The Bank of England's approach to resolving failed institutions

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- The Bank of England has an objective to protect and enhance UK financial stability, as part of which firms must be able to fail without destabilising the rest of the financial system.
- Resolution is the process by which the UK financial authorities can intervene to manage the failure of a firm in an orderly way. The aim is to ensure continuity of the critical economic functions and services provided to customers, and that the costs of failure are borne by shareholders and unsecured creditors rather than taxpayers.

Overview

Since the start of the financial crisis in 2007, there has been a paradigm shift in the approach of the authorities to managing the failure of a bank, building society or investment firm ('firms'). During the crisis, because standard insolvency procedures would have been inadequate, public funds were used to bail out some banks to prevent greater disruption to the financial system and the wider economy. There is now a resolution regime in place that is specifically designed to deal with firm failure in an orderly way.

The Bank of England is the United Kingdom's resolution authority. From January 2015, it will have a set of legal powers that complies with international standards for resolution regimes. This article describes how the Bank expects to use these powers in practice, in order that a firm's critical functions continue to operate without requiring taxpayer bailouts. It is based on *The Bank of England's approach to resolution*, published in October 2014.[2]

Before a firm can be put into resolution it must be failing or likely to fail; and it must not be reasonably likely that recovery action will be taken outside of resolution to reverse that. There are clearly defined roles for the relevant UK authorities. When resolving a firm, the Bank must have regard to the seven statutory objectives of the regime. A number of built-in safeguards provide a degree of protection for depositors, clients, counterparties and creditors.

A set of stabilisation tools may be used if that is deemed necessary in the public interest to meet the objectives. Stabilisation may be achieved by transferring all or part of a firm to a solvent private sector purchaser or a bridge bank, or by carrying out a 'bail-in' to absorb losses and restore solvency using the firm's own resources. Before the failed firm (or its successor) can exit resolution, it may need to be restructured to address the causes of failure and restore confidence.

If the public interest test is not met, firms can be put into a form of insolvency. This ensures that protected depositors are transferred to another deposit-taker or a payout is made to those depositors, and that client assets are returned as soon as is reasonably practicable.

As part of the ongoing regulatory process, the Bank and the relevant prudential supervisor (the Prudential Regulation Authority or Financial Conduct Authority) are developing individual plans for firms within the scope of the regime to ensure that resolution is feasible and credible. The actual tools used will be those that achieve the objectives of resolution at the point of failure.

Firms will be required to make structural and operational changes to ensure that resolution plans can be carried out if that becomes necessary, such as ensuring that there is sufficient loss-absorbing capacity in the right places within firms to allow a bail-in to be successful. Consequently even the largest, most complex firms will be resolvable without the need for taxpayer support and without causing disruption to the financial system or wider economy.

(1) The authors would like to thank Ruth Hite, Jordan Thursby, Eamonn White and Venetia Wingfield for their help in producing this article.
(2) For the full publication, see Bank of England (2014a).

One of the objectives of the Bank of England is to support and enhance the stability of the UK financial system. This is achieved in part by prudential regulation and supervision, which promotes the safety and soundness of firms, among other objectives. However, the regulatory system in the United Kingdom is not designed to ensure that no firm ever fails.

Resolution is the process by which the authorities can intervene to manage the failure of a firm in an orderly way. The Bank is the United Kingdom's resolution authority for banks, building societies, central counterparties and certain investment firms. The Bank seeks to ensure that any of these firms — whether large or small — can fail without causing the type of disruption that the United Kingdom experienced in the recent financial crisis.

If a firm within scope of the resolution regime fails, the Bank will aim to ensure that the adverse effects of that failure are minimised, for example so that:

- access to deposits protected by the Financial Services Compensation Scheme (FSCS) is maintained: around £1.1 trillion of retail deposits are held by individuals,[1] the majority of which are likely to be protected by the FSCS;[2]

- customer payments continue to flow: in the United Kingdom, payments of around £300 billion are transferred each day through banks on behalf of retail and business customers, for example to complete house purchases and to pay salaries and bills;[3]

- credit and other critical functions continue to be provided to the wider economy; and

- the risk of disorderly 'fire sales' of the firm's assets, or termination of its derivatives contracts, is minimised.

The resolution arrangements in the United Kingdom are evolving. This article sets out the key features of the United Kingdom's regime for banks, building societies and certain investment firms (hereafter referred to as 'firms') that will prevail once the EU Bank Recovery and Resolution Directive (BRRD) applies, from 1 January 2015.[4] It is based on *The Bank of England's approach to resolution* that was published by the Bank in October 2014.[5]

The first section of this article outlines the aims of resolution and describes the resolution powers available to the Bank. The second section sets out how the Bank expects to use those powers to carry out the resolution of a failing firm in practice.

