

Financial Stability Paper No. 5 – July 2009

# The UK Special Resolution Regime for failing banks in an international context

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# The UK Special Resolution Regime for failing banks in an international context

Peter Brierley

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This paper seeks to place in an international context the UK Special Resolution Regime (SRR) for failing banks,<sup>(1)</sup> which came into effect in February 2009 with the adoption of the Banking Act. The SRR's key purpose is to enable an orderly resolution of a failing UK bank to be carried out in a manner preserving the public interest, particularly by maintaining financial stability, preserving confidence in the banking sector, and protecting both depositors and the taxpayer. The Northern Rock crisis in 2007 demonstrated clearly that the UK authorities lacked the powers necessary to achieve such a purpose at that time.

## Introduction

The paper shows that the new SRR draws on and in several respects goes beyond best practice internationally. This reflects:

- (i) its *design*, which has been influenced by the approach of other countries with special regimes, notably the United States, and is intended to be fit for purpose in modern financial markets;
- (ii) the fact that, unlike most other countries' regimes, it is based on a set of *statutory objectives*;
- (iii) the ability to *trigger* the regime before a bank is balance sheet insolvent, which is not available in some other countries but which increases the prospects of an orderly resolution preserving franchise value;
- (iv) linked to this, an approach designed to reduce the generic risk of *regulatory forbearance* that applies to all such regimes but is not addressed by most of them;
- (v) a more flexible and broader set of *tools* to resolve failing banks than is available in most other countries;
- (vi) the ability to *split* a failing bank between its good and bad parts, a particularly important feature given the current financial crisis, in which many banks have toxic assets which no one wants to buy;

(vii) a more explicit, comprehensive and transparent set of *safeguards* to protect shareholders, creditors and counterparties of a failing bank than any other country, while still preserving the overriding ability to resolve a failing bank in the public interest; and

(viii) more developed provisions facilitating the resolution of banking *groups* than in most other SRRs.

Many of these advantages reflect the fact that the United Kingdom has been the first major country to make fundamental legislative changes to its bank resolution regime during the current financial crisis. It has therefore been able to learn from the problems experienced during the crisis and incorporate innovative features into the design of the SRR to address these problems.

The adoption of the Banking Act was preceded by a lengthy period of consultation, starting in the autumn of 2007 and including the publication by the tripartite authorities of one discussion paper and no less than four consultation documents.<sup>(2)</sup> This consultation demonstrated that there was clear support for the adoption of the SRR by a majority of respondents, notably international organisations such as the

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(1) In this paper, 'banks' are defined as authorised UK-incorporated deposit-taking institutions, including building societies. The SRR applies to all such UK-incorporated banks, including UK subsidiaries of foreign banks, and encompasses also their branches outside the United Kingdom (given that these are not separate legal entities). But the SRR does not apply to foreign subsidiaries of UK banks, nor to UK branches of foreign banks, both of which would be subject to the resolution regime of the home country of incorporation of such entities.

(2) These are listed in the references section at the end of the paper.

IMF and BIS, banking and finance specialists, academics, market participants and regulatory bodies.

Although most respondents accepted the need for change and a framework facilitating orderly bank resolutions, there was some concern on the part of the City, notably among certain trade associations and law firms, that the new powers introduced under the Act might be used in a draconian manner. The authorities sought to address this concern through close consultation with City organisations on the secondary legislation<sup>(1)</sup> and Code of Practice<sup>(2)</sup> introduced alongside the Act. The secondary legislation provided the key safeguards and protections for shareholders, creditors and counterparties of any bank placed into the SRR. And City organisations have been formally consulted on the need for any further changes to the secondary legislation through the establishment under the Act of the Banking Liaison Panel.<sup>(3)</sup>

## Key principles in resolving failing banks

Interestingly, however, neither the majority of the consultation responses nor the Parliamentary debates on the Bill included much reference to the *approaches of other major countries to the resolution of failed banks*. This paper therefore seeks to demonstrate that the design of the UK SRR has been influenced by the approach of other countries, most notably the United States. And it has also sought to meet the recommendations in this area of international organisations, particularly the IMF and World Bank.<sup>(4)</sup>

Most other G10 countries have some form of 'special' arrangements for resolving distressed banks, in the sense that these are distinct from the application of general (corporate) insolvency law to bank failures. Although the institutional structure of these arrangements varies significantly from country to country, they generally enable the authorities to take resolution actions that are legally separate and distinct from those that govern the resolution of non-banking companies. That option was not available to the UK authorities prior to the passage of the Banking Act — the United Kingdom was previously completely dependent on the application of corporate insolvency law, such as the Insolvency Act of 1986, to the resolution of banks.

## The drawbacks of resolving banks using corporate insolvency law

The United Kingdom's corporate insolvency law has evolved over a long period and provides an effective regime for the resolution or liquidation of industrial and commercial companies. This is designed to maximise the prospects of restructuring or rescuing a distressed company, provides for an orderly liquidation of the company if a rescue is not possible or there is no prospect of restoring its longer-term viability, and

treats shareholders and creditors of the company as fairly as possible.

But the corporate insolvency law is much less appropriate to distressed banks, for the reasons explained in Box 1.<sup>(5)</sup> Deposit-taking banks are fundamentally different from industrial and commercial companies. The failure of banks can generate large negative *externalities* to the stability of the financial system, in a manner unlikely to apply to non-financial companies. Application of the corporate insolvency law could aggravate rather than reduce these system-wide losses.

Furthermore, *speed* is much more important in resolving banks than companies in general. This is because of the risk that even solvent banks may rapidly become insolvent if they experience a run in consequence of real or imagined problems affecting the bank or, even more unpredictably, other similar banks thought to be in a distressed state. This emphasises the need to act quickly, before the onset of actual bankruptcy, in the banking case. That in turn means a need if necessary to override the rights of shareholders and creditors, which as noted above are protected under the corporate insolvency law, for the greater good of resolving the bank effectively in an orderly manner that protects the public interest and provides continuity of access to vital banking services.

