

<b>Title:</b> Post Implementation Review of the Bank Recovery and Resolution Directive <b>PIR No:</b> RPC-HMT-5103(1) <b>Original IA/RPC No:</b> <b>Lead department or agency:</b> HM Treasury <b>Other departments or agencies:</b> Bank of England, Prudential Regulation Authority, Financial Conduct Authority <b>Contact for enquiries:</b> Henry Grigg, <a href="mailto:henry.grigg@hmtreasury.gov.uk">henry.grigg@hmtreasury.gov.uk</a>	Post Implementation Review
	<b>Date:</b> 01/02/2022
	<b>Type of regulation:</b> EU
	<b>Type of review:</b> Statutory
	<b>Date measure came into force:</b> 01/01/2015
	<b>Recommendation:</b> Keep
	<b>RPC Opinion:</b> Green

## 1. What were the policy objectives of the measure?

### Policy background and context

1. The Global Financial Crisis showed that when certain financial institutions were at risk of failing, allowing them to enter insolvency and fail was unlikely to be in the public interest. If a bank entered insolvency, the critical functions the bank performs such as deposit taking and lending would cease and may not be replaced quickly by other banks.
2. The insolvency of one bank can cause contagion within the sector as banks are often highly interconnected through either loans or providing other funds. If one bank fails, then other banks would no longer have access to those funds. Liquidity problems may arise and some payment obligations may not be met. This could trigger a loss of confidence and sudden withdrawal of funds as depositors try to protect their money, causing further liquidity problems.
3. Neither banks nor regulators were sufficiently prepared to deal with, plan for or manage the orderly wind down of a large bank. There were also no means of coordination in place in the event of cross border bank failure. While there was a supervisory framework in place, this was inadequate and unable to deal with the resolution of large, cross-border firms.
4. Likewise, many EU Member States – including the UK at that time – did not have adequate powers to manage a bank failure, leaving the authorities with no choice but to intervene using public funds. The UK Government provided billions of pounds to prevent widespread collapse of the UK financial sector – according to the National Audit Office, peak support for the financial sector in December 2009 was £955bn<sup>1</sup>.
5. Although some Member States did have tools available, or introduced tools to deal with the crisis, including the UK following the introduction of the Banking (Special Provisions) Act 2008 and then the Banking Act 2009, there was no uniform regime at the EU level. There was therefore a need to establish a framework for managing firm failures across the EU. This is because large banks tend to operate across borders, both EU and third country, and different tools available in different countries would have made it harder to resolve banks that operate in multiple countries.

<sup>1</sup> <https://www.nao.org.uk/report/maintaining-the-financial-stability-of-uk-banks-update-on-the-support-schemes/>

## Policy introduction and objectives

6. The Bank Recovery and Resolution Directive (Directive 2014/59/EU or 'BRRD') entered into force on 2 July 2014. It established a common framework across the EU to the recovery and resolution of banks and investment firms, bringing the EU's framework, including the UK at the time, in line with international standards set out by the G20 Financial Stability Board (FSB).
7. The UK already had a Special Resolution Regime (SRR) in place for banks, building societies and investment firms, prior to the introduction of the BRRD. This was introduced largely by the Banking Act 2009. This regime gives the Bank of England – the UK's resolution authority – a range of tools and powers to manage the failure of a bank, building society or investment firm in a way that limits risks to financial stability and protects depositors, whilst limiting risks to public funds. BRRD therefore built on the UK's existing framework.
8. The UK's resolution framework as updated by BRRD is underpinned by a series of special resolution objectives, which include:
  - Ensuring the continuity of banking services and of critical functions
  - Protecting and enhancing the stability of the UK's financial system
  - Protecting and enhancing public confidence in the stability of the UK's financial system
  - Protecting public funds
  - Protecting investors and depositors
  - Protecting client assets
  - Avoid interfering with property rights

