Annex: Worked examples in relation to the Bank Resolution (Recapitalisation) Bill

Summary

1. This document sets out a series of worked examples of resolution scenarios. These examples are stylised and not based on any specific real-life firms. They are intended to be used for explanatory purposes. Any resolution would involve a series of case-specific judgments.
2. These examples have been produced with the assistance of the Bank of England. In developing the examples, the Treasury and Bank of England have considered the examples requested during the discussion of amendments at Grand Committee and the document therefore aims to illustrate these as clearly as possible. This includes examples outlining the potential use of:
   - The bail-in power;
   - The bail-in and transfer powers in combination, with and without the use of the new mechanism; and
   - The transfer powers in conjunction with the new mechanism.

Assumptions and context

3. The assumptions used in these examples are consistent with the government's cost-benefit analysis published in July 2024 alongside the introduction of the Bill.
4. These examples come with some limitations, given their stylised nature. These include the assumption that losses, and the required shortfall amount, are each, in turn, equal to a firm's minimum capital requirements set in advance of the resolution. In practice, the Treasury and the Bank of England would expect both of these assumptions to vary on a case-by-case basis, and that the losses incurred prior to resolution action and the extent of recapitalisation will vary. The resolution conditions assessment and resolution valuations that must be undertaken before any resolution action is taken would affect the extent of any recapitalisation that might be required.
5. The examples also assume that each of the relevant steps illustrated occur contemporaneously with each other, whereas in practice events may occur over time, and the resolution action itself would not necessarily take place only after all capital resources are fully exhausted. In practice, given that judgements on the viability of a firm are a forward-looking assessment, it is probable that, absent the existence of sufficiently credible and timely recovery options, interventions could take place in advance of all capital resources being exhausted. As a result, a conservative revaluation of the firm's resources would be required before resolution action may be taken, which might crystallise previously unrealised losses.
6. Each of the starting balance sheets in the examples differ. This is to broadly reflect a realistic example of a capital requirement, and, as a result, a minimum requirement for own funds and eligible liabilities (MREL), for firms set that preferred resolution

strategy (i.e. firms with a preferred resolution strategy of either bail-in, transfer, or modified insolvency procedure).

7. Finally, further explanation has been provided setting out how the bail-in power may be applied given the regulatory capital, debt, or other liabilities of the firm. This is based on the powers available through the Banking Act 2009 as currently set out, including those liabilities deemed as excluded. Any exclusion of liabilities introduces other risks in relation to differences in treatment that may mean affected creditors pursue compensation claims following the resolution.

Worked example 1: Bail-in without use of the new mechanism

8. This example outlines how the Bank of England would typically apply its bail-in powers for a UK-headquartered firm with a bail-in strategy that has met its end-state MREL requirements. The intention would remain that these firms are resolved using their own resources without the use of the new mechanism.

9. There are 14 firms with a UK resolution entity where the Bank of England currently plans to apply its bail-in powers should they fail, and which currently meet their end-state MREL. In addition to their capital requirements, these firms are expected to maintain additional MREL resources, equal to capital requirements, to support their recapitalisation in resolution, and continued operation (that is, their MREL is generally set at two times their Minimum Capital Requirement (MCR)). The firms' preferred resolution strategies and requirements are published by the Bank of England.[1]

