HM Treasury

Bail-in powers implementation:

summary of responses

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1 Introduction

1.1 The Special Resolution Regime (SRR) established in the Banking Act 2009 ('the Banking Act') confers a number of resolution powers on the Bank of England and HM Treasury. The Financial Services (Banking Reform) Act 2013 ('the 2013 Act') confers on the Bank of England a further stabilisation option for the resolution of banks, building societies, investment firms, and certain banking group companies: the bail-in stabilisation option.

1.2 On 13 March 2014 the government published the consultation document *Bail-in powers implementation* ('the bail-in consultation'). This sought views on three pieces of secondary legislation required for bail-in implementation. They were:

- the Building Societies (Bail-in) Order
- the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order
- the Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations

The consultation also sought views on three other issues:

- a proposal to align the creditor hierarchy of banks and building societies through early transposition of the depositor preference provisions in the Bank Recovery and Resolution Directive (BRRD)
- a proposal to make changes to the UK's implementation of the Financial Collateral Arrangements Directive (FCAD), following changes to that Directive set out in the BRRD;
- application of the bail-in tool to banking group companies.

1.3 The consultation closed on 6 May 2014. The government received 16 written responses. During this time, the government also met with a range of industry stakeholders. The purpose of this document is to summarise these responses and outline how the government intends to proceed.

1.4 The government has also consulted on the intended approach to transposition of the BRRD. That consultation closed on 28 September 2014. The BRRD consultation outlined a number of remaining high level policy decisions still to be finalised and also covered a number of issues raised in the bail-in consultation.

1.5 One of the main changes to the approach set out in the bail-in consultation is that the government now intends to amend the domestic bail-in legislation as part of transposition of the BRRD and to commence the legislation from 1 January 2015. This also applies to the depositor preference measures from the BRRD which will be implemented at the same time as the rest of the Directive. Another key change relates to the safeguards for the protection of set-off and netting rights. The government now intends to apply the safeguard to a broad set of liabilities with certain specific exceptions, as opposed to specifying which liabilities would be protected.

1.6 Further details on these changes, as well as responses to all questions, are set out in Chapter 2

2 Summary of responses

2.1 The government received 16 responses to the "Bail-in powers implementation" consultation ('the bail-in consultation'). This paper sets out the questions asked, a summary of the responses received and the position taken by the government as a result.

Question 1 Do you agree that it is appropriate for members to lose control of a building society (i.e. a demutualisation) where a society enters resolution and the Bank of England considers use of the bail-in powers to be appropriate?

2.2 Respondents agreed that bail-in powers should be applicable to building societies and that demutualisation was an option that could be used to achieve the bail-in of a building society. However, all respondents who expressed views on this question opined that there are circumstances where demutualisation would not be appropriate. Respondents did not believe that demutualisation was necessary in order for bail-in to apply to building societies. Respondents sought clarification that other solutions would be first considered before resorting to demutualisation.

2.3 In common with other resolution tools, the bail-in tool can only be exercised in relation to banks and building societies when the exercise of the power is necessary, having regard to the public interest. In this respect, the government recognises that not all building societies in severe difficulties would be placed into resolution as they would not meet the public interest test: some may be left to go into insolvency. Or, where the conditions for the public interest test are met with respect to a building society, the bail-in tool may not be the most appropriate resolution option. In cases where the bail-in tool is used, the government believes that demutualisation would most likely need to occur in order to be able to apply the tool effectively, for the reasons explained below.

2.4 In a bank bail-in creditors are generally written down and receive equity in the institution as compensation, giving them rights to influence the direction of the firm and a claim on any future profits. Since building societies are owned by their members, they do not have equity in the same way a bank does, meaning that bail-in without specific provision would not work in the same way as there are no shares to redistribute.

2.5 Under the government's proposed approach, a building society could be demutualised for the purposes of a bail-in through either a transfer of the whole building society into a Public Limited Company (PLC) that is wholly owned by the Bank of England, bail-in administrator, or a person nominated by the Bank of England, or to convert the society into a PLC. This will be provided for in the resolution instrument. The resolution instrument would also be able to convert members' shares into deposits with the successor company, in order to protect members' deposits. Deposits covered by the Financial Services Compensation Scheme (FSCS), which includes members' deposits in building societies, are an excluded liability under the Banking Act 2009 ('the Banking Act'), and therefore out of scope of the bail-in power.

