**Special Resolution Regime: Code of Practice – Annex on the new bail-in option**

1. **Introduction**

**1.1** The amendments made to the Banking Act 2009 by the Banking Reform Bill will have the effect of inserting a new stabilisation option (the “bail-in option”) into Part 1 of the Banking Act 2009 which extends to England, Scotland, Northern Ireland and Wales.

**1.2** The bail-in option is available in relation to banks, building societies and investment firms (as defined in the 2009 Act, and referred to together in this document as “banks”). Secondary legislation will provide relevant modifications to the 2009 Act and other legislation in relation to the application of the option to building societies. The option is also available under specified conditions in relation to banking group companies.

**1.3** This annex to the Code of Practice supports the legal framework of the special resolution regime under Parts 1 to 3 of the 2009 Act, and provides guidance as to how and in what circumstances the Bank of England, as the resolution authority, will use the bail-in option.

**1.4** The annex is published here in draft in order to provide further clarity on these issues as the amendments pass through Parliament. The Banking Liaison Panel has a statutory remit to advise the Treasury on the Code of Practice under Section 10(2)(b) of the Banking Act 2009, and the Treasury will consult the Panel before finalising the annex. We will also reflect on any views raised by the wider industry following the introduction of the amendments to the Act, in particular with regard to draft secondary legislation on matters such as safeguards on which the Treasury will consult with industry and other key stakeholders.

**1.5** There are outstanding changes that need to be made to the Code in order to reflect changes to the regulatory architecture, and other changes to the resolution regime introduced in the Financial Services Act 2012 and the Banking Reform Bill. This annex broadly reflects these changes (for example, referring to the Prudential Regulation Authority (the “PRA”) and the Financial Conduct Authority (the “FCA”), rather than the FSA) but does not attempt to make all of the changes necessary. These changes will be made in due course, and this annex will be replaced by, and incorporated within, a fully updated version of the Code which will reflect all of these recent changes.

1. **The authorities’ regard to the Code**

**2.1** The authorities (the Bank of England, the Treasury, the PRA and the FCA) are obliged to have regard to the Code under section 5(4) of the 2009 Act. The authorities will therefore be obliged to have regard to this annex (once finalised), as well as the rest of the Code, when considering the use of, or using, the bail-in option.

**2.2** One of the primary purposes of the Code is to provide a guide for banks and building societies, creditors and financial markets, to how the authorities will seek to achieve the special resolution objectives and how the stabilisation powers may be used in practice. The primary purpose of this Annex is to provide a guide as to when and how the bail-in option may be deployed in practice.

**2.3** Consistent with the rest of the Code, this annex should be viewed as a guide to the most likely use of the powers available under the bail-in option. The powers may be exercised in a range of ways, provided that these are consistent with the special resolution objectives set out in section 4 of the 2009 Act. So while the authorities must have regard to the Code (and this annex), they are not necessarily bound to adopt an approach set out in the Code where circumstances arise which mean that another approach better meets these objectives.

1. **Banking Liaison Panel**

**3.1** Consistent with its commitment in the current Code, the Treasury will consult the Banking Liaison Panel when making material changes to the Code and, as noted above, will consult on this annex to the Code.

1. **Overview of the bail-in option**

**4.1** Bail-in is an additional stabilisation option, available to the Bank of England, which enables it to recapitalise a failed institution by allocating losses to its shareholders and unsecured creditors by writing down and/or converting their claims to equity broadly in a manner that respects the hierarchy of claims in liquidation. Bail-in of a firm is intended to stabilise it through recapitalisation, and enable it to comply with regulatory requirements, in particular capital requirements imposed by the PRA and to continue providing essential functions without disruption to services.

**4.2** Bail-in is designed to ensure that the institution’s solvency is restored and continues operating while remaining under private ownership and control. This will in general be achieved by compensating creditors with bank equity, and the value of that equity will be allocated in accordance with the creditor hierarchy in insolvency.

**4.3** Following the bail-in, the bank will continue to be authorised and regulated by the PRA and FCA, who will authorise it and assess its compliance with threshold conditions and other regulatory requirements in the usual way.

1. **Special resolution objectives**

**5.1** The special resolution objectives set out in section 4 of the 2009 Act apply in all circumstances, regardless of the choice of stabilisation option. Therefore, when deciding on use of the bail-in option, and when exercising the powers available in relation to that option, the authorities must have regard to the special resolution objectives, as outlined in Chapter 3 of the Code.