Figure 1: Bail-in without use of the new mechanism

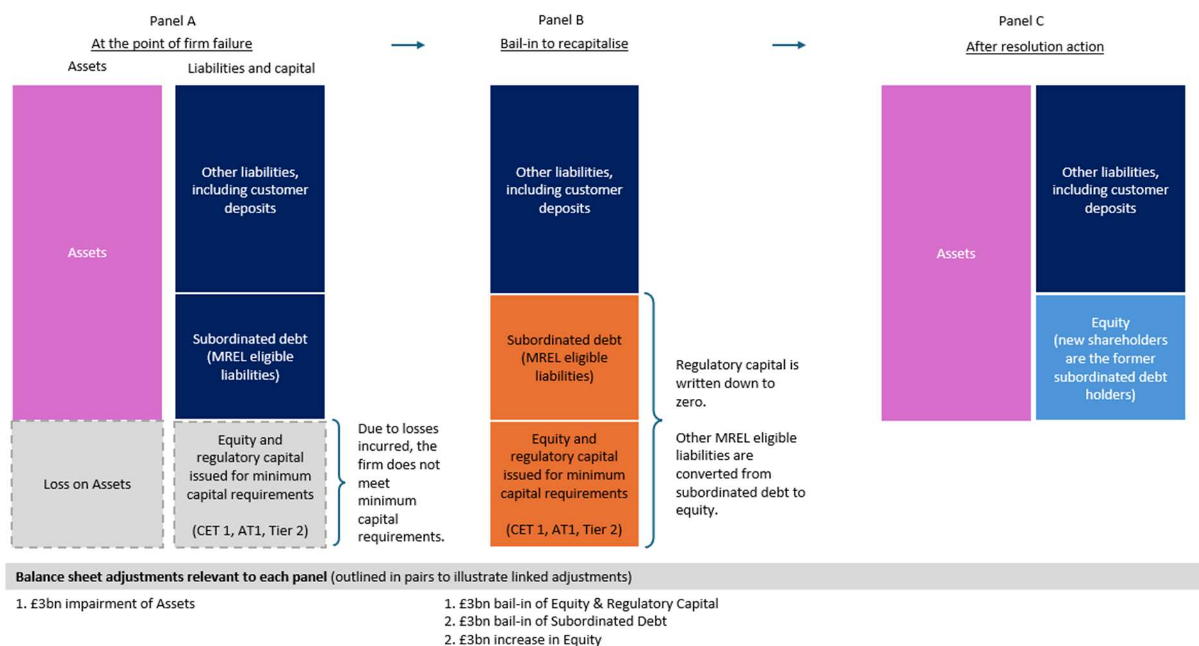


Figure 1 explanation

10. Panel A: Illustrates the loss experienced by the firm on its assets, resulting in it no longer being able to meet its MCR.

11. Panel B: In order to recapitalise the failed firm, enabling it to meet its MCR and maintain market confidence, the Bank of England writes down all regulatory capital (all equity, additional tier 1, and tier 2 capital instruments). Given the extent of the losses, it is necessary to also write down MREL-eligible liabilities, in this case subordinated debt, to generate sufficient equity. The equity is generated as a result of the reduction in the failed firm's liabilities through that write down.

[1] https://www.bankofengland.co.uk/financial-stability/resolution/mrels

12. Panel C: Former holders of MREL-eligible instruments receive shares in the resolved firm. The firm is able to sustain market confidence and meets its MCR.

Worked example 2: The bail-in and transfer powers in combination with and without the use of the new mechanism

13. This example outlines how the Bank of England would typically apply its transfer powers for a UK-headquartered firm that has not met end state requirements. There is currently one firm with a preferred resolution strategy of bail-in that has commenced, but not yet completed, its transition to end-state MREL. This firm is expected to meet end-state external MREL in July 2026. The illustrative numbers used in this slide reflect an example of capital requirements for firms with a bail-in strategy.

Figure 2: The bail-in and transfer powers in combination with and without the use of the new mechanism

