LexisNexis®

This article was first published on Lexis®PSL Financial Services on 6 November 2014. Click for a free trial of Lexis®PSL.

Three-step strategy for resolution of failed institutions

06/11/2014

Financial Services analysis: Has the Bank of England (BoE) taken the right approach towards the resolution of failed financial institutions? Andrew Wilkinson and Alexander Wood, partners, and Kate Stephenson, consultant, in the business finance and restructuring team at Weil, Gotshal & Manges LLP, consider the proposed framework of resolution measures.

Original news

Bank of England resolution for failed banks and firms, LNB News 23/10/2014 122

To achieve orderly resolution when a bank, building society or investment firm fails, firms need to have feasible and credible resolution strategies, and financial authorities must have the necessary resolution powers and the capacity to apply them. The approach to be taken by the Bank of England (BoE) in resolving a failure is set out in a new publication which outlines the three stages of resolution--stabilisation, restructuring and exit from resolution.

For more information on the background to the Bank Recovery and Resolution Directive 2014/59/EU (BRRD), see 'The EU Recovery and Resolution Directive: preventing another financial crisis' (2013) 10 JIBFL 641, LNB News 12/11/2013 35, written by Alex Wood.

What is the background to the Approach Document?

The BRRD has imposed a common approach to the recovery and resolution of banks and investment firms within the EU.

It is required to be implemented under national law from 1 January 2015. The BoE is responsible for the resolution of a failing bank, building society or investment firm under the (amended) Banking Act 2009 (BA 2009).

The Approach Document sets out the bank's 'toolkit' or framework of resolution measures and sets out exactly how it would go about resolving a bank, building society or investment firm in practice once the BRRD becomes effective. The bank's aim is to ensure that the adverse effects of any failure of a firm within the scope of the resolution regime are minimised.

The stated objective in publishing the Approach Document is to ensure that financial institutions, their owners, investors and customers understand the risks involved--and the protections in place--when a firm fails.

What are the key issues raised in the document?

Aims of resolution

The aim of the resolution regime is to ensure losses arising from failure are borne by the shareholders and unsecured creditors of failed firms, rather than the general public. It also aims to ensure that the critical economic functions of the failing firm (such as settling financial transactions, retail and corporate banking and market-making in certain securities) are not interrupted during resolution.

Key features of the resolution regime

Triggering the resolution regime

Before a firm can be put into resolution, two key conditions must be satisfied:

- the firm must be failing, or likely to fail--for example, if it is failing or likely to fail to satisfy its threshold conditions for authorisation in a way that justifies the withdrawal of its authorisation
- it must not be reasonably likely that action will be taken--outside the resolution regime--that will result in the firm no longer failing or likely to fail

In addition, in order for the regime's stabilisation tools to be used, it must be necessary for them to be used, having regard to the public interest in the objectives of resolution. This is because the stabilisation tools allow authorities to take actions which may affect property rights. (Where the public interest test is not met, firms may be put into a modified form of insolvency procedure, providing they hold protected deposits and/or client assets.)

Stabilisation and other tools

The stabilisation tools available to the bank are:

- transfer to a private sector purchaser
- transfer to a bridge bank (a subsidiary of the bank which meets the relevant conditions for authorisation, pending a future sale or share issuance), and
- bail-in--used to absorb the losses of a failed firm and recapitalise it using the firm's own resources (the claims of shareholders and unsecured creditors are written down and/or converted into equity to restore solvency, in a manner that respects the hierarchy of claims in insolvency)

For those parts of the firm that do not need to be maintained permanently but may need to be wound down in an orderly manner, there are two tools that can be used only in conjunction with one or more stabilisation tools. These are:

- asset separation tool--to allow assets and liabilities of the failed firm to be transferred to and managed by a separate asset management vehicle, with a view to maximising their value through an eventual sale or orderly wind-down
- bank (or building society) administration procedure--to put the part of a failed firm that is not transferred to the bridge or private sector purchaser (known as the residual bank) into administration

The regime also includes provisions to ensure that a firm's entry into resolution does not, by itself, trigger contractual early termination rights or other events of default. In addition, the regime provides for services and facilities from other companies in the group to continue to be provided to the firm in resolution.

The choice of resolution strategy will emerge from the process of resolution planning conducted by the bank. It will be informed by factors including the:

- complexity of the firm's balance sheet
- scale of its trading book, and
- extent of its foreign operations

The 'no creditor worse off' safeguard

The regime requires that no shareholder or creditor will be left worse off after the use of stabilisation tools than they would have been if the firm had been placed into an insolvency proceeding. A 'no creditor worse off' valuation of the firm will be prepared by an independent valuer, appointed by the Treasury, as at the point of resolution. Where the valuation reveals a shortfall, shareholders and/or creditors will be entitled to compensation to close the gap, financed by the industry.

Use of public funds

Resolution planning will be conducted on the assumption that no public funds will be available to cover the losses of creditors and shareholders in resolution. However, the Approach Document recognises that public funds may be needed as a last resort.