## Background on policy implementation

9. In the UK, the Government introduced the Bank Recovery and Resolution Order 2014 and Bank Recovery and Resolution (No.2) Order 2014, to make the changes necessary to the UK's SRR to implement the BRRD. The principal change to the UK's regime was the provision for the Bank of England, as the UK's resolution authority, with powers to bail-in the liabilities of a failing firm. These powers were coupled with new requirements for certain firms to maintain a minimum amount of equity and debt to absorb losses and provide for recapitalisation in the event of a bank resolution – also known as the Minimum Requirement of Own Funds and Eligible Liabilities (MREL).
10. The Bank Recovery and Resolution Order 2014 (SI 2014/3329) came into force on 1 January 2015. The Bank Recovery and Resolution (No.2) Order 2014 (SI 2014/3348) came into force on 10 January 2015, with the exception of part 9 which came into force on 1 January 2016.
11. A number of other statutory instruments were introduced to transpose the BRRD effectively. These included:
  - The Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (SI 2014/3350), to provide protections for holders of a bank's liabilities in the event of a bail-in. This came into force on 1 January 2015;
  - The Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014 (SI 2014/3330), to ensure that shareholders and creditors of a bank

are not left worse off following a bail-in than if the firm had instead been placed into insolvency. This came into force on 1 January 2015;

- The Banks and Building Societies (Depositor Preference and Priorities) Order 2014 (SI 2014/3486), which amended the bank insolvency creditor hierarchy by creating a new secondary class of preferential debt (that part of a deposit which is not covered by the Financial Services Compensation Scheme (FSCS) because it is over the £85,000 limit for covered deposits). This came into force on 1 January 2015;
- The Building Societies (Bail-In) Order 2014 (SI 2014/3344), which ensured the Bank of England's bail-in powers extended to building societies. This came into force on 10 January 2015.

12. Moreover, the UK also implemented part of the BRRD through the Bank Recovery and Resolution Order 2016 (SI 2016/1239). This came into force on 16 December 2016. This legislation made some improvements to the UK's transposition, including by:

- ensuring that certain financial instruments can take effect in accordance with their terms, where specified by the resolution authority, to support a firm's stabilisation;
- providing standalone powers to the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) to require the removal and replacement of directors and senior managers and to appoint temporary managers;
- giving the Bank of England backstop powers to independently resolve the UK branch of a third country (non-EEA) institution, where the Bank has refused to recognise the actions of a third country resolution authority; and
- giving the Bank of England powers to convert a failing building society into a company, to support the use of the bridge bank tool in relation to building societies.

13. Although the UK has now left the EU, the Government committed to reviewing the effects of the BRRD during its transposition.

### Scope of Post Implementation Review

14. This review's scope applies to the BRRD in its entirety. However, much of the UK's resolution regime was already in place before BRRD was transposed. As such, the detail of the PIR focusses predominantly on those elements of the Directive that introduced new requirements into UK law, and therefore novel impacts or requirements on firms – in particular the introduction of bail-in powers, and the requirement for firms to hold MREL.

15. This review does not cover the UK's transposition of the Bank Recovery and Resolution Directive II (BRRDII). BRRDII makes amendments to BRRD provisions, in order to update the EU's bank resolution regime across the EU. The Directive also updates the framework on Minimum Requirement for own funds and Eligible Liabilities (MREL) to bring the harmonised EU resolution and MREL frameworks into conformity with international standards. The UK implemented BRRDII through The Bank Recovery and Resolution (Amendment) (EU Exit) Regulations 2020, which came into force on 28 December 2020.

## **2. What evidence has informed the PIR?**

16. The analysis underpinning this PIR is informed by work undertaken by the Bank of England (the Bank) in its capacity as the UK's resolution authority, particularly in how it assesses the costs of the BRRD to authorities and to firms. The Bank has updated the analysis used in this PIR to take into account the methodologies used in the Bank's published cost-benefit

analyses (CBA)s in 2015<sup>2</sup> and 2017<sup>3</sup>, that informed the public consultations on the Bank's approach to setting MREL. More detail about the Bank's approach to this analysis is set out in Section 4.

17. HMT also consulted the Banking Liaison Panel, a group of industry and regulatory bodies and experts, on 18 May 2021. The minutes of the panel's discussion can be found online.<sup>4</sup>

### **3. To what extent have the policy objectives been achieved?**

18. The Government considers that the UK resolution regime measures introduced in the Banking Act 2009, and then subsequently added to through the BRRD, remain important in order to manage risks to financial stability, consumers and public funds, and that the original policy objectives continue to be met.
19. It is worth noting that, since BRRD came into force and it was transposed into UK law, the UK has not had to use resolution tools and powers to manage a bank, building society or investment firm failure, as no firms in scope of the Special Resolution Regime have failed. In addition, as already mentioned, the UK already had a number of these tools and powers before BRRD was introduced.

