A response to HM Treasury's consultation on

Enhancing the Special Resolution Regime

March 2024

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

We are pleased to respond to the HM Treasury's (HMT) consultation paper (CP) on Enhancing the Special Resolution Regime**.**

HMT's proposals

HMT proposes providing a new mechanism to facilitate use of certain existing stabilisation powers to manage the failure of small banks that would otherwise be expected to be subject to the Bank Insolvency Procedure (BIP). This builds on the learned experience of the Silicon Valley Bank UK case which demonstrated that smaller banks may be revealed at the point of failure to be systemically significant or critical to the economy.

This proposed new mechanism will sit alongside the exercise of the Bridge Bank and Private Sector Purchaser (PSP) transfer resolution powers to provide greater optionality in terms of sources of capital for a small bank in resolution.

It would allow the Bank of England to use funds provided by the banking sector to cover costs associated with a resolution, including those associated with recapitalising and operating the failed bank. These funds would initially be provided by the Financial Services Compensation Scheme (FSCS) as needed in the event of a failure, and subsequently funded by an *ex-post* levy on the banking sector.

As is currently the case for a bank to be placed into resolution four conditions must be met, which are:

1. *a firm is failing or likely to fail – determined by the PRA in consultation with the Bank;*
2. *it is not reasonably likely that action will be taken that will result in the firm recovering – determined by the Bank, in consultation with the PRA, the FCA and HMT;*
3. *resolution action is necessary in the public interest – determined by the Bank, in consultation with the PRA, the FCA and HMT; and*

4. *resolution objectives would not be met to the same extent by placing the firm into insolvency – determined by the Bank, in consultation with the PRA, the FCA and HMT.*

In making these determinations HMT's Special Resolution Regime code of practice supports the legal framework of the special resolution regime and provides guidance as to how and in what circumstances the authorities will use the special resolution tools.

We have considered HMT's proposals with a wide cross-section of our members. Whilst all agree that they are a pragmatic response to a difficult problem, our members, large, mid-tier and non-MREL firms have different concerns, some of which have been captured in this response.

Key messages

1. We agree that it is important that there is a credible resolution regime for that minority of smaller banks that are systemically significant or critical upon failure.
2. HMT's proposals will provide the authorities with more tools to manage a failing small bank, enhancing financial stability where required.
3. All members agree that HMT's proposals are a pragmatic approach.
4. Our expectation is that the BIP should remain the default option were a small bank to fail, rather than this new mechanism becoming the default route
5. HMT should include 'no creditor worse off' type principles in the public interest test, which would be balanced against the overriding objective of ensuring financial stability, to ensure that the costs of resolution to the FSCS do not exceed the counterfactual, being the costs of placing the failing bank into the BIP.
6. The costs of resolution to be borne by the FSCS should not include the cost of financing any legal action that may subsequently emerge after the decision to recapitalise the bank.

Response to questions

1. **Do you agree with, or have any comments on, the proposal for the Financial Services Compensation Scheme to provide funding to recapitalise failing small banks, where these firms are placed into resolution rather than insolvency?**

Support for FSCS provision of recapitalisation funding

If it is decided to exercise resolution powers the failed bank must have adequate funds to recapitalise it, so it can continue to meet minimum capital requirements for authorisation or to cover the costs of restructuring. These must come from somewhere.

Our members agree that the government's proposal to utilise the FSCS to provide these funds is a pragmatic and expedient approach. They agree that funding these costs should take place in a way that distributes costs equitably across industry, avoiding unintended consequences, for instance skewing competition in the market or unfairly placing undue burdens on particular groups of firms, large or less large. Members propose that these concerns can be mitigated through the design of the funding mechanism used, for example by ensuring

appropriate 'no creditor worse off' type protections are put in place Our members have not identified other viable solutions to the funding of the recapitalisation and other costs of resolution, although we have debated a number of alternate means of funding, which would impact different member cohorts in different ways. As they have not met with general approval they have not been included in this response.

Alternatives rejected

Requiring smaller banks to meet an *MREL* calibrated for the use of resolution tools, would impose a disproportionate level of cost and would create barriers to competition and growth amongst this mid-tier sector which is an important source of lending to SMEs. MREL debt issuance is particularly challenging for smaller banks, who do not have established debt programmes, will not be regular issuers in the debt markets, will not always have a credit rating, and will only issue at sub benchmark size. It would also expose smaller banks to refinancing risk, the inability to do so being itself an insolvency event. These factors and others significantly reduce access to debt markets and, if they are able to issue, significantly increases the risk premium at issuance above the level expected based on a pure credit assessment. Overall, it would be impractical to ask these banks to issue MREL as acknowledged in the CP – it is also not a requirement imposed on any small banks in any other regulatory jurisdictions.

