]), attempts to instil the lessons of the last financial crisis, in particular to minimise the repercussions of the insolvency of financial institutions[3] and the problem of institutions that were "*too big to fail*", whose collapse would cause shockwaves and whose bailouts would require vast sums of money from taxpayers. The goal of the BRRD is to create a harmonised EU framework for the orderly failure of financial institutions.[4]

The BRRD gives responsibility to a national resolution authority, and creates special regimes to deal with the collapse of banks and other financial institutions such as building societies and certain investment firms.

BRRD II amended the regime on 20 May 2019[5] to improve provisions for banks' loss absorbing capacity and equity and debt requirements, and to require contractual recognition of bail-ins (a resolution tool discussed below). Member states were required to transpose BRRD II by 28 December 2020, only three days before the end of the UK transition period.[6] The way the UK decided to transpose BRRD II in light of this timeline is discussed under "*How will the UK resolution and special administration regimes change with Brexit?*" below.

The UK Regime

The UK is considered an "*intellectual leader*" in bank resolution, "*setting the benchmark internationally*".[7] The Act created a comprehensive UK resolution regime in compliance with the BRRD. There are differences between the Act and the BRRD. Some are superficial, such as the differences in resolution tools' names that are described below. Others are more substantial.

Resolution authority

The UK's resolution authority is the Resolution Directorate within the Bank of England ("**the Bank**"), whose core 2017 text *The Bank of England's Approach to Resolution*, generally known as the Purple Book, sets out the Bank's approach to resolution. The Bank's website also holds copious literature on the topic and HM Treasury has published policy guidance on the special resolution regime[8] (although this has not been updated since 2017).

UK resolution objectives

The Act contains seven objectives, as against the BRRD's five.[9] These seven are:[10] (i) to ensure continuity of UK banking services and other critical functions; (ii) to protect and enhance the stability of the UK financial system; (iii) to protect and enhance public confidence in the stability of the UK financial system; (iv) to protect public funds; (v) to protect investors and depositors covered by a relevant compensation scheme; (vi) to protect client assets where they may be affected; and (vii) to avoid infringing property rights contrary to the Human Rights Act 1998. The third and seventh are not objectives found in articles of the BRRD.[11]

The Bank conducts regular stress tests to assess the ability of the UK's largest financial institutions to deal with crises. Alongside the Bank's activities, the PRA supervises firms' "*proximity to failure*", whilst firms themselves are required to carry out their own stress testing.

Should a financial institution fail, the Bank has prescribed tools and strategies to minimise the wider impact of the failure, as set out below.

Resolvability assessment framework

The Bank sets a resolution strategy for each firm of either bail-in (for the largest firms, explained under "*Resolution tools in the UK*" below), partial transfer or insolvency (for smaller firms),[12] indicating the tools that it would expect regulators to apply if the firm failed.

In July 2019, the Bank and the PRA published a resolution framework for major UK banks (the "**Framework**"), in two parts.

The Bank's guidance (with attached policy statements), *The Bank of England's approach to assessing resolvability*, supplements the *Purple Book* by explaining the capabilities firms should have and the outcomes they must achieve to be resolvable.[13] The Framework applies to the largest firms (where the Bank has notified a firm that the preferred resolution strategy for the firm would be bail-in or partial transfer, or where the firm is a material subsidiary of an overseas banking group),[14] although the primary focus is on firms with retail deposits of £50bn or more.[15] As a minimum, the Framework requires firms to take responsibility to ensure that they (i) have adequate financial resources, that is they meet minimum capital requirements for eligible liabilities ("**MREL**"), can assess capital and recapitalisation in a timely manner, and can analyse and mobilise liquidity in resolution; (ii) can continue to do business through resolution and restructuring;[16] (iii) can co-ordinate and communicate effectively internally and externally to enable orderly resolution and subsequent restructuring. Firms should consider the stylised resolution timeline, annexed to Appendix 1, when considering whether they meet these objectives.[17]

The PRA published new regulatory requirements as part of the Framework. These require the very largest firms, with over £50bn in retail deposits, to realistically assess their preparations for resolution, submit reports of those assessments to the PRA biennially, and publish a summary of the report submitted, and a supervisory statement explaining that the PRA expects firms' assessments to follow the Bank's criteria.[18] This is expected to be a substantial and substantive exercise: "*A firm should not treat its report as a regulatory compliance exercise*" and reports will "*typically be around 250 pages in length" without supporting documents, although "the level of detail should not be excessive*".[19]

Resolution tools in the UK

Should an institution fail, the Banking Act 2009 gives four stabilisation options, which reflect those in the BRRD, although their names are slightly different. These will be used if: (i) a financial institution is failing or likely to fail;[20] (ii) it is not reasonably likely that other action will avert failure;[21] and (iii) it is in the public interest.[22] These tools will usually be applied over a "resolution weekend" (outside of market hours).