1. **Roles of the authorities**

**6.1** The roles of the authorities under the special resolution regime are as set out in Chapter 4 of the Code, (noting changes to reflect the new regulatory architecture introduced by the Financial Services Act 2012).

**6.2** The PRA, which is a subsidiary of the Bank of England, is responsible for making the determination that the regulatory pre-conditions for use of the stabilisation powers are met. In the case of an FCA-only authorised investment firm, the FCA will determine whether the regulatory pre-conditions are met (see below).

**6.3** The Bank of England is responsible for the operation of the special resolution regime, including the decisions as to the use of the private sector purchaser option, the bridge bank option, and the new bail-in option. The Treasury is responsible for the temporary public ownership (TPO) option.

**6.4** As is the case with its other stabilisation powers, before deciding whether it is in the public interest to exercise the bail-in option and if so how to react, the Bank will consult with the PRA, the FCA and the Treasury and have regard to their representations in relation to the condition in section 8A(2), including the impact of the exercise of the power in relation to public confidence in the stability of the UK financial systems

1. **General and specific conditions for choosing the SRR tools**

***Determining that the regulatory pre-conditions are satisfied***

**7.1**The pre-conditions for use of the bail-in option are identical to those for the other stabilisation options (see section 7 of the 2009 Act), and therefore these are covered by the Code at paragraphs 5.6 – 5.11.

***Determining in that the specific conditions for exercising the bail-in tool are met***

**7.2** The process for determining that the specific condition for exercising the bail-in stabilisation power is met (see new section 8A) is the same as for the other stabilisation powers, and therefore covered by the existing Code in paragraphs 5.12 – 5.17.

***The choice between the tools***

**7.3** As outlined in the Code (paragraphs 5.18 – 5.26), in choosing between the resolution tools, the Bank of England will consider the relative merits of the stabilisation options and the bank insolvency procedure having regard to the particular circumstances of the failing bank and which option best protects the public interest having regard to the special resolution objectives. The Code also outlines some general considerations.

**7.4** Paragraphs 5.19 – 5.22 of the Code set out general considerations that may be taken into account choosing between the original resolution options. In addition to those considerations, the Bank of England may take into the account the existence of the new bail-in option.

**7.5** Resolution by way of a bail-in may be preferred where exercise of another stabilisation power would be more likely to result in risks to financial stability or confidence in the banking system, costs or operational disruption to depositors, or risks to public funds. For example, bail-in may be appropriate where transferring the property or business of the firm would result in unacceptable disruption to continuity of banking services or raise other financial stability concerns.

***Specific considerations relevant to building societies***

**7.6** The provisions include a requirement that the Treasury makes an order to modify the 2009 Act and other relevant legislation in connection with the application of the bail-in stabilisation option in relation to building societies.

**7.7** The Treasury is progressing this work, working closely with the Bank of England, the PRA and the FCA with a view to exercising this power at the earliest possible stage. We intend to consult on the detail of the order and on the commencement of the powers in the Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (commonly known as the Butterfill Act) relating to the creditor hierarchy for building societies, which we anticipate commencing at the same time as the order.

***Specific considerations relevant to group companies***

**7.8** The Bank of England may exercise the bail-in power in respect of a banking group company if the following conditions are met:

* Condition 1 is that the PRA (or the FCA where the firm in resolution is an FCA-only authorised investment firm) is satisfied that the general conditions for the exercise of a stabilisation power are met in respect of a bank in the same group.
* Condition 2 is that the Bank of England is satisfied that the exercise of the power in respect of the banking group company is necessary, having regard to the public interest in:
* the stability of the financial systems of the United Kingdom;
* the maintenance of public confidence in the stability of the banking systems of the United Kingdom; or
* the protection of depositors.
* the protection of any client assets that may be affected.
* Condition 3 is that the banking group company is incorporated in, or formed under the law of, the United Kingdom.

**7.9** Therefore, the power will be exercised in relation to banking group companies in situations where the Bank of England is satisfied that action only on the bank itself is not sufficient to achieve the special resolution objectives.

**7.10** In determining whether it is necessary to take action in relation to a group company, the Bank of England will consider whether action in relation to the bank alone would be sufficient for the purposes specified in section 8A of the 2009 Act.

**7.11** Examples of situations where action at the level of the parent undertaking of a failing bank is necessary might include cases in which the parent undertaking owns the failing entity and is responsible for issuing external share capital and debt to the market before down-streaming it to the bank.

