Bank resolution and safeguarding the creditors left behind

By Geoffrey Davies and Marc Dobler of the Bank's Special Resolution Unit.(1)

Not for the first time, the global banking crisis illustrated the vulnerability of banks to a loss of confidence by their depositors, other creditors and counterparties. The experience highlighted the need to have special arrangements for dealing with failing banks — a 'special resolution regime' — that provides the authorities with the tools necessary to reduce the systemic risks arising from a bank's failure while at the same time limiting the taxpayers' exposure to the costs. The United Kingdom's own Special Resolution Regime for dealing with failing banks and building societies was born out of the difficulties in dealing with the failure of Northern Rock in the autumn of 2007.

This article is in two parts. The first provides a general overview of the principal objectives and features of a bank resolution regime, drawing in particular on the design of the United Kingdom's Special Resolution Regime (SRR).

The second part of the article considers the measures adopted in the design of the SRR to provide appropriate protection to uninsured creditors and counterparties of a failed bank. These creditors could typically include bondholders and wholesale depositors as well as market counterparties owed sums by the bank under derivatives and other financial contracts. These protective measures — referred to as 'creditor safeguards' — can be broadly divided into two categories: *ex-ante* restrictions on the ways in which resolution tools can be deployed and *ex-post* rights to compensation.

This second part aims to show why these safeguards are necessary and how their design requires a careful balance between providing an appropriate degree of market certainty on the one hand and retaining sufficient flexibility to effect an orderly resolution on the other. Finally, it offers some examples from the resolution of the Dunfermline Building Society to show why getting the balance of creditor safeguards right is so important to effective resolution.

Part 1: An overview of bank resolution

Bank failures have the potential to occur very quickly. The 'maturity transformation' which banks undertake, ie funding long-term assets such as mortgages with short-term liabilities such as deposits payable on demand, makes them inherently vulnerable to a rapid loss of confidence by their creditors. A run by depositors to withdraw their funds can swiftly put pressure on the bank's ability to repay these debts. And while a bank that is solvent and still viable may look to the central bank to provide liquidity as lender of last resort, the herd effect of a run can leave little time to stabilise the situation and avoid a downward spiral into insolvency.

Why have a bank resolution regime?

Generally when a company fails and it cannot restructure its debts or be sold in order to continue as a going concern, its owners or creditors will wind it up. The company's assets are sold over time, with the proceeds used to satisfy, as far as possible, its creditors' claims in a fixed order of priority. That is an approach common to most countries and generally operates successfully for firms large and small, regulated and unregulated.

Prior to the adoption of the SRR, insolvent banks in the United Kingdom were subject only to normal corporate insolvency law. The insolvency process allows losses to fall on creditors who have assumed the risk of lending to the bank, removes uncompetitive banks from the market place and makes space for new competition. Assuming it is successfully combined with rapid payout of compensation by a deposit insurance scheme, insolvency provides some protection to the bank's retail depositors, while ensuring that depositors with deposits in excess of the insurance limit retain responsibility for the investment choices they make.(2)

But the insolvency of a bank, particularly one with a large number of depositors and financial counterparties, has the

(1) The authors would like to thank Kushal Balluck and Sagar Shah for their help in producing this article.
(2) The liquidation on 16 June 2011 of Southsea Mortgage & Investment Company is an example of how a small deposit-taker may be wound up using the SRR's bespoke insolvency tool that permits rapid payout of insured depositors, without the resolution having wider systemic effects.

potential to generate wider costs or 'negative externalities' for society extending well beyond the losses to a bank's immediate creditors. Banks play an essential role in the payments system, they provide credit for goods and services and act as repositories for public savings and cash balances. Banks also play an essential role in the transmission of monetary policy.(1) But unlike other types of business, it is very difficult for banks to operate once in insolvency.

Commencement of insolvency leads to a freeze in the bank's ability to make payments, which effectively results in the end of its business.(2) The sudden severing of these interconnections between a bank and the rest of the financial system and wider economy can have highly undesirable systemic effects. Individuals and small companies are entitled to compensation by the Financial Services Compensation Scheme (FSCS) for the first £85,000 of their deposits. But even a relatively short delay in the time needed by the FSCS to process and pay many deposit insurance claims can lead to hardship for households and businesses left temporarily without access to their savings. Disruption of this kind can undermine depositor confidence, potentially triggering contagion to other banks and endangering financial stability.

The insolvency practitioner appointed to manage the insolvency has neither responsibility nor powers to address these wider risks — their duty is limited to acting in the financial interests of the creditors. For these reasons corporate insolvency law can be ill-suited for resolving failed banks. In the absence of a bank resolution regime, the alternative to insolvency is stark. As the run on Northern Rock in 2007 and its subsequent nationalisation in February 2008 graphically demonstrated, the provision of liquidity to a failing bank may fail to stabilise the balance sheet. In such circumstances, and when the failure presents a systemic risk, the authorities can be left with little option but to use public money to support the bank and keep it open to prevent systemic disruption.

Bailing out a bank in this way transfers the cost and risk of a bank failure from its creditors to taxpayers.(3) In addition to these direct costs, the anticipation of such action can create an ongoing risk to the system. The lack of a credible resolution regime encourages a 'moral hazard' problem. The management, shareholders and creditors of the largest banks come to operate under the assumption that the bank will not be allowed to fail and that they will not be required fully to account for the risks that they take. This implicit guarantee of state support generates a subsidy for banks that are considered too big or important to fail, allowing them to fund themselves more cheaply than small banks.(4) In turn this can lower incentives for market discipline and encourage the sorts of risky behaviour that may increase the likelihood that this public support may eventually be required.

