

EXPLANATORY MEMORANDUM TO
THE BANKS AND BUILDING SOCIETIES (PRIORITIES ON INSOLVENCY)
ORDER 2018

2018 No. 1244

1. Introduction

- 1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

- 2.1 This instrument implements Directive (EU) 2017/2399 (the Bank Creditor Hierarchy Directive) of the European Parliament and of the Council. The Directive amends the EU's Banking Recovery and Resolution Directive (BRRD), specifically the ranking of unsecured debt within the insolvency hierarchy. The instrument provides for a new class of secondary non-preferential debt to be issued by financial firms.
- 2.2 Firms may issue this new class of debt to meet their obligation to have sufficient loss-absorbing and recapitalisation capacity in the event of resolution. As this new class of debt comes below other senior debt (but above subordinated debt) in the creditor hierarchy, it should enhance legal certainty and thereby reduce the risk that any creditor is left worse off in the event of resolution than they would be in an insolvency.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

- 3.1 None.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

- 3.2 As the instrument is not subject to parliamentary procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business.

4. Extent and Territorial Application

- 4.1 The territorial extent of this instrument is England, Wales, Scotland and Northern Ireland
- 4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

- 5.1 The Economic Secretary to the Treasury has made the following statement regarding Human Rights:

“In my view the provisions of the Banks and Building Societies (Priorities on Insolvency) Order 2018 are compatible with the Convention rights.”

6. Legislative Context

- 6.1 This instrument amends the law on priority of creditors by amendment of the Insolvency Act 1986, the Insolvency (Northern Ireland) Order 1989, the Bankruptcy (Scotland) Act 2016 and related primary and secondary legislation, to implement amendments made by the Directive to Article 108 of the BRRD.

7. Policy background

What is being done and why?

- 7.1 On 23 June 2016, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in force. During this period the Government will continue to negotiate, implement and apply EU legislation. This legislation has been prepared with these assumptions in mind
- 7.2 In November 2016, the European Commission proposed a package of reforms (BRRD II) to strengthen the resilience of the EU banking sector. This included proposals to implement the Financial Stability Board's Total Loss-Absorbing Capacity (TLAC) standard into EU law. The proposals integrate the TLAC standard into the Minimum Requirement for own funds and Eligible Liabilities (MREL), which has already been applied to all EU banks as of 2016.
- 7.3 MREL comprises the firm's regulatory capital and debt instruments that meet certain eligibility criteria, and is the loss absorbing capacity that EU banks are required to hold to bear losses in resolution. The purpose of MREL is to help ensure that if firms fail, the resolution authority can use these financial resources to absorb losses and recapitalise the continuing business. As a result, MREL is a critical element of an effective resolution strategy.
- 7.4 Although BRRD II is still subject to negotiations between the EU Council and the European Parliament, the Bank Creditor Hierarchy Directive was fast tracked and agreed by the EU Council and European Parliament on 12 December 2017. It came into force on 28 December 2017 and has a transposition deadline for member states of 29 December 2018.
- 7.5 The Directive amends the creditor hierarchy in article 108 of the BRRD requiring member states to create a new class of secondary non-preferential debt in their creditor hierarchy. The creditor hierarchy dictates the order in which assets are distributed to creditors in the case of an insolvency or resolution.
- 7.6 The Directive provides firms with an alternative to existing options to meet their MREL requirement. The primary motivation for fast tracking the Directive was to introduce a harmonised approach to the availability of statutory subordination across the EU, which is one of the subordination methods provided for in the TLAC standard.
- 7.7 The introduction of statutory subordination through this new class of secondary non-preferential debt will predominantly benefit building societies as, due to their legal structure, they do not have the option of structurally subordinating their MREL through a holding company. Building societies are expected to benefit from a lower cost of funding resulting from the lower expected pricing of secondary non-

preferential debt instruments relative to the other subordinated debt instruments that building societies are able to issue.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

- 8.1 This instrument does not relate to withdrawal from the European Union / trigger the statement requirements under the European Union (Withdrawal) Act

9. Consolidation

- 9.1 Consolidated versions of the Acts and the other instruments amended by this Order are available on commercial websites. However, given the limited amount of Parliamentary time available, there are currently no plans to consolidate the legislation.