2.6 The Bank Recovery and Resolution Directive (BRRD) also requires covered deposits (the first £85,000 eligible for FSCS protection) rank above ordinary unsecured debts in the insolvency hierarchy (which the Bank of England must generally respect when bailing in an institution). Covered deposits are already a preferential debt under the Insolvency Act 1986[1], ranking them higher than ordinary unsecured creditors. The BRRD also requires that eligible deposits rank

[1] As amended by the Financial Services (Banking Reform) Act 'the 2013 Act'.

above ordinary unsecured creditors, but below covered deposits. This means other creditors of a building society will suffer losses first protecting depositors from bail-in.

2.7 Furthermore respondents asserted that demutualisation was not required in order to implement the BRRD. Specifically Article 43(4) of the BRRD states that *"Resolution authorities may apply the bail-in tool to all institutions or entities [...] while respecting in each case the legal form of the institution or entity concerned or may change the legal form."* However, the BRRD text clearly permits Member States to implement the proposed option to demutualise a building society for the purposes of exercising the bail-in powers. The government considers that it would be difficult to meet the requirement of the BRRD that instruments of ownership are cancelled transferred or severely diluted without demutualisation occurring. The government therefore intends to continue with the proposed approach as set out in the bail-in consultation.

Question 2 Do you agree with the proposed approaches for demutualising a failing building society?

2.8 Respondents agreed with the approach, subject to their view that demutualisation was not necessary in order to apply bail-in to a building society.

2.9 The government recognises that the bail-in tool may not be the most appropriate resolution tool in every circumstance. However, when it is used, the government believes that demutualisation will probably need to occur, as it seems the most operationally straightforward way of achieving the bail-in of a building society.

Question 3 Do you think that there are any circumstances where demutualisation would not be appropriate? If so, how could bail-in be made to work in these circumstances?

2.10 Respondents thought that there were circumstances in which demutualisation would not be appropriate and that the legislation should cater for the possibility of bail-in without demutualisation. For example, respondents thought that Core Capital Deferred Shares (CCDS) could be used as a means to absorb losses while maintaining the society's mutual status. These instruments grant a share in future profits without granting other powers of shareholders such as the power to direct management. Respondents said that Additional Tier 1 or Tier 2 capital instruments may be convertible into CCDS if a building society is failing. Respondents argued that this would potentially provide a large pool of "instruments of ownership" that can be bailed in. They considered that they could be bailed-in according to the write down procedures set out in the BRRD without the need for demutualisation.

2.11 Respondents also questioned the assertion made by the government in the consultation that the market for CCDS would be more limited than the market for ordinary shares and that this would leave the bailed-in creditors in a worse position than in insolvency. Equity-like instruments such as CCDS are relatively new and untested, with only one building society currently issuing CCDS. One respondent noted that, as investors in a mutual, building society creditors are not necessarily motivated by profit or incentivised by the economic value of their instrument.

2.12 The government recognises the relative novelty of CCDS, and the fact that they have not been widely issued. It considers that there is a risk CCDS instruments may not provide adequate compensation to affected creditors in all cases, triggering 'no shareholder or creditor worse off' claims[2]. These instruments may be difficult to value in resolution given they are a new type of instrument, and the additional uncertainty that this leads to in terms of marketability and future

[2] "No Creditor Worse Off" provision entitles creditors to an independent valuation and assessment of their treatment in resolution compared to what their treatment would have been under normal insolvency proceedings. Compensation will be paid up to the value of any difference.

cash flows. The government does not feel the alternatives suggested by respondents are appropriate at this stage although there may be an argument that this should be reviewed in the event that the CCDS market grows significantly.

2.13 Furthermore two respondents noted that demutualisation does seem inappropriate where a mutual solution could be found through utilisation of the power of direction of the Prudential Regulation Authority (PRA) involving a transfer to a mutual successor. This power (which includes the power to direct a transfer to a company as well as a building society) is available to the PRA when it considers it expedient to protect the investments of shareholders or deposits.

2.14 The government agrees that where there are viable alternatives to resolution available, these should be fully explored. In cases where such a transfer is reasonably likely, the tests for using the resolution tools are unlikely to be met since entry into resolution requires that there is no reasonable prospect of alternative action which would prevent the failure of the firm, including supervisory action. In cases where private sector and supervisory measures cannot restore a building society to meeting its threshold conditions with a reasonable timeframe, resolution powers may be available.

Question 4 Do you think that any other modifications (beyond those included in the draft Order) are required to ensure that the successor bank can be bailed-in effectively?