Given these risks, the principal objective of a bank resolution regime is to give the authority responsible for its operation (the 'resolution authority') a range of options for dealing with a failing bank beyond normal insolvency. To be effective, these options must be capable of preserving financial stability by sustaining any vital economic functions performed by the bank while ensuring that the bank's losses are borne by its shareholders and creditors and not by the taxpayer.(5) This is the rationale for the 'stabilisation' or directed transfer powers available to the authorities under the SRR.

Transfer powers: splitting the balance sheet of the bank

The legal power to transfer some or all of the business of a failed bank to another company lies at the core of the United Kingdom's SRR and of most other bank resolution regimes around the world.(6) Transfer powers may be used to split the balance sheet of a failed bank into at least two parts (a 'partial transfer'):

- one part, — typically including the retail deposits(7) plus any marketable assets and liabilities from the failed bank — is immediately transferred to a buyer, which would likely be another bank. If a buyer cannot be found quickly enough, the business is transferred to a temporary 'bridge bank' specially set up by the resolution authority to manage the business until it can be sold; and

- another part, comprising the remaining assets and liabilities, is not transferred and stays on the balance sheet of the failed bank, which typically enters a special form of insolvency (in the UK SRR this is termed the 'bank administration procedure' to distinguish it from the bespoke whole bank liquidation process in which insured depositors receive compensation from the FSCS, which is known as the 'bank insolvency procedure').

The purpose of splitting the balance sheet in this way is to transfer to a solvent and stable entity, creditors and financial counterparties of the bank deemed a systemic risk and which therefore need to be protected to maintain financial stability.

(1) See Hüpkes (2005) for a more in-depth discussion of the essential role in the economy that banks play.
(2) See Huertas (2011).
(3) See Parker (2011) and Herring (2011) for further discussion of the risks of open bank assistance.
(4) Research has suggested that 'too big to fail banks' benefit from an implicit subsidy in their cost of funding worth between 10 and 50 basis points (see Claessens *et al* (2010)). The Bank of England has estimated that the implicit funding subsidy to UK banks and building societies in 2009 amounted to £100 billion (Bank of England (2010)).
(5) The Financial Stability Board (FSB) has recently published a consultation paper setting out what it considers to be the key attributes that should be part of a resolution regime for financial institutions (FSB (2011)).
(6) The transfer powers are called 'stabilisation powers' in the United Kingdom's SRR and a 'purchase (of assets) and an assumption (of liabilities)' in the United States. The United States has had a bank resolution authority since 1933 and Canada since 1967. Transfer powers have also existed in Italy for some time and have been recently adopted in Germany.
(7) This could potentially be limited only to the insured amount of any deposits, ie up to the current limit of £85,000 for each eligible depositor, with the remainder of the balance being left in insolvency.

In addition, good-quality assets and business lines that may attract a going concern sale premium may be transferred. Creditors whose claims do not satisfy these criteria are left in the residual bank, thereby removing the need for public funds to support them. By providing the resolution authority with flexibility to decide how the balance sheet should be divided, the transfer powers thereby offer a range of alternative options that sit between insolvency and nationalisation.

The key features of the United Kingdom's SRR(1)

The bank resolution regime in the United Kingdom evolved in two steps. Initially, broad powers were set out in emergency legislation introduced in February 2008 and conferred on the Treasury primarily for the nationalisation of Northern Rock.(2) The power to use this legislation for new bank failures automatically expired after one year, and was replaced by a permanent bank resolution framework set out in the Banking Act 2009. The SRR sought to draw on best practice internationally. It provides roles for the Financial Services Authority (FSA) in triggering the SRR and for the Treasury, principally in retaining its nationalisation powers and its control of the use of public funds in resolution. The largest role is reserved for the Bank of England which, as resolution authority, can operate its transfer powers within the following framework:

Scope of application: The SRR extends to all UK-incorporated firms that are authorised by the FSA to accept deposits.(3) Investment banks and other financial institutions therefore fall outside its scope if they do not have a deposit-taking licence. The UK branches of foreign banks also fall outside of the resolution regime's scope as they form parts of companies incorporated overseas.(4)

Trigger for use: Transfer powers are most effective in preserving franchise value and expediting orderly resolution if they can be used before a bank enters insolvency and its financial transactions are suspended. But the prospect of intervention at too early a stage in a bank's decline can further destabilise it, hastening its demise and reducing the prospects of a private sector solution to its problems. The United Kingdom's SRR seeks to avoid this risk by specifying two triggers for using the SRR tools. First, the FSA must decide that the bank is failing, or likely to fail, the regulatory requirements it must meet in order to be authorised to take deposits. And second, the FSA must also determine that it is not reasonably likely that action (outside the SRR) may be taken by or in respect of the bank that would enable it once again to meet these regulatory requirements. These determinations can therefore be reached by the FSA before the bank is insolvent, but once the realistic prospect of recovery has gone.