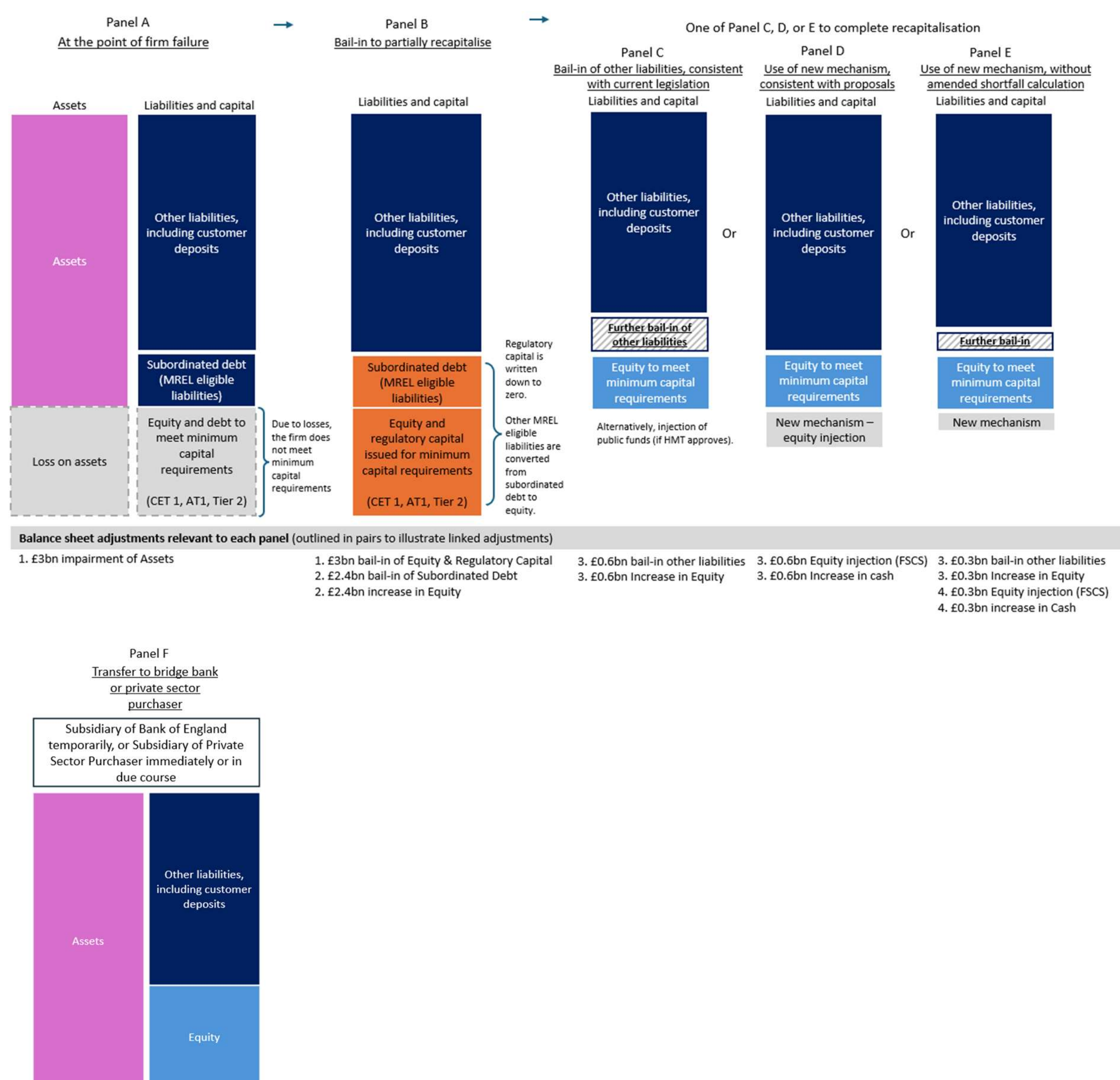


Figure 2 explanation

14. Panel A: Illustrates the loss experienced by the firm on its assets, resulting in it no longer being able to meet its MCR. The firm has not yet met its end-state MREL

requirements and there is insufficient additional loss-absorbing resource for the firm to support its recapitalisation to sustain market confidence.

15. Panel B, in combination with one of Panel C, D or E, outline possible routes that may be followed to achieve its recapitalisation. Panels C, D or E are examples of scenarios that may arise. They may not always arise at the same time. We have used these to illustrate possible situations that the legislation is intended to address.

16. Panel B: The Bank of England exercises its bail-in powers to write down all regulatory capital. Given the extent of the losses, it is necessary to write down MREL-eligible liabilities, in this case subordinated debt, to generate sufficient equity. The equity is generated because of the reduction in the failed firm's liabilities. However, this does not generate sufficient equity to sustain market confidence and meet regulatory capital requirements because the firm had yet to meet its end-state MREL requirement.