The UK framework for resolution

A core feature of a stable financial system is that firms must be able to fail in an orderly way. That is, without excessive disruption to the overall financial system, without avoidable interruption to the critical economic functions that these firms provide,[6] and without exposing taxpayers to losses. This principle underpins the Financial Stability Board's international standard for effective resolution regimes (the Key Attributes), agreed by the G20 leaders in 2011.[7] The arrangements for the resolution of failing firms in the United Kingdom are designed to comply with the Key Attributes.

The need for a robust resolution regime

The need for an effective set of resolution arrangements was made clear during the recent financial crisis. Given the risks to financial stability that would have arisen had some institutions been allowed to fail and enter normal insolvency, it was necessary for the public authorities to intervene to limit the disruption, including by providing public funds to recapitalise some banks (for example, the £45.5 billion of equity capital injected into Royal Bank of Scotland). In effect this meant that the gains from banking activities in the run-up to the crisis accrued to the private sector, but when failures occurred the losses were shared with the public sector (often referred to as a taxpayer bailout).

Robust resolution arrangements seek to ensure that losses arising from failure are borne by the shareholders and unsecured creditors of failed firms (just as they would be for non-financial companies), rather than the general public. This will sharpen incentives for the private sector to find a private sector solution to difficulties within a firm, avoiding the need for resolution altogether.

A credible resolution framework is also critical to ensuring that the risks attached to investing in firms are priced appropriately. Removing the implicit guarantee from the UK government to the largest financial institutions should strengthen incentives for firms to demonstrate to their customers, clients and investors that they are not taking excessive risks.

(1) See Table C1.1: Industrial analysis of monetary financial institutions deposits from UK residents, Bank of England *Bankstats*, October 2014.
(2) The FSCS is the deposit guarantee scheme for the United Kingdom; see www.fscs.org.uk for more details.
(3) Average daily gross value of payments transferred through CHAPS, Bacs and Faster Payments in 2013. For more details, see the annex on page 15, Bank of England (2014b).
(4) The Bank's statutory responsibilities for resolution also extend to central counterparties (CCPs) — these are not covered in this article. For more information about the role of CCPs, see Nixon and Rehlon (2013).
(5) See Bank of England (2014a). Both the publication and this article are a complement to the Code of Practice issued by HM Treasury — see HM Treasury (2010). It is currently being updated to incorporate the transposition of the EU Bank Recovery and Resolution Directive into UK law.
(6) Some examples of these functions are: making and receiving payments; extending credit and taking deposits; clearing and settling financial transactions; other retail and corporate banking; borrowing and lending between financial institutions; market-making in certain securities; and custody services.
(7) See Financial Stability Board (2014) for the latest version of the Key Attributes.

To achieve orderly resolution, the authorities also need feasible and credible resolution strategies for individual firms. The use of resolution powers must not result in unacceptable consequences for the rest of the financial system or the wider economy, which would include not interrupting the critical economic functions of the failing firm during resolution.

Main features of the UK regime

The resolution regime comprises a set of tools that enable a firm to be stabilised ('**stabilisation tools**'), and other tools to assist with winding down parts of the firm that do not need to be maintained. There is also a set of modified insolvency procedures that enable the UK authorities to wind down a firm without compromising public policy objectives such as financial stability.

The stabilisation tools can only be used if it is necessary to do so, having regard to the public interest in achieving the objectives of resolution (known as the '**public interest test**'). These objectives, the roles played by the different authorities in the regime, the nature of the tools and the safeguards in place for their use are set out in more detail below.

There are **seven statutory objectives** to which the Bank must have regard when resolving a firm. They are not ranked in any particular order. These objectives are to:

- ensure the continuity of banking services in the United Kingdom and of critical functions;
- protect and enhance the stability of the financial system of the United Kingdom;
- protect and enhance public confidence in the stability of the financial system of the United Kingdom;
- protect public funds, including by minimising reliance on extraordinary public financial support;
- protect depositors and investors covered by relevant compensation schemes;
- protect, where relevant, client assets; and
- avoid interfering in property rights, in contravention of the European Convention of Human Rights.

The resolution regime aims to ensure that public funds are not put at risk in resolving the failing firm or its successors. The powers and tools are specifically designed to ensure that shareholders and unsecured creditors meet the cost of firm failure. This represents a paradigm shift from the situation that existed during (and prior to) the financial crisis. A taxpayer bailout of a firm should be considered only as a last resort.