Objectives for choice and use of the tools: The Banking Act sets out five objectives that the Bank of England, as resolution authority, must balance when determining the selection and use of the resolution tools. These are:

- to protect and enhance UK financial stability;
- to protect and enhance public confidence in the stability of the UK banking system;
- to protect depositors;
- to protect public funds; and
- to avoid interfering with property rights in contravention of the United Kingdom's Human Rights Act 1998.

The Bank of England is entitled to balance these statutory objectives as it sees fit. Before using a transfer power it must first satisfy itself (following consultation with the Treasury and FSA) that use of the power is necessary for one or more of the first three of these objectives. This necessity test serves the purpose of ensuring that there is sufficient public interest to justify interfering with the property rights of the failing bank or its shareholders (see the box on page 216 for why this is necessary).

The SRR also gives the Treasury power to take into temporary public ownership a bank or the bank's parent company (if incorporated in the United Kingdom) through the compulsory acquisition of shares from its shareholders. This is a last resort measure for use where, for example, it is considered that the complexity, scale and urgency of the crisis would make the Bank of England's powers to transfer part or all of the failing bank's business to another buyer or bridge bank unworkable or insufficient to protect financial stability. The threshold for its use is consequently higher than for the other powers; the Treasury must be satisfied that this action is necessary to resolve or reduce a serious threat to financial stability or to protect public funds that have been provided for that purpose.

Making the transfer: The SRR is an 'administrative' rather than 'judicial' process; the Bank of England does not need court approval to exercise its transfer powers and can do so once the SRR has been triggered simply by issuing a written transfer document (the 'transfer instrument'). The transfer instrument sets out the terms of the transfer and the time at which the transfer becomes automatically effective.

Insolvency of the 'residual bank': In a partial property transfer, the part of the failed bank not transferred to a bridge bank or commercial purchaser (called the 'residual bank') is likely to be placed into an insolvency process managed by an insolvency practitioner (the 'bank administrator'). This process (called the 'bank administration procedure') departs from a

(1) For further discussion see Bailey (2009) and Brierley (2009).
(2) The Banking (Special Provisions) Act 2008.
(3) Credit unions are explicitly excluded on the grounds that their size makes resolution through normal insolvency procedures sufficient.
(4) Since the introduction of the SRR, the FSB, European Commission and IMF have all put forward proposals to extend the transfer powers available in bank resolution regimes more broadly to other systemically important financial institutions.

Bank resolution and the protection of property rights

For a resolution to be effective, the resolution authority must be able to transfer a failed bank's business or, in the case of temporary public ownership, acquire the bank's shares without the need to obtain the consent of the bank, its counterparties or the relevant shareholders. Similarly, the resolution authority requires certain powers to modify or override contractual terms in order to allow for the transferred business to continue operating. To the extent that these powers involve the expropriation of, or interference with, property rights, they must be consistent with Article 1 Protocol 1 of the European Convention of Human Rights. Article 1 Protocol 1 (which is incorporated into domestic law by the Human Rights Act 1998) prevents individuals and legal entities within the European Union from being deprived of their possessions and property rights except in the public interest. Care was therefore taken when developing the United Kingdom's SRR to impose certain of the public interest objectives as pre-conditions to the use of the transfer powers and to establish mechanisms for compensating persons for the value of the property or property rights that were taken away or interfered with.

normal insolvency process in certain key respects. Perhaps most significantly, it makes it the priority of the bank administrator to ensure that the residual bank provides services (eg the continued provision of IT infrastructure, or the servicing of mortgages) on a temporary basis to the new owner of the transferred business to allow the owner to operate the business effectively until successor arrangements can be implemented. The bank administrator is also required to obtain the consent of the Bank of England before it takes a number of actions in relation to the residual bank's business.

All these modifications are designed to facilitate the transfer of business. They also reflect the fact that the purchaser may not have had an opportunity to agree on some of the transitional arrangements that usually accompany the sale of a banking business and therefore is likely to need this general assurance of support. For similar reasons, the Bank of England is also given powers to impose, cancel or modify certain obligations owed between the transferred business and companies that were formerly part of its group before it was transferred.

Use of public funds: While the SRR is designed to minimise the need for public funds, a resolution may still require their use,(1) albeit in circumstances where the risk of loss to the taxpayer is much lower than in a bailout. The Treasury retains a controlling hand in the use of public funds in the United Kingdom's SRR and the Bank must therefore obtain the Treasury's consent before exercising a resolution tool that is likely to have implications for public funds.

Since the introduction of the United Kingdom's SRR a great deal of further progress has been made both within Europe and globally to identify the key attributes of an effective resolution regime.(2) These initiatives recognise the importance of ensuring that broad transfer powers are combined with adequate safeguards. The remainder of this article considers the different types of safeguards and the reasons behind adopting them.

