FINANCIAL SECRETARY TO THE TREASURY
HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Lord Vaux of Harrowden
House of Lords
London
SW1A 0PW

19 September 2024

Dear Lord Vaux,

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 a number of 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 the provisions that are in place or would be introduced under this Bill to recoup dividends that had been paid out to shareholders prior to a firm's failure (as distinct from imposing losses on shareholders for the shares themselves), to offset the recapitalisation costs of managing the firm's failure in resolution. You also raised particular concerns with respect to dividends paid to foreign shareholders and investors. UK subsidiaries of international banks are subject to PRA regulation and supervision. The PRA requires such subsidiaries to meet minimum capital requirements in the same way as UK-domiciled banks with no international parent company. And in certain circumstances there may be restrictions on capital distributions.[1] As such, this ensures there is a minimum level of capital held in any UK subsidiary.

The bank resolution regime does not set out powers allowing the Bank of England to claw back money that has already been paid out to shareholders and there are no provisions in this Bill that would grant such a power. Any such power could potentially have unintended consequences for confidence of investors across the banking sector.

[1] 'Box 5: Stages in the Proactive Intervention Framework', PRA's approach to banking supervision, July 2023.

However, in practice, the mechanism in the Bill would accompany the Bank of England's transfer and mandatory write-down powers. That means that overseas shareholders would bear losses. In the event that a bank is owned by an overseas parent company, they would suffer losses on its investment in the subsidiary.

You also asked a point of clarification, on whether the reports that the Bank of England would be required to produce to ensure ex-post scrutiny would include a comparison with the counterfactual costs of insolvency. The government intends to include provision in the Code of Practice (to which the Bank of England must have regard when exercising resolution powers) so that, after the new mechanism has been used, the Bank of England will be required to disclose the estimated costs to industry of options that were considered as part of these reports, including the costs in the counterfactual of insolvency.

I can also expand here on a point that I addressed briefly in answer to one of your questions in Committee. You asked whether, on a second or subsequent recapitalisation payment, the Bank would have to look again at whether the insolvency route is the one it should pursue, rather than a subsequent recapitalisation payment. I responded by saying the Bank would always look at the situation at the time and make each individual decision on that basis. You asked me to confirm whether it would always have to do so.

The scenario you were describing would be one in which resolution powers had already been used by the Bank of England to transfer all or part of a failing firm to a Bank of England-owned Bridge Bank, having been unable to sell it. You then noted the potential for a further set of costs to arise over time – this may be the case, for example, if the capital position of the firm subsequently deteriorated whilst it is in the Bridge Bank. This would mean that further recapitalisation could be necessary to restore its capital ratio to the extent necessary to sustain sufficient market confidence and enable it to continue to meet, for at least one year, the conditions for authorisation and to continue to carry out the activities for which it is authorised. In such a scenario, the Bank of England would have to consider insolvency as an alternative to requesting a subsequent recapitalisation payment from the Financial Services Compensation Scheme (FSCS), on the mechanical basis that the logical outcome of not making the payment would be that the institution became insolvent (absent an alternative source of funding such as a buyer).

Finally, you asked about a scenario in which the new mechanism is used to recapitalise a firm upon transfer to a Bridge Bank but the firm is then subsequently placed into insolvency from the Bridge.

As outlined in the worked examples included as an Annex to this letter, upon entry into resolution any regulatory capital in a firm would be written down and any additional MREL resources it holds would be bailed in. However, in the case of a small bank, any resources eligible for bail-in that it maintains beyond that may be operating liabilities. If the bail-in tool were used, it would be at the Bank of England's discretion to determine the extent to which to recapitalise the firm by bailing in these liabilities in pursuit of its public interest objectives. Bailing in such liabilities, which include for example other deposits not protected by the FSCS could have adverse consequences for financial stability and confidence in the UK financial system. Using FSCS funds as an alternative or supplement to these resources under the new mechanism therefore offers another option to recapitalise the firm in resolution through an injection of new equity – see worked examples 2 and 3 in the Annex to this letter.

I should clarify at the outset that under the terms of the Banking Act 2009, a Bridge Bank can only be created with a view to selling the firm or its business in resolution. We expect that to be the outcome in the majority of cases, rather than the eventual insolvency scenario you described.

Having said that, when FSCS funds are used to recapitalise a firm in resolution, they would do so through an injection of new equity, as worked examples 2 and 3 in the Annex explain. Therefore, if the firm in the Bridge Bank were subsequently placed into insolvency, the FSCS would assume its customary super-preferred status in the creditor hierarchy with respect to depositors to whose rights it is subrogated in the insolvency once it has paid out compensation. It would, though, have no claim with respect to any recapitalisation payment it has made under the new mechanism. Any reimbursement for that payment would only be received through the mechanism set out in clause 2 of the Bill, requiring the Bank to reimburse FSCS where it has made a recovery in relation to the failed firm.

You asked whether this would leave some lenders to the firm better off in the subsequent insolvency than they would otherwise have been had the firm not been recapitalised in resolution. In the case of holders of MREL instruments, the answer to that question would be no, as those resources would have been entirely bailed in at the point at which there was any recourse to FSCS funds under the new mechanism. For the holders of other more senior operating liabilities that are not subject to any bail-in, it is a technical possibility, although the facts would depend on each case. The government considers the outcome where such creditors are significantly better off to be reasonably unlikely, which reflects the likely duration between recapitalisation and subsequent insolvency, and the fact that if insolvency were to occur it would likely reflect that the firm had continued to suffer serious losses over a period of time, limiting any potential benefit for other creditors. Nevertheless, the possibility reflects a key choice that is made by the authorities when a firm fails, to use resolution powers on public interest grounds with regard to the Special Resolution Objectives. In such circumstances, the alternative of allowing a firm to go into insolvency may have wider consequences for financial stability and confidence in the UK financial system, as a result of uncovered depositors suffering losses, for example. Further, the alternative in resolution to using FSCS funds under the new mechanism may be to use public funds, which could also leave lenders to the firm potentially better off than in a counterfactual in which the whole firm immediately entered insolvency.

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