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# Alert

## Restructuring

The Co-operative Bank – first use of “bail-in” powers by the UK’s Prudential Regulation Authority – or not?

Following a rating agency downgrade and recent management changes, on 17 June 2013 the Board of the Co-operative Bank announced a comprehensive recapitalisation plan. This was widely reported in the media<sup>1</sup> as involving the first use by the Prudential Regulation Authority (the “PRA”), one of the two UK regulators for banks and other financial institutions, of its “bail-in” powers. The reality, however, is a little more complicated than has been portrayed in the media.

### Background – the Co-operative Bank

The Co-operative Bank is currently a 100% owned subsidiary of the Co-operative Group, which owns a number of businesses in the retail and financial services sectors. It is primarily a retail bank but also has some corporate business in the SME sector. The Co-operative Group is a mutual society owned by around six million individual members and about 80 local co-operative societies. Profits are used to expand its business and are from time to time distributed to members.

The Co-operative Bank is widely perceived in the UK market as a challenger to the hegemony of the big four retail banks (Barclays, HSBC, Lloyds and RBS). It is much smaller than all of those more well-known banks, but expanded in 2009 through the acquisition of the Britannia Building Society. For some time, it was expected that the Co-operative Bank would acquire a portfolio of retail branches which Lloyds was required to sell by the EU and UK competition regulators, but that deal fell apart earlier this year and Lloyds is now pursuing other plans for that business. It was shortly after the announcement of the failure of the Lloyds deal that it became apparent that there were serious deficiencies in the Co-operative Bank’s capital position, resulting to some extent from over-expansion at the time of the Britannia acquisition. This was followed by a downgrade from Moody’s applying to all the Co-operative Bank’s debt securities. The chairman, CEO and various other members of the Bank’s senior management were replaced.

### Background – the PRA

Under the UK’s new regulatory structure, which came into effect on 1 April 2013, the PRA (a subsidiary of the Bank of England) is responsible for regulating the capital of financial institutions authorised in the UK.

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The conduct of their businesses is regulated by a separate body, the Financial Conduct Authority (“FCA”). The recapitalisation of the Co-operative Bank is the first real test of the PRA’s powers in a situation of financial stress.

### “Bail-in” powers

Solving the “too big to fail” problem, and creating the right tools for regulators to deal with troubled banks, has been the subject of extensive discussion at the European Union level. For some time, the EU has been discussing a proposed directive on Resolution and Recovery of banks<sup>2</sup>. This would require all member states to confer on their regulators various powers, such as power to make rules on the maintenance by banks of resolution plans, power to transfer all or part of the business of a bank to a “bridge bank” with a view to a sale to a third party, and the power to appoint special managers of a bank. Most of these powers are already available to the PRA under changes to English banking law enacted after the crisis of 2008<sup>3</sup>.

Most controversially, the Resolution and Recovery Directive will contain a power for the regulators to require a “bail-in”. This is a power to require creditors of a bank to convert their debt into shares of the bank or to write it off. Negotiations on the precise scope of the bail-in power are continuing, with outstanding questions including whether or not it should apply to senior debt or depositors who have or who do not have the benefit of deposit guarantee schemes. Clearly, however, the bail-in power will apply to junior or subordinated debt securities, whether or not those securities contain an express power on the part of the issuer to require conversion into shares (some securities issued since 2008, such as so called “CoCos”, contain an express contractual power to require conversion, but this is by no means universal).

### The Co-operative Bank’s plan

The plan announced on 17 June 2013 has a number of elements:

- An exchange offer, to be effected in October 2013, in relation to one series of preference

shares and nine series of subordinated debt securities. Holders of these securities will be offered ordinary shares in the Co-operative Bank and/or senior debt securities issued by the parent company, the Co-operative Group. It appears that the pricing of the exchange offer will be below the nominal value of the affected securities, thus generating a profit which will also count as regulatory capital for the Co-operative Bank;

- Pending effectiveness of the exchange offer, the Co-operative Bank will not pay coupons on the affected securities;
- The Co-operative Group will also contribute to the Co-operative Bank the proceeds of sale of the Group’s insurance and asset management businesses; and
- Additional capital will be provided by cost savings and sale of non-core assets by the Co-operative Bank.

The plan appears, once all its elements have been completed, to provide capital of up to £1.5bn, which should be sufficient capital to restore the Co-operative Bank to financial health. It has the full approval of the PRA. Details of the plan are expected to emerge over the next few months as the exchange offer and the prospectus for the new ordinary shares in the Bank are published.

### Comments on the plan

Despite the use of the term “bail-in” in the press, this is not a bail-in in the sense envisaged by the draft Resolution and Recovery Directive. It does not involve the use of statutory powers by the PRA to compel conversion of debt into shares. Instead, the more conventional technique of an exchange offer is being used. Holders of debt could presumably reject what they are offered under the exchange offer, but will be faced with the stark alternative of holding worthless debt if the exchange offer fails.

More importantly for the co-operative movement generally, the Bank’s problems have led to an erosion of its mutual status. The new ordinary shares which holders of debt securities will receive will be listed on the London Stock Exchange. Although the Bank will still be majority owned by its mutual parent, its board of directors will be subject

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to the scrutiny of external investors and the publicity which accompanies a full listing. Effectively, this is an IPO by the back door.

The PRA seems to have passed this first test of whether resolution of a bank is possible without state support. The key question for the PRA and other European regulators is whether their new powers will be adequate in a much larger and more complex case.

- <sup>1</sup> See, for example, the reports at [www.bbc.co.uk/news/business-22932330](http://www.bbc.co.uk/news/business-22932330) and in the Financial Times, Companies section on 18 June 2013.
- <sup>2</sup> See, for example, the text of the current proposal from the European Parliament which can be found at <http://www.europarl.europa.eu/document/activities/cont/201306/20130605ATT67282/20130605ATT67282EN.pdf>
- <sup>3</sup> Through the Banking Act 2009

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