2.15 Respondents did not propose any further modifications which they considered necessary (subject to their view that demutualisation is not a necessary condition for bail-in to be applied to building societies).

2.16 The government is proposing some technical drafting changes in the draft Building Society Bail-in Order, including to ensure that BRRD requirements are fully reflected, however the policy content remains the same.

Question 5 Do you agree that it is desirable to allow the creation of a holding company structure for the successor bank?

2.17 Respondents agreed that it would be desirable to allow for the creation of a holding company structure for the successor bank, subject to their view that it is not always necessary to demutualise the society in order to apply bail-in to building societies.

2.18 The government believes that in cases where demutualisation occurs in order to effect a bail-in, the resolution instrument should provide the flexibility for the successor bank structure to include a holding company. This would mean that, if the future successor bank needed to be resolved, particularly by means of bail-in, it would be operationally more straightforward for the Bank of England to carry this out.

Question 6 Does any special provision need to be made to deal with building societies where members have agreements in place to assign any windfall benefits to charitable organisations?

2.19 Respondents did not believe there was a need for any special provisions in respect of the assignment of windfall benefits to charitable organisations. The government does not propose to make any special provision for these agreements.

2.20 One respondent noted that there is a need to ensure that agreements to assign windfall benefits would not catch the conversion of shares to deposits if a building society is demutualised as part of resolution, and that the determination of any compensation payments paid under the Special Resolution Regime provisions would not be affected.

2.21 Under section 100(1) of the Building Societies Act 1986, any distribution of funds upon conversion is permissive and not mandatory. In a demutualisation for the purpose of bail-in, this

discretion would not be exercised. Therefore, the government believes that the conversion of shares to deposits and determining compensation payments would not be affected by the assignment of any windfall benefits.

Question 7 Do you agree that early transposition of the BRRD is the best approach for aligning creditor hierarchies, and ensuring that the bail-in tool is effective?

2.22 Respondents disagreed with the proposal to transpose early the BRRD provisions concerning creditor hierarchy on the grounds that early implementation of parts of the BRRD would cause confusion in the market and create inequality between UK and non UK banks. They also noted the need for an impact assessment prior to implementation.

2.23 The government no longer intends to implement these changes early. The government's intention is that these changes will now be transposed along with the rest of the Directive, applying from 1 January 2015.

2.24 An impact assessment for the BRRD, which includes the changes to the creditor hierarchy, has been prepared and published alongside the consultation on transposition of the BRRD.

2.25 Respondents sought clarification of how the government intends to transpose the depositor preference, and in particular where eligible deposits would rank in relation to floating charges. Moreover, respondents thought that there should be a further consultation on this issue.

2.26 In order to provide further clarity, the consultation on the transposition of the BRRD outlined the government's approach in more detail and included a draft of the Order making the changes to the creditor hierarchy.

2.27 As a result of the changes made by the 2013 Act (which have not yet been commenced), covered deposits are preferential debts under Schedule 6 of the Insolvency Act 1986[3] and paid out in priority to ordinary unsecured creditors. The government intends to introduce a new class of preferred debts – secondary preferential debts – which will be paid out in priority to ordinary unsecured creditors, but are subordinated to existing preferential debts. This will comprise eligible deposits (the amounts over £85,000 that would otherwise be eligible for protection). Both classes of preferential debts will be paid ahead of floating charges.

2.28 Respondents also sought clarification of the interpretation of section 48C of the Banking Act which excludes deposits "covered by a scheme that is comparable to the FSCS" from the scope of bail-in powers.

2.29 The government can confirm that section 48C of the Banking Act will be amended so that 'protected deposits' will be defined as deposits covered by the FSCS and other deposit guarantee schemes established under Directive 94/19/EC or Directive 2014/49/EU (the Deposit Guarantee Scheme Directives), in order to comply with the BRRD. The definition of 'protected deposits' is necessarily limited by BRRD, which limits protection to deposits covered by EEA (European Economic Area) deposit guarantee schemes and therefore cannot be extended to include deposits covered by non-EEA deposit guarantee schemes.

2.30 However, deposits in third country branches of UK banks will benefit from a more senior ranking than they have previously since BRRD requires that eligible deposits from non-EEA countries should rank ahead of ordinary unsecured creditors in the 'second tier preference' – i.e. equal to EEA deposits above the coverage level.

[3] As amended by The 2013 Act

Question 8 Do you agree that the list of liabilities excluded from the bail-in option provides sufficient protection for the holders of these liabilities, so that no further provision is necessary in this Order?

