Andrew Bailey: The UK bank resolution regime

Speech by Mr Andrew Bailey, Executive Director for Banking Services and Chief Cashier of the Bank of England, at The Institute of Chartered Accountants in England and Wales (ICAEW) Financial Services Faculty breakfast, London, 26 November 2009.

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The UK bank resolution regime

Thank you for inviting me to speak this morning. One of the characteristics of bank resolutions, to which I will return later, is that they have to be done quickly to a fixed deadline and involve working through the night. They also require extensive involvement by accountants and lawyers, so, I have had some experience with spending nights and early mornings with accountants. The only, but important difference, is that I don't get to choose when to spend my early mornings on resolutions, whereas you did choose to listen to me early this morning, for which I am very grateful.

Some history

The 2009 Banking Act, passed in February, created the new bank resolution regime in the UK. In its first nine months it has been used once, at the end of March for the Dunfermline Building Society. There is a long history of involvement by the Bank of England in dealing with the problems of banks in the UK in order to underpin the stability of the financial system, much longer than the history of banking supervision. The history of the Bank in the nineteenth century features quite a few such interventions. More recently, although none came amid conditions comparable to those which occurred last autumn, the Bank was extensively involved in resolving problems in the secondary banking crisis of the 1970s, in Johnson Matthey Bankers in the 1980s, and then in the early 90s with a number of smaller banks. My own first involvement with resolving banks came at that time, with the resolution of National Mortgage Bank.

We now face a much bigger challenge in terms of building a more robust financial system. There are three parts to this task: regulation, structure and resolution. Today, I am going to talk about the last of these. In the past, our resolution toolkit was limited. We could use the Bank of England's own financial resources, as we did with Johnson Matthey Bankers and National Mortgage Bank. Or, we could determine that it was ***not*** necessary to provide financial support on grounds of a threat to the financial system, but nonetheless that it would be helpful to facilitate the orderly winding-up of an institution by undertaking what I would call "mopping up activities" of a type which only a central bank can typically undertake because it provides a safe house and neutral party. This was the case with Barings, in which I was also heavily involved.

There is therefore nothing new about bank resolution.

Why have a resolution regime for banks?

Why do we need a special resolution regime for banks? The first reason is that at the point when actions have to be taken to deal with a bank in difficulty, there will inevitably be a considerable amount of uncertainty about how bad that bank's problems are. This is because the scale of the problem will depend on how the future unfolds. But we will know at that point that if the authorities don't act, the problems of the institution will quickly get much worse, and a deposit run may well ensue. The second reason for a special resolution regime is that the process of resolution itself must not add to the uncertainty and loss of confidence. Put

simply, it has to be fast and decisive. Most bank resolutions happen over weekends. My overwhelming guiding principle is that by no later than first thing on Monday morning we must be able to tell depositors that their money is safe and its new home is …… There is a simple test of this – the answer to the depositor's question "Is my money safe?" must be yes – no hesitation or qualification can be added.

Normal corporate insolvency procedures are therefore inadequate for banks for a number of reasons. First, because they can only be initiated at the point of insolvency, whereas a loss of confidence in a bank by its depositors will often precede that point. Second, normal insolvency procedures are not well suited to ensuring continuity of key banking functions, particularly access of depositors to their funds, but also the provision of credit. Third, a bank failure may involve substantial negative spill over and externalities – for instance to other banks via their inter-connectedness. But in normal insolvency procedures these externalities would not be taken into account when determining what to do in insolvency. Fourth, depositors play a special role as creditors of a bank. Unlike the creditors of a typical company, they are very numerous in number, most are not professional market participants, and their claims in the bank are in the form of money.

The recent experience in the UK

These are therefore strong reasons for treating the resolution of banks differently. But we didn't start in this position at the onset of the financial crisis in 2007. At the time of the start of Northern Rock's problems, the UK did not have a special resolution regime; rather, we were relying on the tools of the past. Northern Rock was a good example of a bank that had a liquidity problem, caused by the closure of its major funding market, for residential mortgage backed securities, and had a heightened probability of experiencing a solvency problem in the future. In my view, if we were faced with the same problem today now that we have a special resolution regime for banks, there is little doubt that Northern Rock could have failed in an orderly way under the resolution regime. But this wasn't possible in September 2007. And given the number and size of depositors, Northern Rock could not be allowed to fail in a way that would have jeopardised the funds of those depositors. It was therefore a stark illustration of the need for a resolution regime.