Temporary access to public funding may still be needed in some circumstances, for example as a loan to the FSCS to support a transfer or payout of protected deposits. But such funds would be expected to be repaid from recoveries in the insolvency and/or from levies on the industry.

Roles of the authorities

There are clearly defined roles in the regime for each of the relevant UK authorities. In practice, the authorities will need to co-operate closely with each other.

The prudential supervisor, either the Prudential Regulation Authority (PRA)[1] or Financial Conduct Authority (FCA),[2] and the Bank will make the decision to put a firm into the resolution regime, having consulted HM Treasury (HMT). As resolution authority, the Bank decides which resolution tools to use and carries out the resolution, except for temporary public ownership and public equity support, for which HMT is responsible. The FSCS pays out or funds the transfer of deposits protected by the deposit guarantee scheme, up to a limit of £85,000 per person per authorised firm, and may also protect investors for losses up to £50,000.[3]

A Memorandum of Understanding on financial crisis management outlines how HMT, the Bank and the PRA will co-ordinate with each other in the run-up to and during the resolution of a firm.[4]

Where relevant, the Bank will also need to consult with regulatory authorities in other jurisdictions when planning for, and carrying out, a resolution. The orderly resolution of a cross-border firm would require close co-operation between all relevant authorities.

Conditions for triggering resolution

There are two key conditions that must be met before a firm can be put into resolution. The first is that the firm must be failing, or likely to fail. This assessment is made by the firm's prudential supervisor (the PRA or FCA). The second condition is that it must not be reasonably likely that action will be taken — outside of the resolution regime[5] — that will result in the firm no longer failing or being likely to fail. This assessment is made by the Bank as resolution authority.

(1) The PRA is responsible for the prudential regulation of banks, building societies, credit unions, insurers and major investment firms. For more information on the role of the PRA, see Bailey, Breeden and Stevens (2012); and for information on the PRA's approach to banking supervision, see Bank of England (2014c).
(2) The FCA is responsible for ensuring that relevant markets function well; for the conduct regulation of all financial services firms; and for the prudential regulation of those financial services firms not supervised by the PRA. For more information see www.fca.org.uk/about/what.
(3) For more information on the proposed changes to the PRA rules on depositor protection, see Bank of England (2014d).
(4) Available at www.bankofengland.co.uk/about/Documents/mous/moufincrisis.pdf.
(5) For example, actions taken by a firm's management including at the behest of shareholders or the prudential supervisor (such as reduced dividend payments, a liability management exercise or a sale of parts of the business).

The regime permits resolution to occur before a firm is 'balance sheet insolvent'.[1] The conditions for entry into the regime seek to strike a balance between facilitating an orderly resolution before all of the firm's franchise value has been eroded, and avoiding placing a firm into resolution before all realistic options for a private sector solution have been exhausted.

Stabilisation tools

The decision to put a firm into resolution does not directly allow use of all of the resolution tools. The stabilisation tools can only be used if that is necessary with regard to the public interest test. In other words, they may only be used if the statutory resolution objectives are unlikely to be met by placing the failed firm into insolvency.

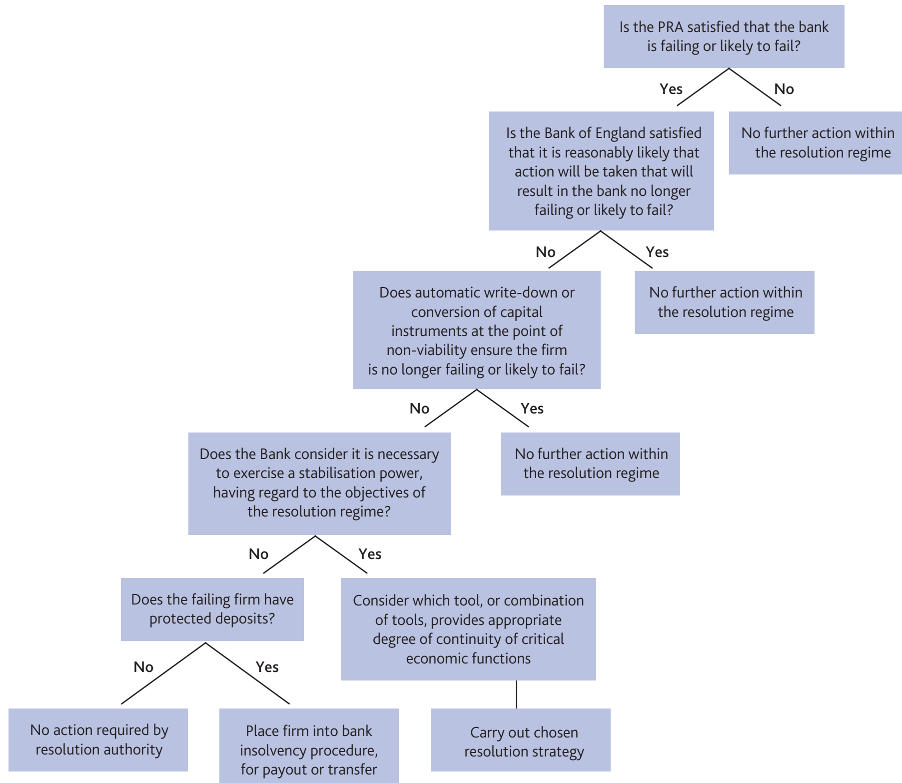
Figure 1 presents a stylised decision tree, setting out the decisions that the PRA as supervisor and the Bank as resolution authority need to make in the course of the resolution of a failing bank. A similar set of decisions would need to be taken in the failure of a building society or investment firm.