1. Bail-in[23] is the appropriate tool for the largest firms with balance sheets of more than £15bn-£25bn. It means that these large firms can be recapitalised without splitting them up or finding a buyer for their business.[24] A bail-in may be "*single point of entry*", targeting one entity within a group (generally the parent or holding company), or "*multiple point of entry*", applying the bail-in to multiple group companies.[25] The former is the Bank's preferred resolution strategy for the largest UK firms.[26]

2. The private-sector purchaser tool[27] is used for medium-sized firms with between 40,000 and 80,000 transactional accounts – an account used at least nine times in the three months up to annual monitoring.[28] If used, all or part of the shares will be bought, usually at auction, by a private purchaser.[29]

3. In default of a private purchaser, the bridge bank tool may be used.[30] In this case, a temporary bank, wholly or partly owned by the Bank, temporarily takes on the failed institution's business in preparation for an onward sale.[31]

4. An asset management vehicle may be used (only ever alongside another tool)[32] to manage the failed institution's assets, with the intention of selling them at a maximised value, or winding down the business.[33]

5. Temporary public ownership is the resolution tool of last resort, which is only available if HM Treasury considers it necessary to resolve or reduce a serious threat to the UK's financial system or, where HM Treasury has already injected financial assistance and temporary public ownership will protect the public interest.[34]

Although resolution tools and insolvency procedures have been deployed for the collapse of smaller firms, they have yet to be used in the collapse of any major bank.[35]

Insolvency

The Act also creates insolvency regimes for banks,[36] building societies,[37] and investment firms,[38] to be used with or, if resolution is not viable, instead of a resolution tool.[39] The modifications compared to normal insolvency are intended to safeguard FSCS-protected deposits and to ensure the continuity of banking services despite the formal insolvency of the firm.[40] These will not be used if the failed institution does not hold protected deposits or client assets.[41]

The insolvency regimes are the Bank (or Building Society) Insolvency Procedures,[42] the Bank (or Building Society) Administration Procedure,[43] and the Special Administration regime.[44]

Under the Bank (or Building Society) Insolvency Procedures, a court-appointed liquidator works with the FSCS to pay out protected deposits (which are super-preferred), and wind up the firm.[45]

The Bank (or Building Society) Administration Procedures are used alongside the private-sector purchaser tool.[46] A court-appointed administrator assists the purchaser by ensuring the supply of the services required for the firm to operate effectively and to proceed to normal administration.

The Special Administration Regime applies where a failed investment firm holds client assets or money and does not meet the public-interest requirements within the Act for resolution. The court will appoint an administrator with the aims of returning client assets (working with the FSCS), engaging with regulators and rescuing the firm as a going concern or winding it up.[47]

How will the UK Resolution and Special Administration Regimes change with Brexit?

The BRRD (and likewise BRRD II) no longer has legal effect in the UK following the end of the Brexit implementation period on 31 December 2020.[48]

The Act and associated secondary legislation in "*onshored*" versions now apply by virtue of: the Financial Regulators' Powers (Technical Standards) (Amendment etc.) (EU Exit) Regulations 2018; the Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018 and the Bank Recovery and Resolution (Amendment) (EU Exit) Regulations 2020.

The former regulations make UK financial regulators responsible for amending as required the EU rules known as Binding Technical Standards, and the latter two make substantive changes to *inter alia* the Act and the Binding Technical Standards. Onshoring, in short summary, means that references to EU law and entities have been changed to refer to domestic equivalents; in addition, changes have been made to treat EEA countries in the same way that third-parties are currently treated.[49] The substance of the regime has not changed and both the Bank and the PRA have said that pre-Brexit guidelines will continue to apply.[50] On 28 December 2020, the PRA published its final PRA Rulebook: (EU Exit) Instrument 2020, reflecting this onshoring.[51]

BRRD II presented a tension referred to above. The UK as an effective member state during the transition period was required to transpose BBRD II by 28 December 2020. But the transition period was due to end on 31 December 2020.[52] The UK Government therefore amended the Act only insofar as BRRD II required changes to be effective prior to 31 December 2020. Changes that would cease to be relevant after the end of the transition period were made only temporarily between 28 December 2020 and 31 December 2020, which is described as "sunsetting". The Bank likewise made limited temporary changes to the PRA Rulebook.[53]

Post-Brexit, the UK will recognise EEA-led resolutions in the same way as third-country resolutions. S89H(4) of the Act presumes that the Bank and HM Treasury will recognise such a resolution. However, it is possible for the UK to refuse recognition for one of the reasons in the exhaustive list at s89H(4), for example where achieving one of the special resolution objectives would require the UK authorities to take action in relation to a UK branch, or where the third country treats depositors less favourably than the UK.

If the intention is for little to change post-Brexit, UK and EEA regulators will be required to co-operate to ensure that protections remain at least broadly equivalent. The number of financial institutions continuing to operate both in the EEA and the UK means a resolution on either side of the Channel will have an impact on the other.

As noted above, the UK has led the way on resolution and its resolution regime is not expected to change in the short to medium term, not least because of the extensive work that has gone into its development over the last decade. Nonetheless, the UK will be free to diverge from the EU regime set out in the BRRD and BRRD II if desired. The recession expected to follow the covid-19 pandemic may alter the parameters but protections seem unlikely to be weakened, since the desire to avoid massive taxpayer bailouts will undoubtedly remain.

