Title: The EU Bank Recovery and Resolution Directive (BRRD) - Impact Assessment **IA No:** **Lead department or agency:** HM Treasury **Other departments or agencies:**	**Impact Assessment (IA)** **Date:** 01/07/2014 **Stage:** Consultation **Source of intervention:** EU **Type of measure:** Secondary legislation **Contact for enquiries:** BRRD.Transposition@hmtreasury.gsi.gov.uk

Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£-1890.0m	£-451.2m	£87.1m	No	IN

What is the problem under consideration? Why is government intervention necessary?

The financial crisis showed that when systemically important banks were at risk of failure, entering insolvency was unlikely to be in the public interest as critical economic functions such as deposit taking and lending would cease. Governments lacked the necessary tools for intervention and, as insolvency was not a viable option, were forced to providing large amounts of public funds to bail-out failing banks. This Directive establishes a framework for the recovery and resolution of credit institutions and investment firms across the EU.

What are the policy objectives and the intended effects?

This Directive establishes a framework for the recovery and resolution of credit institutions and investment firms across the EU. At a high level, the policy intentions are to; maintain financial stability and confidence in the banking sector, minimise the loss to society from banking crises, reduce the moral hazard and strengthen the EU internal market.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

This Directive ensures authorities have the necessary tools and powers to intervene before problems occur to maintain stability. Furthermore, when circumstances deteriorate beyond repair, authorities must be able to ensure that the critical economic functions and services they provide to the economy can be maintained and that the cost of failure is born by the bank's creditors, not taxpayers.

There are a variety of measures included in the Directive. They are designed under the following broad categories: preparation and prevention, improve early invention measures, clear and robust resolution tools, efficient cross border cooperation, financing arrangements to protect taxpayer money.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 01/2019

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister: Andrea Leadsom Date: 07/07/2014

Summary: Analysis & Evidence

Policy Option 1

Description: Transpose and appy the BRRD by 1 January 2015

FULL ECONOMIC ASSESSMENT

Price Base Year 2009	PV Base Year 2014	Time Period Years 5	Net Benefit (Present Value (PV)) (£m)		
			Low:	**High:**	**Best Estimate:** -1890.0

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low			£248.3m	**£1312.7m**
High			£697.3m	**£3258.5m**
Best Estimate			£404.4m	**£1890.0m**

Description and scale of key monetised costs by 'main affected groups'

The main area where costs are expected to arise is from the bail-in tool and depositor preference, due to higher debt prices. This cost is estimated to be between £248.3m and £697.3m per year. Part of this could be mitigated as the UK already has a domestic bail-in tool. Costs to the authorities are also expected to increase due to a higher level of supervision and increased resource cost. This has been estimated at 494k this year, and rising by 1.5% per annum thereafter.

Other key non-monetised costs by 'main affected groups'

Areas of non-monetised cost include resolution financing arrangements and Minimum Requirements for Eligible Liabilities (MREL) as well as other early intervention and preparation measures. The potential costs arising from these measures are difficult to estimate and cannot be predicted with any real degree of accuracy. They are also likely to differ on a firm by firm basis.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	N/A		N/A	**N/A**
High	N/A		N/A	**N/A**
Best Estimate	See Text		See Text	**See Text**

Description and scale of key monetised benefits by 'main affected groups'

It is not possible to estimate the monetised benefits from this Directive with a sufficient degree of accuracy. They cannot be estimated as the majority of the benefits will only acrise if a bank were to experience severe dificulties or enter resolution. It is not possilbe to predict or estimate the probability of such an event occuring. Please see the text for further details.

Other key non-monetised benefits by 'main affected groups'

Taxpayers will be less exposed to the cost of future banking crises
Resolution authorties will have the necessary tools to resolve failing institutions.
Enhanced cooperation between Member State authorities to resolve cross border institutions
Benefits from greater financial stability due to a reduction in the probability and severity of future banking crises leading to higher future GDP levels.

Key assumptions/sensitivities/risks | **Discount rate (%)** | 3.5

The long run driver of tax receipts is GDP, so Exchequer cost is directly related to the impact on GDP
That businesses pass over 100 per cent of any cost impact onto customers. The modelling has been done on a static basis and any behavioural change has not been taken into account.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			**In scope of OIOO?**	**Measure qualifies as**
Costs: 87.1	**Benefits:** See Text	**Net:** -87.1	No	IN

Evidence Base

Problem under consideration

1. The financial crisis showed that when systemically important banks were at risk of failing, entering insolvency and allowing them to fail was unlikely to be in the public interest, as is the case for other businesses. If the 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 and debtors try to protect their money, causing further liquidity problems.

3. As insolvency is likely to be an unacceptable outcome for the reasons outlined above, Governments were forced to provide public support. The UK government provided billions of pounds to prevent widespread collapse of the UK financial sector.

4. Because of the lack of viable alternatives to insolvency, large barks are seen to benefit from an implicit state guarantee. This can lead management and shareholders to expect to gain from taking excessive risk while society would cover the downside losses of this risk. Over time this has led to banks having a skewed incentive structure to take on unnecessary risk without being fully responsible for dealing with the consequences.

Rationale for intervention

5. In the recent financial crisis, many of the banks at risk of failure across the EU were large and systemic in their home country, meaning insolvency would have had a major impact on financial stability.

6. The crisis exposed a lack of special powers and tools available to authorities to manage an orderly failure of banks. During the crisis there were broadly only two options for the authorities to deal with failing banks; placing them into a formal insolvency procedure, or supporting them with public funds.

7. At the EU level, neither banks or 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 some supervisory framework in place, this was focussed on a going concern basis and proved inadequate to deal with the resolution of large, cross-border firms.

8. Many Member States did not have adequate powers to manage a bank failure, leaving the authorities with no choice but to intervene using public funds. 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, the tools differed. These differences are likely to lead to inefficient resolution strategies and deliver sub-optimal results at the EU level. This is because large banks tend to operate across borders, both EU and third country. Different

tools available in different countries make it harder to resolve banks that operate in multiple countries.