As the consultation notes we have considered in the past the building up a *mutualised fund*, to be contributed to by smaller banks and used in the event of one or more of their failures. But we have concluded that the practicalities of ensuring 'fair' risk sensitive contributions would be too challenging.

2. **Do you agree with the proposal to recoup the funds from the whole deposit-taking class?**

We agree that the use of the new mechanism to support the resolution of a smaller bank is unlikely to imposed additional upfront costs.

We also welcome the expectation that, where there is a net cost to the resolution, levy-payers will be levied on an ex-post basis, mirroring the current approach to the pay out of covered deposits after the operation of the BIP.

However, the mechanism could create uncertainty as it will not be clear ex-ante how often and to what extent any levy would be imposed. Indeed, a potential increase in the levy is to be anticipated as part of recouping the costs of resolution from the whole deposit taking class. It is important to compare this level of costs with relevant counterfactuals, for example the costs of resolution via insolvency and associated FSCS costs., which is why we have suggested that a case-study based Cost Benefit Analysis (CBA) be undertaken.

But our members have a different view on whether the proposed modification of the Special Resolution Regime will really benefit all deposit takers, as the HMT asserts, or whether the benefits will flow only to the group small banks, (aside from the small bank that actually fails) as contagion risk will be averted. This affects some of our members' appetite to agree with the proposal that funds should be recouped from the whole deposit taking class.

Our larger members already issue significant amounts of MREL, hold additional G-SII/O-SII buffers, are subject to more intensive supervision and fund the lion's share of the FSCS levy. In reality shareholders of other larger and mid-tier banks will bear the costs of a small bank's recapitalisation because of the way the FSCS levy is allocated. We do recognise that this consultation is not about redrawing the lines on which banks are levied.

Some firms have suggested that the allocation methodology could be calibrated to apply a proportionately higher ex post charge (all else equal) to smaller banks, which would be more likely to see benefits of the resolution of another small bank, through the mitigation of contagion risk. than MREL-banks. Other members noted that the PRA has acknowledged that the likelihood of firm failure is a product of a number of factors, including business model type, rather than simply firm size. UK Finance recognises that these factors and others, such as liquidity, capital and credit quality, are already captured in the existing FSCS calibration through the risk adjustment factor This suggestion does not find universal favour with our members.

Members do all agree that:

a) it is better to impose costs on shareholders and creditors than on taxpayers;
b) that ideally the costs of failure should be borne by shareholders and creditors of failed bank – on the 'polluter pays' principle.

But we concede that;

c) this is not possible for small banks because imposing MREL is likely to result in them incurring significant additional costs.

So, members support the compromise offered by HMT's proposals but recommend that safeguards are put in place to keep the costs to the industry below or equal to those that would have occurred if a failing small bank were placed into the BIP– similar to the current No Creditor Worse Off principle – which we recommend should be a specific requirement under the Public Interest test.

Impact on mid-tier banks

Some of our mid-tier members note that the consultation does not require any changes to capital requirements or MREL for smaller banks and we would not support any such requirement. Mid-tier banks that have raised their full MREL , often meeting it with Core Equity Tier 1 capital (CET1), have done so at a higher cost than larger banks whilst smaller banks are exempt from the requirement. These banks feel they would pay twice under HMT's proposals, once because of their higher MREL issuance costs and again as they are levied for the costs of resolution of the failed smaller bank.

Duration of funding in resolution

Our members note that the Bridge Bank mechanism is applied where no private sector purchaser can be found. Ownership of failed banks in a Bridge Bank mechanism should not be left open-ended. It would be helpful to understand the decision process about how HMT and the BoE would determine that a resolution strategy is no longer appropriate and should switch to the BIP.

3. **Do you agree with the proposed scope of application for the proposed mechanism?**

We appreciate the government has been explicit about which costs it would estimate in advance of placing a failing bank into resolution and to which FSCS funding would apply.

These are limited to:

- The costs of recapitalising the failed bank
- The operating costs of the Bridge Bank
- HMT and Bank of England costs in relation to the resolution

We view these activities as the maximum scope of the application of the proposed funding mechanism but would like further information on the extent of HMT's and the Bank's legal and professional expenses.

Future legal expenses

It is not inconceivable that aggrieved former shareholders might launch a legal challenge to the authorities' decision to apply the new Special Resolution regime mechanism to a failed bank. Alternatively, the failed bank may subsequently become subject to enforcement action from a regulatory body, for instance in relation to alleged conduct/consumer duty breaches.

Our members are all absolutely clear that they do not expect to fund redress or litigation that may emerge over the course of the resolution, but only the costs of the recapitalisation plus the authorities' estimate of the costs directly associated with it. We would appreciate confirmation that HMT does not expect to use banks' FSCS funding, as provided for by the new mechanism, to defend such actions. If this is not the case there is a risk that, *in extremis*, the FSCS becomes a source of funding for litigation, vexatious or otherwise.