If the public interest test is met, the Bank may use one or more of the following stabilisation tools in order to ensure the continuity of critical economic functions:

- to transfer all or part of a firm's business to a willing and appropriately authorised **private sector purchaser**;
- transfer all or part of a firm's business to a **bridge bank** — a wholly-owned subsidiary of the Bank of England — pending a future sale or share issuance;
- carry out a **bail-in** to absorb the losses of a failed firm, and recapitalise it (or its successor) using the firm's own resources. Shareholders and unsecured creditors are written down and/or converted into equity to restore solvency, in a manner that respects the order in which losses would fall in an insolvency.

For those parts of the firm that do not need to be maintained permanently, but may need to be wound down in a measured

Figure 1 Example decision tree for a bank entering resolution[a][b]



(a) Excludes temporary ownership and public equity support, which are to be used only where HM Treasury considers this is necessary to reduce or resolve a serious threat to financial stability, or to protect existing public financial assistance to the firm in question.
(b) For simplicity, assumes the bank has no client assets, and therefore the relevant modified insolvency procedure is the bank insolvency procedure.

(1) The point at which the value of a firm's assets falls below the value of its liabilities. For more information about the risks to banks' balance sheets and their effect on bank capital and liquidity, see Farag, Harland and Nixon (2013).

way, there are two tools that can be used only in conjunction with one or more of the stabilisation tools:

- **asset separation** allows assets and liabilities of the failed firm to be transferred to (and managed by) a separate asset management vehicle, with a view to maximising their value through an eventual sale or orderly wind-down;

- **bank (or building society) administration procedure** places the residual part of a failed firm that is not transferred to a bridge bank or private sector purchaser into administration. The priority of the administrator is to ensure that the residual part continues to provide necessary services (for example IT infrastructure, or mortgage servicing) to the new owner of any transferred business until permanent arrangements for those services can be put in place.

When considering which stabilisation tool (or combination of tools) to use, the Bank must balance the resolution objectives. A box on page 415 provides more information about the choice of resolution strategy and the way in which this interacts with developing firm-specific resolution plans, assessing resolvability and removing barriers to resolution.[1]

If the public interest test is not met, firms may be put into **a modified insolvency procedure**[2] if they hold protected deposits or client assets (or both). An insolvency practitioner will be appointed to manage the wind-down of the firm, with a priority to either transfer protected depositors' accounts to another deposit-taker or to facilitate a payout to those protected depositors by the FSCS. Similarly, an administrator of an investment firm is required to return client money or assets as soon as is reasonably practicable. Where the firm holds neither protected deposits nor client assets, it would be placed into ordinary insolvency.

Safeguards for creditors[3]

The resolution regime provides a number of built-in safeguards for creditors that are designed to provide certainty about how they would be treated in a resolution.

There are protections for financial arrangements where the use of stabilisation tools may otherwise undermine their original purpose (to reduce the counterparty's loss in the event of a default by the firm). These may include: transactions that rely on arrangements to mitigate credit risk faced by counterparties; where collateral has been pledged as security; structured finance arrangements (such as securitisations and covered bonds); and certain other capital and financial market arrangements (such as the rules within investment exchanges and clearing houses).

The regime also requires that no creditor will be left worse off after the use of the resolution powers than they would have been had the whole firm been placed into a normal insolvency proceeding. Where there is any shortfall, those creditors will be entitled to compensation.

Conducting a resolution

The three key phases to carrying out a resolution using the stabilisation powers are described below and illustrated in **Figure 2**:

- **stabilisation**, in which the provision of critical economic functions is assured, either through transfer to a solvent third party or through bail-in to recapitalise the failed firm;

- **restructuring**, during which any necessary changes are made to the structure and business model of the whole firm or its constituent parts to address the causes of failure; and

- **exit from resolution**, where the Bank's involvement as resolution authority in the failed firm and any successor firms comes to a close.

