EXPLANATORY MEMORANDUM TO

THE BANKING ACT 2009 (RESTRICTION OF SPECIAL BAIL-IN PROVISION, ETC.) ORDER 2014

2014 No. 3350

1. This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 This instrument is being made with the Bank Recovery and Resolution Order 2014, the Banks and Building Societies (Depositor Preference and Priorities) Order 2014 and the Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014 to implement Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (the "BRRD").

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 These instruments make the necessary amendments to the Banking Act 2009, the Financial Services and Markets Act 2000, the Insolvency Act 1986 (and related primary legislation) and to secondary legislation made under those Acts to implement the requirements in the BRRD. The Bank Recovery and Resolution Order 2014 amends the Banking Act 2009 to ensure that the Special Resolution Regime provided for in that Act complies with the BRRD, and to extend the powers of the Bank of England to intervene before it becomes necessary to resolve a failing financial institution. It also amends the Financial Services and Markets Act 2000, to ensure that the Prudential Regulation Authority and the Financial Conduct Authority are able to comply with requirements imposed on competent authorities under the BRRD; and the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the "partial property order"), and the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 (the "compensation regulations") to ensure that the existing safeguards provided for in relation to partial property transfers under the Banking Act 2009 are consistent with the BRRD.

4.2 The Banks and Building Societies (Depositor Preference and Priorities) Order 2014 amends the law on preferential debts, by amendment of the Insolvency Act 1986, the

Insolvency (Northern Ireland) Order 1989, the Bankruptcy (Scotland) Act 1985 and related primary and secondary legislation, to implement Article 108 of the BRRD. It also amends the Building Societies Act 1986 to change the priority given to building society depositors on insolvency.

4.3 The Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014 make provision for compensation, equivalent to that made in the compensation regulations, where the Bank of England exercises its bail-in powers. The Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 ensures that the safeguards provided for in the partial property order also apply where the Bank of England uses its bail-in powers to make a partial property transfer.

4.4 The BRRD was given scrutiny clearance by the House of Lords European Union Committee on 12 June 2013[1] and by the House of Commons European Scrutiny Committee on 21 June 2013[2].

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

> "In my view the provisions of the Bank Recovery and Resolution Order 2014, the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014, the Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014 and the Banks and Building Societies (Depositor Preference and Priorities) Order 2014 are compatible with the Convention rights."

7. Policy background

- What is being done and why

7.1 The BRRD entered into force on 2 July 2014. The Directive establishes a common approach within the EU to the recovery and resolution of banks and investment firms. The Directive aims to provide member States with a common framework for the resolution of banks and investment firms, as well as ensuring cooperation between member States, and with third countries, in planning for and managing the failure of cross-border firms.

7.2 The UK's Special Resolution Regime (SRR) is set out in the Banking Act 2009. It provides the Bank of England, as the resolution authority, with a number of stabilisation

[1] http://www.publications.parliament.uk/pa/cm201314/cmselect/cmeuleg/83-v/8318.htm
[2] http://www.parliament.uk/documents/lords-committees/eu-sub-com-a/CWM/cwm2013-14/CwMsubA9May13-30Nov13-.pdf – see p.9

options designed to enable them to manage the failure of an institution – by transferring ownership to a private sector purchaser, transferring some or all of the business of the bank to a subsidiary of the Bank of England (known as a bridge bank) or by cancelling or reducing liabilities of the bank in order to recapitalise it. The Bank Recovery and Resolution Order 2014 makes the changes to the SRR necessary to implement the BRRD, creating a new stabilisation option (transfer to an asset management vehicle), and extending the Bank of England's powers to bail-in the liabilities of a failing institution.

7.3 Certain of a bank's liabilities are subject to contractual protections for the counterparty – such as the right for a claim to be set-off or netted against another. In the case of financial contracts (such as derivatives contracts, stock lending and repurchase agreements), these rights are vital to the daily functioning of the markets in these financial contracts. Therefore, in order to avoid destabilising these markets, it is necessary to give the holders of these arrangements legal clarity about how they will be treated in a bail-in. These protections are effective in the event of the firm entering insolvency. The Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 ensures that the protections are also effective in the event of resolution.