### **4. What were the original assumptions and how have these changed?**

20. Two impact assessments (IAs) were prepared alongside the implementation of the BRRD. The first<sup>5</sup> assessed the impact of the Directive as a whole, whilst the second<sup>6</sup> focussed on technical aspects of the bail-in tool. To note, no impact assessment was developed for the measures implemented by the Bank Recovery and Resolution Order 2016, as these measures were judged not to impose a cost on business on an ongoing basis.

#### **Costs**

21. The IA estimated costs for the bail-in tool and changes to depositor preference, since these elements were new in UK law. It did not estimate costs for other elements of BRRD. For some of these, the IA concluded that BRRD did not introduce material and additional private costs to banks over and above the cost associated with the existing resolution framework, primarily because a number of powers already existed in UK law. For others, the IA argued that the exercise of a power may have costs on a specific business, but there were not costs arising from the legislation itself.

#### **Bail-in powers**

22. For the estimates of the bail-in tool, these costs were expected to materialise through higher funding costs for bank unsecured debt. A range of the possible (basis points) increase in funding costs was used for the IA. The cost was calculated by taking the past average annual issuance of unsecured debt from the largest UK banks<sup>7</sup>, and multiplying this by the increase

<sup>2</sup> <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/boes-approach-to-setting-mrel-consultation.pdf?la=en&hash=F1602B73F5746DE4B9BBD55719FB8D9F056943C5>

<sup>3</sup> <https://www.bankofengland.co.uk/-/media/boe/files/financial-stability/resolution/internal-mrel-consultation-october-2017.pdf?la=en&hash=33594C3FB3C7F1D129033AFE4E3A2BF20A4F9AA8>

<sup>4</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1051770/BLP\\_minutes\\_18\\_May\\_2021.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1051770/BLP_minutes_18_May_2021.pdf)

<sup>5</sup> [http://www.legislation.gov.uk/ukia/2014/403/pdfs/ukia\\_20140403\\_en.pdf](http://www.legislation.gov.uk/ukia/2014/403/pdfs/ukia_20140403_en.pdf)

<sup>6</sup> [http://www.legislation.gov.uk/ukia/2014/402/pdfs/ukia\\_20140402\\_en.pdf](http://www.legislation.gov.uk/ukia/2014/402/pdfs/ukia_20140402_en.pdf)

<sup>7</sup> Based on average annual issuance from Barclays, HSBC, RBS, Lloyds and Co-op over the period 2010-2013

in basis points (an upper, best estimate and low increase). This produced an estimate for the annual impact on bank debt funding costs, estimating the total cost of bail-in at between £35m and £294m. Relatedly, the IA estimated that the measures in BRRD, including bail-in, represented a negligible impact on GDP. It is worth noting that a wide range was adopted, on the recommendation made at the time by the Regulatory Policy Committee, given the uncertainty in assessing the impact of this tool.