9. Authorities can only act in their home country and without a framework for cooperation in place; the system relied on the ad hoc cooperation of different Member States. This could lead to sub-optimal or even competing resolution strategies between Member States at the EU level and to delays in executing the resolution.

Policy objectives and intended effects

10. The BRRD has several high level policy intentions, they are:

- To maintain financial stability and confidence in banks, ensure continuity of essential economic functions and to avoid contagion to the wider market.
- To minimise the loss to society as a whole by protecting taxpayer money, depositors and reducing the problem of moral hazard
- To strengthen the internal market for banking services at the EU level while maintaining a level playing field

11. The Directive focuses on five main areas for reform:

- Preparation and prevention to make both banks and supervisors more prepared for crisis situation and enable resolvability
- Improving the early intervention measures for supervisors
- Providing authorities with clear tools and triggers to enable timely and robust resolution with legal certainty
- Enabling efficient cooperation of authorities in cross border resolution
- Developing arrangements for resolutions to be financed from private sources, thereby protecting taxpayer money.

Policy Option Description

12. The BRRD outlines a framework to ensure the recovery and resolvability of credit institutions and investment firms across the EU. The recent financial crisis highlighted the need for more effective methods of dealing with failing banks. This Directive ensures authorities have the necessary tools and powers to intervene before problems occur to maintain stability. Furthermore, when circumstances deteriorate beyond repair, authorities must be able to ensure that the critical economic functions and services institutions provide to the economy can be maintained and that the cost of failure is born by the bank's creditors, not taxpayers.

13. Article 130 requires Member States to adopt and publish the necessary laws, regulations and provisions to comply with the Directive by 31 December 2014 and for these measures to be applied by 1 January 2015. The Directive offers some flexibility to Member States around the commencement of the provisions under section 5 of chapter

IV of Title IV (the bail-in provision). The bail-in provisions will have to be adopted by 31 December 2014 but can be commenced by 1 January 2016 at the latest.

14. This was included to give Member States a transitional period to implement the bail-in tool, and to allow market participants to prepare for its introduction. In the case of the UK, the Government has made it clear it does not intend to delay commencement. Indeed, the UK has already taken domestic powers through the Financial Services (Banking Reform) Act 2013 which introduced a bail-in tool that is broadly similar to the requirements of the BRRD. And UK institutions have known of the Governments intention to introduce a bail-in tool for a number of years

15. The Government also believe that, if these powers were needed before 1 January 2016, the Market fully expects the Government to commence and use them. Surveys have demonstrated there is widespread acceptance in the markets that the UK will introduce a bail-in tool by 2015[1]. Given this, and due to the fact the necessary legislation must be completed by 1 January 2015, the Government believe that any impact on bank debt prices from the introduction of bail-in are likely to arise whether or not the legislation is commenced.

16. The Government does not therefore believe that a transitional period is necessary. This Impact Assessment has therefore been prepared on the basis that the bail-in tool is introduced from 1 January 2015, along with the rest of the Directive.

Costs and Benefits

17. The European Commission ("the Commission") produced an impact assessment for their legislative proposal on the BRRD in June 2012[2]. The Commission's assessment represents a good starting point for own analysis as the broad policy measures are the same. The Commission's assessment split the policy measures into five main categories. They are; preparation and prevention, early intervention, bank resolution, cross boarder crisis management and financing arrangements. The analysis below follows these same categories and looks at each in turn.

Preparation and prevention

18. These measures are designed to make both banks and supervisors more prepared for crisis situations and to try and prevent banks from failing. The Commission's assessment identified suboptimal levels of preparedness amongst banks and supervisors were for crisis situations and ways in which these problems were being addressed. These measures include requiring, recovery and resolution plans to be drawn up and maintained, voluntary group financing arrangements and the removal of barriers to resolvability.

Early Intervention

19. These measures are designed to give supervisors the necessary tools to intervene before the point of failure and attempt to recover the firm before it fails. These measures

---

[1] 'European Bank Bail-in Survey Results'. J.P Morgan. April 2013

[2] http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_assessment_final_en.pdf

include effective intervention triggers and requiring the firm to put in place measures from its recovery plans.

Bank Resolution

20. These measures are intended to give the authorities the necessary powers and tools to resolve failing banks. The resolution tools in the BRRD are similar to those already in the Special Resolution Regime (SRR) in the Banking Act 2009. The Government will align the SRR to the BRRD as part of transposition. At the forefront of the BRRD is the bail-in tool. This is the tool giving Member State resolution authorities to write down and cancel debts of a bank, and convert debt into equity in order to recapitalise a failing bank. The UK already has a domestic bail-in tool for which an Impact Assessment[3] was carried out for its implementation on a one year transition basis before the bail-in tool under the BRRD is required.

Cross Border Crisis Management

21. Many banks operate in several jurisdictions and across borders both within and outside the EU. The measures in the BRRD are designed to help facilitate the resolution of large, cross border banks. This includes measures such as information sharing and joint decision making.

Financing

22. During the recent financial crisis, large amounts of public funds were required in order to maintain financial stability and limit contagion across the market. The BRRD introduces measures to develop financing arrangements for bank resolution that do not require taxpayer money, with the aim of providing common levels of protection for all Member States. The Directive also includes measures to change the priority of deposits in the creditor/insolvency hierarchy (also known as depositor preference) which will reduce the risk that covered deposits will be exposed to losses, and reduce the exposure of the Deposit Guarantee Scheme.

