FINANCIAL STABILITY AND DEPOSITOR PROTECTION: SPECIAL RESOLUTION REGIME

The ABI's Response to the Tripartite Authorities' consulation

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General comments

1. The ABI is happy to respond to the Tripartite Authorities consultation on details of the proposed Special Resolution Regime. As major institutional investors controlling funds worth £1,500bn, our members are significant shareholders in and lenders to the UK banks. More generally, as an important constituent of the financial services sector, our industry has a real stake in the smooth running of the banking system and we welcome the opportunity for further debate.

2. The SRR proposal would allow the Authorities to take control of a bank, which failed to meet threshold conditions or appears in imminent breach of meeting them. The Authorities could impose a sale of all or part of the bank, transfer some of its assets and liabilities into a bridge bank for eventual resale or take the bank into temporary public ownership. There is also to be a modified bank insolvency procedure to enable the deposit protection scheme to pay out.

3. We remain of the view that the case for such a Special Resolution Regime is not proven and that the current design requires substantial change. While such arrangements exist in other jurisdictions, notably the US, their purpose and structure are not necessarily suited to the more complex UK market, which is populated by larger banks with a greater wholesale and international presence. It is worth noting that the much-admired rescue of Bear Stearns led by the Federal Reserve earlier this year did not involve the imposition of an SRR. In the US, too, an SRR does not suit every situation.

4. The proposed SRR focuses on protecting retail depositors at the expense of overriding the property rights of shareholders and other lenders. Loss of property rights is a very serious matter. The cost of capital to British banks will rise if an SRR is introduced as now proposed by the UK Authorities. Our members have indicated that they will become more selective about investing in the securities issued by British banks and about placing wholesale deposits with them if this regime is adopted. This applies to investments both in the equity and in the debt of banks. Bondholders are concerned that the proposed arrangements for netting of exposures will place them at a disadvantage because their security will be weakened.

5. Investor concerns relate to the structure of the regime, its oversight and to the compensation for loss of property rights. We do need an orderly means of dealing with failing banks, but current proposals are still being pushed through with too much haste. Any regime should be introduced on the basis of a fully considered consensus, which will minimise the impact on overall confidence. Our response aims to offer proposals on how the prospects for such a consensus might be improved.

6. Given that the proposals override existing property rights, we are particularly concerned that, under the current proposals, there is too little onus on the Financial Services Authority to take all steps necessary to prevent the need for an SRR in the first place. Once an SRR is imposed, it should be a clear requirement that the FSA explain and justify publicly the actions it had taken earlier to try prevent this point being reached.

7. Such actions should include consulting with the main existing shareholders to see whether they are willing to assist, for example by coming up with additional capital or supporting a change of management. Such a consultation would have to come at a late stage and be private. Consultees also recognise that they would become insiders and be unable to trade pending any formal announcement. However, the record with Bradford & Bingley shows long term UK institutions are able to make decisions quickly.

8. Shareholders, who have been offered such a chance to support, will be more reconciled to the loss of their rights if they decline to do so than those whose interests have been ignored.

9. This will be particularly true if there is also a clear understanding on the part of all concerned that systemic risk exists. Hitherto there has been little public debate on the definition of systemic risk. While the Authorities appear to consider that a shock to retail confidence constitutes systemic risk, the market focuses more on the risk of contagion to other banks and would rely on other mechanisms, including the solid offer of depositor protection to give confidence to the retail market. It is important that these differences are reconciled if the SRR is to go ahead on the basis of consensus.

10. Infringement of property rights is less offensive if the SRR regime only enters force when it is clear that all else has failed and the requirement is for orderly wind-down. Indeed at the point where the SRR is needed, all that may be necessary is an enhanced administration process, because the other tools would be redundant. Where there is no systemic risk banks should be allowed to fail. The Authorities should not be aiming at a zero-failure regime.