Part 2: Protections afforded to creditors and counterparties in the SRR

Compensation safeguards: the 'No Creditor Worse Off' principle

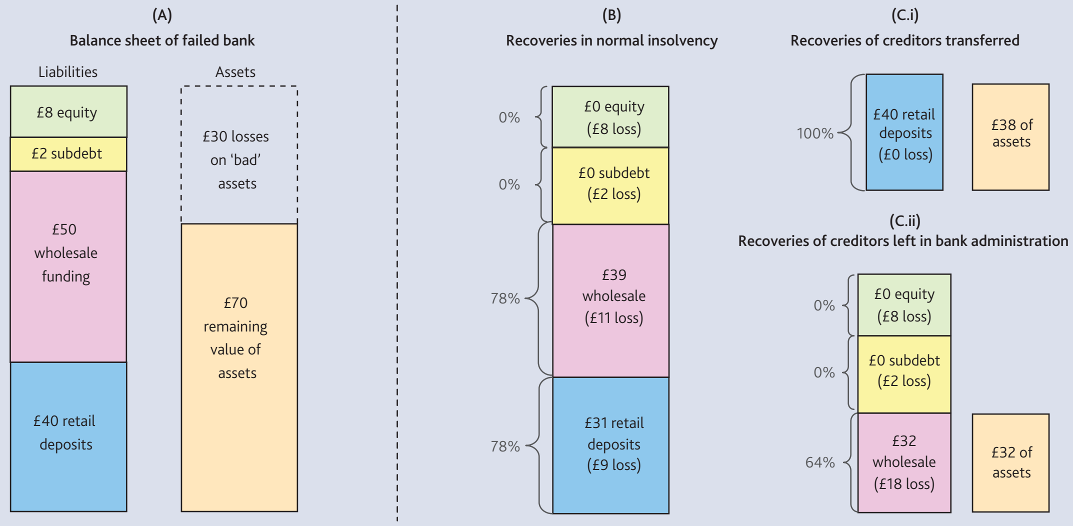
Depositors and other creditors whose claims are transferred out of a failed bank in a resolution clearly benefit from the use of the transfer powers. They are able to continue as depositors of a new bank with all of their transferred funds intact and with little, if any, disruption in their access to banking services. Counterparties of the bank whose contracts are transferred to the buyer are similarly able to carry on as before rather than deal with the consequences of the bank's insolvency.

Creditors, such as bondholders or other wholesale funders, that the resolution authority may have decided to leave behind in the residual bank do not enjoy these benefits. They must claim instead for repayment of their debts in the bank's insolvency. But as is shown in the box on page 217, a decision to split the balance sheet in a way that fully protects depositors and certain other creditors could, on the face of it, put those creditors left behind in a potentially worse position than had the transfer powers never been used and the bank had been left to go through normal insolvency.

One reason for this lies in the fact that, under UK insolvency law, depositors in the United Kingdom rank equally — or '*pari passu*' — with other ordinary senior creditors and therefore should share any losses equally between them.(3)

(1) For example, the Treasury may be required to provide funds upfront to facilitate a transfer of liabilities (as in the case of the Dunfermline Building Society resolution) and will later seek to recover some or all of these costs from the FSCS as described in Part 2 of this article.
(2) For example, the European Commission's consultation on technical details of a possible European crisis management framework, 6 January 2011; the FSB Consultative Document on effective resolution of systemically important financial institutions, 19 July 2011.
(3) This contrasts with some other jurisdictions, most notably the United States, where depositors rank ahead of the other creditors (so-called 'depositor preference').

The potential effect of transfer powers on creditors left in the insolvent bank



This example shows how a partial property transfer could prejudice creditors whose claims are left behind in the residual bank, especially in a country (such as the United Kingdom) where retail deposits rank equally with wholesale deposits and other ordinary creditors in insolvency. Panel A shows a simplified balance sheet of a bank which is insolvent as a result of a £30 write-down of its bad assets. Panel B shows the estimated recoveries creditors might receive in a normal insolvency, while panel C shows recoveries if a partial transfer was carried out instead. In panel C, all retail deposits (not just those amounts insured by the FSCS) are transferred to a commercial purchaser, along with higher-quality assets. C.i assumes that the purchaser accepts £2 more of liabilities than assets in the partial transfer, with the difference effectively constituting a purchase price for acquiring the failed bank's deposit franchise. Equity, subordinated debt and wholesale deposits, together with lower-quality assets, are left behind in the residual bank, which goes into the bank administration procedure (C.ii). If the bank's £100 book value of assets were worth only £70 in insolvency, the percentages in grey represent the net recoveries as a proportion of the original claims for each type of creditor. Wholesale creditors incur an extra loss of £7 directly as a result of the transfer as compared to a normal insolvency. This is because in insolvency of the whole firm they would have had an equal claim over the £70 remaining value of the assets with the transferred depositors and would have received £39 (78% of £50) instead of £32 (64% of £50) in the bank administration procedure. The FSCS can be required to contribute towards reducing this shortfall by providing an amount up to the net loss the FSCS would have incurred if it had paid out insured depositors and sought to recover their claims in the insolvency of the whole bank. Any remaining shortfall (for example, arising from the decision to transfer significantly more liabilities than just insured deposit balances) may entitle the wholesale creditors to compensation by the Treasury under the creditor safeguards. Treasury consent to such a transfer is required if it is likely to lead to compensation.

But the decision to transfer retail depositors along with higher-quality assets of an equivalent, or nearly equivalent,(1) amount to another bank can result in the creditors left in the insolvency (with the remaining lower-quality assets) effectively subsidising the depositors that have been transferred. Any shortfall between the assets and liabilities of the bank, which would have been shared equally among depositors and the other unsecured ordinary creditors in insolvency, falls to be borne exclusively by the creditors left behind. And while the immediate sale of the banking business as a 'going concern' is more likely to retain its value and achieve a greater price than a sale out of insolvency, this may be insufficient to make up the difference (see the example above).