Costs
Private costs to Banks[4]
Preparation and prevention

23. The BRRD requires firms to submit and maintain up to date recovery plans. These plans detail firm specific information and outline actions that can be taken by the firm to mitigate stresses or crisis events. These plans are submitted to supervisors who review them to ensure that banks identify reasonable efforts to recover from difficulties without entering resolution. In principle, this introduces costs for banks, in having to draw up these plans and supervisors in having to review them. However, in the UK, banks and PRA-regulated investment firms are already required to draw up and maintain these plans under the Prudential Regulation Authority (PRA) rules[5]. We do not believe that the recovery plans required under BRRD will therefore bring a material and additional private

[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/271121/Bail-in_IA.pdf
[4] The term ‘bank’, unless otherwise stated, includes building societies but not credit unions, 730k investment firms and any other credit institution within the scope of this Directive.
[5] http://media.fshandbook.info/Handbook/Recovery-and-Resolutionv1_PRA_20140101.pdf

cost to banks in the UK, over and above the cost associated with the existing regime (which were estimated at between £150m and £400m annually[6] when it was first introduced). While some of the detailed BRRD requirements differ from those under current domestic requirements – for example, BRRD recovery plans will require stress testing subject to European Banking Authority (EBA) technical guidelines – we do not believe that these differences are such as to result in material additional costs to UK banks and PRA-regulated investment firms.

24. Investment firms that are regulated by the Financial Conduct Authority (FCA) however, are currently not required to produce these plans. The FCA has the power to require these but do not currently exercise this power. The BRRD will require them to do so. The FCA regulates approximately 300 investment firms within the scope of the BRRD and the information contained in these plans will differ depending on firm size and systemic importance. Proportionality provisions in the Directive mean that requirements on what information is required will depend on a number of factors, including size and interconnectedness of the institution. It is difficult to estimate these costs as it will depend on the FCA's approach to implementation. This FCA will be consulting concurrently with the Government's consultation, and will include looking at the impact on firms of these measures. Therefore, it should be possible to provide a better estimate on the Final Stage IA which will accompany the laying of the regulations.

25. The BRRD also requires Member States to give powers to authorities to remove any obstacles and barriers to resolution highlighted in the resolution plans. Banks will bear the cost of any restructuring pursuant to their recovery and resolution plans. However, these will differ on a firm by firm basis as the level of restructuring required will be different in each case. In the UK, the PRA already has this power and can require a firm to restructure itself, amongst other things, in order to remove these barriers. The FCA also has wide-ranging powers over the firms it regulates, which could in principle be used to require structural changes if necessary. Therefore, the introduction of these measures through the BRRD is not assessed to have any additional impact to UK banks.

26. As part of preparation and prevention, BRRD regulates how banking group companies may undertake voluntary financial support to other areas of the group. Under BRRB, these arrangements must meet certain criteria and are subject to approval from supervisors of all relevant groups. Ultimately, though, any such decision on whether to undertake such support will remain a commercial one for banks and as such cannot be estimated with any real certainty. And UK regulators already have powers that could be used to prevent such payments where they could impact on a firm's stability. The Government therefore estimates that there will be no direct cost of this measure.

27. Overall, the European Commission's Impact Assessment for BRRD noted that, although an increased level of supervision is likely to have some increased operational cost for banks, it was assumed to be immaterial. We agree with this assessment in the case of the UK, not least because the PRA and FCA already require firm to comply with these or similar measures. The possible impacts to authorities' costs are detailed below.

<u>Early Intervention</u>

---

[6] FSA (2011) Consultation Paper 11/16, Recovery and Resolution Plans, Annex 1, p10 http://www.fsa.gov.uk/static/pubs/cp/cp11_16_dp_annexes.pdf

28. Having clear triggers for early intervention is key to ensuring that action is taken at the right point. A trigger that requires the bank to have already become insolvent is too late due to the value destruction associated with insolvency. On the other hand, it is important that resolution is the last resort and that all other private means of recovery have been explored. The final BRRD text gives supervisors and resolution authority's qualitative and discretionary powers of when to pull resolution triggers. The Commission Impact Assessment did not expect any costs to arise from early intervention triggers. We agree with that assessment.

29. A firm's failure or difficulties may be wholly or partly a result of sub optimal management. The BRRD gives supervisors the power to remove and replace senior management when found to not be adequately performing their duties. The BRRD also allows for temporary administrators to take charge of a firm that is judged to be at risk of failure. Any costs associated with this would only arise if the temporary administrator was to be put in place and would differ on a firm by firm basis. They cannot therefore be estimated in advance with any confidence and we have not attempted to do so in the Impact Assessment.

Bank Resolution

30. This part of the Directive firstly sets out the triggers and conditions required for a bank to be placed into resolution and for resolution tools and powers to be used. In a resolution, the authorities must also have regard to the resolution objectives. These resolution objectives require the resolution to ensure continuity of critical functions, avoid significant adverse effects on financial stability, protect public funds and protect depositors, client funds and assets. The resolution triggers require the firm to be failing or likely to fail, there is no reasonable prospect of recovery through private measures and that a resolution action is considered to be in the public interest. These triggers are based on the supervisor's and resolution authority's assessment of individual firms and are broadly aligned with the existing triggers in the Banking Act 2009. The Commission estimated that these triggers and conditions themselves do not cause any costs to business, however there are likely to be indirect costs following these due to resolution action.

31. The BRRD includes a minimum harmonised set of resolution tools for all Member States to ensure a more effective regime of dealing with bank failure. The four resolution tools are: a) the sale of the business tool; b) the bridge institution tool; c) the asset separation tool; d) the bail-in tool. These tools may be used individually or in combination with each other (with the exception of the asset separation tool which can only be used in conjunction with another tool). Each of these tools is assessed in turn below.

32. The UK already has the sale of business tool under the Banking Act 2009, where it is referred to as the "private sector purchaser" stabilisation option. The Bank of England may transfer the whole or part of the business to a private sector buyer.

33. The UK also has the power to transfer a business to a bridge institution. To use a stabilisation tool, it must be in the public interest to do so. This public interest 'test' includes protection of stability of UK financial systems, protection of confidence in banking system and protection of depositors. A bridge institution may be required where a private sector buyer is not found and it's not in the public interest to enter insolvency.

34. The BRRD, in certain areas, is more prescriptive than current legislation and the Government will of course ensure these provisions are met. One main difference is the BRRD imposes a 2 year limit on the resolution authority operating a bridge institution. In certain circumstances this may be extended but otherwise the institution will either be sold or be wound down under normal insolvency. This may mean creditors of the bank suffer higher losses than if no such time limit was in place (although would still most likely be a better outcome than disorderly failure). However the Government cannot accurately estimate these costs as they will differ for each case and would anyway only arise if the bridge bank tool were to be employed – the probability of which is not something we can assess with any accuracy. Largely, the other differences between the domestic and European tool are technical and as such, no additional costs are expected from implementation of these measures.