**7.12** Condition 3 limits the scope of the power over group companies to those incorporated in the UK. This means that, in the case of a group with cross-border operations and banking group companies in different countries, only banking group companies incorporated in the UK fall within the scope of this power.

1. **Use of the bail-in powers**

**8.1** The bail-in option is to be effected by way of one or more resolution instruments under new section 12A of the 2009 Act which may be followed by one or more supplemental resolution instruments and other forms of instrument.

**8.2** A range of new powers are available to the Bank of England including the power to make special bail-in provision, including a conversion power (new section 48B), the power to make provision in relation to securities (new section 48L) and the power to appoint one or more bail-in administrators to perform specified tasks (see new section 12B).

 ***Special bail-in provision***

**8.3** Where a bank is subject to bail-in, the Bank of England may make special bail-in provision. In particular, this allows the Bank of England to:

* cancel a liability of the bank, including any contract under which the bank specified in the instrument has a liability;
* modify the terms, or the effect of the terms, or any contract under which the bank has a liability.

**8.4** The powers could be used for the purposes of:

* reducing a liability, including the principal or outstanding amount payable under the contract;
* discharging the bank from obligations created by the contract – for example cancelling future coupon payments.

**8.5** The Bank of England also has a conversion power which enables it to convert a liability from one form to another, including a conversion of all or part of the liabilities attaching to securities into another form, type or class of new or pre-existing securities. For example, this power could be used to convert a debt instrument partially into shares and partially into another type of debt security. The Bank of England also has the power to transfer the existing shares previously held by the bank’s former shareholders to the bailed-in creditors.

**8.6** This allows the Bank of England to take actions thereby reducing the liabilities side of the bank’s balance sheet, and recapitalising the bank.

**8.7** A power to make a special bail in provision may be exercised only for the purpose of, or in connection with, reducing or deferring a liability of the bank.

***Excluded liabilities***

**8.8** Certain liabilities are excluded from the power to make special bail-in provision (as described above). The powers conferred by the special bail-in provision cannot be used in relation to:

* deposits covered by the Financial Services Compensation Scheme (FSCS) or an equivalent overseas scheme;
* liabilities to the extent they are secured;
* client assets, including client money;
* liabilities with an original maturity of less than seven days which are owed to a credit institution or investment firm (save in relation to credit institutions or investment firms which are banking group companies in relation to the bank);
* liabilities arising from participation in a designated settlement system and owed to such systems (including central counterparties authorised under Regulation (EU) 648/2012), or to operators or participants in such systems;
* liabilities owed to central counterparties recognised by the European Securities and Markets Authority (ESMA) in accordance with Article 25 of Regulation (EU) 648/2012;
* liabilities to employees or former employees in relation to accrued salary or other remuneration (with the exception of variable remuneration);
* liabilities owed to employees or former employees in relation to rights under a pension scheme (with the exception of discretionary benefits); and
* liabilities to a creditor arising from the provision of goods or services (other than financial services) that are critical to the daily functioning of the bank’s operations (with the exception of creditors that are companies which are banking group companies in relation to the bank).

**8.9** In the case of secured liabilities, the secured amount shall be excluded from bail-in. If any part of the liability is unsecured, then the bail-in powers may be applied to the unsecured part. For example, if a liability of £100 m is secured with an asset worth £80 m, then the bail-in provisions may be applied to the £20 m representing the unsecured part of that liability.

**8.10** The determination of whether the provision of goods and services are critical to the continuing operation of the bank shall be made by the Bank of England in consultation with the PRA and the FCA. This exclusion does not apply to creditors that are companies within the same banking group as the bank subject to the exercise of the powers. For example, liabilities to a service provider within the same banking group will not be excluded from the scope of the bail-in provision.

**8.11** Where the Bank of England exercises its powers to make special bail-in provision, it will have regard to the principle that the exercise of the powers should respect the creditor hierarchy in insolvency. This principle would generally mean that creditors’ claims would not be written down or converted until more junior liabilities have been, and that the Bank of England will seek to treat creditors of equal rank equally.

**8.12** The primary exception to this principle is that the liabilities excluded from the bail-in provisions are not included in this consideration. Liabilities in the same class as excluded liabilities can be modified or cancelled, notwithstanding the fact that liabilities in that class have been excluded through statutory provision.