23. Since this IA was published and following the introduction of the bail-in tool, the Bank issued two public consultations and Statements of Policy on its approach to setting MREL. As part of the first consultation in 2015 the Bank published a CBA, which it later updated as part of the second consultation in 2017, detailing the impact of MREL on banks' funding costs. These CBAs benefitted from a better understanding of the scale of debt that banks would need to issue to meet MREL. The methodology used in the CBA therefore provides a more credible estimate of the cost of the bail-in tool. This is because the debt instruments that are likely to be the most affected by the introduction of a bail-in tool in terms of their pricing are those that are the most likely to be bailed-in (i.e. MREL instruments).
24. This PIR now incorporates this enhanced methodology and the Bank's evidence on the stock of MREL debt that firms would raise, which drives funding costs. Again, the Bank noted a number of caveats when presenting its CBA. This has led to the Bank providing conservative cost assumptions and estimates that may overstate the potential funding costs.
25. The CBA estimated the shortfall between 2015 MREL-eligible resources and 2022 requirements (referred to as the cost of "long-term debt restructuring"). The CBA also estimated a "net shortfall" as the remaining gap to 2022 requirements if firms can convert to MREL resources their liabilities that are structurally similar to MREL resources but do not meet all of the eligibility criteria. For example, group operating companies may have long-term senior unsecured debt. If this debt were issued from a holding company, it would be structurally subordinated and MREL-eligible.
26. The CBA estimated an estimated upper-bound ongoing cost of £1.4bn across all UK headquartered firms subject to MREL. The costs were estimated as follows:
  - The cost of long-term debt restructuring is based on the estimated ongoing cost of replacing current near-eligible MREL term debt with MREL-eligible term debt — in line with the FSB's approach to measuring the cost of TLAC requirements.
  - The cost of closing any net shortfalls that may remain for some institutions after the restructuring of term debt is measured by issuance of new debt which results in balance sheet expansion, with proceeds of issuance invested in assets earning a yield of 1.2% (average yield on ten-year gilts over the past three months).
27. As noted above, the Bank's CBA is a conservative (by which we mean likely to be high) estimate based on a counterfactual in which UK institutions do not have to satisfy any MRELS. Given the differences in methodologies, the estimate in their CBA is not directly comparable to the 2014 IA. This is because it assesses the cost of MRELS by looking at the debt instruments that are the most likely to be bailed in, and in doing so it has been informed by the quantum of MREL that banks have and will have to issue to meet end-state requirements. The 2014 IA estimate, on the other hand, was not informed by the evidence of how much MREL has been issued. For example, Bloomberg data suggests that average annual debt issuance by the major UK banks between 2015 and 2019 was higher than estimated in 2014, at £40.7bn rather than between £17.6bn and £33.9bn as previously estimated. Finally, as

mentioned later in this report, the Government and the Bank still consider that the policy provides an overall net benefit (see paragraph 31).

28. In terms of the impact on GDP, both the 2014 IA and Bank's CBA concluded that the impact of the bail-in tool and MREL requirements on GDP is negligible. The Bank has stated in its CBA that increasing the cost of bank credit to the real economy could have a negative effect on investment and the level of GDP. In calculating the impact, the Bank assumed that each firm subject to MREL would increase its lending rates in order to offset its increase in funding costs in a way that leaves its return on equity unaffected; and that, for each firm, loans that will be repriced constitute 40% of the firm's total assets. Both the 2014 IA and the Bank's CBA concluded that this implies that a 0.01 percentage point increase in a firm's weighted average cost of funding translates into a 0.025 percentage point increase in that firm's lending rates. This led the Bank to conclude in its CBA that MREL increases the cost of credit to a representative borrower by around 0.06 percentage points per annum. Using standard macroeconomic models, this translates into a reduction in the level of GDP of 0.04%.
29. As stated in paragraph 17, the Banking Liaison Panel discussed the UK's transposition of the bail-in tool on 18 May 2021. Panel members commented that the bail-in tool remained essential and was a common feature of regimes in other jurisdictions. There was some debate on the extent to which the tool and the requirement for firms to hold MREL had introduced material costs to firms, with some commenting that these costs had not been prohibitively expensive and others suggesting there had been some burdens on certain firms. Other members also made specific comments about the application of the bail-in tool for building societies.

#### Creditor hierarchy

30. The IA also took a similar methodological approach for modelling costs as a result of the change to the creditor hierarchy implemented by BRRD. The increase in basis points was taken from the IA for the Financial Services (Banking Reform) Act 2013. The increase in costs was modelled on a static basis, in that it assumed that banks would not change their behaviour in response to the increase in funding costs. This estimated the cost of depositor preference for banks and building societies combined to be £213m and £401.7m per year. The Bank does not believe there is evidence to suggest that these assumptions have changed since the IA, and therefore judge that the estimated costs would be largely similar to those estimated in the IA. The Banking Liaison Panel agreed that the changes to depositor preference remained important and did not comment directly on the previous assumptions about the costs of this change.