The use of stabilisation tools is likely to involve a number of separate transactions that will be carried out by the Bank. These will be similar in effect, and follow similar principles, to existing corporate transactions: for example a business transfer to a willing purchaser is akin to an acquisition. The key difference is that the Bank has the legal power to act without seeking the consent of shareholders, creditors or the existing management of the firm. This is designed to ensure that action can be taken quickly and effectively.

As part of the process of resolution, the Bank will expect to remove the senior management considered responsible for the failure of the firm and appoint new senior management, as necessary, to any continuing parts of the failed firm not transferred directly to a purchaser.

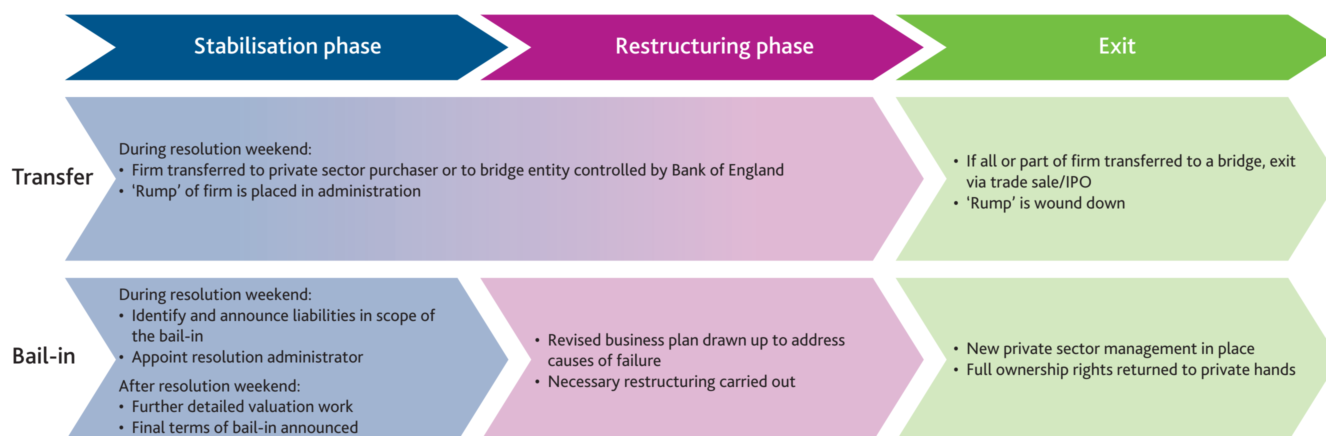
The rest of this section provides more detail on each of the three phases.

Stabilising a firm in resolution

The Bank will decide which of the stabilisation tools — a transfer to a purchaser or bridge bank, or a bail-in — should be used in order to secure the appropriate degree of continuity of a failed firm's critical economic functions. Whichever approach is taken, there will need to be some capacity for the firm's losses to be absorbed at the point of resolution, so that solvency can be restored. It is also likely that the Bank will

(1) For more information on effective resolution strategies, see Box 4 on page 46, Bank of England (2014e).
(2) For protected deposits, the bank insolvency procedure (or the equivalent for a building society) under the Banking Act 2009. For an investment firm holding client assets or client money, the special administration regime, as set out by the Investment Bank Special Administration Regulations 2011.
(3) For more information, see Davies and Dobler (2011).

Figure 2 Stages of resolution



need to provide liquidity to the firm in resolution, for instance if external funding sources are not available to that firm.(1)

As part of the stabilisation of a firm, the Bank will aim to ensure that the firm's existing arrangements for accessing payment systems, clearing and settlement systems and central counterparties remain intact. These are the essential components of the financial market infrastructure. This approach supports the goal of an orderly resolution, by minimising any disruption to existing transactions.(2)

For the more complex resolution cases, it will be advantageous for the authorities to have up to 48 hours outside normal market hours to conduct the initial transactions. This is often referred to as the 'resolution weekend'. It will not always be essential to have an actual weekend — the amount of time required will depend on the extent of advance planning that has been carried out and the speed of the firm's failure. If a firm meets the conditions for entry into the resolution regime mid-week, resolution will begin at that point.

At an appropriate point in the process, such as at the end of the resolution weekend, the Bank will announce:

- the nature of the resolution strategy being carried out: for example a transfer and the destination of the various parts of the business of the firm; or a bail-in and confirmation of the liabilities that will be affected;
- that the firm's core functions will continue without disruption to customers;
- that depositors and investors protected by the FSCS continue to be protected; and
- that the firm will open for business as normal, for example on the Monday morning.