35. The asset separation tool allows the resolution authority to transfer some or all of the assets, rights and liabilities of the institution under resolution to a one or more asset management vehicle. This is for the purpose of facilitating one or more of the other resolution tools in the Directive.

36. The Bank of England already has the power to transfer some or all of the assets, rights and liabilities through section 12 of the Banking Act 2009 for the purposes of the asset separation tool. The Bank of England can use these powers to transfer some or all of a business into a bridge institution. The BRRD simply separates out these powers more clearly. Since the UK already has these powers, the costs of this will have already been priced in to the market and as such, no new cost will arise from this tool.

Bail-in

37. The bail-in tool allows the Bank of England to write down or cancel liabilities including debts in a failing bank and convert debt into equity. This reduces the liabilities of the bank, recapitalising it and allowing it to remain a going concern. It also allows the bank to remain open during the time of stress and maintain its critical functions to the economy, such as deposit taking and lending. The UK already has a domestic bail-in tool, implemented through the Banking Reform Act 2013. The domestic bail-in tool is broadly in line with the one proposed in this Directive, but as above, the Government will ensure that any differences are aligned by the transposition deadline.

38. When the domestic bail-in tool was introduced, an Impact Assessment was carried out estimating its effects. It analysed the effects of introducing the tool on a transitional basis, given that the BRRD required the tool around a year later. This Impact Assessment assesses the long term impact of bail-in. In reality, any costs associated with the introduction of a bail-in tool would have come from the point at which the domestic bail-in tool was introduced.

39. As noted in paragraph 14 above, the BRRD must be transposed into UK legislation by 1 January 2015, but the commencement of the bail-in tool could be delayed until 1 January 2016. However, in the case of the UK, the Government has made clear that it does not intend to delay commencement and, indeed, has already taken similar bail-in powers domestically. This Impact Assessment has therefore been prepared on the basis that the bail-in toll is introduced from 1 January 2015, along with the rest of the Directive.

40. The costs of bail-in are likely to materialise in the same way as outlined in the domestic bail-in tool impact assessment, i.e. through higher funding costs for bank unsecured debt. Given that these debt instruments are now more likely to suffer losses in a resolution than without the bail-in option, investors may demand higher rates of return to compensate for this. In our original impact assessment for the domestic bail-in tool, we estimated the impact on funding costs was estimated to be between 25-50 basis points. This was derived from taking into account the experiences seen in the US and Denmark, as well as the Commission's analysis in its Impact Assessment.

41. The Commission's Impact Assessment drew on a JP Morgan survey, which estimated that the funding costs associated with bail-inable liabilities would rise by 87 basis points with the introduction of a bail-in regime (based on a single-A rated bank). Both the Commissions Impact Assessment and our own Impact Assessment for our domestic bail-in regime argued that a series of factors would mitigate this impact, not least the safeguard built into the regime that will ensure that no creditor is left worse off than they otherwise would be in an insolvency.

42. However, we note the recommendation made by the Regulatory Policy Committee that we should adopt a wider range in assessing the impact of the bail-in tool. Accordingly, we have for this impact assessment adopted an 87 basis point impact (in line with the unadjusted JP Morgan survey results) as the top end of our range and reduced the bottom end of our range marginally to 20 basis points. This bottom-end estimate draws on the US experience. When the US introduced the Dodd-Frank Act in 2010 (which included a tool capable of imposing losses on creditors in an equivalent way to bail-in as well as a variety of other measures), the top 4 large US banks saw their funding costs rise by 20 basis points. This was, however, a transitory impact. After the initial spoke, funding costs broadly returned to their initial levels over the following 3 month period. This minimal impact is in line with our own experience. There was no significant discernible impact on UK bank debt prices when we introduced our domestic bail-in tool last year.

43. The Government therefore believe that the range being adopted for this Impact assessment is a conservative one. For the our best estimate we have adopted a level towards the lower end of this range – in line with the mid-point of the 25-50 basis point range used in the domestic bail-in tool impact assessment.

44. Average annual unsecured debt issuance from the largest UK banks[7] has been £33.9bn since 2010[8]. However, from 2012 (and taking into account estimated annualised 2014 data), the average issuance has been lower, at £17.6bn. The table below summarises the estimated impacts to the cost of funding at these levels of issuance.

	Average Annual issuance of £33.9bn	Average Annual Issuance of £17.6bn
20bps	£67.8m	£35.2m
87bps	£294.9m	£153.1m
37.5bps	£127.1m	£66.0m

[7] Barclays, HSBC, Santander, RBS, Lloyds, Co-op.

[8] 2010 -2013. Range used as issuance was skewed immediately following the crisis

Data source: dialogic. Dialogic only capture public issuance.

45. Assuming that debt issuance continues at these levels, the Government therefore estimates (using the widest range of estimated impacts) that the annual impact to bank debt funding costs is between £35.2m and £294.9m per annum. On the same basis, the best estimate for the cost of bail-in is £96.5m (mid-point of the 37.5 basis point impact range)

46. The BRRD also includes investment firms[9] within the scope of bail-in. The domestic bail-in regime can similarly be applied to investment firms. But large investment firms operating in Britain are not UK-owned and generally are funded by intra-group transactions from their parent entities overseas. International discussions are underway through the Financial Stability Board on the resolution arrangements for such institutions – our current expectation is that the resolution strategy for these firms would be lead by their home authorities in cooperation with the UK as host authority. It is difficult to estimate what impact BRRD could have on such firms. Total debt issued since 2010[10] by the UK subsidiaries of investment firms operating here has been just $486m, with an average annual issuance of $121.5m[11]. Assuming investment firms felt the same impact on funding costs as banks, annual cost of debt issuance for large investment firms may increase by $0.2m and $1.1m, which at the current average annual exchange rate is between £0.1m to £0.7m.