In February last year emergency legislation was introduced in the form of the Banking Special Provisions Act, or BSPA, which created a temporary resolution regime, temporary insofar as the BSPA had a one year sunset clause. The BSPA, which facilitated taking Northern Rock into temporary public ownership, also contained broad powers for the Treasury, as the lead authority in that regime, to protect financial stability and the public interest by statutory transfers of the property of UK banks. The Treasury was also able to override or modify contractual property rights in order to give itself more room for manoeuvre.

Creating this regime turned out to have been prescient, because in September of last year it was used to resolve Bradford and Bingley by transferring part of its business, namely Bradford and Bingley's deposit taking activities, to Santander, leaving the rest in public ownership. The BSPA therefore enabled a new home to be found for the deposits over the course of a weekend. It also included an important mechanism to ensure business continuity, whereby a bank could be broken up over a weekend and this would not cause chaos in the bank's operations because a clear agreement was reached over the weekend for the continuing supply of services by the rump to Santander in order to make sure that it was business as usual on Monday morning for the transferred business.

The new regime

The BSPA contained broad powers, on the basis that it was temporary. Thus in February this year the new Banking Act came into force and created a permanent and more wide ranging special resolution regime or SRR for deposit takers incorporated in the UK. It is therefore a big and very welcome step forward.

The SRR has five objectives: to maintain financial stability; to protect confidence in the banking sector; to protect depositors in banks; to protect public funds; and to avoid interfering with property rights in contravention of the European Convention on Human Rights. These five objectives are not ranked in order of importance; rather, in each resolution case, a judgment needs to be made on how to balance these objectives taking into account the particular circumstances of the case.

The SRR provides a number of tools to deal with a bank. The first test that must be applied is to assess whether the public interest objectives could be met by implementing a rapid payout of insured deposits, or any other definition of deposits which the authorities wish to protect via a top-up extension of the deposit insurance scheme. The remainder of the bank would then be put through something known as the bank insolvency procedure. The test of whether this procedure could be used depends in large part on how long depositors would face without access to their funds. At the moment I think few banks could meet an acceptable timetable for payout. Moreover, for bigger banks this would always be too disruptive as an approach. Work is underway to facilitate rapid payout of depositors under the Financial Services Compensation Scheme and I hope that in the next year, banks will be able to meet the objective that they have been given by the FSA to be able to make payouts to depositors within seven days. This is not a trivial task as I readily recognise, and achieving it would not mean that this approach would always be chosen in a resolution. That depends on the situation at the time.

If the failure of a bank is determined to have wider systemic consequences that could undermine financial stability, confidence in the banking system or depositor protection, then the SRR provides a range of other tools to be used. It is possible to direct part or all of a failing bank's business to a private sector purchaser after a sale process has been undertaken. Second, it is possible for the Bank of England to take control of part or all of a bank's business through a bridge bank controlled and owned by the Bank. A special bank administration procedure can be used in combination with a partial property transfer or bridge bank. This administration procedure is broadly the same as a conventional administration save for the very important difference that the administrator has a statutory objective to support the transferred business with any infrastructure left in the insolvent rump. Finally, under the SRR provisions, it is possible to take a bank into temporary public ownership. For this approach, the Treasury would be in the lead, and there is a higher test of systemic importance to be passed (there must be a serious threat to financial stability) for this approach to be used.

As I have indicated, the SRR contains important roles for all of the authorities. The FSA is responsible for triggering the SRR by determining, broadly, that a bank no longer meets its threshold conditions for authorisation, and there is no reasonable prospect of it taking actions to correct the situation within an acceptable timeframe. The FSA is also responsible for approving the transfer of business to another institution that it authorises.

The Bank of England is responsible for operation of the SRR (with the exception of Temporary Public Ownership, where the Treasury is responsible). The Bank will consult the FSA and Treasury before selecting the SRR tool to be used, and we need to obtain the agreement of the Treasury to the implications of the chosen tool for the use of public funds. Also, the Bank can make recommendations to the FSA when it feels that the SRR should be triggered, though as I have said, the decision is for the FSA.

Finally the Financial Services Compensation Scheme (FSCS) plays an important role in the resolution process. This would be very obvious if an actual payout of depositors was chosen and the FSCS would work very closely with the administrator. They also have a prior role in assessing whether payout is feasible in a reasonable time. But the FSCS can also be requested to contribute to the cost of other forms of resolution up to the net amount it would have failed to recover in insolvency if there was an actual payout. This approach can be used, for example, where there has been a transfer of deposits – and the FSCS can provide

a suitable deposit to contribute to the immediate cost to the authorities. The FSCS does not however operate a pre-funded scheme in which money is available on call to provide such a substitute deposit. It may therefore have to borrow from the Treasury in order to contribute to the immediate cost of the resolution (as in Bradford & Bingley), with the FSCS contribution ultimately amounting to the cost of any eventual shortfall in recoveries. The FSCS is therefore an important part of the overall resolution landscape, and I will come back at the end of my remarks to consider how these arrangements might develop.