2.31 Respondents generally agreed with the list of excluded liabilities subject to the list being consistent with the BRRD and some points of clarification.

2.32 The government can confirm that the list of excluded liabilities will be amended to ensure full consistency with the BRRD, as set out in the consultation on BRRD transposition.

2.33 Respondents requested further details of the timing of the valuation of unsecured claims and what methodology would be used.

2.34 For the purposes of resolution, a fair, prudent and realistic valuation of the amount of assets, rights and liabilities will be carried out. The BRRD specifies that this is to be done by an independent valuer. However, the BRRD also allows for this to be carried out by the Bank of England as resolution authority on a provisional basis, where it is not be possible to use an independent valuer (e.g. due to urgent circumstances). Where a provisional valuation has been carried out, the Bank of England must arrange for a full independent valuation as soon as reasonably practicable. The European Banking Authority (EBA) is also currently developing technical standards to specify the valuation methodology.

2.35 Respondents sought clarification on the interpretation of 'so far as it is secured' used to describe the exclusion of secured liabilities. Secured liabilities are excluded from the bail-in tool. There may be liabilities that are only partly secured, e.g. they may be under-collateralised. In these instances, the unsecured part of the liability would be subject to bail-in by being treated as an unsecured liability equal in value to the amount by which it is under-collateralised.

2.36 Respondents asked how bail-in would work for a residual claim on covered bonds especially when considered alongside the termination rights override in section 48M.

2.37 Residual claims on covered bonds would usually mean an amount owed which is not covered by the collateral. This fraction of the claim would be unsecured. The BRRD requires this kind of claim to be subject to bail-in powers, although how this will work in practice will depend on the resolution valuation (the valuation would have to suggest the assets in the covered pool were worth less that the covered bond liabilities). Given that covered bonds tend to be over collateralised, this may not be a likely outcome in practice.

2.38 Respondents asked how the exclusions would work practically. For example, would a resolution instrument explicitly specify any liabilities that are excluded from the scope of the bail-in or would section 48B simply operate so as to imply that bail-in cannot be applied to liabilities listed in that section? The majority of excluded liabilities will be those listed in section 48B (as amended). However, in limited circumstances, the Bank of England will have power to exclude other liabilities in the resolution instrument. The government also notes liabilities to a service provider incurred before the point of bail-in, which are listed under section 48B(8)(i) of the Banking Act 2009, would be excluded from bail-in, even in the event that the service was no longer provided following bail-in.

Question 9 Do you agree with limiting the scope of this safeguard to those "protected liabilities" defined in the draft restriction of bail-in provision Order?

2.39 Certain liabilities benefit from protection in insolvency due to set-off and netting rights. If these liabilities were bailed in without regard to these rights, this may give rise to significant 'no shareholder or creditor worse off' compensation claims as well as potentially causing market instability. The safeguard will ensure that these rights are recognised in bail-in. Respondents

generally agreed with the principle of limiting the scope of the safeguard to certain liabilities but opinions differed on what the scope should be.

2.40 In particular, respondents wanted to understand the policy rationale for applying the safeguard only to certain liabilities subject to set-off o netting arrangements and why, for example, liabilities arising from cash clearing, payments business or corporate deposits would not also need to be netted before bail-in. One respondent thought the scope was overly limited and that protections needed to extend beyond maintaining the integrity of netting sets and provide assurance that the process of determining the close-out amount would match the process the parties had selected in the agreement for exercising termination rights. Another respondent thought that liabilities subject to on-balance sheet netting arrangements that are recognised as eligible funded credit risk mitigation under Article 195 of the Capital Requirements Regulation should be protected. To provide adequate protection for liabilities subject to set off or netting arrangements, one respondent thought that the scope of the safeguard should be equivalent to Article 3 of the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009. One respondent argued that inadequate protection for set off and netting arrangements would discourage liquidity providers from continuing to provide liquidity to stressed banks when such support would be most valuable, as the providers would need confidence in the legal effectiveness and inviolability of the rights of set-off and the collateral on which they rely in order to manage the resulting credit risk.