The drawbacks of exclusive reliance on corporate insolvency law were demonstrated as the Northern Rock (NR) crisis unfolded from mid-2007. Without an SRR, the authorities could not take control of NR away from its shareholders and senior management while the bank was still balance sheet solvent. The result was that an early resolution of NR's problems proved to be impossible, the bank continued to lose franchise value, making a sale of its business more difficult, and, in the absence of a private sector solution that preserved financial stability, had eventually to be nationalised. The only alternative to nationalisation would have been to put NR into administration, which for all the reasons listed in Box 1 would not have adequately maintained financial stability. Had the authorities been able to have placed NR into an SRR at an earlier stage, when more of its value remained, it is possible that part or all of the bank would have been sold to a private sector buyer. This would have avoided the need to impose additional potential losses on the taxpayer by having to nationalise the bank.

(1) The two key statutory instruments which came into force on 21 February 2009 under the secondary legislation were: *The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009*, S.I. 2009 No. 322; and *The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009*, S.I. 2009 No. 319.

(2) See HM Treasury, *Banking Act 2009 Special Resolution Regime: Code of Practice*, February 2009.

(3) Section 10 of the Act sets out provisions relating to the Banking Liaison Panel. Its membership includes trade associations representing the banking sector, eg the BBA, BSA and LIBA, City law firms and insolvency experts, along with representatives of HMT, the Bank, the FSA and the FSCS.

(4) See IMF/World Bank (2009).

(5) The issue has also been explored in the academic literature. One of the best articles setting out the case for special bank resolution arrangements is Hupkes (2005).

## Box 1

### Reasons why corporate insolvency law is inappropriate for banks

(1) It focuses on individual companies in isolation so does not address the fact that banks, unlike industrial and commercial companies, are vulnerable to *losses of confidence*, which may lead to runs, contagion and wider systemic consequences that undermine the public policy objective of maintaining financial stability.

(2) Neither the *bankruptcy courts* nor the *insolvency practitioners* appointed to conduct a proceeding under the corporate insolvency law are required to take into account public policy objectives linked to the maintenance of financial stability. The actions they mandate or carry out in pursuit of their objectives could, therefore, worsen a banking crisis.

(3) It may only be initiated at the point of insolvency<sup>(1)</sup> and so inhibits *early and decisive pre-emptive intervention* designed to forestall potential problems — which in the banking sector can escalate rapidly to affect not only the bank in difficulty but

also other banks which are or are thought to be in similar positions.

(4) It is not well suited to ensuring the *continuity* of key banking functions, especially payments to and from customer accounts and access to overdraft and other credit facilities, all of which will be frozen by the moratorium that generally comes into effect in a corporate insolvency proceeding.

(5) Related to this point, it is not well-adapted to allow the *real-time decision-making* of a kind to manage the risks to which most banks of any size are exposed, eg dynamic hedging techniques.

(6) It does not recognise the particular position of bank *depositors*, who — unlike the creditors of an industrial company — are numerous in number, are not professional market participants and whose claims on the bank, as 'money', have a major role in the wider functioning of the economy.

(1) The definition of insolvency in the corporate law encompasses both 'cash-flow' insolvency, in the sense of inability to pay debts as they fall due, and 'balance sheet' insolvency, in the sense of liabilities exceeding assets.

## Key features of SRRs

In special resolution regimes, the main objective is to ensure an orderly resolution of a failed bank which preserves financial stability and confidence in the banking system. The design and key features of such regimes are fundamentally different from the corporate insolvency law.<sup>(1)</sup> In particular, the initiation and implementation of resolution measures are generally under the control of the authorities; and the rights of the stakeholders of the bank are generally subordinated to the powers of the authorities. Such features have been replicated in the UK SRR introduced under the Banking Act.

In what follows we look at several key aspects of the UK SRR and consider how they compare with corresponding provisions in regimes in other leading financial centres. We focus in particular on the following key features:

- (i) the *objectives* of the regime;
- (ii) the *trigger(s)* for initiating the regime;
- (iii) the *resolution toolkit*;
- (iv) the ability to effect *partial* as well as whole-bank property transfers;
- (v) the *safeguards* designed to protect creditors, counterparties and shareholders of a failing bank, especially in the context of partial property transfers;
- (vi) the way the regime deals with *banking groups* which carry out other financial activities as well as deposit-taking; and

- (vii) the application of the regime to the resolution of UK-incorporated banks with *international activities*.

## Objectives

The objectives of the UK SRR are listed in Section 4 of the Banking Act and, in summary, are to:

- maintain financial stability;
- protect confidence in the banking sector;
- protect depositors;
- protect public funds; and
- avoid interfering with property rights in contravention of the relevant articles of the European Convention on Human Rights (ECHR).

Most other countries do not specify statutory objectives in their regimes, but a minority do include in their legislation some sort of public interest remit to those conducting the resolution of a failed bank, defined in broadly similar terms. Box 2 provides more details on these approaches.

Although the UK SRR specifies a set of objectives in the legislation, the Act does not define terms such as 'financial stability'. This is exactly in line with the approach taken in other countries whose SRRs are subject to an overarching

(1) For a good account of the key differences in the United States, see Bliss and Kaufman (2006).

## Box 2

### Objectives of SRRs in other countries

In the United States and Canada the Federal Deposit Insurance Corporation (FDIC) and the Canada Deposit Insurance Corporation (CDIC) are subject to least cost resolution (LCR) requirements, whereby they must adopt the resolution method which costs the least to the deposit insurance fund regardless of other objectives. The LCR requirements can in turn be overridden in the United States and (under current proposals) Canada under certain tightly defined circumstances by 'systemic risk exceptions' (SREs), which effectively means that the resolution regimes of these countries are subject to an overarching objective relating to the maintenance of financial stability.

A similar exemption also applies in Japan, which may be invoked if the failure of a bank could disrupt overall financial stability or affect the stability of the national and local economies. Again, therefore, the financial stability objective is emphasised.

Some countries specify public interest objectives in their SRRs, including New Zealand and Hong Kong. The legislation in Hong Kong, for example, provides the Hong Kong Monetary Authority with the ability to exercise special powers to effect an orderly resolution of a failed bank if that is considered to be in the public interest.

Most countries, however, notably continental European countries, tend not to specify financial stability or public

interest objectives explicitly in their legislation relating to the resolution of failing banks.

An LCR requirement, subject to a systemic risk override, is arguably most appropriate to countries which do not have concentrated banking structures. This helps to explain why, until the current crisis, the SRE had never been invoked in the United States. Such an approach is less applicable to the United Kingdom, which would probably require much more frequent recourse to the override given its much more concentrated commercial banking sector.