Carrying out a transfer of business(3)

Using one or a combination of the transfer tools, the Bank can take alternative approaches to stabilising the failed firm at the point of failure, depending on the complexity of the firm and the prevailing market conditions.

Where there is a willing purchaser for the whole firm, the firm can be transferred in its entirety to that purchaser. This approach avoids the complexities of maintaining continuity of services when splitting the firm apart in resolution, for example separating deposits that are protected by the FSCS from those to be left behind in administration.

If there is no appropriate purchaser for the whole firm, the Bank can choose to transfer only the liabilities associated with the failed firm's critical economic functions — such as protected deposits — to a purchaser, backed by good-quality assets.

The availability of different transfer options will depend upon a number of factors. For example, the degree of interest from potential purchasers will be determined by the nature of the difficulties at the firm; the ease with which the firm can be valued; and market conditions at the time.

In a transfer of business an acquirer would also need to demonstrate that the acquired or merged business meets the threshold conditions necessary for PRA or FCA authorisation. Such a transfer would generally be effected through an auction process over a 'resolution weekend', unless it were necessary to forgo an auction on financial stability grounds or to complete the transaction speedily. In a transfer of shares

(1) This liquidity may be provided under the terms of the Bank's published schemes, as set out in the Sterling Monetary Framework 'Red Book', see Bank of England (2014f), or on a bilateral individually tailored basis. Any such liquidity provision would need to comply with the European Commission's State aid framework.
(2) For more information about the importance of continuity of payments for customers in a resolution, see Carter (2012).
(3) This can include the transfer of shares or property. For a stylised example of how transfer tools could be used to resolve a failing institution and protect critical economic functions, see Box 2 on page 17, Bank of England (2014a).

Choice of resolution strategy

The choice of resolution strategy emerges from the process of resolution planning. This is conducted by the Bank, working with the PRA and/or the FCA and relevant overseas authorities, based primarily on information provided by the firms. For example, PRA-regulated firms are required to prepare and maintain information on their financial, legal and operational structure, as well as the critical economic functions they perform, and to provide this information to the PRA in the form of resolution planning packs.(1) This information is used by the authorities to identify the preferred resolution strategy, before a firm encounters difficulties. A stylised example of the choice of resolution strategy for a failing bank that is likely to require the use of one or more stabilisation tools — for example bail-in of a holding company, sale to a purchaser, or temporary transfer to a bridge bank and subsequent sale — is set out below.

The choice of strategy will be further informed by a number of additional factors, including the complexity of the firm's balance sheet, the scale of its trading book and the extent of its foreign operations.(2) More detailed resolution planning based on the preferred strategy — with supplementary information provided by the firm — helps to identify any barriers that might prevent the Bank from carrying out the resolution strategy successfully, should that prove necessary.

For global systemically important banks (G-SIBs), resolution strategies are discussed in Crisis Management Groups (CMGs) made up of home and key host financial authorities. The objective of CMGs is to improve preparedness for, and facilitate the resolution of, each G-SIB. In the European Union, as part of the implementation of the BRRD, resolution colleges will aim to facilitate co-operation between home and host resolution authorities for firms that operate in more than one Member State, and provide a forum for joint decisions on resolution planning, assessing resolvability and addressing barriers to resolvability.

The resolution planning that the UK authorities have already carried out, in collaboration with their international colleagues where relevant, have identified a number of common barriers:

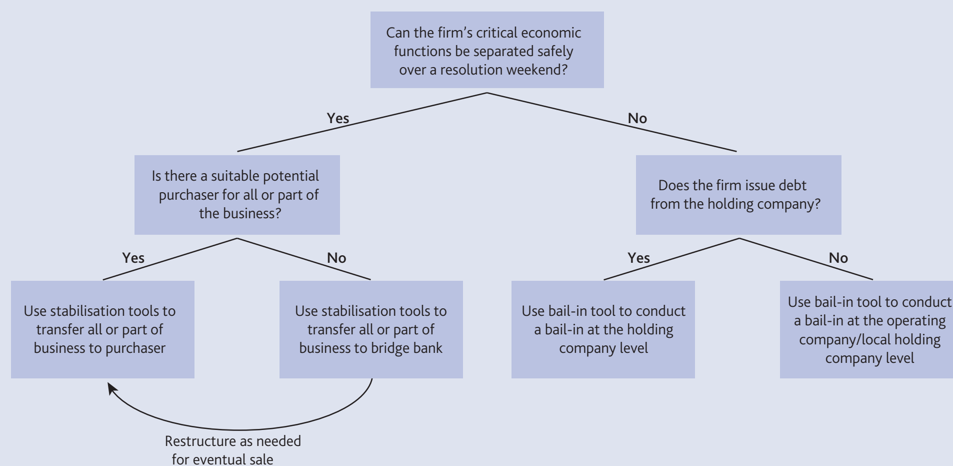
- insufficient loss-absorbing capacity at the holding company and/or operating company;
- the risk of disorderly close-out of contracts governed by foreign law once the firm enters resolution;
- an inability to ensure the supply of services from within the group that support critical economic functions; and
- a lack of flexibility in firms' systems that would affect the authorities' ability to value the firm rapidly.