The unsecured creditors left behind in the residual bank would therefore have to bear the extra costs of saving a bank's retail depositors, effectively disrupting the normal ranking of these creditors. Quite how much extra these creditors could lose would depend upon the split determined during the resolution. Without this information, creditors would have no means of assessing in advance their likely 'loss given default' in a resolution. And exposing these creditors to additional losses beyond what they could expect to incur in an ordinary insolvency would go further than necessary to address the

(1) The purchaser may pay a premium for acquiring the new customers and the franchise of the deposit business. This premium for the deposits amounts to the difference between the deposit liabilities and the assets transferred with them.

problems of moral hazard. These are all outcomes that the SRR has sought to avoid by the introduction of the so-called 'No Creditor Worse Off' (NCWO) safeguard.

The NCWO safeguard applies to bank resolutions that involve a partial transfer. It entitles creditors to compensation from the state if it is determined that the amount they end up recovering in the residual bank's insolvency is less than what it is estimated they would have recovered if the whole bank had simply been placed into insolvency. An independent valuer is appointed to make this assessment and the compensation is effectively the shortfall between the actual amount they have recovered and the estimated recovery had no split occurred. By placing a floor on their losses based on this counterfactual, the safeguard permits creditors of a bank to assume that the losses they could be exposed to will be either the same or better than in insolvency.

One consequence of a transfer of insured depositors in a resolution is to remove the need for the FSCS to pay them compensation; the insured depositors simply become the depositors of the bank that has acquired the deposit business so the need for compensation does not arise. But as is shown in the diagram in the box on page 217, a transfer of all depositors along with matching assets can also create a greater loss for those creditors left behind. If so, compensation from the state may become payable and the effectiveness of a resolution regime in reducing the risk to public funds is diminished.

To avoid a situation where the Treasury is required to pay public funds as compensation while the industry-funded FSCS effectively avoids having to pay compensation, the Treasury is entitled to ask the FSCS to contribute to the cost of the resolution. In a normal payout the FSCS would be required to pay compensation upfront to the insured depositors and then seek to recover as much as possible of this amount by taking their place as a creditor in the bank's insolvency. In order to replicate this, the FSCS can be asked to contribute an amount equal to the estimated loss the FSCS would have incurred had the transfer never taken place and it had instead been required to pay out compensation in insolvency and assume their claims in the insolvency.

Calculating how much of its payout the FSCS would have failed to recover is again the job of the independent valuer. Once calculated, the FSCS can be required by the Treasury to contribute up to this amount to meet the costs of the resolution. The FSCS contribution could be provided *ex ante*, eg to inject cash into the transfer, or *ex post*, eg to reimburse the Treasury or the Bank of England for any costs incurred in the course of the resolution, eg a cash payment to support the transfer of assets and liabilities to another person.

In this way, the FSCS continues to cover the costs of protecting insured depositors whether in a payout in insolvency or in a non-payout resolution using the transfer powers. Only where it is deemed necessary for financial stability reasons to protect liabilities other than insured deposits, does it become more likely that funds or compensation paid by the Treasury may not be fully recouped.

Safeguards that restrict the use of resolution powers

The NCWO safeguard provides the first level of protection to assure creditors that their ranking will be respected and allows the resolution authority to act more swiftly and decisively in the knowledge that actions that might otherwise upset the ranking of creditors in insolvency can be offset by compensation.

By contrast, the second type of safeguard acts to constrain the resolution authority's discretion in the use of its powers. As has already been described, the SRR provides the resolution authority with broad powers to transfer property and contracts in a way that best meets its resolution objectives. These powers could potentially be used in a manner that splits up the contractual rights and obligations that collectively make up a financial arrangement in a way that undermines its economic purpose.

Preserving these arrangements sets up a tension between providing certainty to market counterparties that their contractual arrangements will be respected in a resolution, and giving the resolution authority sufficient flexibility to split the balance sheet. Balancing these competing interests is crucial as significant uncertainty could negatively impact upon the price of debt or other financial contracts issued by banks in the United Kingdom, potentially generating an ongoing deadweight loss for the economy. For this reason the safeguards were the subject of close scrutiny and comment by financial market participants throughout the development of the SRR.[1]

The result was the introduction of rules that prevent the resolution authority from using its transfer powers to split up certain defined types of financial arrangement (see the box on page 219). These types of protected arrangement are broadly speaking arrangements whose purpose is to reduce the counterparty's loss in the event of the failure of the bank. Netting and set-off arrangements that allow each party to reduce the amounts they owe to each other into one net sum are therefore covered. So too are arrangements that use collateral assets to protect against the risk of non-payment. If these arrangements cannot be relied upon, the counterparty has no way of measuring what loss it may suffer in a resolution. Retaining the effect of these arrangements therefore plays a similar role to respecting the ranking of creditors.

(1) The Treasury consulted a panel of experts to provide it with advice during the development and drafting of the safeguards. The Banking Act established a permanent statutory panel of experts (the Banking Liaison Panel) that meets quarterly to advise on the safeguards and other aspects of the SRR.