Only limited guidance on such objectives is provided in the laws of any of those countries that identify them. For example, Section 141 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which lays down the rules and provisions relating to the US LCR requirement and the SRE, offers no definition of financial stability and only a certain amount of guidance as to how a determination under the SRE should be made.<sup>(1)</sup> The Japanese legislation similarly makes no attempt to define financial stability or the stability of the national and local economies. And the Hong Kong legislation similarly offers no definition of the public interest.

(1) FDICIA specifies two criteria for invoking the SRE: first, compliance with the LCR requirement must have serious adverse effects on economic conditions or financial stability; and second, a non least cost resolution must avoid or mitigate such adverse effects. So not only must a systemic situation exist, but also the non least cost actions proposed must have some reasonable chance of success.

financial stability remit or a public interest test, as Box 2 indicates. Indeed the United Kingdom provides more guidance on these issues than most other regimes through the Code of Practice published under Section 5 of the Act.

### Triggers for the SRR

The triggers for initiation of the key powers available in the UK SRR are set out in Section 7 of the Banking Act. They are twofold and both conditions must be satisfied. First, the bank must be failing, or likely to fail, to satisfy its 'threshold conditions'.<sup>(1)</sup> Second, it must not be reasonably likely that action will be taken by or in respect of the bank (other than potentially through the SRR) that would enable it once again to satisfy the threshold conditions.

The main reason for using the threshold conditions as the trigger is that these are the regulatory requirements which any UK bank undertakes to meet in order to gain authorisation from the FSA to accept deposits and carry out regulated

banking activities. It is appropriate, therefore, that banks that no longer meet the conditions for authorisation, and have no prospect of doing so in future, should be placed into the SRR and may lose their deposit-taking authority.

These decisions are in essence regulatory judgements and so are taken by the FSA in the United Kingdom. The United Kingdom is no different from virtually all other major countries with special regimes in assigning to the banking supervisors the right to trigger the SRR. This does of course raise the generic and frequently highlighted risk of *regulatory forbearance*, which in this case means that the banking supervisors may delay too long in triggering the regime. This could be because they believe this would be an admission of

(1) The five threshold conditions are specified in Section 41 of the Financial Services and Markets Act 2000. They relate to: (1) legal status — the bank must be a body corporate or partnership; (2) location of offices — the head office of a body corporate constituted under the laws of any part of the United Kingdom must be located in the United Kingdom; (3) close links — these must not prevent effective supervision; (4) adequate resources — interpreted widely to include liquidity, capital, provisioning, human resources and risk management processes; and (5) suitability — interpreted to include that management be fit and proper.

regulatory failure on their part, or because they fear possible legal challenge from shareholders, directors or creditors of the failed bank.

This risk is partly addressed in the United Kingdom by a key aspect of the design of the triggers, which is that they enable a failing bank to be placed into resolution *before* it is balance sheet insolvent. In this respect, the UK SRR fully meets a key recommendation by the IMF/World Bank.<sup>(1)</sup> This is intended to increase the chances of an orderly and rapid resolution in a manner which preserves as much as possible of the remaining franchise value of the bank. Practice in other countries varies on this crucial point. Many do not permit resolution action until a bank is insolvent or on the verge of insolvency. But others do specify pre-insolvency thresholds for resolution. Box 3 provides further details on other countries' approaches to triggering their SRRs.

Another way to address the risk of regulatory forbearance would have been to give the Bank of England, in its capacity as the special resolution authority, the right to trigger the regime as well as the FSA. This could have been justified on the grounds that any forbearance by the banking supervisor would be likely to undermine the prospects of an orderly resolution of a failed bank, thereby making it more difficult for the resolution authority to discharge the responsibilities for which it is accountable. *Dual control of the trigger* would, therefore, be designed to mitigate the fact that regulatory forbearance in this context is a risk imposed by the banking supervisor on the resolution authority.<sup>(2)</sup>

In the event, the UK SRR does not incorporate this feature, because the Government decided that the FSA, as the banking regulator, should be the lead authority to decide whether a bank is failing. Ministers feared that dual control of the trigger would be likely to lead to dual regulation of banks, which they thought would be wasteful and costly.<sup>(3)</sup> Instead, the Bank has been given the right to make a *recommendation* to the FSA to trigger the regime.<sup>(4)</sup> Although a less powerful deterrent to regulatory forbearance than dual control, such a right still has the potential to mitigate this risk somewhat, because it would be likely that such a recommendation, although made in private, would become public knowledge following a resolution. This is reinforced by the fact that the UK SRR ensures that the authorities are accountable to Parliament for actions taken under the regime.

In other countries' regimes, neither dual control nor a right to recommend pulling the trigger are generally available to the resolution authority.<sup>(5)</sup> But other techniques may be employed to reduce the risk of regulatory forbearance. The US SRR seeks to address this risk through the use of transparent and quantitative triggers under its 'Prompt Corrective Action' rules.<sup>(6)</sup> But these are not the only triggers that may initiate the SRR nor do they eliminate the ability of

the US banking supervisors to exercise discretion in whether or when to appoint the FDIC as receiver.<sup>(7)</sup> In many continental European countries, such discretion also exists and is if anything reinforced by the fact that the triggers for resolution tend to be wholly qualitative rather than, as in the United States, partly quantitative.

## The resolution toolkit

The UK SRR provides the authorities with four key tools:

- (1) the power to direct and accelerate a transfer of part or all of a failing bank's business<sup>(8)</sup> to a *private sector purchaser* (PSP);
- (2) the power to take control of part or all of a failing bank's business through a bridge bank owned and controlled by the Bank of England;
- (3) the power to place a failing bank into *temporary public ownership* (TPO);<sup>(9)</sup> and
- (4) a modified *bank insolvency procedure* (BIP) to close a failing bank and facilitate fast and orderly payout of depositors' claims under the Financial Services Compensation Scheme (FSCS) or transfer of their insured deposits to a healthy private sector bank.