47. In principle, there could be a wider impact on the funding costs of the overseas parent of the UK subsidiary (as its intra-group funding could potentially be subject to bail-in). This would though depend on the regime in the home authority – for example, US investment firms are already subject to a bail-in regime and we would not expect to see an additional impact there. We have not therefore included such a cost in this assessment.

Eligible liabilities

48. The BRRD also requires firms to hold a Minimum Requirement of Own Funds and Eligible Liabilities (MREL). These liabilities must be able to absorb losses on resolution. The Bank will set the framework as to the level of MREL each firm must hold. These requirements are similar to the ”Primary Loss Absorbency Capacity” (PLAC) in the loss absorbency measures proposed in the Independent Commission on Banking (ICB) recommendations[12] on banking reform.

49. The IBC recommended that banks hold 17% of risk weighted assets (RWAs) as bail-inable debt. The BRRD does not give a minimum requirement and this is set by local resolution authorities (in the UK, the Bank of England). A higher level of loss absorbing capacity can introduce costs to banks through having to raise more capital or issue more debt. There are also ongoing debates at the global Financial Stability Board (FSB) level on what the appropriate amount of loss absorbing capital that global systemically important banks should have. This work is ongoing and as such, there is currently no defined minimum standard. Establishing the framework for regulators to set minimum

[9] PRA regulated, €730k share capital investment firms used.

[10] 2010 is used as issuance returns to more normal levels following the 2008 crisis.

[11] This is largely distorted due to £300m issuance by Morgan Stanley in 2011

[12] https://hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf

requirements does not in itself tincur a cost to business. We have not therefore included any cost in this impact assessment.

Financial Collateral Arrangements Directive (FCAD)[13]

50. The BRRD also requires Member States to ensure that, in a resolution, the resolution authority have the power to interfere with financial collateral arrangements for the purposes of a resolution. The Banking Act 2009 grants the Bank of England powers to interfere with contractual rights, including the power to temporarily 'switch off' termination rights for financial contracts. BRRD made changes to FCAD to limit the extent to which certain financial collateral arrangements are protected from these powers. No changes are needed to current UK legislation as a result and we have not therefore allowed for any resulting costs from this measure.

Cross border crisis management

51. The recent financial crisis also demonstrated that authorities lacked the ability to deal with the failure of large, cross border banks (i.e. those that operate in multiple jurisdictions). The Directive therefore includes measures to improve the cooperation both between Member States and between Member States and third countries. These measures provide for higher information sharing and require certain decisions to be made jointly with other countries.

52. The BRRD also requires Member State resolution authorities to attend resolution colleges to plan and deal with failures of cross border institutions. However, the Commission estimate that in normal times, the costs associated with these cross border measures would be minimal and in times of crisis, would not be material.

Financing

53. One of the fundamental principles behind the BRRD is not only to allow more effective resolution of banks, but to ensure the cost of bank failure is born by its shareholders, creditors and banks themselves and not the taxpayer. The BRRD includes provision for member states to ensure appropriate financing arrangements are put in place to ensure the effective application of the resolution tools and powers.

54. These financing arrangements may be used by the resolution authority for a number of reasons, including a guarantee of assets and liabilities, loans to an institution and to pay compensation. The BRRD requires Member States to meet a minimum target level of financing of at least 1% of deposits covered by a deposit guarantee scheme (Financial Services Compensation Scheme in the UK).

55. This financing will be funded by industry. The UK intends to use the existing Bank Levy to cover these costs. The Government will continue to raise funds through this method and, if resolution financing was needed, make the funds available.

56. The Bank Levy was introduced in January 2011. The current rate is 0.088% of all of a bank's debt (with exceptions for; the first £20bn of taxable debt, borrowing backed by the

[13] Directive 2002/47/EC, implemented in the UK as SI 2003/3226. Financial Collateral Arrangements (no 2) Regulations 2003

government and deposits covered by the FSCS). The Bank Levy has so far raised £1.6bn per annum since it was introduced and is expected to raise £2.7bn this year.

57. The ex ante fund must reach a target level of 1% of covered deposits over the next 10 years. This should be spread as evenly as possible over the period (i.e. raising around 0.1% annually). The cost of this is estimated at £1.3bn[14]. This places a contingent liability on banks.

58. The UK intends to use the Bank Levy for the ex ante part of its resolution financing arrangements. The Government estimate that there will be no additional burden placed onto UK banks as a result of this measure.

59. When the available financial means is not sufficient to cover the losses, extraordinary ex post contributions from industry may be collected. These must not exceed three times the annual amount of normal contributions. If required, these contributions would increase costs to industry. However, they will only be required in extraordinary circumstances and will depend on the specific resolution scenario. Therefore they cannot be estimated with accuracy.