Creditor safeguards that restrict the use of transfer powers

- **Netting, set-off and title transfer arrangements (eg repos):** Netting and set-off arrangements are used by banks and their counterparties to mitigate credit risk. These arrangements operate to allow each party to calculate and set-off amounts owed by and to each other under one or more contracts to produce a single net sum. Title transfer arrangements similarly work to reduce credit risk by linking an obligation to repay one or more debts with the obligation of the lender to redeliver collateral. To work as intended the relevant rights and obligations must remain owing to and from the parties to the arrangement at the point at which the netting, set-off or redelivery takes place. The UK legislation therefore operates to prevent the transfer instrument from being used to split up rights and liabilities under such arrangements save in the case of certain 'excluded rights and liabilities' (eg retail deposits and loans).

- **Secured liabilities:** Where a debt is secured against collateral assets (eg a mortgage), the UK legislation prevents the transfer powers from transferring this collateral separately from the debt that the collateral secures.

- **Capital market arrangements:** Securitisation programmes, covered bonds and other structured finance arrangements can comprise many separate contracts, each of which is necessary for the arrangement to operate as a whole and many of which serve a purpose only in relation to that wider arrangement.(1) As a result, the legislation seeks to define these types of capital market arrangement and to require that they be kept whole in a resolution. To allow some of these contracts to be left in the insolvency (where they could be terminated) while moving others to a new entity would risk the arrangement breaking down.

- **Financial market arrangements:** Certain rules and arrangements within investment exchanges and clearing houses are designed to minimise the effect of the default by a participant. These arrangements are protected by legislation in the United Kingdom that is designed to ensure the financial stability and the smooth running of the system. The United Kingdom's SRR avoids upsetting these statutory protections by preventing the transfer instrument from modifying them or rendering them unenforceable.

- **Termination rights:** The transfer powers give the resolution authority the power to prevent counterparties from relying on the resolution as grounds for terminating a contract. This power to override termination rights cannot however be used to prevent a counterparty triggering netting or set-off arrangements where the arrangements relate to a wide range of financial contracts.

(1) A mortgage securitisation programme, which pools mortgage loans as security for bonds issued to investors, will have many contractual arrangements, for example, between the bank which sells the mortgages, an issuer which purchases and structures the portfolio of mortgages and issues the bonds, a trustee which represents the interests of investors which purchase the bonds, a servicer which performs the usual functions of collecting mortgage receipts, a cash manager, swap counterparties etc.

The need for certainty lies at the heart of these safeguards. By setting them out in legislation,(1) financial participants are able to continue to rely on these risk mitigation techniques and assume that they will provide the same protection in a resolution as in insolvency. Similarly, regulators and credit rating agencies are able to accept the legal enforceability of netting and other protected arrangements when determining whether they satisfy various regulatory requirements.(2)

The legislation also sets out the remedial steps which must be taken if the resolution inadvertently breaches the safeguards, perhaps as a result of incomplete information at the time of the resolution. If a transfer incorrectly separates rights and obligations under a netting or set-off arrangement, the legislation permits the counterparty to continue to exercise its rights to set-off or net an amount it owes against the failed bank to reduce its exposure to the continuing business. Whereas if other types of arrangement are disrupted, the resolution authority must instead restore the protected arrangement by carrying out a further transfer of rights and liabilities in order to cure the breach.

Why the safeguards must have exceptions

The resolution authority will generally want to retain as much discretion as possible to disentangle the liabilities that need to be supported in the resolution (particularly the insured retail deposits) from those that can be left in insolvency. In addition, commercial purchasers may be interested only in purchasing some assets and liabilities of the business of the failed bank and not others. The safeguards, by requiring certain assets and liabilities to be kept together, operate instead to limit the resolution authority's freedom to determine this split.

Ensuring that a transfer does not breach the safeguards also significantly increases the need for detailed and up-to-date information about a firm's protected arrangements. This in turn increases the amount of time required for planning by the resolution authority in advance of the resolution. How much

(1) They are contained in the (amended) Banking Act 2009 (Restriction of Partial Transfers) Order 2009 (SI 2009/322).
(2) If Bank X lent Bank Y £50 million and Bank Y deposited £20 million with Bank X, and these contracts are covered by a netting arrangement, the regulator would only require Bank X to hold regulatory capital to support the net exposure of £30 million rather than £50 million on a gross basis.

time is needed for this due diligence will be a function of the number of such contracts, which may increase exponentially with the size and complexity of the firm. And this due diligence exercise is further complicated by the need to conduct it in a way that reduces the risks that news of the contingency planning is leaked, potentially further destabilising the bank.

There is a risk that in complying with these creditor safeguards, the operational challenges become so onerous that the resolution authority is incapable of undertaking a resolution of anything other than a small and simple bank. That would undermine the effectiveness of a bank resolution regime and tip the balance too far in favour of market certainty and away from the public interest in protecting financial stability and curbing moral hazard.

To avoid this outcome, the SRR contains a number of exceptions from the requirement that protected arrangements should always remain undisturbed. The most important category of exception applies to FSCS-insured deposit accounts or accounts which are mainly used or marketed to these insured depositors.(1) The Bank of England is able to transfer these without the need to confirm whether or not they form part of a protected arrangement (eg an offset mortgage linking a retail deposit with a mortgage). This is necessary to ensure that a retail deposit book can be transferred to prospective purchasers within the time needed for effective and expeditious resolution.