17. Panel C: This assumes the current legislative arrangements remain in place. Further equity could be generated through writing down more senior liabilities of the firm. In practice, these liabilities, which could include the uncovered portion of deposits of large businesses, amongst other unsecured liabilities, would all sit in the senior unsecured class in the insolvency creditor hierarchy. Some liabilities in this class are statutorily excluded. This is explained in further detail below. Alternatively, it may be, subject to safeguards around ensuring shareholders and creditors bear loss, necessary for the Treasury (at its discretion) to approve the use of public funds to support the recapitalisation.

18. Panel D: This assumes that the proposed legislative arrangements are implemented. Following the bail-in in Panel B, and after establishing there are no further MREL-eligible liabilities for bail-in, it would be possible to request the Financial Services Compensation Scheme (FSCS) to make resources available to the Bank of England. This would be up to the amount deemed necessary as part of the amended shortfall analysis that would be performed as part of the decision to enter resolution.

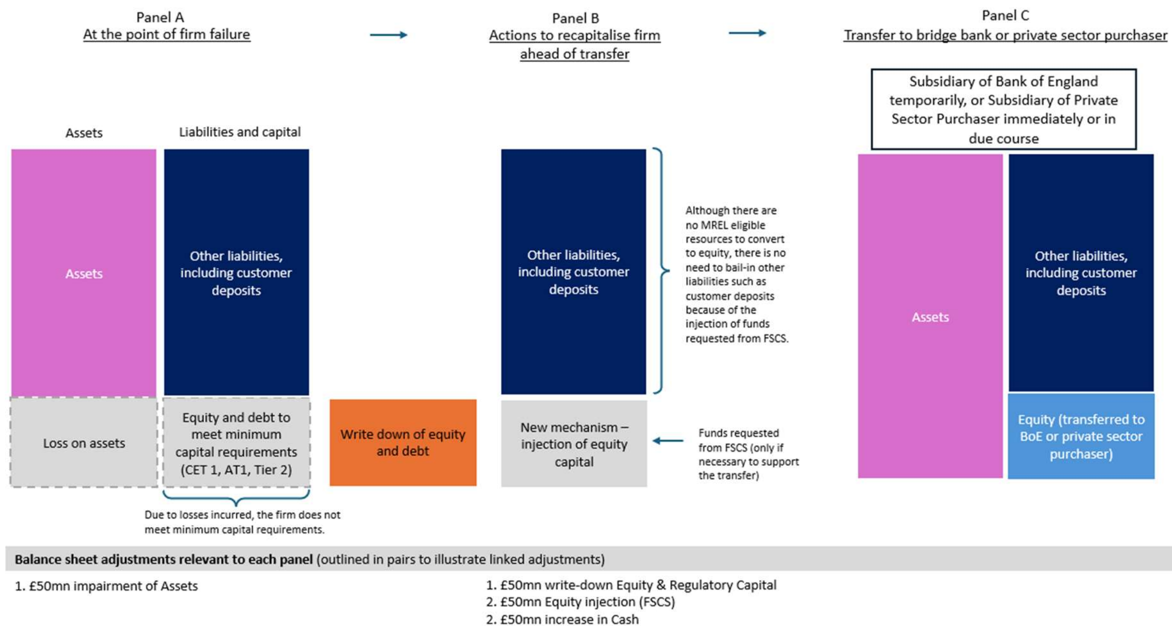
19. Panel E: This assumes that the proposed legislative arrangements are implemented, but amendments are not made to the calculation of the shortfall amount. Following the write-down in Panel B, the shortfall amount analysis would indicate that the continued shortfall requires the write down of other liabilities eligible to be bailed-in as outlined in Panel C. Only once the write down of these other non-excluded liabilities was exhausted, would the FSCS contribution be available.

20. Panel F: In all circumstances where the new mechanism is used, the ownership of the equity is transferred to either a Private Sector Purchaser, or a Bridge Bank, with a view to subsequent sale. The firm would now sustain market confidence and meet its MCR.