Depositor Preference

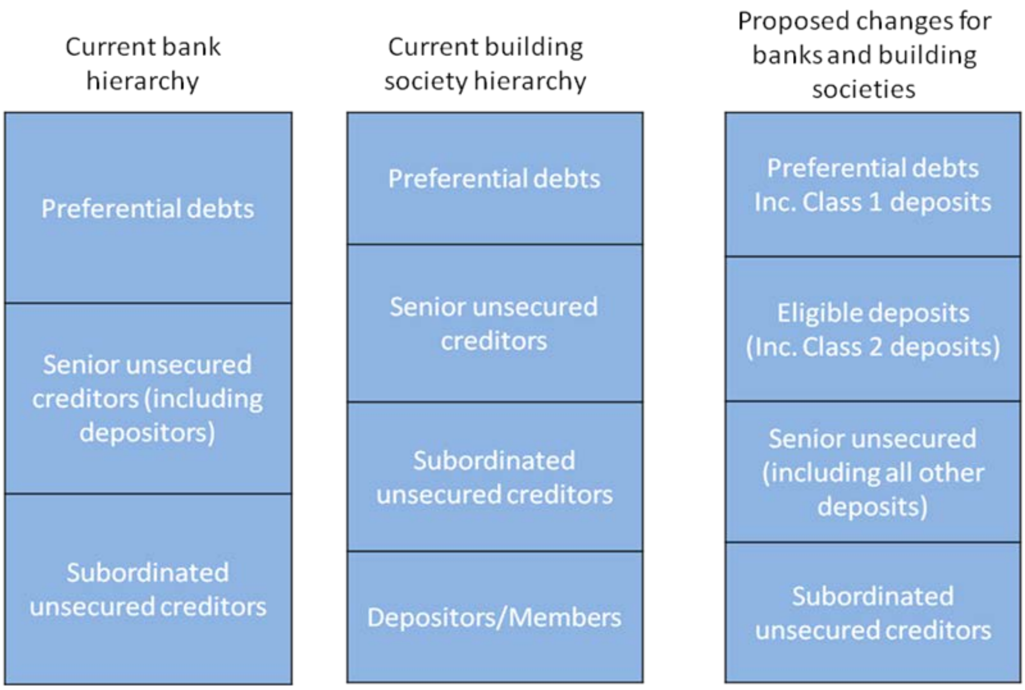
60. Article 108 of the Directive provides for changes to the ranking of deposits in the insolvency/creditor hierarchy (depositor preference). This change will affect both banks and building societies. In insolvency, creditors of a failed firm have a claim to any residual value of the firm and receive this in order of priority according to the insolvency hierarchy. In the Financial Services (Banking Reform) Act 2013, the Government introduced a form of depositor preference. This ranked deposits that are insured by the FSCS – i.e. up to £85,000 (class 1 deposits) equal with existing preferential debts. Class 1 sit above ordinary unsecured creditors and other FSCS ‘uninsured’ deposits. This measure has yet to be commenced however.

61. The BRRD also introduced a second tier of preference for eligible deposits (deposits that are eligible for protection save for being above the coverage limit) from both deposits in European Economic Area (EEA) countries and non-EEA branches of EEA institutions (class 2 deposits). Class 2 deposits will also sit above ordinary unsecured creditors but below class 1 deposits.

62. For building societies, the current creditor hierarchy is different to that of banks. Depositors in building societies are usually members of the society. Building societies are owned by their members and member deposits currently rank below ordinary unsecured creditors. Figure 1 below shows the proposed changes to the creditor hierarchy.

<u>Figure 1</u>

[14] Total UK covered retail deposits are £1.35tn. 0.1% of this is £1.35bn. Source: Bank of England Bankstats (monetary & Financial Statistics) Table A2.2.1. April 2014



63. By moving deposits higher up the creditor hierarchy, they will be entitled to any recoveries of a failed firm in full, before unsecured creditors will receive anything. Pushing down unsecured creditors in this way is likely to lead to them demanding higher rates of return on their debt and other investments to compensate for the subordination. An impact assessment for the Banking Reform Act[15] took the levels of short terms debt and modelled a 25-50bps impact on the costs of funding. This range was drawn from estimates provided by UK banks. The Banking Reform Act IA estimated the aggregate cost to banks of £200m to £380m per year. This figure represents the cost of preferring FSCS covered deposits for banks. The majority of UK deposits are insured by the FSCS (98%). Therefore, taking the above estimate as 98% of preferring all deposits (both covered and eligible), the cost of depositor preference for banks is estimated at £204m to £387.7m.

64. As noted above, member deposits in building societies are currently subordinated to unsecured creditors. The BRRD aligns the hierarchies of both banks and building societies as shown in figure 1. The change for building societies can almost be thought of as two step process. Firstly ranking member deposits pari passu with unsecured creditors and then covered and eligible deposits are moved above unsecured creditors in the way described above. In reality, this change would happen simultaneously.

65. The change for building societies under stage 1 above is akin to the powers under section 2 of the Building Society (Funding) and Mutual Society (Transfers) Act 2007 (commonly known as the 'Butterfill' Act). This power gives enables the Treasury to amend the creditor hierarchy for building societies so that members rank pari passu with unsecured creditors. It has been the Government's stated intention to exercise this power for some time and was consulted on in 2012[16], but has yet to be commenced.

66. As the change in the hierarchy is more extensive for building societies than for banks, it follows that the impact on funding costs will be greater. The effect of the Butterfill powers

[15] http://www.parliament.uk/documents/impact-assessments/IA13-21.pdf

[16] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81426/condoc_future_building_societies.pdf

(moving member deposits to rank pari passu with unsecured creditors) has been estimated at 20bps. The impact is thought to be small as this has been widely expected by markets for some time and it is understood that credit rating agencies currently ascribe no benefit to unsecured creditors for their seniority in this respect.

67. Assuming the impact for preferring covered and eligible deposits is the same for building societies as it is for banks, the total basis point impact of depositor preference on building societies is estimated at between 45 and 70bps. This is thought to be an upper bound estimate given that credit ratings downgrades are the likely trigger for increased funding costs, and credit rating agencies are thought to regard debt issued by building societies in broadly the same way they do equivalent bank debt.

68. At the end of 2014-Q1, the total stock of building society unsecured debt was around £15bn and average annual issuance has been around £2bn since 2010. Assuming average issuance remains the same, the estimated annual increase in debt servicing costs to building societies is between £9m and £14m per year.

69. There may also be a compliance cost of depositor preference for building societies through amendments to their rules. The distribution of any surplus following the winding up or insolvency of a society is included in these rules. Depositor preference means that members will be out of scope of these rules and will therefore need to be changed. This may incur a resourcing and administrative cost to the building society. Building societies are able to update their rules (and do so) relatively frequently and as such, the Government expect any compliance cost to be small and absorbed into normal business costs.

70. The total cost of depositor preference in the BRRD for both banks and building societies is estimated to be £213m and £401.7m per year. This affect has been modelled without taking possible behavioural changes into account.

Safeguards

71. The BRRD also contains safeguards around the use of the stabilisation tools. In particular, the no creditor worse off principle. This is that no creditor, as a result of resolution action, should be left in a worse position than they otherwise would have been had the bank entered insolvency. The Directive requires an independent valuation of the treatment of creditors. Where there is any difference, payment may be financed through the resolution financing arrangement.