It is important to ensure that a regime like the SRR contains appropriate protections. At the heart of it is the ability given to the Bank to alter the treatment of property rights from the base of normal insolvency law. When the Act was being drafted, the lawyers talked a great deal about avoiding "Henry VIII" powers. I thought that this might have something to do with having the power to chop off heads. But that was not the case; rather, it derives from Henry's dissolution and seizure of the monasteries, which was an extreme case of intervention in property rights. The Bank of England's Special Resolution Unit takes on a more temporal role in its treatment of property rights, and one – you will be pleased to hear – that is shaped by secondary legislation to provide safeguards and a Code of Practice. I think we can be quite confident that Henry VIII saw no need for a code of practice.

The safeguards in our regime were drawn up in consultation with practitioners. They can be divided into two categories: restrictions on the use of the SRR powers; and mechanisms for payment of compensation where property rights are unreasonably affected by the use of the special resolution powers. In the case of the restrictions, there is protection for netting and set-off arrangements, secured obligations and capital market instruments such as covered bonds and securitisations, to ensure that they are not disrupted by the transfer powers. This is an important part of the regime, and I want to emphasise that it is not in the interests of the authorities to disrupt instruments and markets that are of course of great importance to other banks. It would just be counterproductive to take that sort of action.

In the case of compensation, the framework established by the Act ensures that the proceeds of the sale of a bank's business are returned to the failed bank's creditors and, if any surplus remains, to the shareholders, after meeting the claims of creditors in priority order. Moreover, creditors left behind in an insolvent entity – typically the rump of the business after other parts are transferred – are entitled to receive compensation to the extent that an independent valuer determines that they have received less than they would have done if the bank had gone into insolvency without the SRR being used. This is the "No creditor worse off" safeguard.

The Code of Practice provides guidance on a number of areas, including how the SRR objectives are to be achieved, factors guiding the choice between different tools, how to determine that it is not reasonably likely that action can be taken by or in respect of a bank to bring it into compliance with the FSA's threshold conditions – ie how to determine that the SRR should be triggered, how to determine the basis for calculating compensation where applicable, and the principles by which the Bank of England should run a bridge bank.

Beyond all of these provisions, the Banking Liaison Panel, whose members include industry bodies, lawyers and insolvency practitioners, in addition to HMT, the Bank and FSA is responsible for providing advice on the wider effects of the resolution regime.

The resolution of the Dunfermline Building Society

The first, and so far only, use of the resolution regime was for the Dunfermline Building Society at the end of March. Our tally of one is in sharp contrast to the US, where to date this year the FDIC has carried out 124 resolutions of failing banks. The US does, of course, have a much less concentrated banking industry.

Dunfermline was, almost needless to say, a very instructive first case to handle. We achieved the key objective of a weekend transfer of depositors, branches and the head

office, on this occasion to Nationwide Building Society. We also managed to transfer the prime mortgage assets over the weekend, also to Nationwide. This was an achievement, because necessarily the due diligence process is more complex for assets than deposit liabilities. The worse quality assets – mainly commercial property loans and bought-in mortgages – were placed into a building society special administration procedure (the building society version of a BAP). But the social housing loan book (for which Dunfermline was the second largest provider in Scotland) and some associated deposits were taken into a bridge bank owned and run by the Bank of England. We ran the bridge bank for three months while a sale process took place.

Dunfermline was therefore a case where we managed to use three of our tools in one go – the transfer powers, BAP and a bridge bank. To give you an idea of the pressure under which resolutions are done, the Dunfermline weekend involved an M&A process, the completion of around 50 legal agreements including a three-way transitional services agreement, setting up a new bridge bank, and putting in place communications to depositors and other stakeholders in order to ensure that branches and call centres etc opened for business as usual on Monday morning. And, there is a very human dimension to all of this. My own colleagues, our advisors and our colleagues in the other authorities have to work under great stress to get a successful resolution in place. But we also have to remember that we need to work with the staff of the bank, to help them to deal with the shock of the resolution taking place, usually following a very difficult period in which the bank has been under great stress, and through all of that ensure that the doors open on Monday morning. I am lucky to have very talented colleagues in the Bank and the other authorities and advisors who don't mind the stress and the risk, or at least that's what they tell me.