The Bank will work with firms to ensure that any such barriers are removed, in consultation with the PRA or FCA and other relevant overseas authorities, as required under the BRRD. As barriers are removed, the preferred strategy might be updated to reflect changes in the firm's arrangements for providing essential services to support critical economic functions, or improvements in its arrangements for separating protected deposits from unprotected amounts (and so on).(3)

This extensive preparation before a firm actually encounters difficulties is essential to secure an orderly failure, that is, the appropriate degree of continuity to the firm's critical economic functions. This will increase the likelihood that any disruption is contained, avoiding a risk to financial stability or a loss of confidence in the financial system.

The final choice of resolution strategy is made only at the point that a firm enters resolution. It will be informed by the resolution planning that has previously taken place, up-to-date information on the condition of the firm, and conditions in economic and financial markets at the time.

(1) Details of revisions to the PRA's arrangements for resolution (and recovery) planning are in *PRA Consultation Paper CP13/14*, 'Implementing the Bank Recovery and Resolution Directive', July 2014; www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1314.pdf.
(2) For more detail on holding company bail-in strategies for complex firms, see www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf.
(3) For example, as a result of *PRA Discussion Paper DP1/14*, 'Ensuring operational continuity in resolution', October 2014 and *PRA Consultation Paper CP20/14*, 'Depositor protection', October 2014, available at www.bankofengland.co.uk/publications/pages/news/2014/125.aspx.



an acquirer would need to seek approval from the PRA or FCA for any change in control.

If a purchaser cannot be found immediately, a bridge bank can be used to maintain the critical economic functions of a failed firm. This should facilitate the future sale of the business to one or more purchasers. It is inherently a temporary measure, and should only operate for as long as is needed to arrange a sale or an initial public offering.

Any part of the firm that is not transferred to a purchaser or bridge bank, such as poor-quality assets and any remaining liabilities that are not linked to critical functions, would be placed into administration or an asset management vehicle.

Carrying out a bail-in(1)

The aim of a bail-in is to stabilise the failed firm and ensure that it can continue to provide critical functions, without any immediate need to split up the firm. This is achieved using the firm's own resources: that is, the interests of existing shareholders are cancelled, diluted or transferred; and the claims of unsecured creditors are written down sufficiently to absorb the losses incurred. Creditor claims are converted into equity to recapitalise the firm.

The main stages of a bail-in transaction within the UK resolution framework are described below.

In the run-up to a resolution, the Bank would create a draft resolution instrument that would give legal effect to the bail-in, including the write-down and/or conversion of outstanding regulatory capital instruments. As part of this preparation, the Bank would identify those liabilities that may be within scope for the bail-in, for example shares, subordinated debt and unsecured senior creditors.

During the resolution weekend, the Bank would confirm which liabilities are included within scope of the bail-in, and the FCA may suspend trading in those instruments. One way of executing the bail-in would be for the Bank to transfer the legal title of the shares to a third-party commercial bank appointed by the Bank to act as a depositary.(2) The Bank is also likely to appoint a resolution administrator, acting under the Bank's direction.

Certificates of entitlement will be issued by the firm to investors holding a liability that is potentially within scope of the bail-in. These represent a potential right to compensation, and provide a mechanism for former creditors to be provided with shares or other instruments in due course. The depositary bank will maintain legal title for these certificates until the final valuation is complete.

During the period immediately after the resolution weekend, further detailed valuation work will be undertaken by the authorities in order to determine the final terms of the write-down of liabilities within scope of the bail-in.(3) Once the valuation work is complete, the final terms of bail-in will be announced, including the terms on which the certificates of entitlement will be exchanged for shares in the firm.

In line with the 'no creditor worse off' safeguard, any shareholders and creditors directly affected by the resolution must not be left worse off than if the whole firm had been placed into insolvency. Creditors may be compensated with shares or other securities in the resolved firm in order to ensure that this safeguard is not breached.