72. The UK is already compliant with the requirement for compensation arrangements for the resolution tools (except bail-in) through the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations. The bail-in tool will also require compensation arrangements. The domestic bail-in tool was implemented under the assumption that the necessary safeguards, including compensation arrangements, would also be implemented. The Government may experience a cost in providing compensation should it be necessary, but this will depend on the particular resolution scenario and the extent to which creditors are treated differently under resolution they would under insolvency. this cannot be estimated with any certainty

73. Safeguards are also required to restrict the use of, and give clarity to the market on how the bail-in, and other resolution tools, will be used. These safeguards specify how the tools are to be used by resolution authorities and are not expected to incur costs to business. The Commission's impact assessment also suggested that the introduction of these safeguards, combined with other factors such as ex-ante financing arrangements could mitigate the impact on funding costs of bail-in by up to 65 per cent.

Summary of Private Costs

74. Private costs from the Directive arise from several key areas, although largely from the bail-in tool and depositor preference. The UK already has a bail-in tool which is likely to mitigate this cost somewhat as market participants may have already priced in the effects of bail-in. Depositor preference measures are likely to cause costs to business through higher funding costs, reflecting unsecured creditor subordination in the creditor hierarchy.

75. The Government estimate the private costs of the BRRD to be between £248.3 and £697.3m per year. This may be materially smaller in practice, since the UK already has a domestic bail-in tool. Market participants are therefore likely to already have priced in the measure to a large degree. The Governments best estimate for total private cost is £403.8m per year.

76. The BRRD is due to be reviewed within 5 years of coming into force. The total net present value over a 5 year period is estimated to be -£2288.38[17]. This is negative because the benefits of this Directive cannot be assigned a monetary value. However, the Government believe that there will be a net benefit from this Directive. More detail is given below.

Costs to the authorities

77. There may also be some incremental costs arising from the BRRD to the authorities that stem from things such as rule making needs and EBA work streams around new regulatory products. The planned increase in resource costs is estimated to be largely similar to that of what would be required in the absence of BRRD. For example, some of the EBA work streams are on areas which would have been progressed in any case, such as valuation in resolution. This is not to say however, that there would be no impact on resource cost to the authorities as a result of BRRD. The Bank of England estimates the increase to be £494k this year, rising thereafter by 1.5% per annum. This is an upper bound (and one which may well be transitional – say 2 years as the BRRD is embedded)

Impact on GDP

78. The most likely area to affect GDP as a result of these measures would come through real lending rates to the economy. For the purposes of these calculations, it is assumed that 100 per cent of any increase in private costs is passed on to consumers. This is based on historical evidence. The Government recognise that past evidence may not reflect future trends.

79. On this basis, and assuming all banks feel cost increases to the same extent, a cost increase can be spread across aggregate total loans and advances for banks. Total

[17] Using a 3.5% discount rate

loans and advances to customers of the top 6 major UK banks is £2.0tn[18]. An increase of between £248.2m and £697.3m represents around a 1 basis point increase. This would translate to a cost increase of less that 0.01 per cent, if spread equally over total loans and advances. Although a material cost to banks, this is small in terms of the wider banking sector and impact to GDP. To put this in perspective, the smallest Bank of England Base Rate (another mechanism that affects the real cost of lending) change is 25 basis points. The Government therefore consider the measures in this Directive to have a negligible impact to GDP

Impact on the Exchequer

80. The long run driver of annual tax receipts is GDP. All else being equal, lower GDP would result in lower tax receipts. Since the impact on GDP is estimated to be negligible, it can be reasonably assumed the impact to the exchequer from these measures will also be negligible.

Benefits to the UK

81. These measures are designed to give Member States greater powers and tools to deal with failing banks. As shown in the recent financial crisis, bank failure can cause severe disruption to the financial sector and the wider economy. By being better able to resolve them, financial stability of the economy will increase. These benefits are difficult to quantify as they will often only accrue if a bank were to experience difficulties or enter resolution. Further details of the benefits from the different areas of the Directive are detailed below.

Preparation and Prevention

82. The measures would improve the awareness of banks towards potential threats to stability and allow banks address these concerns. Increased supervision and control will allow supervisors to develop clearer resolution plans for banks and address any barriers to it.

83. There may also be a benefit to the authorities by reducing their costs for external advice and analysis, such as legal advice. As the BRRD requires more information from firms and sets a standardised framework to resolution planning, authorities may require less external advice. This benefit is impossible to quantify as it will depend on each individual situation/resolution, but is a reasonable prospect.

Early Intervention

84. Early intervention is designed to allow supervisors to intervene in a struggling firm before it reaches the point of failure. Effective action at this stage can prevent a firm entering resolution, and therefore avoid creditors experiencing losses, and the other costs associated with resolution. The appointment of a temporary administrator may also have some incremental benefit, as they would be replacing poor performing management, however it would depend on the actions of the temporary administrator as to what benefits were realised.

---

[18] HSBC, Barclays, Lloyds, RBS, Nationwide and Santander UK

Bank Resolution

85. By introducing a harmonised set of resolution tools and powers for all Member States, this will increase the ability for authorities to effectively resolve failing banks, increasing financial stability. With credible resolution tools, the duty to use capital instruments to absorb losses prior to resolution, and the duty to bail-in 8% of liabilities before industry money is used to absorb losses, the perceived implicit state guarantee which assumes that large banks will be bailed-out should they fail is reduced. This curtails the risks banks take, making them safer and less likely to fail. It also benefits bank creditors and depositors, as there are greater prospects that if a bank does enter resolution, its critical functions and continuity of services can be maintained and, for example, depositors may still access their money.

86. The lack of tools and powers available to the authorities in the recent financial crisis and as letting systemic banks go insolvent would cause greater and wider macroeconomic impacts to the economy, governments were forced to step in and provide billions in financial support. A harmonised set of tool will allow for a more managed and orderly resolution in future failures, protecting the taxpayer from these bail-outs.