7.4 The Act also states that shareholders and creditors should not be left worse off as a result of the exercise of the stabilisation powers than they would have been had the firm not been resolved, but instead placed into insolvency. The Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014 are intended to ensure this is the case.

7.5 The Banks and Building Societies (Depositor Preference and Priorities) Order 2014 creates a new class of preferential debt (that part of a deposit which is not covered by the Financial Services Compensation Scheme because it is over the £85,000 limit for covered deposits), and amends the law on preferential debts to ensure that this new preferential debt is treated as a "secondary preferential debt", ranking after all other "ordinary preferential debts" (which include deposits covered by the Financial Services Compensation Scheme).

7.6 The Government does not consider that any alternatives to legislation are appropriate, since the BRRD requires that resolution authorities have substantial powers to interfere with property rights, where justified and proportionate to the public interest. It is therefore necessary that these powers are set out in legislation with appropriate safeguards, in order to provide a sufficient level of certainty and clarity for those whose rights may be affected.

7.7 The Government has used copy-out wherever it considers that this gives the necessary clarity and is consistent with existing UK legislation. A copy-out approach has not been adopted for the Directive as a whole, because the Government does not consider that the language of the Directive is in all cases sufficiently clear and precise. Using copy-out in these cases would lead to material uncertainty for investors and others who may be affected by this legislation, and who therefore need complete clarity on how it operates.

- Consolidation

7.8 The Treasury does not have plans to consolidate the Banking Act 2009, the Financial Services and Markets Act 2000 or the secondary legislation made under those Acts at this time. Commercial publishers produce consolidated versions of the Act, and of secondary legislation made under it, both in electronic and hard copy versions.

8. Consultation outcome

8.1 A consultation on transposition of the BRRD was published on 23rd July 2014 and closed on 28th September 2014. In accordance with current guidance on consultations, this period was judged to be sufficient to allow industry to consider the proposals, while also allowing time for the legislation to be completed by 31st December 2014 as required by the BRRD. During the consultation period, the Treasury also met with a number of industry bodies and banks.

8.2 The Treasury received a total of 14 responses to the consultation from banks, building societies, pension funds and industry groups. The responses were generally positive about the approach suggested by the Government, subject to some concerns about specific provisions.

8.3 Respondents raised concerns about the treatment of legacy capital instruments – instruments which, when issued, fulfilled the requirements of capital but which don't meet current standards. This has been addressed in the final draft of the legislation by clarifying that grandfathering provisions in the Capital Requirements Regulations will apply here.

8.4 A number of respondents also raised concerns about the Bank of England having powers to require a firm to make changes in order to increase its "resolvability", and powers to enforce these requirements. The Directive requires that the Bank of England has these powers. However, in order to give industry greater certainty about how the Bank of England will exercise these powers the Bank Recovery and Resolution Order 2014 includes a requirement that the Bank of England publishes a policy statement on this before the powers can be used.

8.5 While respondents generally agreed with a proposal that the "No creditor worse off" safeguard would not apply to holders of capital instruments, this was contingent upon this being consistent with the approach taken by other Member States, since if it was inconsistent then UK firms could be at a competitive disadvantage. As it seems that other member States will take a different approach, the Bank Recovery and Resolution Order 2014 has been amended to apply the safeguard to all shareholders and creditors.

8.6 The Banking Act 2009 (Restriction on Special Bail-in Provision, etc.) Order 2014 and the Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014 were the subject of a consultation published on 13 March 2014. The consultation closed on 7 May 2014. This was judged to be a sufficient consultation period to allow a considered response from interested parties due to the sophistication of these

parties, their familiarity with the relevant issues. 16 responses were received, and the respondents substantially overlapped with respondents to the July consultation.

8.7 Responses generally agreed with the policy aims of the legislation, but had some comments on the approach taken. In particular, several respondents raised concerns that the safeguard did not apply to a broad enough range of liabilities. In response to these concerns, the draft legislation was updated to apply to a wider range of liabilities. This new approach was outlined in the September consultation, and was widely supported by respondents.