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- (1) See IMF/World Bank (2009), *op. cit.*, page 5, which establishes as a key principle of bank resolutions that they should be capable of initiation at a 'regulatory threshold', ie when the bank's net financial position has fallen below a specified level but it retains a positive net worth.
  - (2) The risk of regulatory forbearance was emphasised by Bank Governor Mervyn King in a speech to the BBA on 10 June 2008. He argued that the risk justified the resolution authority having a powerful voice in the use of the trigger. As the Governor put it: '...any resolution authority will have a natural interest in the timing of a decision to place a bank under its control'. In subsequent evidence to the Treasury Select Committee on 22 July 2008, the Governor made clear that he would have preferred a regime where the Bank, as the special resolution authority, had the right to trigger the regime.
  - (3) These points were made by Ian Pearson, the Economic Secretary to the Treasury, during the House of Commons committee stage debate on Section 7 of the Banking Bill on 6 November 2008.
  - (4) In a similar manner, the FSA has the right to make a recommendation to the Bank on the choice of SRR tool(s) to be used in any case. These rights are not enshrined in statute, but are part of the operating framework of the SRR. And the Act does contain a number of requirements for consultation between the tripartite authorities in the triggering and implementation of a resolution under the SRR.
  - (5) Assuming the resolution authority is not also the banking supervisor. If the resolution authority does also have responsibility for banking supervision, clearly it will have a significant role in the timing of a resolution. In the United States, the FDIC has considerable influence, deriving from its triple role as the resolution authority, a banking supervisor (see below) and the deposit insurer.
  - (6) Like the least cost resolution requirement, these rules were introduced under FDICIA in 1991.
  - (7) The US approach is complicated by the fact that the FDIC also has supervisory responsibilities: it shares these with state regulators for US state-chartered commercial banks that are not members of the Federal Reserve System and for US mutual savings banks. If any of these institutions failed, the FDIC's appointment as receiver would be made by the state regulators. Chinese walls exist between the FDIC's supervisory and resolution divisions.
  - (8) The Act defines 'business' of the bank to relate to either its shares or its property, including both assets and liabilities. So the Act provides for both share and property transfer powers, referred to collectively in Section 1(4) as 'stabilisation powers'. These are exercised in relation to tools (1), (2) and (3), referred to in Section 1(3) of the Act as the 'stabilisation options'. The BIP is also an SRR tool, but is not defined in the Act as a stabilisation option because it does not involve the application of a stabilisation power.
  - (9) Note that a bank placed into TPO is different from a bridge bank: the TPO tool involves the Government acquiring all the *shares* of the failing bank, while the bridge bank tool involves a transfer to a company owned by the Bank of England of only part or all of the *property* of the failing bank.

### Box 3

#### SRR triggers in other countries

In the United States the SRR triggers are partly quantitative, linked to the prompt corrective action (PCA) rules. Under PCA, the US banking supervisors may appoint the FDIC as receiver within 90 days of a bank's tangible equity ratio falling below 2% (termed 'critically undercapitalised'). But the US banking supervisors may initiate SRR measures against a failing bank on various other grounds, which are mainly qualitative. They may do so, for example, in the event of violations of law, unsafe or unsound practices or on the basis of critical management failures, regardless of whether the bank is critically undercapitalised or not. Furthermore, the FDIC does not have to be appointed as receiver within 90 days of a bank becoming critically undercapitalised if the US banking supervisors determine that such action would not serve the purposes of prompt corrective action. But an appointment does have to be made eventually if the bank remains in the 'critically undercapitalised' PCA zone for four quarters.

Japan also has a fairly similar form of PCA, while Canada has a more qualitative version, with the authorities being able to impose increasing restrictions on a bank as it moves through certain 'stages', in much the same way as the US banking supervisors can do under PCA. Unlike the US and Japanese rules, however, the Canadian remedial actions are not linked to particular published quantitative measures of performance, such as risk-based capital ratios. But like the FDIC, the CDIC is

These tools may in some cases be alternatives and in other cases complements. In the resolution of the *Dunfermline Building Society* in March 2009, the first institution to be resolved using the powers of the Banking Act, part of the business of the society was transferred to a PSP and another part was initially transferred to a bridge bank. Although it is not possible to be prescriptive, in many cases a transfer to a PSP, if it can be arranged quickly and at an appropriate price, is likely to be the tool best able to meet all the SRR objectives. But a transfer to a bridge bank may be the best option if such a private sector solution requires more time to arrange, for example because potential PSPs need to carry out further due diligence on the bank's books.<sup>(1)</sup> It may be necessary to take a bank into TPO if there is no reasonable prospect of selling it to a PSP, either directly or through a bridge bank, in the short run *and* the bank's failure could represent a serious threat to financial stability. And finally, the BIP is most likely to be used for a bank whose failure is unlikely to have adverse systemic consequences and for which there is unlikely to be a buyer because little or no franchise value remains.<sup>(2)</sup>

able to take resolution action if necessary at a pre-insolvency threshold. This is similar to the UK approach, where a distressed bank is likely to undergo a period of heightened supervision by the FSA and, if this does not succeed in bringing about effective remedial action, may be placed into the SRR at a pre-insolvency threshold.

In European SRRs the triggers, as noted above, are also qualitative, but some do permit pre-insolvency action. In Italy, for example, special administrators may be appointed to resolve a bank if its activities have involved serious administrative irregularities or violations of laws, or if serious capital losses are expected. In France, the Commission Bancaire has the power to suspend a bank's management before the bank becomes insolvent and use this as a reason for appointing a provisional administrator. In Switzerland, the authorities can take resolution action if the bank does not meet its capital adequacy requirement after the expiry of a deadline set by the regulator, or if justified concerns exist that the bank is overindebted or if justified concerns exist that the bank has serious liquidity problems.

In many other European countries, however, it is not possible for the authorities to override shareholders' property rights at a pre-insolvency threshold, thereby reducing the likelihood of an orderly resolution if shareholders are unable to agree on a voluntary restructuring. This proved to be a particular problem facing the Dutch and Belgian authorities in the resolution of Fortis bank last year.

The SRR toolkit is augmented by the fact that existing resolution tools that were already available to the authorities prior to the adoption of the SRR are still available for use, such as public sector *capital and liquidity injections* and *liability guarantees*. And to support the use of the tools, the nature of the FSCS has been changed to enable FSCS *funds*<sup>(3)</sup> to be used to support not only the BIP tool but also any of the other tools as long as the support does not exceed the amount the FSCS would have incurred (net of recoveries) had it paid out to eligible depositors. Box 4 briefly considers how this toolkit compares with those available in other countries.