87. National Accounts for the relevant period show that the UK Government exposure to

Cross Border Crisis Management

88. A harmonised set of resolution tool across the EU will also create a more level playing field for banks that operate across borders. EU banks can expect to be subject to the same tools, which benefits the way groups are treated in resolutions. The measures to introduce more effective cooperation and information sharing between Member State authorities will also assist in resolving large, cross border banks. Banks which operate across the EU will only have to comply with one harmonised set of requirements, rather than dealing with different requirements from the regulators in each Member State. This will reduce the cost of compliance. These measures will improve the effectiveness of any future cross border resolution.

Financing

89. During the financial crisis, the Government was forced to intervene and support the UKs banking sector to a massive degree. The National Audit Office has assessed that the UK Government provided total support in excess of £1 trillion[19].

90. With the BRRD in place, the direct cost of bank failure will be absorbed by bank creditors. Before firms can access any funding via the resolution financing arrangement, 8 per cent of the firm’s liabilities must have had the bail-in tool used on them. This effectively removes the implicit state guarantee for banks up to the first 8 per cent of their balance sheet liabilities, as no financing will be received until this threshold is met. It is considered extremely unlikely that losses will exceed 8 per cent of total liabilities in any but the very worst cases of bank failure.

[19] The financial stability interventions chapter. The Comptroller and Auditor General’s Report on Accounts for the House of Commons. July 2013.

91. The introduction of depositor preference will also reduce the contingent liability of FSCS contributions from the banking sector. The FSCS levies industry to recoup the costs of compensation. This levy is based on the probability of expected FSCS payouts and its expected recoveries. As financial stability increases (reducing the probability of bank failure) and the FSCS is moved up the creditor hierarchy through depositor preference, its expected payouts will decrease, and expected recoveries will increase, therefore reducing the levy placed on the banking sector.

92. It is difficult to say exactly how much the FSCS levy is expected to reduce by. However, to give an illustrative example, the average FSCS levy over the past 6 financial years has been just over £700m per year, not an insignificant cost to industry. Measures in this directive would be expected to lead to a material reduction in this cost.

Total Benefits

93. Overall, the Government believe that this Directive will have a net benefit the UK. This is partly due to the large amount of similarities this Directive has to the UK's existing Special Resolution Regime and therefore, many of the measures are already broadly in place in the UK.

94. In response to the recent financial crisis, the government commissioned the Independent Commission on Banking (ICB) to report on the reforms needed to improve stability and competition of the UK banking sector and the Government took forward many of its recommendations in the Banking Reform Act 2013. The ICB report estimated that the costs of financial crises were around 3% of GDP per annum (roughly £46bn when measured against 2013 GDP). By implementing reforms to increase financial stability, these costs can be avoided. The Government's White Paper on banking reform[20] estimated that the recommended reforms may see UK GDP increase by as much as £9.5bn per year.

95. The measures in the BRRD are designed to set a framework for the recovery and resolution of banks across the EU and promote financial stability. These reforms will help reduce the implicit government guarantee to large banks, promote financial stability and reduce the probability of future banking crises. Overall the government expects there to be a net benefit to the UK economy form this Directive.

Assumptions

96. The modelling for this IA has been done on a static basis. The costs to business have been estimated assuming that any increase in funding costs is fully passed onto consumers and business models remain the same. In practice, firms may restructure themselves or seek alternative sources of funding. However thing change is hard to quantify or predict and is a decision for individual firms.

Wider Impacts

97. A number of wider impacts have been considered for these measures and are detailed below. Much of these will depend on how industry responds to the measures.

[20] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32556/whitepaper_banking_reform_140512.pdf

Impacts on the labour market

98. Increased costs may mean firms decide to reduce costs elsewhere, such as staff costs. Firms may decide to cut jobs and or pay, but to what extend is unclear. Any reduction in staff numbers is likely to be concentrated in London as around one third of financial and insurance sector employment is based in London.

Business borrowing decisions

99. An increase in wholesale debt funding costs may push up real lending rates to the economy. Large businesses may be better able to access other sources of funding, mitigating some of this impact, whereas small and medium sized businesses are less likely to be able to. However, any decision to pass on costs to consumers is a commercial one and cannot be predicted accurately.

Impact on competition and competitiveness of the UK banking sector

100. The measures in this Directive are expected to improve the competition within the banking sector through greater financial stability. The reduction on the implicit state guarantee large banks are seen to enjoy will reduce the comparative disadvantage faced by smaller banks.

Impact on Small and Micro businesses

101. Small and micro businesses will benefit from increased financial stability and the increased continuity of finical services. These measures also reduce the likelihood of future financial crises.

102. Small banks are also included within the crisis management framework, meaning a more level playing field across the sector. Their resolution will be managed by a specialised resolution authority if they fail. A better managed resolution will help avoid contagion.

103. The resolution tools and powers are very unlikely to be used on small and micro businesses because even the smallest banks will not be either small or micro. If such a bank were to exist, the Government anticipates that it is unlikely to meet the statutory test for use of resolution tools –which require their use to be in the public interest of financial stability, maintaining confidence in the banking sector and protecting deposits and client assets.

104. There may be an impact to small and micro businesses to the extent that they are customers of larger banks, building societies or investment firms. A small or micro business will benefit from greater deposit protection through depositor preference and be less exposed to losses in the event of a failure. To the extent to which small and micro businesses borrow from larger banks, they may see an increase in the cost of borrowing if costs are passed on to consumers through higher interest rates. The extent to which small and micro business will be impacted by this is difficult to quantify, as any interest rate increases are a commercial decision for banks.

One in two out status

105. The measures under consideration in this IA implement an EU Directive. European Union Regulation, Decisions and Directives are out of scope of the OITO rule.

Equality impact

106. The Government has considered its obligation under the Equalities Act 2010. The Government does not believe these measures will impact upon discrimination, equality of opportunity or good relations towards people who share relevant protected characteristics under the Act

107. The Government considered that the proposals are compatible with the Convention rights protected by the Human Rights Act 1998

Summary of IA and implementation plan

108. Overall the Government believe there will be a net benefit to the UK as a result of this Directive. The Government is required to transpose the directive in National Law by 31 December 2014, with the measures being applied from 1 January 2015.