HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Baroness Bowles
House of Lords
London
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Dear Baroness Bowles,

Thank you for your contributions to the debates at Committee Stage on the Bank Resolution (Recapitalisation) Bill on 5 and 10 September. During those debates, you raised questions on which I said I would write to you. Alongside this letter, I have attached an annex that sets out the worked examples that you and others requested at Committee Stage, which has been developed with the assistance of the Bank of England

You asked about clause 4(3) of the Bill. This amends section 12AA of the Banking Act 2009, to allow the Bank to take into account the funds provided by the FSCS when they are calculating the contribution of certain categories of creditor required when exercising the bail-in write-down tool. I hope that this letter clarifies the purpose and effect of this provision.

Key principle

As a point of overarching principle, the government's clear expectation is that, when the Bank uses the new mechanism to support the exercise of its resolution stabilisation powers to transfer all or part of the firm to a Private Sector Purchaser or Bridge Bank, all MREL resources would be written down or otherwise fully exposed to loss, as is the case now. Legislation would continue to require the Bank to write down in full, severely dilute, or cancel shares and reduce or convert to equity all other regulatory capital instruments. This would apply before using any funds from the FSCS. In addition, the government would expect the Bank to exercise its powers to write down or convert to equity any eligible liabilities that would count towards its MREL requirement before the new mechanism is deployed.

Clause 4(3) of the Bill seeks to grant the Bank of England the capacity to exercise its discretion to decide whether bailing in resources that are senior to MREL in the creditor hierarchy (such as uncovered deposits) would best serve the public interest when FSCS funds under the new mechanism would, alternatively, be available to meet any shortfall. In these circumstances, for small banks, it is likely that a substantial portion of any resources senior to MREL are operating liabilities for the failed bank (e.g. payments owed to suppliers, or uncovered deposits from businesses). Therefore, the write down of these liabilities may negatively impact and destabilise the continued operation of the failed firm.

I have set out some more detail below which should explain how the relevant provisions would work, and can be read alongside the worked examples enclosed with this letter, which aim to clarify the intent of this provision and how it is expected to work in practice.

Further detail

Where the principal method of stabilising a firm selected by the Bank of England will be transfer to a Bridge Bank or Private Sector Purchaser, then mandatory write-down or reduction of shares and regulatory capital or 'own funds' debt instruments will normally be required under section 6B of the Banking Act 2009, in the case of 'own funds' debt instruments to the extent required in the Bank's view to achieve the statutory Special Resolution Objectives.

However, there are some circumstances where bail-in may also be relevant to a scenario where the new mechanism is deployed and where it may be used as a precursor to transfer to a Bridge Bank or Private Sector Purchaser. For example, if resolving a firm which has not yet reached its MREL above minimum capital requirements, the Bank of England would expect to write down or convert to equity any MREL eligible resources that may be available to the extent that it is necessary so to do in order to restore market confidence in the firm, and ensure it meets its minimum capital requirements on a forward-looking basis. While mandatory reduction under section 6B of the Banking Act 2009 requires the write-down of own funds instruments, the bail-in tool allows additional unsecured and uninsured liabilities to be bailed-in, including but not limited to non-own funds liabilities eligible for MREL. This may be the preferred write-down mechanism for the Bank of England to use for both the regulatory capital and the MREL eligible liabilities. Even where firms are not required to meet MREL beyond minimum capital requirements, bail-in may be preferred if it allows the writing down of non-own funds eligible shares or subordinated debt or other unsecured, uninsured liabilities to which mandatory reduction under section 6B does not apply.

The purpose of the Bill is to ensure that, when there are insufficient resources on the firm's balance sheet (beyond the regulatory capital and any other MREL resources) that

might readily be written down or converted to equity, the FSCS is able to provide resources in their stead to ensure a successful transfer to a willing private sector purchaser, or to ensure any Bank of England-owned Bridge Bank to which the firm is transferred is adequately capitalised. This helps protect public funds against unnecessary risk or loss whilst ensuring that decision-makers in a resolution have some flexibility to decide on the desirability of bailing in liabilities such as uncovered deposits that could potentially have severe market confidence or financial stability impacts. Ultimately this would be a judgement for the Bank to take in light of the approach that best achieves the Special Resolution Objectives.

The intention behind the provision is still for the Bank of England to write down or convert, at a minimum, available MREL eligible resources that the firm may have, up to the amount necessary to achieve a successful resolution (that is, to meet the shortfall amount) before considering the use of funds from the Financial Services Compensation Scheme (FSCS) under the new mechanism, if it is necessary (i.e. that is, the FSCS mechanism would only potentially be used when there are insufficient regulatory capital and MREL resources to meet the shortfall amount).

Shortfall amount concept in section 12AA

Section 12AA of the Banking Act 2009 provides for the practicalities of the write-down process under bail-in, the instruments affected and order of write-downs, and the target capitalisation. The target capitalisation is provided for using the concept of a "shortfall amount", which is used in section 12AA(1) to require the bail-in to be conducted, working in order of the creditor hierarchy until the target capitalisation is reached.

