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UK Regulators Published Reforms and Proposals in January 2024 That Will Impact the Banking Sector, Including a Consultation on Managing Small Bank Failures

In this alert we consider various reforms and proposals to the banking sector announced by UK regulators.

- On 11 January 2024, HM Treasury published a consultation paper on enhancing the UK's Special Resolution Regime for smaller banks.
- On 25 January 2024, HM Treasury released a report containing the Prudential Regulation Authority's (PRA's) conclusions following its 2023 review of the rules on ring-fencing.
- On 30 January 2024, the Bank of England (BOE) published a policy statement on its updated enforcement approach.

We examine the key features and impacts of these developments below.

Extending the UK Bank Resolution Regime to Smaller Banks: HM Treasury Consults on Proposals

On 11 January 2024, HM Treasury published a consultation paper on enhancing the UK's Special Resolution Regime (SRR). The SRR is a pre-insolvency regime that the Bank of England (the UK's resolution authority), in conjunction with other relevant regulatory bodies, can apply to failing banks. The current regime does not apply to smaller banks (*i.e.*, those that are subject to the "MREL" requirements).[1] For such banks, there is a specific Bank Insolvency Procedure designed to ensure that depositors are compensated prior to subjecting the bank to a normal insolvency procedure.

HM Treasury now proposes to extend the regime to cover small banks rather than either require such banks to maintain MREL (which is perceived to be disproportionately costly for smaller banks who may not have ready access to the capital markets) or to create a mutualised fund to facilitate the resolution of such banks. Levies on the banking sector (which HM Treasury considers to unduly affect the capital resources of contributing firms) would be used to finance this fund. Officials anticipate that providing relief to small banks using the SRR would reduce contagion risk and grow public confidence, and thus investment, in the financial sector.

The SRR emerged in the wake of the financial crisis, and its efficacy was demonstrated by the successful resolution of Silicon Valley Bank's UK entity in 2023. For more details on this event, see our client alert "Bank of England Resolves Silicon Valley Bank UK Through Sale to HSBC."

[1] MREL, the "minimum requirement for own funds and eligible liabilities," is the minimum sum of eligible debt and equity a firm is required to hold to ensure it can support an effective resolution through recapitalisation.

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The SRR includes five stabilisation mechanisms that can be used in combination to stabilise a bank on the verge of insolvency, subject to certain conditions. These mechanisms are:

- Sale of the bank, in whole or part, to a Private Sector Purchaser (PSP).
- Sale of the "good" assets and functions of the bank to a bridge bank.
- Transfer of the "bad" assets to an asset management vehicle.
- Bailing-in liabilities.
- Government stabilisation, such as temporary public ownership.

The consultation paper proposes a new stabilisation mechanism in which funds provided by the banking sector are used to meet the costs of operating and recapitalising a failing small bank.

The proposals are one measure among other efforts to enhance deposit payouts, compensation and the operation of the Financial Services Compensation Scheme (FSCS). The UK Prudential Regulation Authority will review the FSCS deposit limit by 2025, for instance.

Scope and Application

The extended SRR can be used where the transfer mechanisms relating to PSPs or bridge banks are being applied to any firm within scope of the existing SRR stabilisation tools, including UK subsidiaries of foreign firms.

HM Treasury clarified, however, that neither credit unions nor third-country branches operating in the UK would be subject to the extended SRR, creating an asymmetry between the banking sector firms liable to fund the FSCS levy and those that may avail of it.

The primary use case for the extended SRR is any failing small bank following:

i. The write-down of shareholder and other capital resources.
ii. The satisfaction of the SRR's resolution conditions.
iii. The Bank of England deciding against insolvency.

The consultation paper does, however, provide for an element of discretion. The Bank of England may, for instance, use the extended SRR for a larger bank still in the process of satisfying its ultimate MREL requirements.

The use of financial arrangements in a resolution would involve amended conditions where the SRR is being applied. The requirements specify that resolution financing arrangements can only be used:

- Where shareholders and creditors have made contributions equalling no less than 8% of the institution's liabilities.
- Where the financing arrangements equal no more than 5% of the institution's liabilities.

The proposal provides that these conditions will be disapplied when resolving smaller banks (as smaller banks are unlikely to meet the conditions).

Funding of the Extended SRR

The funding liability for the extended SRR would fall on all UK banks, credit unions (and Northern Ireland credit unions) and building societies, as well as certain non-UK banks operating through a UK branch.

To collect the requisite funds, the FSCS would charge an *ex post* levy on the banking sector (in the same way that it would currently do to fund a payout or transfer of covered deposits for a bank placed in insolvency). The proposed rules would allow the FSCS to potentially receive proceeds from the sale of failed banks. These powers will necessitate amending the FSCS's current statutory framework.

