Demystifying Bank Resolution

Whilst the events surrounding HSBC's acquisition of Silicon Valley Bank ("SVB") demonstrated that the UK bank resolution regime worked well, regulators and firms will now be scrutinising resolution plans, the potential impact of a bank resolution and measures which can be taken to minimise risks. *But what is bank resolution?* In this note we seek to explain this, the effect of resolution for a counterparty of a resolved firm and how firms can prepare for a resolution.

What is bank resolution?

Following the financial crisis and the perception that banks had become 'too big to fail', a resolution regime was introduced in 2009 to provide regulators with powers to stabilise a failing firm. The regime is not intended to ensure that firms will never fail, but to ensure that if a firm does fail it does so in an orderly way whilst ensuring that the critical operations of the firm can continue and the impact on depositors, public funds and the wider financial system is minimised. One key component of the regime is that losses should fall first on shareholders and investors, given that they take the upside when a firm is thriving. The Bank of England conducts resolution planning for all banks, building societies and certain investment firms operating in the UK (being around 400 firms). There are broadly 3 resolution strategies, being (i) bail in, (ii) transfer to a private sector purchaser or (iii) insolvency.

What is a bail in?

This is normally the resolution strategy for the biggest banks. Bail in essentially allows the Bank of England as the resolution authority to write down claims of a firm's unsecured creditors and convert those claims into equity. An orderly restructuring of the business will then follow once the firm has been recapitalised and can continue providing its functions without interruption.

What is a transfer to a private sector purchaser?

This involves the sale or transfer of all or part of a firm to a private sector purchaser (or to a temporary 'bridge bank' established by the Bank of England pending a sale or transfer) without requiring the consent of the firm, its shareholders, customers or counterparties. Normally this might be the resolution strategy for smaller and medium-sized firms where the likelihood of sale is credible and where the public interest test for use of resolution powers is met. This was eventually the strategy for SVB.

Insolvency

The strategy for most UK firms will be insolvency as they are unlikely to meet the public interest test for the use of resolution powers. If a firm holds deposits or client assets, it will be placed into a special bank insolvency procedure ("BIP") which is essentially a modified version of the corporate insolvency process, with particular amendments to reflect the fact that the subject entity holds deposits or client assets. The liquidator's primary objective in a BIP is to return deposits which are protected by the Financial Services Compensation Scheme ("FSCS") as quickly as possible, and then wind up the affairs of the bank so as to achieve the best results for the bank's creditors as a whole. The regime otherwise operates in a similar way to a corporate insolvency process. As opposed to bail in and transfer to a private sector purchaser the purpose of an insolvency is to wind down the affairs of the firm. This means that, whilst key operational systems and controls may continue to run for a period

of time, new business would not be taken on and certain non-essential functionality would be closed down as quickly as possible. Customers would not be able to make deposits and withdrawals.

What powers does the Bank of England have and how I am protected in the event of a bail in or transfer?

The Bank of England has very wide powers under the Banking Act 2009, whether it be the power to write down and convert a firm's capital instruments and liabilities, sell all or part of a firm, replace the management of the firm, or impose temporary stays. The resolution regime also stops a firm's counterparties from terminating contracts simply because the firm enters resolution. Given these wide powers could interfere with the rights of shareholders and creditors, there are some important rules around their use:

(a) the Bank of England must pursue certain objectives when it resolves a firm, including protecting FSCS covered depositors and investors and client assets, or avoiding interfering with property rights;

(b) four resolution conditions must be met before the Bank of England can use stabilisation powers, namely: (i) the firm is failing or likely to fail; (ii) it is not reasonably likely that action by or in respect of the firm will prevent the firm failing or being likely to fail; (iii) the exercise of the power must meet the public interest test; and (iv) the resolution objectives would not be met to the same extent by placing the firm into an insolvency process;

(c) the Bank of England must arrange an independent valuation of the firm's assets and liabilities prior to the use of any resolution powers;

(d) any netting, set-off or collateral arrangements should be protected; and

(e) no shareholder or creditor must be left worse off than they would have been in an insolvency.

How am I protected if a firm goes into insolvency?

It depends on the products you hold. In terms of deposits at a firm that has entered a BIP for example, this will depend on what type of entity you are and what your account balance with the firm is. The FSCS only applies to certain types of entity, and deposits held on behalf of most regulated entities are excluded from protection. However, if you are a non-regulated corporate entity or a sole trader, you are likely to be entitled to some protection. The FSCS only offers a maximum compensation sum of £85,000 for the aggregate eligible deposits each depositor holds with a bank (whether held in one or multiple accounts). If you hold an account as a business partnership, the partnership will be treated as a single entity, and it will have only one compensation limit (and not one for each partner).