Issues arising

The resolution of Dunfermline was in my opinion a success: on Monday morning depositors knew their money was safe. But it illustrated well the difficulties of resolving banks. Resolution is after all invasive surgery on a bank. I want therefore to highlight a number of areas where in my view more work is needed to hone our regime further.

The first concerns funding of the FSCS. In my view we should be doing everything we can to minimise the reliance of the industry on public money, this is just not an acceptable state of affairs. One thing that can be done over the coming years, but gradually, is to pre-fund the FSCS with industry contributions. This would reduce the need for the FSCS to borrow from government and would provide a larger bulwark before the use of public money has to be contemplated. It is welcome that the Government supports pre-funding. There is a further issue of whether and how this pre-funding should be calculated, and in particular whether it should be done on a basis which takes into account the riskiness of each bank and thus the probability of causing a call on the FSCS. Since the FSCS is an insurance scheme, there is clearly a case for calculating the premium on a basis that reflects risk. But a lot more thinking is needed before we can be sure that this can be done in an appropriate way.

The second area in which we need to work to ensure that the resolution regime is as good as we can get it concerns the whole area of safeguards. There is a natural tension between the desire for precision in defining the protection of property rights at a very detailed level and the need for flexibility in a regime that has to be able to react to the situations that come our way. We don't get to choose the problems we face. I recognise that tension. I don't have a radical plan for changing the current regime, but I recognise that we have to keep a very careful eye on striking the right balance between having the discretion to deal with problems and ensuring that banks and markets know as much as they can about what we would, and would not, do in a resolution. This is why the Code and the Liaison Panel are important parts of the machinery.

The third area in which more work is needed concerns information and advance planning. In recent years the Bank has been forcefully arguing the importance of information gathering to

the government and FSA. In my experience resolution work is like icebergs – I don't mean that in the sense that banks are about to hit them. It is like icebergs in the sense that a vast amount of the work done is beneath the surface, hidden from view. Because resolution is an invasive form of surgery, it requires a very large amount of information to be carried out safely. Moreover, the planning work has to be done quietly, out of sight in order to avoid fuelling the failure of the bank, and it needs to start well in advance of the actual resolution weekend. As the authority responsible for resolution operations, the Bank of England faces a tension. In the ideal world, we want to work closely with the management of the bank to plan a resolution, at a time when it remains a contingency option that management naturally wish to avoid. But we also have to avoid the sense that a bank is receiving the attention of the undertakers. A very important development here will be the production and maintenance of resolution plans, as part of the overall recovery and resolution plans, or living wills. I spoke on this subject last week, and the text is available on the Bank of England website, so I am not going to labour the point today. But the general principle is that resolution is a very information hungry activity. To give an example, the FDIC in the US has recently adopted a rule requiring deposit takers to provide detailed information on their derivatives positions within a 60-day period after being notified by the Authorities to do so. The rule was only introduced earlier this year but it will be worth considering a similar approach in the UK.

Finally, there is a large missing piece to what I have said about the resolution regime, namely how it would deal with banks that operate with branches or subsidiaries in other countries, and likewise how foreign banks operating in the UK would be sorted out. There is now a great deal of attention on this issue, in the G20, in the EU and via the FSB working group on cross-border crisis management chaired by Paul Tucker, and rightly so. I think it is fair to say that the regimes in the US, Canada, Japan and the UK come closest at present to meeting a kite-mark standard, but more needs to be done in continental Europe. I therefore support the recent European Commission consultation calling for EU countries to adopt resolution regimes. Also, I think that we are much more likely to make progress in this field by agreeing on how national regimes can fit together to deal with international banks, rather than trying to devise an international resolution regime. The key issue then is burden-sharing, and that together the national regimes provide for equitable treatment of creditors whatever their domicile. A robust set of resolution regimes should not allow for bias in favour of domestic creditors. The UK, I should stress, is not one of those countries, but we are keen to work to produce a framework of resolution regimes that allows bias in favour of domestic creditors to end.

Thank you for listening to an account of the UK resolution regime. It is an important development as part of making our banks more robust to failure. It sits alongside enhanced regulation and supervision, and whatever structural changes may take place in the industry. But it remains work in progress, and in an important respect always will be because it needs to be ready to respond to threats that will evolve as well. And, finally, I should tell you my motto as head of the resolution unit, namely that I am happiest when we don't need to perform a resolution.