Practical experience of using the tools and applying the safeguards

The resolution of Dunfermline Building Society (DBS) in March 2009 was the first, and so far the only time, that the transfer powers have been used by the Bank of England under the United Kingdom's SRR; previous bank resolutions were carried out under the earlier, temporary legislation (see **Table A** for details of all uses of property transfer powers in the United Kingdom). The resolution of DBS provides an illustration of the practical challenges faced by a resolution authority in seeking to comply with the creditor safeguards. It also shows the effect these safeguards can have in shaping the assets and liabilities transferred in the resolution.

While the resolution of DBS was not the biggest of the resolutions undertaken in the United Kingdom (**Table A**), it was the most complex in terms of splitting assets and liabilities between three different legal entities — the original building society which went into administration, the purchaser (Nationwide) and the bridge bank. It was the only partial transfer to date in the United Kingdom where financial assets (the own-originated mortgage portfolio) from the failed firm were transferred along with the retail deposits(2) and wholesale depositors (eg larger companies).(3)

The treatment in the resolution of derivatives contracts covered by netting arrangements offers a good example of the challenges faced by a resolution authority. As typical for even a small and relatively simple banking operation, DBS had entered into a number of swap contracts to hedge different parts of its business, which were subject to a netting agreement. The netting safeguards required the Bank of England to keep all the swap contracts under each netting agreement together even though the underlying assets and liabilities that they hedged were split between Nationwide and the residual bank. In addition, some of the netting agreements included general 'sweep up' clauses that unexpectedly captured rights and liabilities that neither party expected to be included when calculating their net exposures.(4)

As a result of these complications a mismatch arose between the location of swaps and the exposures they hedged. That resulted in some parts of the business being unhedged until it could be determined which swap contracts covered which exposures. This took time to resolve by identifying which swaps to close out (at cost) and which to leave open, resulting in a delay before the Bank of England was able to inform swap counterparties how they were treated in the resolution.(5)

Finally, DBS highlighted the difficulties faced by the resolution authority in splitting a balance sheet with precision, especially when the accuracy of the information provided by the failed bank cannot be assured. Following the resolution of DBS, it was possible to undertake a further more detailed audit which identified that the definition of 'commercial loans' used in the transfer documentation had unintentionally transferred a number of additional commercial loans to Nationwide. These loans had not formed part of the agreed transaction and had been managed by the bank administrator in the period following the resolution on the assumption that they had not been transferred to Nationwide.

The issue was resolved by the Treasury using its powers under the Banking Act(6) to amend the definition of 'commercial loan' in the transfer document with retrospective effect to align the legal effect of the transfer with the transaction that had been agreed. While such retrospective powers are to be exercised

(1) Loans to retail depositors are similarly carved out of the exceptions to allow for residential mortgages and other loans to depositors to be transferred alongside retail deposits.
(2) In one other case, Bradford & Bingley, fixed assets in the form of the branch network were transferred.
(3) The ranking of retail depositors of building societies differs from that of banks in insolvency; the retail depositors are treated as shareholder members and rank below other depositors in priority. The wholesale deposits would have recovered in full in the insolvency and therefore transferring them did not risk increasing resolution costs.
(4) These included bonds issued by some swap counterparties that were held as investment assets by DBS. Following the resolution of DBS, it was decided to change the statutory safeguards to exclude transferable securities such as bonds and other listed securities from netting protection unless the parties explicitly indicate in the netting agreement that they should be included.
(5) This type of mismatch will typically arise except in simple cases, such as when only deposits and cash are transferred. It should also be noted that the safeguard does not require all swap counterparties to be treated alike. Some can be left in insolvency and others transferred to the purchaser.
(6) Section 75 of the Banking Act 2009.

Table A Details of resolutions in the United Kingdom which have used partial transfer powers

Time and date of resolution[(a)]	Failed institution	Which statute[(b)]	Details of assets and liabilities transferred in the transfer instrument[(c)]	Other information
7.40 am on Monday 29 Sept. 2008	Bradford & Bingley plc	B(SP)A	All c.3.6 million retail deposit accounts and the branch network were transferred to Abbey National plc (part of the Santander group). The FSCS provided c.£15.7 billion of funds to back the deposits and HM Treasury (HMT) provided c.£2.7 billion (total c.£18.4 billion).	Shares in the bank were transferred to HMT and, once nationalised, the deposits and network of the bank were transferred to Abbey. The mortgage book remains in the nationalised company to allow for a managed rundown. As of 1 January 2010, total assets of the nationalised company were £49.4 billion, of which £39 billion were mortgages.
9.27 am on Tuesday 7 Oct. 2008	Heritable Bank plc which was a UK subsidiary of Landsbanki Islands hf Iceland	B(SP)A	22,344 retail deposit accounts with balances of c.£547 million backed by funds of c.£457 million from FSCS and c.£90 million from HMT were transferred to ING Direct Bank.	The firm and the remainder of its balance sheet including loan assets with a book value of c.£1.1 billion went into administration. About 340 FSCS-eligible deposit accounts (value c.£8 million) were not transferred and were paid in full by the FSCS and HMT.
12.05 pm on Wednesday 8 Oct. 2008	Kaupthing Singer & Friedlander Limited which was a UK subsidiary of Kaupthing Bank hf Iceland	B(SP)A	c.157,000 online (marketed as 'Edge') accounts with balances of c.£2.7 billion were transferred to ING Direct Bank backed by c.£2.5 billion of funds from the FSCS and c.£0.2 billion from HMT.	The firm and the remainder of its balance sheet including loan assets with a book value of c.£3 billion were placed into administration. c.7,000 FSCS-eligible deposit accounts (value c.£360 million) not transferred were paid in full by the FSCS and HMT.
8.00 am on Monday 30 March 2009	Dunfermline Building Society	Banking Act	Retail deposits (c.£2.3 billion), wholesale deposits (c.£0.8 billion), fixed assets including 34 branches, liquid assets (c.£0.6 billion) and the own-originated residential mortgage portfolio (book value c.£1 billion) were transferred to Nationwide Building Society. HMT injected cash of £1,555 million to back the retail deposits transferred. A second partial transfer was undertaken to transfer social housing mortgages (c.£0.5 billion book value) and associated deposits (c.£5 million) into a bridge bank owned by the Bank of England. This allowed more time for a competitive tender of this specialised portfolio, which was subsequently sold to Nationwide on 1 July 2009.	The remainder of the liabilities, including subordinated debt (c.£50 million), and assets (total book value c.£1.1 billion) primarily the commercial loans and the acquired mortgage portfolios went into a building society administration procedure.