2.41 In response to these concerns, the government intends to take a different approach, where the safeguard will apply to a broad set of liabilities with certain exceptions that are defined in the Restriction of special bail-in provision Order. There will not be a requirement for the liabilities which are not subject to the safeguard to be subject to set-off or netting prior to being bailed in, although these liabilities will continue to be protected under the 'no shareholder or creditor worse off' safeguard and any rights to set-off and netting that would have been protected in insolvency will be reflected in that calculation. The liabilities excluded from the set-off and netting safeguard are:

- liabilities in relation to an unsecured debt instrument which is a transferable security issued by that banking institution
- liabilities in relation to a capital instrument issued by that banking institution
- liabilities owed in relation to subordinated debt
- unsecured liabilities in relation to any instrument or contract which –
    - at the date it was issued, had a maturity period of 12 months or less or
    - is not a derivative, financial contract or qualifying master agreement
- unsecured liabilities owed to another member of the same group as a relevant banking institution which are not owed in relation to derivatives, financial contracts or qualifying master agreements
- liabilities which relate to a claim for damages or an award of damages or a claim under an indemnity

2.42 This approach is more consistent with the Banking Act (Restriction of Partial Property Transfer) Order 2009 and the government believes that should provide market participants with a high degree of certainty about the treatment of different liabilities in a bail-in.

2.43 Another respondent thought that the Authorities should retain the discretion to exclude, in their entirety, derivative positions from bail-in powers as the complexity of a financial institution's derivative portfolio could make close out and netting difficult to apply.

2.44 The government recognises that identifying the net position of a derivatives portfolio is complex. However, the BRRD includes derivatives within the scope of liabilities to be bailed-in, and therefore they cannot be completely excluded. Liabilities which are between institutions not part of the same group and that have an original maturity of less than seven days are excluded from bail-in. There may also be liabilities that have no maturity date, and are callable on demand (with a less than seven day notice period) The government interprets this exclusion to apply to liabilities that are callable on demand with a notice period of less than seven days. Derivatives are also excluded to the extent they are secured (including on a title-transfer basis).

2.45 Three respondents highlighted that the definition of 'derivatives' used in the draft Order differs from that in the European Market Infrastructure Regulations (EMIR) and that the definition of 'master agreement' is unclear and further clarification is required. The definition of derivatives has been aligned to that in EMIR.

2.46 Respondents also called for guidance on how the safeguard would work in practice and more details on how this safeguard would be aligned with the BRRD, noting that they felt the BRRD was largely silent on this point, but that the context implied that safeguards were necessary.

2.47 In practice, financial contracts will be closed out in order to generate a net liability to be bailed-in. For other types of contracts, bail-in could be applied on a notional net amount as if the relevant set-off rights had been exercised at the point of resolution. Further details of how the authorities expect the safeguards to operate in the UK will be provided for in the updated Code of Practice, which will be published in January 2015.

Question 10 Do you agree with the definition of 'financial contracts'?

2.48 Respondents generally agreed with the proposed definition of financial contracts but suggested some points for further consideration. One respondent thought that Article 5(4) of the BRRD prevented a bank from using repurchase agreements ('repos') of their own covered bonds as a means of generating liquidity. The government believes that repos, including ones of this kind, are captured by the definition of 'financial contracts'.

2.49 Respondents highlighted differences between the definition of 'financial contracts' in the draft Restriction of special bail-in provision Order and that in the BRRD. Respondents sought guidance on the government's intentions and the reasoning behind these departures from the BRRD. The definitions are largely aligned, except that the draft Order did not include inter-bank borrowing agreements where the term of borrowing was three months or less. However, the government does not believe it necessary to include this in the definition of financial contracts in the Order since such loans would be protected from a set-off and netting perspective under the new approach. Respondents also felt that the definition was insufficiently broad to capture all set off and netting arrangements that may need to be protected in resolution – this has been addressed above (paragraph 2.41).

2.50 Respondents asked for the Explanatory Note accompanying the draft Order to explain that the intention of the Order is to capture swaps and options on commodities and futures contracts where such contracts are entered into for investment purposes. The Order makes clear that the definition of 'financial contract' includes swaps and options on commodities and sets out the circumstances in which financial contracts are protected liabilities. Respondents also felt that the Explanatory Note should also explain how the related definitions of derivatives and financial contracts within EMIR and the Markets in Financial Instruments Directive (MiFID) respectively, interact. The Order now uses the same definition of derivatives as EMIR, as does the

BRRD. Both pieces of legislation cross-refer to the derivatives listed in Annex 1 section C points (4) to (10) of MiFID, and the protection under the Order extends to these instruments.

Question 11 Do you agree that the Order should prevent special bail-in provision being made in respect of a protected liability subject to set-off or netting?

2.51 Respondents agreed that the Banking Act 2009 (Restriction of Special Bail-in Provision) Order should prevent the bail-in of liabilities subject to set-off or netting arrangements on a gross basis and supported the principle that the bail-in power could apply to the net liability resulting from the close out of set-off or netting arrangements if the liability is not an excluded liability.