**8.13** As is currently the case when allocating losses using its current powers in a partial transfer, the Bank of England will also have flexibility to choose not to make special bail-in provision, or to make different special bail-in provision in relation to different liabilities of the bank (including as regards liabilities in the same class). This discretion is likely to be exercised in circumstances including, but not limited to where:

* it is not possible (including for operational reasons) to bail in certain liabilities within a reasonable timeframe;
* different treatment is necessary and proportionate to achieve the continuity of critical functions and core business lines;
* different treatment is necessary and proportionate to avoid giving rise to widespread contagion that would severely disrupt the functioning of financial markets;
* absent different treatment, there would be destruction in value such that the losses borne by other creditors would be higher than if these liabilities were not bailed in.

***Derivatives and similar financial transactions***

**8.14** In terms of the application of the power to make special bail-in provision to derivatives and financial transactions with similar characteristics (in particular, stock loans and repurchase agreements (“repos”)), the Bank of England’s expectation is that, to the extent that such contracts are bailed in, those contracts will be closed out before they are bailed in. For this purpose, where appropriate, the Bank of England intends to close out the contracts which are subject to the power and have not already been closed-out, prior to or at the time of the application of the power.

**8.15** In exercising its power to close-out the contracts, the Bank intends to follow the applicable contractual provisions, to the extent practicable; so it would expect that any applicable close-out netting would be taken into account. Further, if a liability is then owed, it will be excluded from bail-in so far as it is secured. In any event, the Bank will respect netting sets applicable to derivatives and other financial transactions in exercising its power to make special bail-in provision, including when calculating the extent to which a liability is secured.

**8.16** The PRA and FCA will be consulted by the Bank of England in accordance with the terms set out in legislation.

**8.17** The level of write down or conversion should respect the “no creditor worse off” principle (discussed further below) that no creditor shall incur greater losses than would have been incurred if the institution or entity referred to had been wound up under normal insolvency proceedings immediately before the transfer, write down or conversion.

***Valuation***

**8.18** Before taking resolution action or exercising the power to write down or convert liabilities, resolution authorities are expected to carry out a valuation of the assets and liabilities of the institution to the extent it is reasonably practicable in the circumstances. Such valuations should follow accepted and well defined market practice and methodology, where available and appropriate.

***Report on special bail-in provision***

**8.19** Where the Bank of England makes an instrument including special bail-in provision, the Bank of England must report to the Chancellor stating the reasons that the provision has been made in the case of the contracts concerned (see, for example, new section 48E). This report should be submitted as soon as is reasonably possible after the exercise of the powers.

**8.20** Where the Bank of England has departed from the insolvency treatment principles, including the principle of equal treatment for creditors of equal rank, the report must state the reasons why it has done so.

**8.21** Upon receiving the report, the Chancellor will lay it before Parliament.

***Power to make provision in relation to securities***

**8.22** The Bank may specify in a resolution instrument how rights attaching to securities issued by the bank should be exercised. For example, it may enable the Bank or a bail-in administrator to exercise voting rights attaching to the bank’s shares during a resolution (new section 48L).

**8.23** Resolution instruments may also make any provision that may be made under the 2009 for, or in connection with, the purposes of transferring securities from one person to another (e.g. to a bail-in administrator and then “onward transferred” to affected creditors).

***Bail-in administrators***

**8.24** Power is conferred on the Bank of England to appoint one or more bail-in administrators to perform such functions as may be specified in the resolution instrument.

**8.25** These functions may include (but are not limited to):

* holding, on a temporary basis, such securities as may be transferred to the bail-in administrator (the securities are to be held and disposed of strictly in accordance with such provision as may be specified in the resolution instrument);
* preparing a business reorganisation plan;
* performing management functions in relation to the bank under resolution.

**8.26** The bail-in administrator and the directors of the bank will work together during the resolution period. The split of responsibilities will be determined by the Bank of England in setting the remit of the bail-in administrator.

**8.27** In some cases the role of the bail-in administrator may be much more limited, and restricted to the holding of the shares and other securities during the period of resolution, with the bail-in administrator taking no active role in management of the bank.

**8.28** The bail-in administrator may be granted all the powers of the shareholders and management and perform that function without involvement from other directors. Alternatively, they may act as part of the management team, being involved in management decisions along with the directors of the bank or may be given no management functions.