These proposals will not involve new upfront costs to the banking sector, and the annual charge levied on banks would only change if the stabilisation powers were in fact used. Further, the FSCS's annual levy limit for deposit-takers would remain subject to a PRA-determined cap currently set at £105 million.

HM Treasury anticipates that the expanded bank resolution regime could reduce the overall sum the FSCS levies on banks given the lower costs of recapitalisation in comparison to depositor compensation arrangements in a bank insolvency proceeding.

The consultation closes on 7 March 2024.

The Prudential Regulation Authority Reviews Its Rules on Ring-Fencing

On 25 January 2024, HM Treasury released a report containing the PRA's conclusions following its review of the rules on ring-fencing of UK banks. The PRA conducted the review throughout 2023, and the report focuses on the elements of the ring-fencing regime provided for in the PRA Rulebook and in PRA supervisory statements.

Officials introduced rules on ring-fencing following the 2008-2009 financial crisis. The rules aim to insulate certain core banking activities from broader investment banking activities. Only a Ring-Fenced Body (RFB) can carry out core activities, while non-Ring-Fenced Bodies (NRFBs) can engage in riskier activities. RFBs are shielded from the potential impact of an NRFB in their consolidation group becoming insolvent through this legal separation.

The report was not intended to effect any changes to the PRA's rules or policies. Instead, it assessed the practical operation of the ring-fencing regime and raised potential areas for improvement. The PRA concluded that the rules are well understood and operating effectively without significant gaps.

The report did, however, identify several areas for improvement, noting that suggestions in the report are indicative only (the PRA plans to issue a consultation on changes to the ring-fencing rules at later date). The key improvement areas recommended in the report are set out below.

Governance Arrangements

The PRA's ring-fencing regime imposes rules on governance arrangements to ensure independence in RFBs' decision-making processes. Requirements relate to board membership, remuneration, HR policy and risk policies. The report concluded that these rules are largely appropriate, but noted their functioning might be improved by:

- Increasing the duration of waivers or modifications granted to ease firms' administrative burden and reduce the frequency of compliance action.
- Limiting the application of some rules to the subgroup level, rather than to each subsidiary individually.

Continuity of Service Provisions

The PRA's ring-fencing rules contain a number of provisions aimed to ensure vital services to RFBs are undisturbed by external issues, such as the insolvency of a group NRFB. Services that may fall under this requirement include information technology services, data management and property management-related facilities. Rule 9.1 of the Ring-Fenced Bodies section of the PRA Rulebook restricts which group entities can regularly supply an RFB with these services. Subject to a full consultation process, proposed modifications to make Rule 9.1 easier to comply with include:

- Integrating the rule into other operational resilience regimes.
- Using modifications to improve flexibility.
- Adjusting the types of services within the rule's scope.

Reporting and Notifications

To supervise ring-fencing compliance, the regime requires certain specific disclosures in the form of ring-fencing reports. The review identified report "RFB005 – Joint and Several Liabilities Arising from Taxes: reports on VAT and bank levy data for group and RFB" as potentially unnecessary and subject to removal. This is because other regulatory monitoring processes cover the same risks and the liabilities covered are immaterial in relation to a firm's Tier 1 Capital holdings.

The PRA intends to analyse the ring-fencing rules in greater depth at a later date and consult on any proposed changes.

The Bank of England's Approach to Enforcement

The Bank of England published a policy statement (PS1/24) on 30 January 2024 to outline its updated enforcement approach. Although the BOE has not typically been as visible in enforcement actions as the Financial Conduct Authority has, the BOE has taken a more substantial approach to enforcement against authorised firms in recent years. Notable examples include the measures the bank adopted against HSBC in 2024 (£82 million in penalties related to failures in FSCS protection) and Credit Suisse in 2023 (£87 million in penalties due to the company's relationship with Archegos).

This policy statement encompasses feedback from earlier consultations, clarifying enforcement powers and introducing changes to enhance cooperation during investigations. Key updates include the introduction of the Early Account Scheme. This is designed to encourage subjects under investigation to cooperate proactively with the investigation process by providing a detailed factual account and related evidence at an early stage. Participation in the scheme may lead to more efficient investigations and can influence the calculation of financial penalties, promoting transparency and expediency in the enforcement process.

The new policy also sets out adjustments to financial penalty calculations, which include amending the "serious financial hardship" thresholds for individuals and changing the starting point for calculating fines imposed on a firm. This starting point will no longer reference an individual firm's financial metrics; instead it will be derived from a firm's impact categorisation and the seriousness of the firm's breach under a preset matrix.

The new approach to enforcement became effective on 20 January 2024.