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UK Bank Resolution Regime: Impact of Proposed Enhancements

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At a Glance

Parliament published the draft Bank Resolution (Recapitalisation) Bill on Friday, aimed at modestly enhancing the UK's already-robust bank resolution regime. The new legislation will increase flexibility in managing bank failures, via a new mechanism allowing the Bank of England (the Bank) to use funds provided by the banking sector to cover certain costs associated with resolving a failing banking institution and achieving its sale.

The proposed legislation will:

- expand the statutory function of the Financial Services Compensation Scheme (FSCS), the body responsible for paying out depositors in a bank insolvency, requiring it to provide funds to the Bank upon request, to be used where necessary to support the resolution of a failing bank;
- allow the FSCS to recover such funds by charging levies on the banking sector (similar to the current arrangements for funding depositor pay-outs in insolvency); and
- empower the Bank to require a bank in resolution to issue new shares.

Although the Government announcement focusses on the resolution of small bank failures, there is no limitation on the size of bank included in the reforms. UK branches of third-country banks are also within scope — despite the possibility that such branches could be recapitalised by their parent.

These reforms will enhance the UK's existing robust resolution regime for banking institutions by giving the Bank a more flexible toolkit to respond to bank failures. Use of the measure would involve increased costs for the banking sector, given the levy — but various safeguards should minimise the impact (as explored below).

Background

The UK's robust resolution regime for banking institutions was implemented in 2009 following the Global Financial Crisis. The most recent use of the regime was the resolution of Silicon Valley Bank UK in March 2023. Whilst that resolution was considered successful, HM Treasury worked with the Bank and other bodies to identify areas for improvement, conducting a public consultation from January to March 2024. The Government response to the consultation and the draft Bill were published on 19 July.

How the Reforms Work

The Bill amends the Banking Act 2009 and the Financial Services and Market Act 2000 as follows.

- **Recapitalisation Payments**: Where the Bank exercises a stabilisation power to achieve:
  - a sale of a bank, building society or investment firm to a private sector purchaser; or
  - a transfer of such a financial institution to a bridge bank,

  then the Bank can require the FSCS to make a recapitalisation payment to the Bank. This is a payment in respect of the Bank's estimated costs required to recapitalise the financial institution and related costs (such as the operating costs of a bridge bank and costs of HM Treasury and the Bank in relation to the resolution). The Bank must reimburse the FSCS for any unused funds.

- **Industry-Wide Levies; Safeguards**: The FSCS can impose levies on the entire banking sector to meet such recapitalisation payments. To assuage potential industry concerns, the Government notes that:
  - *'Ex post' Levy*: a levy will only be imposed after this mechanism is actually used, avoiding upfront costs for firms: the banking sector only pays when it needs to;
  - *Cost-effective Resolution*: using FSCS funds to place a small bank into resolution will usually result in lower overall costs than placing the firm into insolvency;[1]
  - *Existing Safeguards*: important safeguards exist within the resolution regime, including:

    - *Conditions/Consultation*: the conditions to placing a bank into resolution, which require the Bank as resolution authority to consult the Prudential Regulation Authority, Financial Conduct Authority and HM Treasury;[2]
    - *Shareholder and Creditor Losses*: the Banking Act requires the Bank to ensure shareholders and creditors of the failed institution bear losses (reducing the size of the request to the FSCS); and
    - *Affordability Considerations*: the Prudential Regulation Authority's consideration of the affordability of any levy raised by the FSCS (including its size and timing);
  - *Transparency*: the mechanism will be transparent: existing measures offer scrutiny of the use of resolution powers after the event and HM Treasury will update the Special Resolution Regime Code of Practice to:
    - provide greater clarity about how the Bank will take account of the costs to the FSCS when considering whether to use the new mechanism; and
    - provide that, following use of the recapitalisation mechanism, the Bank will be required to disclose publicly the estimated costs to industry of the options that were considered; and
  - *Exclusion of Credit Unions*: credit unions (which are outside the scope of the resolution regime) will not be required to contribute to the levy.
- **Parameters for Using Recapitalisation Mechanism**: The Government will not set out definitively the circumstances in which this mechanism would be used. Critically, however, the mechanism is a tool to facilitate resolution action; it is only available if the resolution conditions have been met to allow the Bank to exercise its resolution powers (including that use of such powers is necessary having regard to the public interest in advancing the resolution objectives).
- **Power to Mandate Issuance of New Shares**: The Bill includes an explicit power for the Bank to require a bank under resolution to issue new shares.[3] This is to ensure that the Bank can move swiftly to ensure FSCS funds are able to recapitalise the failing bank.
- **Scope**: Although the Government expects the recapitalisation payment mechanism will generally be used to support the resolution of "small banks",[4] the mechanism will apply to banking institutions of any size (that fall within the scope of the resolution regime). The changes also apply to subsidiaries of banks headquartered in another country; whilst it is possible that the parent may recapitalise the subsidiary outside of resolution, this may not always be possible (as was the case with Silicon Valley Bank UK). The mechanism may also be used to manage multiple firm failures simultaneously.

For further information, see the official Consultation Response.

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1. The consultation response offers two main reasons for this: first, the FSCS's initial outlay to effect the recapitalisation is likely to be considerably lower than the amount required to pay out all covered depositors; second, the recapitalisation and continuation of a failing firm avoids the potentially long and costly process of recovering value through an insolvency estate. ↩

2. In summary: 1. Is the PRA satisfied that the firm is failing or likely to fail? 2. Is the Bank satisfied that it is not reasonably likely that action will be taken that will result in the firm recovering? 3. Does the Bank consider it necessary to exercise a resolution power, having regard to the public interest in the advancement of one or more of the objectives of the resolution regime? 4. Does the Bank consider that the resolution objective would not be met to the same extent by use of a bank insolvency process? ↩

3. Specifically: where a bank resolution is effected via share transfer instrument (providing for the transfer of securities issued by the bank) and the Bank requires a recapitalisation payment to be made, then the share transfer instrument may include a provision requiring the specified bank to issue securities. ↩

4. I.e., those not required to hold the Minimum Requirement for own funds and Eligible Liabilities (MREL) above minimum capital requirements. ↩

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Suggested Reading

- 18 July 2024 Kirkland Alert King's Speech: Key Implications for the Distressed Market

- 15 July 2024 Kirkland Alert New UK Listing Rules: Implications for Financially Distressed Companies
- 20 June 2024 Kirkland Alert No More Automatic Stays for Winding-Up Petitions Involving an Arbitration or Exclusive Jurisdiction Clause