10. Consultation outcome

- 10.1 In September 2018, The Treasury published a consultation document, ‘Technical consultation on the draft Banks and Building Societies (Priorities on Insolvency) Order 2018’.¹
- 10.2 The consultation document set out the Government’s proposed approach to implementing the directive into UK law.
- 10.3 The consultation ran from 12 September 2018 to 10 October 2018, during which time the Government received ten written responses from banks, building societies, law firms and industry groups.
- 10.4 Respondents broadly agreed with the Government’s approach to the implementation of the EU directive as outlined in the consultation paper. Most respondents agreed that building societies are likely to be the most significant users of this new instrument and will issue MREL eligible debt through statutory subordination. Several building society respondents specifically welcomed the opportunity to issue MREL eligible debt instruments by means of statutory subordination, as it will reduce their costs of complying with MREL policy.
- 10.5 Many respondents saw limited incentive for banks to take advantage of this legislation given their ability to issue MREL-eligible debt through structural subordination. However, some respondents noted that banks would be interested in issuing internal MREL resources in the form of secondary non-preferential debt. The current Statement of Policy on the Bank of England’s approach to setting MREL (2018) allows this.
- 10.6 While the response from industry was broadly positive, some respondents made technical comments on the drafting of the Order, which was published alongside the consultation. Notably, a number of respondents requested further clarity in the definition given for tertiary non-preferential debts within the draft Order. They suggested that the proposed wording could lead secondary non-preferential debt to be incorrectly interpreted as a subordinated class of debt. This has been addressed in the final draft of the legislation. The Government has accepted a proposed clarificatory

¹ The consultation document can be found at: <https://www.gov.uk/government/consultations/draft-banks-and-building-societies-priorities-on-insolvency-order-2018-technical-consultation/technical-consultation-on-the-draft-banks-and-building-societies-priorities-on-insolvency-order-2018>

amendment to the definition of tertiary non-preferential debts which should resolve the concerns raised above.

- 10.7 In answer to questions on the impact of this legislation on existing debt instruments or bondholders within the capital structure, industry respondents did not believe that there would be any material or adverse effect. Respondents identified that some second order effects might arise. For example, the new layer of secondary non-preferential debt should provide increased protection for the existing ordinary non-preferential debt, potentially improving credit quality. In addition, as issuance shifts towards secondary non-preferential instruments, the scarcity value of ordinary non-preferred debt could increase, pushing yields upwards for these instruments.
- 10.8 No respondents stated that significant time will need to be spent by compliance officers in order to understand these changes to the legislation.
- 10.9 The consultation response document will be published alongside the consultation document.²

11. Guidance

- 11.1 No guidance is being issued on this instrument since it is largely based on existing insolvency rules and practice, which will be familiar to insolvency practitioners and their advisors.

12. Impact

- 12.1 The cost to business, charities or voluntary bodies is estimated to be £1.27m in total over a ten-year period. This impact will take the form of wage costs incurred by parties that will need to learn about the new regulation and disseminate the information around their firms. The wage costs relate to enforcement officers in the insolvency service, compliance officers in firms issuing this new class of debt, and compliance officers in the client institutions purchasing the debt. There are not expected to be any non-monetised costs.
- 12.2 There is no cost to the public sector.
- 12.3 The benefit to firms is estimated to be £106.53m in total over a ten-year period. These benefits should arise as secondary non-preferential debt is cheaper to issue than Tier 2 debt. Therefore firms, and particularly building societies will be able to meet their MREL requirements at a lower cost by issuing in this class.
- 12.4 An Impact Assessment is submitted with this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

13. Regulating Small Business

- 13.1 The legislation applies to activities that are undertaken by small businesses. While no deposit-taking banks, or building societies in the UK are likely to meet the definition of a small or medium-sized enterprise (SME), there may be investment firms which are small businesses and are covered by this legislation. However, we do not expect SME investment firms to fall within the Bank of England's MREL-setting framework of being required to hold MREL above regulatory capital requirements and therefore we do not expect SME investment firms to make use of this legislation.

² The consultation response document will be published at: <https://www.gov.uk/government/consultations/draft-banks-and-building-societies-priorities-on-insolvency-order-2018-technical-consultation>

14. Monitoring and Review

- 14.1 The instrument includes a requirement for the Treasury to carry out a review of the legislation and publish a report setting out the conclusions of the review. The first report must be published before 18 December 2023. Subsequent reports must be published at intervals not exceeding 5 years.
- 14.2 A statutory review clause is therefore included in the Regulation

15. Contact

- 15.1 Louisa Graham at Her Majesty's Treasury, Telephone: 020 7270 6442 or email: Louisa.Graham@hmtreasury.gov.uk can be contacted with any queries regarding the instrument.
- 15.2 Robert Kramer, Deputy Director for the Resilience and Resolution Team at Her Majesty's Treasury can confirm that this Explanatory Memorandum meets the required standard.
- 15.3 The Economic Secretary to the Treasury can confirm that this Explanatory Memorandum meets the required standard.