***Directors***

**8.29** The Bank of England may appoint new directors of the bank under resolution (in the same way it may do so in connection with its other stabilisation powers under the Act). Cases in which such action may not be appropriate may be where the directors have recently been replaced and, in the view of the Bank of England, having consulted with the PRA and FCA, are not responsible for the failure of the bank.

**8.30** At the end of the resolution process, when the shares or other instruments of ownership and control of the bank are transferred to the new owners, these shareholders will be able to exercise all normal shareholder rights, and will therefore have the ability to appoint directors as they see fit (subject to the normal approval and supervision of the PRA and the FCA).

***Business reorganisation plans***

**8.31** Following intervention using the bail-in option the Bank of England may require a bail-in administrator or one or more directors of the bank under resolution to prepare a business reorganisation plan.  This plan will assess the factors that led to the bank’s failure and set out how the business will be returned to viability (including by reference to compliance with PRA and FCA regulatory requirements), and operate as a going concern.

**8.32** The plan may include (but is not limited to):

* selling parts of the business;
* reorganisation or restructuring of the business;
* withdrawal from certain activities.

**8.33** The plan must be approved by the Bank of England following consultation with the PRA and the FCA.

**8.34** In deciding whether to task a bail-in administrator or one or more directors of the bank to prepare the business reorganisation plan, the Bank of England will consider such factors as the scale of the challenges faced by the bank under resolution.

**8.35** The business reorganisation plan may include recommendations by the person submitting the plan as to the exercise by the Bank of England of any of its resolution powers in relation to the bank. This may be relevant where, for example, a bail-in administrator has identified a buyer for part of the business of the bank, and recommends that the Bank of England use its property transfer powers to effect a sale. In practice, the Bank of England may use its powers in such a manner until control of the bank is handed over to the shareholders.

***Supplemental, reverse and onwards transfers***

**8.36** The Bank of England may make various instruments following the making of one or more instruments under new section 12A. This applies for the exercise of any of their stabilisation powers, including the bail-in stabilisation option.

***Transfer powers in relation to group companies***

**8.37** Where the authorities have exercised stabilisation powers in respect of a group company, the transfer powers may be used to transfer property or securities of the group company, in the same way that can be used in relation to the property or securities of the bank.

**9. Safeguards for bail-in**

***No creditor worse off***

**9.1** The safeguards include a requirement to establish compensation arrangements with regard to ensuring that no person is worse off as a result of the application of the bail-in option than they would have been had the bank gone into insolvency. This will take into account any compensation that they would have been entitled to receive from any statutory compensation schemes which covered those creditor’s claims. This is similar to the existing safeguard which applies in the case of partial property transfers.

**9.2** The “no creditor worse off” provisions will be established by regulations made under new section 60A of the 2009 Act, and will be kept under review by the Treasury. The Regulations may require orders to be made in specified cases:

* to provide for the appointment of an independent valuer;
* to provide for the valuer to assess the treatment that the relevant person of the failing bank would have received had the bail-in option not been deployed and the whole bank been put into insolvency (the “insolvency treatment”);
* to provide for the valuer to assess the treatment which such creditors have received, are receiving or are likely to receive if no compensation (or further compensation) is paid (the “actual treatment”).

**9.3** If the independent valuer determines that there is a difference between the insolvency treatment and the actual treatment and a person in such a situation had been made worse off than they would have been had the bank entered insolvency, compensation would generally be payable to that person. In assessing the amount of any compensation the valuer will be obliged to follow any mandatory principles specified in the regulations or orders and may, for example, be required to take account of any equity instruments issued to the person concerned during the course of the bail-in in assessing the difference in treatment.

***Safeguards order***

**9.4** Similar to the arrangements in relation to partial property transfers, the Treasury will make an order requiring the Bank of England to respect certain arrangements (called “protected arrangements”) when deploying the bail-in option. For example, the order may provide that if liabilities under derivative transactions or other financial contracts are subject to a netting agreement, such liabilities will be bailed in on a net basis.

**9.5** The secondary legislation will set out remedies in the event of a breach of the safeguards.

**10. Exit from resolution**

**10.1** The bank will be considered to have exited resolution at the point at which the bailed-in creditors assume control over the bank in their capacity as the new shareholders. Any acquisition of control is subject to the ordinary powers normal approval of the authorities, taking into account the reputation and financial soundness of person who acquires control.

**10.2** At this point, the new shareholders will be able to exercise all normal shareholder rights, subject to the requirement of ongoing supervision of the bank which may include continuing to implement the business reorganisation plan.