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1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.
2 By the Financial Services Act 2012, the Bank Recovery and Resolution Order 2016 and Brexit legislation discussed below. See HM Treasury Transposition note at www.assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/335755/PU1678_final__1_.pdf.
3 E.g. BRRD, recital (1).
4 The Bank of England's Approach to Resolution ("The Purple Book"), p.7.
5 Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC.
6 BRRD II, article 3(1).
7 Independent Evaluation Office of the Bank of England, "Evaluation of the Bank of England's Resolution Arrangements", June 2018, p.3 and p.13, box 2.
8 www.gov.uk/government/publications/banking-act-2009-special-resolution-regime-code-of-practice-revised-march-2017.
9 BRRD, article 31(2).
10 Banking Act 20009, ss.4(3) to (9).
11 C.f. BRRD recitals (50) and (53).
12 Purple Book, [3.2].
13 The Bank of England's approach to assessing resolvability, [1.12].
14 The Bank of England's approach to assessing resolvability, [1.9].
15 The Bank of England's approach to assessing resolvability, [2.19].
16 The Bank of England's approach to assessing resolvability, [1.14]-[1.16].
17 The Bank of England's approach to assessing resolvability, Appendix 1, Annex 1, [1.1].
18 PRA Rulebook CRR firms: Resolution assessment instrument 2019; PRA policy statement 15/19 Resolution assessment and public disclosure by firms; PRA supervisory statement 4/19 Resolution assessment and public disclosure by firms.
19 PRA supervisory statement 4/19 Resolution assessment and public disclosure by firms, [3.6]-[3.9].
20 Banking Act 2009, s.7(2).
21 Banking Act 2009, s.7(3).
22 Banking Act 2009, s.7(4).
23 Banking Act 2009, ss.12A, 81A and 84A.
24 Purple Book, Box 1.
25 Purple Book, [2.7]-[2.9].
26 Purple Book, Box 3.
27 Banking Act 2009, s..11; "sale of business" in articles 38 and 39 of the BRRD.
28 Purple Book, Box 1.
29 Purple Book, [2.19].
30 Banking Act 2009, ss.12 and 84D; "bridge institution" in articles 40-41 of the BRRD.
31 Purple Book, [2.18].
32 Banking Act 2009,s.8ZA.
33 Banking Act 2009, s.12ZA; ("asset separation" in article 42 of the BRRD
34 Banking Act 2009, ss.9 and 13; one of the "government financial stabilisation tools" in BRRD articles 56-58 .
35 For a more detailed analysis of the UK bank resolution regime and case studies to mid-2019, please see Bank Resolution: Key Issues and Local Perspectives, Chapter IX, Hodge Malek QC, James Potts and Sophia Dzwig.
36 Banking Act 2009, s.91.
37 Banking Act 2009, s.130 and Building Societies (Insolvency and Special Administration) Order 2009.
38 Investment Bank Special Administration Regulations 2011 and Investment Bank Special Administration (England and Wales) Rules 2011.
39 Purple Book, [1.12].
40 Purple Book, [1.12] fn.6 and [1.41].
41 Purple Book, [1.40].
42 Banking Act 2009, Pt 2.
43 Banking Act 2009, Pt 3.
44 Investment Bank Special Administration Regulations 2011 and Investment Bank Special Administration (England and Wales) Rules 2011.
45 Banking Act 2009, Pt 2; Purple Book, [[1.40]-[1.43] and fig.4.
46 Banking Act 2009, Pt 3.
47 Investment Bank Special Administration Regulations 2011, paragraphs 6, 7 and 10ff; Purple Book, [1.44]
48 UK-EU Withdrawal Agreement, article 126; European Union (Withdrawal) Act 2018, ss.1 to 3; and Bank Recovery and Resolution and Miscellaneous Provisions (Amendment) (EU Exit) Regulations 2018, approved by the House of Lords on 19 December 2018.
49 See Government guidance published 29 October 2019 www.gov.uk/government/publications/draft-bank-recovery-and-resolution-and-miscellaneous-provisions-amendment-eu-exit-regulations-2018/the-bank-recovery-and-resolution-and-miscellaneous-provisions-amendment-eu-exit-regulations-2018-explanatory-information.
50 "Interpretation of EU Guidelines and Recommendations: Bank of England and PRA Approach after the UK's withdrawal from the EU", 2019, [2.2].
51 PRA Policy Statement 30/20.
52 The Bank Recovery and Resolution (Amendment) (EU Exit) Regulations 2020. See also Explanatory Memorandum, in particular [7.1]-[7.12].
53 PRA Policy Statement 28/20.

Sophia Dzwig
Author

sdzwig@3vb.com

David Simpson
Series Editor

dsimpson@3vb.com

3 Verulam Buildings
Gray's Inn, London WC1R 5NT
T +44(0)20 7831 8441
E chambers@3vb.com