Reasons for exercising the mechanism

We continue to view the BIP as the default approach to be applied to a failing bank and it is important that the BIP approach should continue to be used in all but the rarest of cases. This new mechanism should not become the default approach. FSCS funds should not be used where the root cause of a bank's failure is a misconduct or operational issue, only where there is a genuine public interest consideration.

The wording at para 3.20 suggests HMT contemplates that there may also be some limited instances where the new mechanism might be appropriate for other banking institutions. The example of a bank still reaching its end state MREL is given. We recommend that HMT is explicit in describing all circumstances where it could envision that the new mechanism being appropriate.

This will avoid generating an implicit investor expectation that the new process could be applied in a wider range of circumstances than those very narrow ones which UK Finance members and HMT envisage as the currently appropriately confined scope.

Removing the 8% and 5% tests

We recognise that as small banks are not required to hold MREL it is right that the 8% and 5% test be disapplied where a small bank is put into resolution.

The CP seems to contemplate, although the wording is vague, using the proposed FSCS drawdown mechanism for larger banks which are still *en route* to meeting their end state MREL. This leaves open the possibility for the Bank to exercise this mechanism for banks much larger than a 'small bank', without a cap on the amount of resolution funding that can be drawn from the FSC.

In our view the circumstances in which the 8% and 5% rules can be disapplied should be limited to the failure of firms that are not required to hold or are in the process of transitioning to holding MREL resources greater than TCR. In the latter case, the quantum of permitted FSCS drawdown should be limited to the amount required to fund the shortfall between the failed banks transition MREL and its end-state MREL.

Prior application of the Public Interest Test

It would be helpful to understand how the public intertest criteria was applied in the case of SVB UK. We understand that the pivoting from the expected application of the BIP to SVB UK to a resolution option was promoted by an increasing understanding, in the immediate wake of its failure, of the importance of SVB UK to the Fintech sector. Fintechs with operating accounts were concerned that they would be unable to access their accounts to make ongoing payments to support the day-to-day operation of their businesses.

In order for banks to understand the thresholds at which the new mechanism might be exercised it would be helpful to know how many operating accounts were held by Fintechs with SVB UK, and how many of these were 'sole-banked' i.e., without a pre-existing alternate operating account with another bank.

Small UK subsidiaries of larger 3rd country banking groups

We do not think the definition of a 'small bank' should extend to the subsidiaries of third country banks which are part of the group resolution plan and not subject to MREL. Small subsidiaries of a large overseas group are likely to receive group support to recapitalise the subsidiary or indeed to manage its orderly wind-down or sale as appropriate. Such banks should not be considered a "small bank" for the purposes of this policy. It would be helpful if HMT confirmed our view.

4. **Do you have any other comments on the proposals set out in this consultation?**

The need for a cost benefit analysis

Although it is widely assumed that the cost of insolvent wind down as well as FSCS pay out costs would be more costly than resolution, a detailed CBA should be provided to support the proposal.

We encourage HMT to provide case study-based examples, drawing on the experience of resolving Dunfermline Building Society and the case of SVB UK. These would enable the industry to understand any potential differences in costs to the industry between the two options.

Timing

A clearer understanding of the timing of the ex-post payment would also be helpful to understand at what point in the process funds could be requested of banks. This will enable our members to understand the financial impacts of the proposals and incorporate them in their capital planning.

Possible refinements to the FSCS

We notice that para. 1.13 refers to ongoing work on changes to the FSCS to support electronic payments and ease of exit for smaller banks. Payment technology continues to evolve. So, following the PRA's recent policy statement we look forward to the FSCS swiftly moving to more modern payment mechanisms to reimburse covered depositors rather than the current arcane payment by cheque.

Revisiting MREL thresholds

We remember that the Bank of England is considering the removal of the 40k – 80k transaction account MREL threshold. We have long argued that, as individuals and SMEs typically now have more than one transaction account, this threshold is redundant. This argument is made even the stronger by HMT's proposals which ensures continuity of transactional accounts, when the public interest test is met, without imposing the costs of MREL on smaller banks and which makes another resolution option available to ensure this.

Preventing contagion, but not a multiple bank failure solution

We agree with HMT that the proposed mechanism should prevent contagion at an idiosyncratic level caused by the failure of one small bank or one yet to reach end-state MREL. But we do not believe it is likely to be a viable solution in the case of multiple banks failing or in an industry wide stress. We would appreciate HMT's confirmation that it shares our view in this regard.

Of course, we would be delighted to discuss our response with HMT if more detail is required in relation to any of the points we have made.

Responsible Executive

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