2.52 One respondent noted that it was unclear whether the Bank of England could make special bail-in provision to convert a protected liability subject to set-off, netting arrangement or title-transfer arrangement into a net debt that is subject to bail-in.

2.53 The government can confirm that this is the intention, as it is necessary in order to generate the net amount in respect of a liability subject to set-off and netting arrangements, which can then be bailed in (provided that the net amount is not an excluded liability).

Question 12 Do you agree with the proposal to amend the regulations implementing Financial Collateral Arrangements Directive (FCAD) in advance of the BRRD transposition deadline, and to amend the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 to ensure consistency?

2.54 Respondents agreed that existing legislation should be amended to ensure consistency but raised concerns with doing so ahead of the BRRD transposition deadline.

2.55 The government can confirm it no longer intends to transpose these requirements ahead of the BRRD deadline. Any amendments needed to UK legislation in order to transpose the provisions in Article 118 of the BRRD will be aligned with the transposition of the rest of the Directive.

Question 13 Do you consider the suggested approach – that the Bank of England uses its powers in order to remedy the breach of the safeguard – is suitable?

2.56 Many respondents raised concerns over the suggested remedy for a breach of the safeguard. The Bank of England may use its powers to either provide the affected creditor with securities in the institution being resolved, or to require that the institution pay money to the affected creditor. Respondents thought that offering securities issued by the bank under resolution by way of compensation for a breach of the safeguard for set off and netting arrangements was inadequate and that cash protection would be required. Respondents suggested the remedy should be equivalent to that set out in Article 11 of the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009. They also suggested using the Code of Practice to provide guidance and greater market clarity.

2.57 One respondent's view was that the proposed remedy may be sufficient in relation to breaches other than those affecting close out, set-off or netting arrangements if the procedure is efficient and transparent with an independent arbiter reviewing decisions.

2.58 While respondents thought that cash was the most appropriate remedy, the government believes it is important to have an alternative option, as cash may not be the most suitable option in every circumstance. For instance, requiring the bank in resolution to pay cash could create a large liability for the bank, which could significantly worsen its financial position and possibly undermine the resolution, with a possible impact on wider financial stability. However, the option to require the bank in resolution to pay cash to affected creditors may in some

circumstances be an appropriate means for remedying a breach. The government therefore intends to maintain the proposal set out in the consultation.

Question 14 Do you agree that the provisions relating to the assessment of the insolvency treatment should mirror, with the necessary differences, the existing provisions in the Banking Act (Restriction of Partial Property Transfers) Order 2009?

2.59 Respondents agreed that the assessment of insolvency treatment should mirror the existing provision for partial property transfers, subject to the Code of Practice providing guidance on the operation of these provisions. They noted that these provisions will need to be consistent with the approaches of other Member States and EBA technical standards.

2.60 One respondent sought further detail on the 'actual treatment' assumptions for valuing relevant securities particularly within a building society structure.

2.61 The government will update the Code of Practice and publish this in January 2015. The BRRD requires that the valuation be carried out by an independent valuer as soon as possible after the resolution actions have been effected. The BRRD also requires the EBA to draft technical standards on the methodology for this valuation and the UKs approach adopted will have to be consistent with the EBA technical standards.

Question 15 Do you agree that the Mandatory compensation arrangements following bail-in Regulations should allow the relevant compensation order to specify the value of relevant securities, or the methodology (or methodologies) for determining value of relevant securities, in order to determine the actual treatment of pre-resolution shareholders and creditors?

2.62 Responses to this question were mixed. Two respondents agreed and another three agreed subject to: the proposal being aligned with EBA technical standards and the BRRD; the methodology being transparent, market-based (where possible) and objectively justifiable; and further detail being set out, in the Code of Practice.

2.63 Two respondents disagreed, stating that the broad discretion given to authorities to set out the terms of the bail-in and, in particular, the bail-in valuation methodologies would significantly reduce market certainty and the extent to which creditors would give any value to the protection afforded by the process of having an independent valuation. These respondents also suggested that the Code of Practice should be used to provide reassurances about the valuation methodology.

2.64 The Code of Practice will be updated to reflect the changes to the Banking Act made by the 2013 Act and the UK's implementation of the BRRD.