(1) The IMF/World Bank work supports bridge bank powers being available to the authorities, subject to a balanced and transparent legal and regulatory framework, see IMF/World Bank (2009), *op. cit.*, page 41.

(2) Further detail on the factors influencing the choice of SRR tools is set out in Chapter 5 of the Code of Practice.

(3) In the United Kingdom, the FSCS raises such funds through *ex-post* levies on the banking system. An alternative approach, adopted in many other countries, is to build up the funds *ex-ante*, through the imposition of deposit insurance premiums on the banks. These premiums would ideally be risk-related, to reflect the fact that riskier banks benefit more from deposit insurance and impose higher expected costs on the deposit insurer than less risky banks. An *ex-ante* fund would impose less procyclical pressure on the banking sector than an *ex-post* fund, and would also mean that the failed bank pays towards the cost of its own failure (thereby meeting the 'polluter pays' principle).

## Box 4

### SRR toolkits

The UK toolkit is broadly similar to that which has been available to the FDIC for over 20 years. The US 'purchase and assumption' (P&A), whereby a healthy bank purchases some or all of the assets and assumes some or all of the liabilities of a failed bank, is equivalent to the private sector purchaser tool in the United Kingdom; the FDIC has had a bridge bank tool since 1987;<sup>(1)</sup> its 'open bank assistance' option, which would generally require the systemic risk exception to the least cost resolution requirement to be invoked, would also entail substantial injections of public funds and part or whole nationalisation, as in the TPO tool; and the US insured deposit pay-off/transfer-cum-liquidation option is very similar to the bank insolvency procedure.

Among other countries, Canada also has a P&A tool, a nationalisation option and a liquidation tool. It also introduced legislation in January 2009 to provide the CDIC with bridge bank powers.

Japan too has P&A, bridge bank, TPO and liquidation tools but historically has preferred to use public sector capital injections and TPO rather than bridge bank powers. That said, the TPO tool in Japan, rather like that in the United Kingdom, is intended to be a last resort and can only be initiated in systemic cases, but the failure of any of the larger Japanese banks would clearly fall into this category.

In European countries with special regimes, bridge bank powers tend not to be available and nationalisation has again

often been the preferred approach to resolving banks whose failure would be likely to have adverse systemic consequences. But a number do have P&A-type tools, which would tend to be used in preference to nationalisation. A good example of this is provided by the Italian regime, where the Banca D'Italia (in its role as banking supervisor) can initiate a compulsory administrative liquidation (CAL) if it considers that a consensual restructuring by special administrators cannot be achieved. A CAL generally involves the transfer of the assets and liabilities of the failed bank to a healthy bank via a P&A type transaction.

More countries are beginning to appreciate that bridge banks paving the way to private sector solutions offer additional flexibility and are an alternative, rather than equivalent, to nationalisation. A bridge bank does not require the authorities or state to acquire the shares of a failed bank, merely part or all of its property. This permits a separation of the economic and control rights of ownership. In the UK SRR, for example, the Bank of England assumes the control rights from ownership of the bridge bank, but the economic benefits of ownership continue to reside with the shareholders of the failed bank.<sup>(2)</sup>

(1) For a good account of the evolution of the bridge bank tool in the United States, see Reidhill *et al* (2005).

(2) Those rights will of course be available only subject to the normal priority ranking in any insolvency proceeding applied to the estate of the failed bank not transferred to a bridge bank or private sector purchaser, ie shareholders will rank behind all creditors.

One distinctive feature of the UK toolkit is that it contains *different pre-conditions for use of the different tools*. This provides greater and more transparent guidance than most other regimes on the key factors influencing the choice of tools. The specific condition for exercising the PSP and bridge bank tools is specified in Section 8 of the Act as requiring at least *one* of the 'public interest' objectives — maintaining financial stability, maintaining public confidence in the banking sector or protecting depositors — to be met. But the condition for exercising the TPO tool is set in Section 9 of the Act at a higher level: this requires a *serious threat* to financial stability to arise from the failure of the bank. This emphasises that TPO is regarded in the UK SRR as a last resort, which as noted in Box 4 is not so clearly the case in a number of other European countries. The UK regime in this aspect is closer to the IMF/World Bank recommendations.<sup>(1)</sup>

The BIP, by contrast, does not require a 'public interest' objective to be met before it may be applied. But it remains the case that the BIP is still part of the SRR toolkit: it is important from a moral hazard perspective that the SRR should not be viewed as a 'no-failure' or 'no-closure' regime. So the authorities must still be guided by the five statutory SRR objectives in deciding whether to use the BIP tool and in implementing it. The conditions for use of the tools imply that the BIP will be used<sup>(2)</sup> if the bank's failure is not likely to trigger the public interest criteria for use of the other SRR tools.

This does not, however, imply a two-tier regime whereby larger failed banks would invariably be subject to a

(1) See IMF/World Bank (2009), *op. cit.*, page 36, which refers to temporary nationalisation as a last resort to resolve a large bank failure with major systemic implications.

(2) Assuming that the grounds for making a bank insolvency order under Sections 96–97 of the Act are met, ie that the bank is unable, or likely to become unable to pay its debts; or that the winding-up of the bank would be in the public interest; or that the winding-up of the bank would be fair (ie just and equitable).

stabilisation option while smaller banks would invariably be placed into the BIP. The *choice of SRR tools* will depend on a range of factors, including the characteristics of the failed bank, the probability of being able to apply the tool successfully to any particular bank, the overall macroeconomic and financial circumstances in which the bank fails, and the causes and consequences of that failure. In the current crisis, the SRR objectives may be better met by applying a stabilisation power to even a relatively small failing bank, rather than by placing it into the BIP.<sup>(1)</sup> This will especially be the case if there is likely to be a buyer for part or all of the bank's business. Evidence from the FDIC's resolutions of the many failed US banks in the late 1980s and early 1990s suggests that recoveries are likely to be substantially greater from a going concern sale of part or all of a failed bank, regardless of size, than from a piecemeal liquidation of its assets.<sup>(2)</sup>

As noted above, the UK SRR allows *FSCS funds* levied from the banking sector to be used to support the exercise of the stabilisation tools provided that this is no more costly than the application of FSCS funds in the BIP. This is an important aspect of the SRR because it may be used to facilitate an orderly resolution that avoids the uncertainties and delayed access to key banking facilities associated with a depositor payout together with piecemeal liquidation of a failed bank's assets. Such a wider role is permitted for deposit insurance funds in most other G10 countries.