Conducting a resolution

The Approach Document explains the key stages of a resolution in greater detail, focussing on the use of stabilisation tools, with examples. It refers to three key phases of a resolution:

- the 'stabilisation phase'
- the 'restructuring phase', and
- 'exit from resolution'

The Approach Document emphasises the concept of a 'resolution weekend' in which the bank would enact the stabilisation measures (whether pursuant to a transfer to a solvent third party or a bail-in to recapitalise the failed firm).

Avoiding 'too big to fail' and other tools

The bank's resolution regime is just one of the tools in the public authorities' toolkit to protect UK financial stability. That toolkit also includes banks' living wills, capital requirements and deposit guarantees in the form of the financial services compensation scheme (FSCS). The Prudential Regulation Authority is responsible for the supervision of banks, building societies and credit unions, insurers and major investment firms--this includes ensuring they are adequately capitalised.

What happens next?

The bank will publish the results of the UK variant bank stress tests on 16 December 2014. This publication follows the results of the European Banking Authority's EU-wide stress tests, which were published on 26 October 2014. However, the bank has cautioned that the results of the European Banking Authority's tests should not be interpreted as indicative of the UK results. We may see UK banks seeking to raise capital and/or dispose of certain assets as a result of the UK variant stress tests.

The tools described in the bank's Approach Document meet the minimum requirements of the BRRD.

All EU member states are required to apply the necessary laws and regulations transposing the BRRD from 1 January 2015. (They have the option of delaying the application of the bail-in measures until 1 January 2016 at the latest.)

The BRRD also introduces the concept of a minimum requirement for loss-absorbency, which aims to ensure all firms have adequate total-loss absorbing capacity, including sufficient liabilities, that could be exposed to loss in resolution--that will be set on a firm-by-firm basis according to criteria set out in the BRRD.

Another key change required by the BRRD is the introduction of mandatory preference in the creditor hierarchy for individuals and SMEs that exceed the deposit protection limit of €100,000 (£85,000). It also introduces mandatory 'super-preference' for deposits protected by EU deposit guarantee schemes, such as the FSCS, for amounts below €100,000 (£85,000). This means that, in insolvency, the FSCS will be in the most senior class of unsecured creditors.

What advice should lawyers/professional advisers give to their clients?

Banks' investors (be they shareholders or debt holders) must be advised that their interests may be materially affected over the course of a resolution weekend. The interests of existing shareholders may be cancelled, diluted or transferred, and the claims of unsecured creditors may be written down. Investors may find that their claims have been transferred to a third party or bridge bank, or left behind to be placed into administration or into an asset management vehicle. There remain unanswered questions as to the operation of a bail-in and how equity and unsecured claims would be written down or converted, and in what relative ranking.

Two main factors help mitigate this risk to third party rights. First, the public interest test requires that, in order for the bank to use the regime's stabilisation tools, it must be necessary to do so having regard to the public interest in the objectives of resolution. The bank must consider the objectives in BA 2009, one of which requires avoiding interfering in property rights in contravention of the European Convention of Human Rights. However, BA 2009 contains a number of other potentially competing objectives, which the bank must weigh in the balance.

Second, the 'no creditor worse off' safeguard requires that no shareholder or creditor will be left worse off after the use of stabilisation tools than they would have been had the whole firm been placed into an insolvency proceeding. As mentioned above, an independent valuer will assess whether there is such a shortfall. The degree of protection afforded by this safeguard will depend on a proper valuation being carried out. In addition, the baseline comparator for the investor's position in an insolvency will now see unsecured senior creditors being subordinated to deposit creditors, following the new insolvency creditor hierarchy in the BRRD.

Finally, financial market contracts that rely on netting and set-off, collateral and certain other arrangements will be protected in the resolution process. Accordingly, counterparties to financial market contracts can continue to exercise their close-out rights--the regime will not undermine the original purpose of arrangements designed to mitigate credit risk. This safe-harbour may therefore impact how the bank deals with liabilities that do fall within the resolution regime. This set of safeguards also means the bank cannot 'cherry pick' when using the stabilisation tools (for example by transferring certain contracts subject to netting arrangements with a given counterparty, while leaving others behind).

The Bank is permitted to depart from this safeguard in certain limited circumstances. The Approach Document cites a detailed discussion of safeguards, set out in Davies, G and Dobler, M (2011) 'Bank resolution and safeguarding the creditors left behind'. This may make a transfer of the business significantly more complex, and may indeed make rescue impossible for an investment bank.

Andrew Wilkinson is a partner in the European restructuring team. He has nearly 30 years restructuring experience as a lawyer, and then as a banker. Before joining Weil, Andrew was European head and co-head of restructuring at Goldman Sachs.

Alexander Wood is experienced in all aspects of business restructuring and insolvency, and focuses on complex insolvency work and financial services (including insurance) insolvency and restructuring. He has particular expertise in the design and implementation of complex schemes of arrangement, cross-border restructurings and formal insolvency procedures.

Kate Stephenson is a consultant/professional support lawyer at Weil based in London.

Interviewed by Julian Sayarer.

The views expressed by our Legal Analysis interviewees are not necessarily those of the proprietor.