Setting the recapitalisation amount – mandatory reduction

In circumstances where mandatory reduction has been used as the relevant write-down mechanism (see section 6B of the Banking Act), the recapitalisation amount will be set based on the expected position of the firm after that mandatory reduction, and will be the amount needed from that position to reach the firm's target capitalisation. That target capitalisation will be the same as provided for by the shortfall amount under section 12AA. The assessed amount needed to achieve that capitalisation will inform the quantum of the funding request to the FSCS under the mechanism in the Bill.

Setting the recapitalisation amount – bail-in

In cases where the Bank of England uses bail-in as a precursor to transfer to a Bridge Bank or a Private Sector Purchaser, the target capitalisation would be assessed based on the shortfall amount concept. However, at that stage, the intention is that the Bank of England should be able to exercise its discretion as to the extent to which that

capitalisation target is then met from (i) the bail-in resource and (ii) from FSCS funds. The "bail-in resource" is distinct from the amount of "MREL" that a firm may hold to bail-in, and refers to the fuller suite of unsecured uninsured liabilities that are on the firm's balance sheet and eligible for bail-in, as set out in the worked examples included as an Annex to this letter. I would draw your attention to worked example 2 in particular. You also asked for a list of the instruments that may be bailed in and where they fall in the creditor hierarchy. This is provided in Table A in the Annex.

The Bank of England would have to assess the extent of bail-in required at the time of resolution. A wide range of unsecured and uninsured instruments and liabilities may be available to be bailed-in. It is the government's strong expectation that some of those elements, specifically own funds and eligible liabilities specifically issued by the firm (or MREL resources), would be bailed-in to absorb losses and recapitalise the firm before any FSCS funding is called upon. However, beyond that point the Bank would be expected to exercise its judgement, depending on the specific firm and what approach best served the Special Resolution Objectives.

In making a judgement as to the extent of the bail-in, the Bank of England would expect to consider the onward impact of bailing-in non-MREL liabilities on financial stability, confidence in the UK financial system, and continuity of critical financial services – in a broad sense, this is consideration of the public interest. For example, if bailing-in certain types of liability would have the effect of further destabilising the business of the firm, other participants in the banking sector or other sectors, or reducing wider confidence in the financial system, these might be considerations in choosing to use FSCS funds instead. Where a willing private sector purchaser is not available and a Bank of England-owned Bridge Bank is created, it would be important to ensure that the Bridge Bank is properly capitalised so that public funds are protected and confidence maintained. Under no circumstances would the Bank of England bail-in covered deposits below the FSCS limit, which are not eligible for bail-in.

Target MREL is set by the Bank of England with the aim of ensuring that loss-absorption and recapitalisation needs are met from own funds and issued MREL liabilities without needing to resort to the kinds of liabilities that the process above might seek to protect from bail-in. The Bank now affords firms that are set an MREL requirement in excess of their minimum capital requirements six years to transition towards that end-state, a period which is extendable by up to two years. And, notwithstanding the setting of MREL requirements, it is possible that at the point of entry to resolution a firm may not be in full compliance with its minimum requirements. It is in these circumstances where the Bank may need to exercise its judgment in the public interest to bail-in liabilities beyond the (inadequate) amount of MREL resources available, and / or to use the new mechanism to draw on FSCS funds to supplement recapitalisation as a precursor to a transfer to a private sector purchaser or a Bridge Bank.

Overall, Clause 4(3) of the Bill therefore ensures that while a firm's MREL resources are expected to be fully exposed to loss through write-down or conversion to equity, the Bank of England may exercise discretion in not bailing in other liabilities beyond a firm's MREL (such as uncovered deposits), having regard to the Special Resolution Objectives, and being able to make use of FSCS funds under the new mechanism instead. This strikes an appropriate balance between ensuring that unsecured, uninsured liabilities may be exposed to loss in line with their position in the creditor hierarchy, safeguarding financial stability, and protecting public and FSCS funds.

Finally, you raised a very legitimate concern about the description in the Explanatory Notes on this clause of the Bill. As a result, the government will update the description in the Explanatory Notes to better reflect the explanation given in this letter and the practical effect of the relevant provision in the Bill.

I hope this explanation is helpful, and I have endeavoured to ensure your questions have been answered thoroughly. I would of course be happy to meet with you for further discussion on this ahead of Report Stage, and will ask my office to arrange this. I look forward to your continued engagement on the Bill.

I am copying this letter to those who spoke in the debates and a copy will be deposited in the Library of the House. I also attach the letter I sent to Lord Eatwell in response to the questions he raised following Second Reading. A copy of this will also be deposited in the Library of the House.

Yours sincerely,

Lord Livermore

FINANCIAL SECRETARY TO THE TREASURY