## Partial property transfers

Perhaps the most widely commented-upon aspect of the UK SRR, based on the consultation responses and the views expressed during the passage of the legislation through Parliament, is the power of the authorities to *split up* a bank and effect a *partial property transfer* (PPT).

Similar powers are available, however, in several other countries' regimes. Again, the PPT powers are closely modelled on the US approach in particular. When the FDIC exercises its power to transfer part of the assets and liabilities (including financial contracts and derivatives) of a failed bank (either to a PSP or a bridge bank), it simultaneously establishes a 'receivership', into which the remaining assets and liabilities are placed. The receivership is very similar to the *bank administration procedure* (BAP)<sup>(3)</sup> that comes into effect in a PPT under the UK SRR. In both cases, essential facilities or services that it has not been possible to transfer may be used to support the PSP or bridge bank as necessary, while assets can be moved between the two entities in order to maximise the chances of effecting a going concern sale at a premium of as many as possible of the failed bank's assets. The PPT powers have been used by the FDIC on many occasions and are proving particularly crucial during the current financial crisis, because so many failed banks have certain toxic assets which

no potential PSP is willing to buy. The new PPT powers were also used in the first application of the UK SRR to the Dunfermline Building Society.

PPTs have been fairly common in *previous crises* over the past 20 years. For example, they were used to effect *good bank/bad bank* resolutions in many Latin American<sup>(4)</sup> and Asian countries. In some cases, the bad banks were handed over to asset management companies (AMCs), which were mandated to work through and realise the problem assets. Developed countries outside the United States, by contrast, have generally not previously used PPTs. This either reflected a lack of the necessary powers, or that whole-bank transfers were possible, or that PPTs were too complex to arrange quickly in reaction to fast-burn bank failures.

But the *current crisis* has resulted in increasing interest in the use of PPTs, bridge banks (as noted in Box 4) and good bank/bad bank resolution approaches, given the cost and difficulty of arranging whole-bank resolutions when there are no current buyers for substantial parts of failed banks' assets.<sup>(5)</sup> In these circumstances, one of the key advantages of a PPT is that it makes it possible to effect a resolution at lower cost to the taxpayer, for example by allowing a greater proportion of the losses to be imposed on junior creditors, such as subordinated debt holders, whose claims may be left behind in the rump of the failed bank rather than being transferred to a private sector purchaser or bridge bank. In current conditions, therefore, the SRR's stabilisation powers, if they can be deployed, are more likely to be used to effect a PPT rather than a whole-bank resolution.

## Creditor and counterparty safeguards

The UK SRR contains a number of explicit safeguards designed to protect creditors, counterparties and shareholders of a failed bank, especially in a PPT. The main safeguards are set out in Box 5.

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- (1) A similar rationale applied implicitly when the Bank of England granted indirect support to small UK banks in the early 1990s. It should also be noted that the BIP envisages that any payout or transfer of insured depositors can be effected rapidly, with most of any payments being made within, say, seven days. This will require improvements in the efficiency of UK banks' systems and infrastructure, which the banks have been given until late 2010 to implement. Until then, a payout under the BIP could take several months, which could itself undermine the confidence of depositors in the banking system, thereby making it more likely that the public interest conditions for use of an SRR tool other than the BIP would be met (if the BIP were accompanied by a payout; this argument applies less to use of the BIP with a transfer of insured depositors).
  - (2) Over the period 1980–94, the costs imposed on the FDIC as a proportion of failed banks' assets averaged around 13% for P&As (including those using bridge banks) compared with 28% for liquidations/deposit pay-offs. See FDIC (1998).
  - (3) It is important not to confuse the bank insolvency procedure, covered in Part 2 of the Act, with the bank administration procedure, covered in Part 3. The BIP is a *whole-bank* liquidation process and as noted is an SRR tool in its own right. The BAP applies only to *part of the bank* and can only be used in a partial transfer, in conjunction with either the PSP or bridge bank tools; it is not therefore an independent SRR tool itself.
  - (4) For an account of how good bank/bad bank resolutions have increasingly become a key aspect of the approach to bank resolutions in Latin America, see Bolzico *et al* (2007).
  - (5) Or the potential buyers would only be prepared to purchase certain assets at a price lower than they would be likely to realise in an insolvency of the whole bank.

## Box 5

### Creditor safeguards in the UK SRR

(1) The net proceeds from the operation and sale of a bridge bank, and if appropriate a bank in TPO, revert to the failed bank's creditors and (if any surplus remains) shareholders through the 'resolution fund order', as specified in Section 58 of the Banking Act.

(2) There is scope also for separate or additional *compensation orders* in any use of an SRR tool, subject to independent evaluation (see Sections 49–62 of the Act).

(3) *Set-off and netting arrangements* are largely protected, such that the Bank of England, as the special resolution authority, would not be able to cherry pick financial contracts with a given counterparty that are covered by set-off and netting arrangements — it would either have to transfer all such contracts to a bridge bank or PSP or leave them all behind in the rump of the failed bank.

(4) *Secured creditors'* claims cannot be separated from the assets securing the liabilities in a PPT.

(5) *Structured finance arrangements*, such as securitisations and covered bond programmes, are protected, so it is not possible to separate the liability from the collateralisation pool in a PPT or to transfer some but not all of the rights and obligations of such an arrangement.

(6) The normal *priority ranking* of creditors is not altered in either the BAP and the BIP, ie secured creditors rank ahead of unsecured creditors and depositors, who in turn rank ahead of subordinated debt holders, who rank ahead of shareholders.

(7) Creditors left behind in the BAP in a PPT will be compensated so that they are no worse off than they would have been in an insolvency proceeding into which the whole bank might have been placed had the PPT and BAP not been used (the 'no creditor worse off' (NCWO) safeguard).

These safeguards, which are enshrined in the secondary legislation that accompanied the Act, are far *more explicit and wide-ranging* than anything available under the special regimes of most other countries. Some have parallels in the US regime. But in general the UK SRR provides more effective protection to creditors than the US SRR. For example, the protection for set-off and netting applies to all financial contracts in the United Kingdom, subject to a limited number of carve-outs relating to assets and liabilities that are not typically netted (eg retail deposits).<sup>(1)</sup> The corresponding US protection only respects the netting of 'qualified financial contracts' (QFCs), which represent a subset of the UK list of financial contracts that are protected.