#### Benefits

31. The 2014 IA did not estimate the benefits. The rationale for this was that the majority of benefits would only arise if a bank were to experience difficulties or enter resolution, and it would not be possible to estimate the probability of such an event occurring. Given there has not been a bank in severe difficulties or put into resolution since the introduction of the IA, this line of reasoning remains valid. The IA concluded, however, that overall there would be a net benefit to the UK as a result of the BRRD, based on the costs of the financial crisis that had been estimated by other studies (e.g. the Independent Commission on Banking) and the benefits that were estimated by the Government's White Paper on Banking Reform. We have concluded that this continues to be a reasonable assessment. This view was shared by the Banking Liaison Panel, who said that the measures introduced by the BRRD continued to be important to meet the resolution regime's objectives.

## Impact on small and micro businesses

32. The UK's resolution regime applies to all banks, building societies, and FCA regulated investment firms. Small and medium-sized firms which have a balance sheet smaller than £15bn - £25bn, and less than 40,000 to 80,000 transactional bank accounts, are regarded as not systemically important firms, and would go through an insolvency procedure if they failed rather than resolution. The cost benefit analysis set out above does not therefore apply to these smaller firms.

### **5. Were there any unintended consequences?**

33. As the powers and tools introduced by the BRRD have not had to be used, it is not possible to identify with accuracy any unintended consequences associated with their use. However, the Government believes that there have been no unintended consequences associated with the introduction of the resolution regime more generally.

## Impacts of Covid-19

34. The effects of the Covid-19 pandemic have also not had an impact on these powers and tools. Indeed, Britain's economy and financial system are fundamentally strong, and the action by the government and the Bank since the financial crisis has substantially strengthened the resilience of the financial system. In addition, the powers and tools introduced by BRRD ensure the authorities have the necessary tools in place to protect financial stability. Moreover, in March 2021, the Bank's Financial Policy Committee reiterated its previous judgements that the core banking system has the capacity to support the UK economy.

### **6. Has the evidence identified any opportunities for reducing the burden on business?**

35. As mentioned, the Government's policy continues to be that maintaining the resolution regime is important to mitigate financial stability, consumer protection and public funds risks associated with a bank failure. It is therefore the Government and the Bank of England's assessment that the UK's resolution powers and tools for banks remain important to ensure these policy objectives are met. The regime is also designed to prevent widespread financial disruption, which could place significant burdens on the financial services sector, financial markets, businesses and the wider economy. As such, opportunities to change the fundamental aspects of the regime in order to reduce burden on business have not been considered.

### **7. For EU measures, how does the UK's implementation compare with that in other EU member states in terms of costs to business?**

36. In its report on the application of the BRRD from April 2019<sup>8</sup>, the EU stated that all Member States had fully transposed the Directive. However, it acknowledged at the time that implementation of the Directive was ongoing across the EU and that Member States were at different stages of implementation. It also noted that there had been a very limited number of cases where the EU's resolution framework had been applied since the BRRD had been adopted. There was no assessment in the EU's report on whether estimated impacts on businesses had materialised.

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<sup>8</sup> [https://ec.europa.eu/info/publications/190430-report-bank-recovery-resolution\\_en](https://ec.europa.eu/info/publications/190430-report-bank-recovery-resolution_en)

## **Recommended Next Steps**

37. This PIR recommends that the UK should **keep** the provisions introduced by the BRRD. This is on the basis that most of the provisions implemented by this Directive were already implemented by the Banking Act 2009, and that these provisions continue to meet the Government's policy objective to ensure risks to financial stability, consumers and public funds associated with a bank failure can be managed effectively.
38. The Government and the Bank have no active plans to review the resolution regime overall, including as a result of the UK's exit from the EU. However, as with most matters of policy, the Government will continue to monitor and evaluate the resolution framework to ensure it continues to be effective in limiting risks to financial stability, consumers and public funds.

## **Sign-off for Post Implementation Review**

### **SCS of Banking Assets and Resolution Strategy Team, HM Treasury**

Signed: **Jonathan Edwards**

Date: 08/07/2021

### **Minister: Economic Secretary to the Treasury**

***I have read the PIR and I am satisfied that it represents a fair and proportionate assessment of the impact of the measure.***

Signed: **Economic Secretary to Treasury**

Date: 14/07/2021