Worked example 3: -The transfer powers in conjunction with the new mechanism

21. This example outlines how the Bank of England would typically apply its transfer powers with use of the new mechanism, for firms without MREL above MCR. There are approximately 140 firms with preferred resolution strategies of modified insolvency.

Figure 3~~3~~: The transfer powers in conjunction with the new mechanism



<u>Figure 3 explanation</u>

22. Panel A: illustrates the loss experienced by the firm on its assets. This means it is no longer able to meet its MCR. The firm does not have any MREL resources above MCR to support its recapitalisation.

23. Panel B: The Bank of England exercises its mandatory write-down powers to write down all regulatory capital, reflecting the losses that have been realised at the point of resolution. In connection with transferring the resolved firm to a private sector purchaser or bridge bank, the FSCS would make resources available to the Bank of England, to the amount deemed necessary to recapitalise the firm in order to sustain market confidence and meet MCR.

24. Panel C: In all circumstances where the new mechanism is used, the ownership of the equity is transferred to either a Private Sector Purchaser, or a Bridge Bank, with a view to subsequent sale. The firm would now sustain market confidence and meet its MCR.

Extent of possible use of bail-in power on liabilities of a bank

25. The MREL resources are the first liabilities subject to bail-in; first own funds and then other MREL instruments. If the level of losses and the recapitalisation needs exceed the available MREL, the Bank of England has the power to bail-in other liabilities following the creditor hierarchy. The relevant class of liabilities after MREL is those within ordinary non-preferential debts (otherwise known as general creditors or unsecured senior creditors). These may include most unsecured liabilities (unless subordinated); commercial or trade creditors arising from the provision of goods and services; uncovered depositors not eligible for FSCS protection (e.g. financial institutions); depositors that are not individuals or SMEs for amounts in excess of £85,000; any unsecured liability for pension deficit; and senior unsecured bonds.[2]

26. Certain liabilities are not permitted to be bailed-in, such as protected deposits, client assets, certain liabilities arising from participation in designated settlement systems or recognised central counterparties (CCPs), certain liabilities relating to salaries and pensions and fully secured liabilities. Other liabilities may be excluded from a specific bail-in in whole or in part at the discretion of the Bank in one or more exceptional circumstances set out in the Banking Act. In summary, these are:
    - it is not possible to bail in the liability within a reasonable time;
    - it is necessary and proportionate not to bail in the liability to maintain continuity of critical functions;
    - it is necessary and proportionate to avoid widespread contagion; or
    - not to exempt the liability would destroy value and losses borne by other creditors which would be higher than if the liability were excluded.

27. Any such discretionary exemptions could mean that the bail-in will depart from the *pari passu* treatment that would apply in a hypothetical counterfactual insolvency proceeding. As such it is possible greater losses will be suffered by those creditors who are bailed-in giving rise to the risk of the Treasury having to compensate bailed-in creditors in order to meet the "No Creditor Worse Off" (NCWO) safeguard. Bail-in of liabilities of this kind is likely to occur only in exceptional circumstances and, in general, bail-in would be expected to proceed on the basis of the creditor hierarchy which would apply in such an insolvency proceeding.

28. The resolution instrument would identify any liabilities that have been excluded under this discretion. The objective of MREL is to ensure firms have sufficient liabilities which can be subject to bail-in to stop such circumstances arising. The intention of the Bill is to allow for the inclusion of an injection of FSCS funds, following bail-in of regulatory capital and MREL-eligible liabilities, instead of bail-in of the next class of

[2] Firms with a bail-in strategy are required to establish a holding company, which would mean that senior unsecured bonds are a relevant class of liability to bail-in.

more senior ranking creditors that includes amongst others deposits in excess of £85,000 of larger corporates.

29. Table A below outlines the classes in the insolvency creditor hierarchy. The table highlights the classes in the insolvency creditor hierarchy that would potentially be subject to bail-in and are classes, or types of instrument, that generally relate to MREL-eligible instruments. The resources the FSCS made available to the Bank of England would form part of the shareholders own funds class in any subsequent insolvency of the firm to which the transfer is made.