Where part of your balance is outside the scope of FSCS protection, and you are an individual or micro, small or medium-sized business you will become a preferential creditor of the bank for your unprotected balance amount (i.e. any amount in excess of the £85,000 limit). There is a modified hierarchy of insolvency claims that applies under a BIP:

(a) Fixed charge holders including capital market transactions (e.g. covered bonds) and trading book creditors (e.g. collateralised positions)

(b) Liquidators (fees and expenses)

(c) Preferential creditors (ordinary), including FSCS deposits (up to £85,000) or employees with labour-related claims

(d) Preferential creditors (secondary), including depositors that are individuals and micro, small or medium-sized businesses for amounts in excess of the FSCS limit

(e) Floating charge holders

(f) Unsecured senior creditors, including (i) bondholders, (ii) trading book creditors (e.g. uncollateralised positions), (iii) creditors with master netting agreements (net position only), (iv) commercial or trade creditors arising from the provision of goods and services, (v) depositors that are not individuals or micro, small and medium-sized businesses for amounts in excess of £85,000 and (vi) FSCS, taking the place of individuals with funds invested with the insolvent firm

(g) Interest incurred post-insolvency

(h) Unsecured subordinated creditors (e.g. subordinated bondholders)

(i) Shareholders (preference shares)

(j) Shareholders (ordinary shares)

How can a firm be ready for resolution?

For a resolution strategy to be workable, it is fundamental that a firm is actually resolvable and has put in place and continuously refreshes its resolution plans in normal times. The major eight UK firms for example are required under the Resolvability Assessment Framework to publish their preparations for resolution, alongside the Bank of England's assessment of those preparations. A firm is also subject to a number of capital and liquidity requirements to ensure that in the event of a failure those resources can be used to absorb losses and allow recapitalisation, and the firm can continue to do business after resolution. The usual capital requirements which a firm must comply with are supplemented by an obligation for banks to satisfy at all times a minimum requirement for own funds and eligible liabilities ("MREL"), as specified by the Bank of England on a case-by-case basis.

How does ring-fencing fit in with the resolution regime?

Ring-fencing is a separate regime to resolution, but like resolution, the ring-fencing regime flowed from the problem of banks which were "too big to fail". Ring-fencing became effective on 1 January 2019, and required banking groups with deposits above a certain threshold to "ring-fence" or insulate their core banking services (broadly, deposit taking) from certain other activities.

There are extensive rules around how the different parts of the bank can interact with each other, and what products can be offered by each side of the ring-fence (as well as which clients can take out those products).

Ring-fencing has been criticised for the cost and compliance burden it places on affected banks, and the fact it gives rise to trapped liquidity within a banking group. Consultations are expected later this year on aligning ring-fencing with the resolution regime, as well as amendments to the rulebook to make the operation of the ring-fence more practical on a day to day basis.

What should my firm be doing?

Firms subject to the resolution regime will undoubtedly be revisiting their resolutions plans (including stress testing). There is likely to be increased scrutiny from the regulators, with a likely sharpened focus on regulatory compliance and potential strengthening of capital and liquidity requirements. Firms will need to monitor any finessing of the resolution regime resulting from the recent events, the Call for Evidence on aligning the ring-fencing and resolution regimes or HM Treasury's consultation paper for a new resolution regime for insurers.

We would expect firms generally to be revisiting their understanding of how the resolution regime works and the issues highlighted in this briefing. Firms should be thinking about their strategy and governance in these situations, which advisors they may need to engage, how they can get liquidity in at short notice and whether existing arrangements constrain that. Firms should be reviewing their liquidity risk management controls, credit risk exposures to banks, cash flow forecasts, whether insurance arrangements for unprotected positions can be put in place and their risk strategy more generally. They should be asking themselves whether they should be diversifying their products and offerings, as well as their banking partners (particularly for example in light of the FSCS limit of £85,000).

We would also expect firms to engage with the regulators in respect of any issues which the SVB and Credit Suisse events highlighted. By way of example, authorised e-money or payment institutions may seek guidance from the Financial Conduct Authority as to the status of client safeguarded funds held in a firm in a BIP and whether these funds still constitute appropriately safeguarded funds.

For our earlier briefings considering the events with SVB, please see Silicon Valley Bank's current position and what to do about it (cms.law) and Update to Silicon Valley Bank's current position and what it means (cms.law).

Contacts

We have a dedicated team of partners with specialist backgrounds and experience that can support firms of any size in connection with bank resolution matters (including insolvency, restructuring, regulatory or M&A expertise). We have a detailed understanding of the resolution process and how interactions with the regulators work, with a number of our lawyers having previously worked or been seconded to the regulators (including the Bank of England).

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