2.65 Pointing to the need to produce a valuation over a resolution weekend and the potential size of the institution being bailed-in, one respondent questioned more generally the extent to which it would be possible to carry out an accurate valuation of the liabilities of the institution in the lead up to and immediately following a bail-in. Moreover, the respondent thought that valuation would be further complicated if other resolution action which involved the transfer of assets and liabilities was being taken subsequently or simultaneously. This respondent opined that arrangements should be in place to manage disputes that arise in resolution and these should be as transparent and swift as possible.

2.66 In response, the government notes that the BRRD sets out the procedures and requirements for Member States with respect to the right of appeal in Articles 85 and 86.

2.67 One respondent sought clarification on whether the contractual netting process and valuation principles for individual derivatives contracts will be applied to determine the net amounts. If this were not possible, confirmation should be given of what legal cover and

valuation principles would be applied. This respondent also thought that there should be a separate power to deal with disputes about netting of individual rights and liabilities of this sort.

2.68 The government envisages that the principles and procedures set out in the relevant parties' contractual documentation would be applied in order to reach the net position. There will also be EBA technical standards on this issue, which will provide further clarification.

2.69 A respondent thought that the provision should state the need for expertise when appointing the independent valuer or bail in administrator which is not currently set out in the legislation. When appointing the independent valuer, the government will ensure that the expertise of the independent valuer is relevant and appropriate for the valuation. Conditions for the appointment and functions of the independent valuer are set out in the Banking Act.

2.70 Finally one respondent highlighted that it would be possible for bail-in to be applied by means of a supplemental transfer instrument after a partial property transfer has been effected. Compensation arrangements should therefore apply to both the property transfer instrument and the supplemental transfer instrument in respect of the same claim or debt.

2.71 The government notes that the treatment of affected creditors shall be determined relative to their position directly before the point of resolution action. In cases where supplemental resolution action is taken, as described above, the compensation arrangement will take into account both actions in respect to the same claim or debt.

Question 16 Do you agree that, for building societies which are demutualised as part of the bail-in, the 'relevant persons' are the shareholding members and creditors of the building society before the demutualisation occurs?

2.72 Respondents agreed that where resolution of a building society proceeds through the demutualisation route, the 'relevant persons' will be the society's members with share accounts and the eligible creditors. Therefore the government does not propose to make any further provision for this.

Question 17 Do you think that any additional provision is required to effectively apply the Mandatory compensation arrangements following bail-in Regulations to building societies?

2.73 Two respondents thought that no additional provision was required, subject to their view that demutualisation should not have to occur for bail-in be to applied to a building society.

2.74 One respondent sought clarification that compensation would apply to banking group companies and highlighted that as the Regulations were drafted compensation arrangements would not apply to holders with beneficial interests.

2.75 Furthermore, respondents asked what modifications are envisaged in section 7(1) of the draft regulations.

2.76 The draft Regulations defines 'initial instrument' as the first instrument made with respect to the failing institution. Respondents suggested that the relevant instrument should be the instrument which resulted in loss to that relevant person.

2.77 Some respondents asked for guidance on what forms of insolvency will be used as the basis of compensation. These respondents thought that Regulation 12(2), which allows the Order to specify the value at which property is to be treated as having been sold or not sold, allows for manipulation of the calculation of compensation by the Treasury. The independent valuer is responsible for the determination of whether any compensation is owed to affected creditors and is responsible for determining its calculation methodology, subject to the parameters set out in the Regulations.

Question 18 Do you agree, where a company in the same group as a bank subject to bail-in is subject to a resolution instrument at a later date than the resolution instrument in respect of the bank, the pre-resolution shareholders and creditors of the group company should be those who are shareholders and creditors at the time the resolution instrument in respect of the group company is made?

2.78 Respondents agreed but highlighted that in the context of group resolution scenarios, any arrangement which would give rise to a different result for creditors depending on the order in which bail-in is applied to different group companies has the capacity to create uncertainty and confusion among creditors.

2.79 The government recognises the concerns raised by respondents, and notes that this is not likely to be a preferred resolution strategy. However, it seems necessary to determine that would happen in that scenario.

Question 19 Do you consider that the approach outlined for the treatment of creditors of banking group companies could have any unintended consequences or cause problems for the resolution? If so, please give details of the risks and any suggestions on how to mitigate them.

2.80 Respondents also thought that the legal drafting of the Mandatory compensation arrangements following bail-in Regulations could be clarified so that it is clear that bail-in powers could not be applied to banking group companies that are defined as such by virtue of having a central counterparty (CCP) within the group.