The US SRR does also feature a version of the no creditor worse off safeguard, which was adopted in 1989. But its relevance was greatly reduced when the United States introduced *depositor preference* in 1993, under which depositors rank ahead of other unsecured creditors in an insolvency. This allows the FDIC, when subrogated to the claims of insured depositors transferred from the failed bank, to rank ahead of the unsecured creditors in the receivership. This is likely, other things being equal, greatly to reduce recoveries for the non-deposit wholesale creditors in the United States.

There is no depositor preference in the UK SRR, so the FSCS, when subrogated to the claims of eligible depositors, will rank equally with the non-depositor unsecured creditors in the BIP or BAP. Given that the FSCS or FDIC will generally be by far the largest creditor, this should improve likely recoveries for

the unsecured creditors in the United Kingdom compared with the United States. The UK *no creditor worse off* safeguard should also be attractive to creditors, because not only does it place a floor on creditors' losses in a PPT, it also allows them to share in the upside if the use of an SRR stabilisation tool generates a greater return from the sale of the failed bank's business than a piecemeal sale in liquidation. In the United States, that upside accrues to the FDIC before the non deposit creditors.

One final important safeguard in the UK SRR, which does not apply in the United States, is the need to meet the statutory SRR objective relating to the avoidance of interference with *property rights enshrined under the ECHR*. This ensures that, where the SRR powers are exercised in a way that would interfere with a shareholder's, counterparty's or creditor's rights by depriving them of their contractual or property rights, the shareholder, counterparty or creditor has a valid claim to proportionate compensation under the Human Rights Act (enshrining the ECHR in UK law). As noted above, the Banking Act provides a detailed framework for the payment of compensation to such claimants. Where a shareholder's or counterparty's contractual rights are overridden by the FDIC in the United States, by contrast, the counterparty has a claim for damages not against the US Government, which is of course not bound by the ECHR, but against the insolvent bank. This could limit the compensation which may be available in

(1) Creditors in the United Kingdom are further protected by the provisions of relevant EU directives, notably the Financial Collateral Arrangements Directive of 2002, which protect the legal enforceability of collateral arrangements.

the United States compared with that in the United Kingdom to less than would be compatible with the protection of property rights under the ECHR. As such, this feature of the US approach could not be applied to the UK SRR without breaching one of its statutory objectives.

Outside the United States, clearly other European countries with special regimes would have to respect the property rights guaranteed under the ECHR. But although this might in some cases require other European countries to provide compensation when exercising SRR-type powers, this is generally left to the discretion of the authorities and little guidance is provided in the primary or secondary legislation governing the regimes in those countries. In Italy, Switzerland and Germany, for example, there are no statutory provisions which mandate compensation to be provided to shareholders and other stakeholders of a failed bank if measures have been taken in respect of a still-solvent bank in order to preserve financial stability. This is also true of major countries outside Europe, notably Japan.

For all these reasons, the UK SRR contains much more explicit, transparent and wide-ranging protections of the property rights of shareholders, creditors and counterparties of a failed bank than does virtually any other country with PPT powers, subject to the overriding need to carry out an orderly bank resolution in a manner protecting the public interest and financial stability.

## Resolution of banking groups

The UK SRR applies to *deposit-taking institutions*. This is because it is this activity that most clearly differentiates banks from other companies and therefore demands a separate regime, for the reasons set out in Box 1. As noted, depositor protection is one of the statutory objectives of the SRR.

The UK banking sector, however, is characterised by a *universal banking* model in which deposit-taking entities are often part of larger financial groups, headed by holding companies. The SRR seeks to address this by imposing certain 'continuity obligations' on such groups, set out in Sections 63–70 of the Banking Act. These impose requirements on former group companies to continue to provide essential services to the transferee to which part or all of the deposit-taking entity's business is transferred in a resolution carried out under the SRR. Such requirements are generally not a feature of most other countries' regimes. They are absent, for example, in the United States, which has been a major obstacle to resolving large US financial institutions during the current crisis.

In addition, Sections 82–83 of the Act enable a parent UK-incorporated *holding company* of a deposit-taking bank to be taken into TPO if the SRR is triggered in respect of the deposit-taker and this is deemed necessary to resolve or

reduce a serious threat to financial stability. And once the holding company is placed into TPO, the share and property transfer powers become applicable to any other bank which is or was in the same group. These features are more developed than in most other countries' SRRs, which tend also to apply largely or wholly to deposit-taking entities.

The holding company provisions of the Act were one of two main changes made through Government amendments to the Act as it was passing through Parliament. The other was prompted by the *Lehman's insolvency*, which has raised a number of complex issues relating to the large UK-incorporated entity Lehman Brothers International (Europe), which had to be placed into an ordinary administration in the United Kingdom. Sections 232–36 of the Act grant the authorities an enabling power under which the Treasury may through secondary legislation make changes to the insolvency law governing UK *investment banks*, if that is deemed appropriate following a consultation exercise. A Consultation Document on the issues raised was published in May 2009.<sup>(1)</sup>

The enabling power could be used in respect of specialised UK-incorporated investment banks. But in practice most investment banking business in the United Kingdom is carried out by larger financial groups which often also have deposit-taking and in some cases insurance<sup>(2)</sup> arms. This raises a broader issue which has assumed much greater importance in the current global crisis, namely whether an SRR *for large and complex financial institutions* (LCFIs) should be developed and, if so, with what objectives. The US Treasury has recently published proposals which effectively advocate an SRR for US LCFIs, defined as bank holding companies and 'Tier 1' — or 'systemically important' — financial holding companies.<sup>(3)</sup>

SRRs for deposit-taking banks, as noted above, tend to be based on the assumption that they are fundamentally different, not only from industrial and commercial companies but also from non-banking financial companies. An SRR for LCFIs would raise a number of complex issues. A regime designed to ensure the preservation of systemically important financial activities (including non-banking activities) would raise issues of how such activities could be identified and separated from the rest of the group's activities. It is also unclear whether all the existing SRR tools should be made available for application also to the non deposit-taking entities within LCFIs, given that one of the main objectives of such tools is to protect depositors.

(1) See HM Treasury (2009).