(a) The time and date the transfer was made.
(b) Banking (Special Provisions) Act 2008 (B(SP)A) or Banking Act 2009.
(c) In all partial transfers to date, total retail deposit balances including amounts above the amount insured by the FSCS have been transferred. The resolutions were undertaken when banks and FSCS did not have the information required — most importantly a 'single customer view' — to make an insurance determination quickly enough to effect a transfer of insured deposits only. They also took place during a systemic crisis when concerns about depositor contagion were acute.

only where there are serious difficulties in using other means to address such errors, they remain a necessary tool to address information limitations that are symptomatic of bank failures.

Conclusion

Bank special resolution regimes are designed to address systemic risks caused by bank failure while freeing the public authorities from the dilemma of having to use public funds to bail out all of a bank's creditors. By doing so, they offer benefits to a financial system not only at the point of use but more generally through their effect on the behaviour of banks and their creditors.

But using transfer powers in a resolution to split a balance sheet can potentially have significant adverse implications for creditors left behind in insolvency as well as for counterparties of a bank if their financial arrangements are unpicked. These implications can generate uncertainty for creditors, regulators and rating agencies with knock-on effects on the cost of bank debt, risking an ongoing deadweight loss for the economy.

The approach adopted in the United Kingdom's SRR to address these risks has been to develop limited but legally binding constraints on the resolution authority's powers together with formal mechanisms for compensating creditors. These safeguards provide counterparties with an appropriate level of certainty as to their treatment in a resolution and allow creditors not transferred to another solvent bank to estimate their loss given default along the same lines as in normal insolvency. The UK experience in developing a comprehensive set of safeguards has been reflected in recent proposals by the European Commission and the FSB for the safeguards which could apply under their proposals for resolution regimes for the EU and for systemically important financial institutions, respectively.

Splitting a complex balance sheet can be challenging, particularly if there is only limited time for due diligence. These challenges increase with the size, complexity and international nature of the bank's operations. The DBS resolution involved a relatively small and simple bank, yet raised a number of complications. The complications highlight the fact that care must be taken when developing

Measures which could ease the practical pressures of complying with safeguards

- Ensure that banks continue to develop their capability to provide more detailed and accurate data on a real-time basis. This is a key focus of the Resolution and Recovery Plans which the FSA and the Bank of England have been developing with banks. The FSA has also introduced new systems and information requirements for deposit-takers, which require the majority (those with more than 5,000 insured accounts) to be able to provide a single figure representing the aggregate amount of an eligible claimant's deposit accounts held with a deposit-taker. This single customer view (SCV) information will be in an electronic format readily transferable to and compatible with FSCS's systems.

- Develop similar information requirements with respect to derivatives portfolios. The Federal Deposit Insurance Corporation introduced a rule in 2009 to require US deposit-takers to provide detailed and up-to-date information in electronic format on their derivatives positions within a set period after being pre-notified.(1) The FSA has published a Consultation Paper proposing new information requirements for derivatives and securities transactions.(2)

- Augment the existing SRR by developing ways to restructure a firm's balance sheet without splitting it into separate parts. There is currently much discussion around the possible use of a 'bail-in' tool to write down or convert into equity some classes of unsecured debt of a firm in resolution. This would enable the resolution authority to allow losses to fall on some creditors by reducing the value of their claims on the firm without having to deal with the operational and legal consequences of transferring some of the business to a purchaser. The practical benefits of such an approach may be significant particularly when dealing with large and complex banks with huge numbers of counterparties and contracts governed by different laws.(3)

(1) See www.federalregister.gov/articles/2008/12/22/E8-30221/recordkeeping-requirements-for-qualified-financial-contracts#h-5.
(2) See Financial Services Authority, *CP11/16: Recovery and Resolution Plans*.
(3) The FSB's Consultative Document on effective resolution of systemically important financial institutions sets out its proposed essential elements of a bail-in regime.

safeguards to ensure that the resolution authority's ability to carry out a successful resolution is not undermined by the practical challenges of compliance. To the extent that measures can be taken in the future to reduce these practical challenges, so it will become easier to accommodate statutory safeguards without compromising the effectiveness of bank resolution tools (see the box above).

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