9. Guidance

9.1 The Banking Act 2009 requires the Treasury to issue a Code of Practice providing guidance on the use of the stabilisation powers. The Code is not considered essential to understanding how the instrument will operate – rather, it sets out how the Authorities expect to exercise their powers under the Banking Act 2009. The Code will be updated to reflect the changes made by these instruments, and the update will be published in January 2015.

9.2 The Bank Recovery and Resolution Order 2014 also places a requirement on the Bank of England to publish a statement on its policy with regards to giving directions under s3A of the Banking Act 2009, as amended by the Order. This gives the Bank of England the power to direct firms to take certain actions in order to facilitate the use of the stabilisation powers in respect of the bank in the event of its failure. The Bank of England will not be able to exercise that power until they have published a statement of their policy in relation to the power.

10. Impact

10.1 The impact on business, charities or voluntary bodies is estimated to be between £298.0m and £837.4m per year. These costs arise due to the higher cost of funding for banks, building societies and investment firms expected due to the bail-in tool and preferring deposits to unsecured creditors. It is anticipated that unsecured creditors are likely to demand a higher rate of return on their investment to compensate for the possibility that their investment may be subject to the bail-in powers.

10.2 The impact on the public sector is estimated to be around £494k per year due to higher costs to the authorities. This arises through higher levels of supervision and implementation costs. These costs may fall over time as the BRRD is embedded.

10.3 Impact Assessments are attached to this memorandum and be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The legislation applies to small businesses.

11.2 While no deposit-taking banks or building societies in the UK are likely to meet the definition of a small or medium-sized enterprise (SME) there may be investment firms which are small businesses and are covered by this legislation.

11.3 To minimise the impact of the requirements on firms employing up to 20 people, the approach taken is for the legislation to include a public interest test for exercise of the resolution powers in the Banking Act 2009, and to provide for simplified obligations to apply to firms whose failure would be unlikely to have a significant negative effect on financial markets or the wider economy. The factors taken into consideration in determining whether this is the case include an institution's size, the scope of its activities, its risk profile and/or its interconnectedness to the rest of the financial system.

11.4 The basis for the final decision on what action to take to assist small business will be taken by the Financial Conduct Authority (FCA) following its consultation on its rules which it will be making as a result of this legislation. In its consultation[3], the FCA set out its proposed approach to ensuring that the requirements are applied proportionately to smaller investment firms. They indicated that they expected to apply simplified obligations to approximately 190 of the 230 firms affected. Prior to publishing their consultation, they consulted with their Smaller Business Practitioner Panel.

11.5 The Banks and Building Societies (Depositor Preference and Priorities) Order 2014 will benefit non-financial small businesses who have deposits with UK banks or building societies – since these deposits will be preferred over ordinary unsecured debts in insolvency, reducing the likelihood that these businesses would experience losses in the event that their bank or building society failed.

12. Monitoring & review

12.1 This instrument is designed to implement the BRRD and ensure that the UK authorities have the necessary powers to plan for and manage the failure of a bank or investment firm whose failure has the potential to damage the UK economy and financial system, or public confidence in that system. A full assessment of the extent to which it delivers that objective may only be possible in the event that such a failure occurs, and the full set of powers is used.

12.2 The measures are also designed to reduce the need for the use of public sector funds in the event of bank failure, and the perception among market investors that such support would be available in the future. This is known as the "perceived implicit guarantee" and it is thought to reduce the cost of funding experienced by firms, particularly the largest firms who are considered most likely to benefit from this support. A reduction or elimination of the "perceived implicit guarantee" would therefore be a success measure for the instrument. It is difficult to measure, but can be approximated from banks' funding costs and credit ratings, which take account of the likelihood of any external support.

[3] http://www.fca.org.uk/news/cp14-15-recovery-and-resolution-directive

12.3 The G20 has also signed up to implement the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions" which set out the key features of resolution regimes considered necessary to ensure the effective resolution of cross-border banks. Implementation of these requirements is monitored by the Financial Stability Board. As a result of this instrument (and those accompanying it) it is anticipated that the UK will be judged to have fully implemented these provisions with regard to banks and investment firms.

12.4 The instruments include a requirement for the Treasury to review the legislation within 5 years, and periodically following that, at least once every 5 years.

13. Contact

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