Table A: Insolvency creditor hierarchy [(a)]

Type of debt or claim
Secured debts (other than floating charges) e.g. security in the form of a mortgage, or fixed charges including but not limited to: capital market transactions (e.g. covered bonds) and trading book creditors (e.g. collateralised positions).
Liquidators' fees and expenses Ordinary preferential debts (or 'super-preferred' debts) Any amount owing in respect of an eligible deposit as does not exceed the compensation caps under the FSCS (up to £85,000, up to £170,000 for joint accounts and up to £1 million for six months for certain qualifying temporary high balances). Contributions to occupational pension schemes. Certain employment (e.g. remuneration) related claims. Debts owed to the FSCS under section 215(2A) of the FSMA 2000 (which may arise where a payment has been made by the FSCS in connection with the exercise of a stabilisation power in respect of a bank, building society or credit union).
Secondary preferential debts Any amount owing to individuals and SMEs for amounts in excess of what would be payable in respect of an eligible deposit as exceeds any compensation that would be payable under the FSCS. Any amount owing to individuals and SMEs in respect of deposits made through a non-UK branch of credit institutions authorised in the UK which would have been an eligible deposit if it had been made through a UK branch of that credit institution. Certain HMRC debts (e.g. VAT and relevant deductions).
Floating charge debts [(b)]
Ordinary non-preferential debts (otherwise called unsecured senior creditors or general creditors) This includes most unsecured liabilities (unless subordinated); commercial or trade creditors arising from the provision of goods and services; uncovered depositors

Type of debt or claim
(e.g. financial institutions); covered depositors that are not individuals or SMEs for amounts in excess of £85,000; any unsecured liability for pension deficit; and senior unsecured bonds.
Statutory interest (in respect of the periods since liquidation) [c]
Secondary non-preferential debts Secondary non-preferential debts are non-preferential debts issued by financial institutions under an instrument where: (i) the original contractual maturity of the instruments is of at least one year; (ii) the instrument is not a derivative and contains no embedded derivative; and (iii) the relevant contractual documentation and where applicable the prospectus related to the issue of the debts explain the priority of the debts under the Insolvency Act 1986.
Tertiary non-preferential debts Tertiary non-preferential debts means all subordinated debts issued by financial institutions, including (but not limited to) debts under CET1 instruments, AT1 instruments and Tier 2 instruments (all within the meaning of Part 1 of the Banking Act).
Shareholders (preference shares)
Shareholders (ordinary shares)

Footnotes

(a) The assets of a company in liquidation will be distributed as shown in the above waterfall. The claims of creditors in the top row will be met first, with any excess assets being passed down to meet claims of creditors in the next row, and so on. Any losses arising from a shortfall between proceeds and creditor claims are incurred, first by shareholders, and then pass up the creditor hierarchy until they are fully absorbed. A key purpose of MREL is to absorb losses. It therefore sits at the lower end of the creditor hierarchy. MREL is made up of 'own funds' and 'eligible liabilities'. The former is made up of regulatory capital and is represented in 'shareholders' and certain 'tertiary non-preferential debts' rows. The latter, made up of instruments that meet specific eligibility criteria, is represented in the 'secondary non-preferential debts' row.

Creditors within a row on the diagram are treated equally (rank ‘pari passu’). Note that trust assets or assets over which creditors have a proprietary interest fall outside of the general estate of the insolvent company and are not therefore shown in this waterfall.

(b) Floating charges that constitute financial collateral arrangements or collateral security (pursuant to the UK Financial Collateral Arrangements Regulation and the Financial Markets and Settlement Finality Regulations) rank senior to preferential debtors and liquidators’ fees and expenses.

(c) In a liquidation, any surplus remaining after the payment of the debts proved in a winding up shall, before being applied for any other purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the company went into the liquidation. Depending on the terms of secondary/tertiary non-preferential debts and their interpretation, these could rank ahead of statutory interest.