Restructuring the firm

Once the firm has been stabilised, either through bail-in or transfer, the next stage would be to consider what restructuring will be required in order to address the causes and consequences of failure, and restore confidence in the firm.(4)

Any restructuring plan will need to ensure that critical economic functions are maintained. And market confidence will need to be restored in order to maintain relationships with counterparties and to enable the firm to access funding markets at a sustainable price. In the case of a bail-in, the Bank will require a resolution administrator or directors of the firm under resolution to submit a business reorganisation plan. This plan would provide, among other things, a description of the measures aimed at restoring the long-term viability of the firm, and a timetable for carrying out those measures.(5)

The restructuring that takes place after the firm has been stabilised is designed to address the causes of failure. This will take time and is likely to require the firm to have sufficient capital in excess of its minimum regulatory requirements. Therefore, it is essential that the expected costs of restructuring the firm are taken into account when determining the extent of the bail-in that will be required.

With a bridge bank, the restructuring effectively takes place over the resolution weekend, when critical functions are transferred to the bridge bank (such as retail deposits backed with supporting assets).

(1) For a stylised illustration of how bail-in could be used to resolve a failing institution and protect critical economic functions, see Box 3 on page 20, Bank of England (2014a).
(2) A depositary bank would hold the shares on trust until they can be distributed to former bondholders or other creditors identified as being entitled to compensation, once the final terms of the bail-in are announced. This period would need to be as short as possible, while allowing sufficient time to ensure that the valuation, on which write-downs are based, is robust.
(3) See Annex 2 of Bank of England (2014a) for further information about valuations in resolution, including the final asset and liability valuation and the equity valuation.
(4) For example: were the losses caused by a single rogue trader or specific market shock, or did they result from widespread problems with the business model? Did they occur in only one business line or many? Did the circumstances of the failure reveal pervasive problems with the risk management of the firm?
(5) The measures may include: the reorganisation of the activities of the group; a withdrawal from loss-making activities; a sale or transfer of assets or business lines; and a restructuring of existing activities to restore competitiveness.

Exit from resolution

Identifying the route for the Bank to bring its involvement with an individual firm to a close is a key part of the resolution. The regime's tools support the objective that firms will either cease to exist or that they will be restructured and able to operate without official liquidity support when the resolution has been completed.

The precise route out of resolution will be shaped by the nature of the intervention that has taken place. For example:

- where all or part of a business is sold to a private sector purchaser, the exit is clear;
- if a bridge bank is used, it must be a bridge to a more permanent arrangement — exit is likely to be through an onward sale to a private sector purchaser, through a share or portfolio sale, or an initial public offering;
- where the bail-in tool is used to recapitalise an existing firm, it is essential that the causes of the firm's failure are addressed directly in order to restore viability and market confidence in the firm;
- when asset separation is used, this will ensure that certain assets of the firm are dealt with in an orderly fashion;
- where an administration or insolvency procedure is used, this will run its course.

Conclusion

As part of the Bank's objective to protect and enhance financial stability, the Bank aims to ensure that firms are able to fail in an orderly way without causing systemic consequences or critical disruption to economic activity. And firms should not expect financial support from taxpayers. Resolution is the process by which the regulatory authorities can intervene to manage the failure of a firm in an orderly way.

Since the start of the financial crisis in 2007, there has been a paradigm shift in the approach of the authorities to managing the failure of a bank, building society or investment firm. If insolvency is not able to deal effectively with a failure of one of these firms, there needs to be a set of credible arrangements in place so that a failure can be as unremarkable as that of any type of company. Hence the statutory resolution regime focuses on continuing the functions of a failing firm, while imposing the costs of failure on shareholders and unsecured creditors.

This article has set out how the Bank, as the United Kingdom's resolution authority, would expect to use its resolution regime powers and tools in practice. It has explained the purpose and objectives of the regime, its key features, the approach that the Bank would take to resolve a failed firm using its stabilisation tools and the arrangements for safeguarding the rights of depositors, clients, counterparties and creditors. Its purpose is to ensure that all those concerned understand the risks involved — and the protections in place — when a firm fails. The Bank retains the ability to exercise its discretion when deciding how best to resolve a firm in pursuit of the objectives of the resolution regime, based on the facts at the point of failure.

It may be that firms will be required to make structural and operational changes in order to ensure that resolution plans can be carried out. A key element of removing the risk of a taxpayer bailout is to ensure that there is sufficient loss-absorbing capacity in the right places in firms to allow a bail-in to be successful. This work has begun and, once complete, will mean that the risk to taxpayer funds will be significantly reduced even for the failure of the largest and most complex firms.[1]

As approaches to resolution, the legal regime and firm structures evolve, *The Bank of England's approach to resolution* document will be updated.

(1) For more details on progress with the reform of the global financial system, see Carney (2014).

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