2.81 CCPs are not subject to the bail-in stabilisation option under section 89B(1A) of the Banking Act, as amended by the 2013 Act. This section states that *"the provisions relating to the third stabilisation option (the bail-in option) are to be disregarded in the application of this Part to recognised central counterparties".* These provisions include section 81BA and section 81CA, which confer the bail-in powers in respect of banking group companies.

2.82 It is the government's view that bail-in cannot be extended to group companies of a CCP unless a bank or investment firm within that group is failing and it is necessary, having regard to the public interest test, to apply bail-in to that group company.

2.83 Respondents noted that care would need to be taken when developing the approach to the application of bail-in powers so as not to inadvertently threaten the viability of a single point of entry resolution strategy.

2.84 The BRRD requires the resolution authority to draw up resolution plans, detailing how it expects a firm would be resolved. In doing this, consideration will be given to the most effective way of achieving a successful resolution, including a multiple or single point(s) of entry strategy. Resolution strategies will be firm specific and take into account a variety of factors. It is the government's view that the single point of entry resolution strategy would not be affected by this approach.

Question 20 Should covered bond vehicles and securitisation vehicles that are not 'financial institutions' or 'investment firms' be within the scope of the bail-in stabilisation option?

2.85 Respondents thought that there would need to be protection for covered bond vehicles and securitisation vehicles; some agreed that those vehicles that are not 'financial institutions' or 'investment firms' should be within the scope of the bail-in stabilisation options, while others thought that all covered bond and securitisation vehicles should be out of scope entirely. Respondents also agreed that secured liabilities would be excluded from the scope of bail in powers. Covered bond and securitisation vehicles were excluded from the transfer stabilisation options in order to ensure relevant structured finance arrangements could not be separated and

that they would continue to be operated from a 'bankruptcy remote' entity. This rationale does not apply with respect to bail-in as assets and liabilities are not being transferred. The consultation raised concerns that a full exclusion of such entities from the scope of bail-in may lead to arbitrage incentives or opportunities to shield investors from bail-in powers.

2.86 Respondents were unsure whether it would be operationally possible to bail-in any uncollateralised net exposure of either a covered bond or securitisation vehicle but if this policy were to be pursued, sought further guidance on how it would be implemented. Furthermore, respondents disagreed with the suggestion in the consultation document that excluding these vehicles from the scope of the bail-in tool would act as an incentive for firms to under–collateralise their securitisations or covered bonds. Respondents noted that the legislative framework for UK-regulated covered bonds, which requires a minimum over-collateralisation requirement of 8%, should prevent this. The government agrees that it would be generally undesirable to apply the bail-in power to the liabilities of vehicles carrying out genuine secured structured finance activity, as to do so would not improve the balance sheet of the institution under resolution, could be disruptive to capital markets and might give rise to compensation claims under the 'no creditor worse off' safeguard.

2.87 Respondents also highlighted that working out the extent to which liabilities are collateralised could, in practice, take considerable time and suggested that the authorities should be obliged to exclude the whole of any secured liabilities from bail-in. Respondents also raised concerns that this would mean UK covered bonds would be treated differently to other EU regulated covered bonds which would damage the competitiveness of the UK covered bond market or have adverse cost implications for UK banks.

2.88 Three respondents agreed that bail-in should apply to all entities that fall within the definition of 'investment firm' or 'financial institution' but thought that careful consideration should be given as to whether bail-in should extend to other banking group companies. They also sought clarification that non-financial banking group companies would not be within the scope of the bail-in tool. The BRRD requires that all financial institutions and investment firms are within the scope of resolution powers and therefore is not possible to exclude all covered bond vehicles and securitisation companies. The Banking Act 2009 (Banking Group Companies) Order 2014 only includes covered bond vehicles and securitisation companies within the definition of 'banking group companies' where they are investment firms or financial institutions (as defined by point (26) article 4(1) of the Capital Requirements Regulation). The government has decided that the scope of the bail-in option will also be limited to covered bond vehicles and securitisation companies that are 'financial institutions' or 'investment firms'.

3 Next steps

3.1 The information published in this document provides a brief summary of the responses to the consultation, *Bail-in powers implementation*, published on 13 March 2014, and the government's position with respect to the points raised.

3.2 The government is grateful for the responses received. Since the consultation, the government has continued to work with industry and stakeholders to develop this legislation, which will now form part of the government's approach to transposition of the Bank Recovery and Resolution Directive, which will be in force from 1 January 2015.

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This document can be downloaded from www.gov.uk

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