(2) The near-failure of AIG and the problems of the monoline insurers in the United States have demonstrated that the failure of insurance companies could also have wider systemic consequences that could undermine financial stability.

(3) In this regime, it is proposed that the FDIC's SRR tools be made available also for the non-banking parts of a bank holding company or Tier 1 financial holding company. This partly reflects the fact that, as noted above, the US regime does not currently contain continuity obligations on financial groups, such as are available in the UK SRR under Sections 63–70 of the Act.

Notwithstanding these difficult questions, a broader SRR might be helpful if the source of problems in the group lay with a non-banking entity, and this in turn threatened the viability of the deposit-taker. The continuity provisions of the Banking Act are designed rather to address the converse situation where the problems originate with the deposit-taking entity, not other parts of the group. This is a matter which requires further consideration in the United Kingdom, especially in the light of the US Treasury's proposals.

## Resolution of cross-border banking groups

An additional layer of complexity raised by the appropriate way to resolve LCFIs is that they often carry out substantial *international activities* through branches and subsidiaries in other jurisdictions.<sup>(1)</sup> The UK SRR applies to UK-incorporated banks and all their branches worldwide, but not their overseas subsidiaries. It also applies to UK-incorporated subsidiaries of foreign banks, but not to UK branches of foreign banks. This is understandable, given that branches are not legally separable from their parent, while subsidiaries are legally separate and locally incorporated. At the EU level, the approach is also necessary to be consistent with the EU *Credit Institutions Reorganisation and Winding-Up Directive* (CIRWUD) of 2001, under which a single resolution would be applied by the home country authorities to an EEA bank and all its branches — but not subsidiaries — elsewhere in the EEA.

The CIRWUD makes no attempt to harmonise EU countries' approaches to bank resolution. Lack of such harmonisation, both in the EU and more widely, is a problem for the resolution of cross-border banks given that countries' international insolvency law will generally be based on one of two fundamentally different approaches. In the *universal* approach, a home country will seek to resolve a locally incorporated international bank as a *single entity*, applying a single proceeding to the bank and all its branches world-wide and treating creditors equitably regardless of their location. This contrasts with the *territorial* approach, under which the international activities of the bank are resolved through *separate entity* resolutions brought by host countries and applying to the local entities, including both branches and subsidiaries, of the bank. These proceedings may be entirely separate from any main proceeding applied to the parent bank by the home country authorities.

The CIRWUD is clearly based on a modified form of universality. Rightly, it applies a universal approach to the resolution of a bank and its branches abroad, but preserves the ability of host countries to apply territorial approaches to locally incorporated subsidiaries. But territoriality could become more problematic if it involves the host country authorities *ring-fencing* any domestic assets attributable to a local branch of a foreign bank and using them to prioritise the claims of creditors of that branch. This is particularly an issue

in the United States, given that it adopted *national depositor preference* in 1993. But any non-EU country could potentially adopt a similar approach in respect of the local branch activities of a UK bank. This could clearly undermine the effectiveness of the UK SRR. For example, it could potentially reduce the assets that might be transferred to a bridge bank or PSP in the United Kingdom, thereby limiting the going-concern premium from the sale of assets and hence lowering recoveries to the creditors.

One potential remedy to some of these problems would be greater *harmonisation of SRR toolkits*. The European Commission has been considering a common intervention toolkit that might be applied to the resolution of an EU bank. This would mandate the use of broadly similar tools to those available under the UK SRR. Greater harmonisation might increase the confidence of host authorities that the resolution approaches of home countries would be well-considered and broadly comparable to those that might be adopted by the host country.

Any *regional solution* at EU level, however, would still not address the issue of how best to resolve distressed LCFIs with international activities outside the EU. This is likely to require *improved co-ordination* between the authorities in the key jurisdictions.<sup>(2)</sup> A number of international organisations, including the G20, the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), are working to address this issue. They are likely to propose reforms to address some of the difficulties and potential conflicts of interest that may impede co-operation between authorities in the different jurisdictions in which major LCFIs are located.

## Conclusion

Much of the public debate leading up to the adoption of the UK SRR was not closely informed by the approaches of other countries to resolving failing banks. This paper therefore seeks to close this gap by placing the SRR in an international context. It concludes that the SRR is at the forefront of best practice internationally. This perhaps explains why some other countries are looking at the United Kingdom's SRR closely as they seek to reform their own approaches. Greater harmonisation of approaches may help to address some of the difficulties of resolving cross-border banks and other complex financial institutions.

(1) The complications that result and their implications for resolution approaches have been explored extensively in the academic literature. See, for example, Bliss (2003), Eisenbeis *et al* (2004), Herring (2002) and Mayes (2004).

(2) Calls by international organisations for better co-operation and co-ordination to facilitate the resolution of international banks and other financial institutions have been a common theme over the past 20 years. See, for example, BCBS (1992) and the Group of Thirty (1998).

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## Glossary of acronyms

**AMC** – asset management company.  
**BAP** – bank administration procedure.  
**BBA** – British Bankers' Association.  
**BCBS** – Basel Committee on Banking Supervision.  
**BIP** – bank insolvency procedure.  
**BIS** – Bank for International Settlements.  
**BSA** – Building Societies Association.  
**CDIC** – Canada Deposit Insurance Corporation.  
**CIRWUD** – Credit Institutions Reorganisation and Winding-Up Directive.  
**ECHR** – European Convention on Human Rights.  
**EEA** – European Economic Area.  
**EU** – European Union.  
**FDIC** – Federal Deposit Insurance Corporation.  
**FDICIA** – Federal Deposit Insurance Corporation Improvement Act.  
**FSA** – Financial Services Authority.  
**FSCS** – Financial Services Compensation Scheme.  
**HMT** – Her Majesty's Treasury.  
**IMF** – International Monetary Fund.  
**LCFI** – large and complex financial institution.  
**LCR** – least cost resolution.  
**LIBA** – London Investment Banking Association.  
**NCWO** – no creditor worse off.  
**QFC** – qualified financial contract.  
**P&A** – purchase and assumption.  
**PCA** – prompt corrective action.  
**PPT** – partial property transfer.  
**PSP** – private sector purchaser.  
**RTC** – Resolution Trust Corporation.  
**SRE** – systemic risk exception (or exemption).  
**SRR** – Special Resolution Regime.  
**TPO** – temporary public ownership.