11. It is distressing to investors that the consultation makes only formulaic reference to the need to avoid interfering with property rights in contravention of the Human Rights Act 1998. When a bank is still solvent, as the Authorities claimed was the case with Northern Rock in the run-up to its nationalisation, those responsible for it have an obligation to preserve value for shareholders and creditors. Indeed the obligation to maximise enterprise value continues throughout the process of administration and liquidation. This obligation should be hard-wired into the arrangements for an SRR.

12. We are further concerned that the proposed arrangements for compensation in the event of nationalisation will require the independent valuer to assume that liquidity assistance has been withdrawn. This apparently means that no reference can be made to break-up value. Where the balance sheet shows a surplus of assets over liabilities, the independent valuer must be able to take this into account. Otherwise, the government may appropriate this value for itself.

13. There is also no guarantee that government control will prevent loss of value subsequent to an SRR being imposed. Where, for example, the Authorities decline to sell a bank at a reasonable price early on in the process only to find that it is subsequently worthless, they are themselves responsible for the loss of value and the burden should not be born by the previous shareholders. Again this points to the need for a requirement in the SRR arrangements to maximise the value of the enterprise.

14. Finally we are concerned that there is no clarity about what will happen to the stock-market quotation of a bank under special resolution. The shares in Northern Rock remained quoted for a long period during the run-up to its nationalisation, and the authorities insisted that it was a solvent. During this period there was weak communication between the board and the market, and shareholders found themselves forced to rely on uncertain information leaked to the press. We remain of the view that this led to a severe risk of a false market in the shares for a prolonged period. This was damaging to confidence and we would not wish this situation to be repeated.

15. Our specific responses are set out below. They are confined to the questions relating to Chapters 2 and 3, which cover most of our members' particular interests. These relate to the SRR objectives, roles and governance and to the SRR tools: stabilisation powers and compensation.

ANNEX

Questions for consultation

2.1 Do you agree with the SRR objective as set out in Clause 4?

No. For the reasons set out above we consider that the objective of avoiding interference with property rights is too weak. The objective of an SRR should be to maximise enterprise value in the interest of all stakeholders. Other objectives should be carried out with this in mind.

2.2 Do you agree with the role of the FSA in determining conditions for entering the SRR?

Since the FSA has the responsibility for regulating individual institutions it seems appropriate for it to decide when the conditions for an SRR are triggered. However, we believe that the Bank of England should have the power to recommend that an SRR be introduced and the FSA should be obliged to take this recommendation into account.

The Bank's ability to recommend an SRR follows naturally from its statutory responsibility for financial stability and the smooth operation of the payments system.

The legislation should include a requirement on the FSA to justify in public after the event the actions it has taken through heightened supervision to prevent an SRR being necessary. It should also explain how it reached its conclusions with regard to the triggers for an SRR.

2.3 Do you agree with the conditions for entering the SRR as set out in draft clause 7?

With regard to Condition 1 we consider that it be a requirement that the bank has failed to meet threshold conditions or is *imminently* likely to do so. The SRR should not be introduced when the failure remains a quite distant prospect.

With regard to Condition 2, the Tripartite Authorities should be required to satisfy themselves that it is *highly unlikely* that action will be taken to enable the bank to satisfy threshold conditions. This is a tougher test than that set out in the draft clause, which refers only to it not being reasonably likely that action will be taken.

As part of the requirement on the Tripartite Authorities to satisfy themselves that action is highly unlikely, they should consult with the bank's leading

shareholders to see whether they as owners are willing to come up with any solutions.

2.4 Do you agree with the role of the Bank of England in operating the SRR in the public interest as set out in draft clause 8?

We have been supportive of the FSA having formal responsibility to manage an SRR because we believe it should be the sole regulator of financial institutions. We do not wish to see groups, consisting for example of both insurance businesses and banks, subject to regulation by different entities. This remains our preference.

We therefore believe it is important to be clear that a lead role for the Bank of England in operating an SRR should be clearly seen as an exception, which in no way negates the principle of the single financial regulator. Moreover, the collegiate approach of the Tripartite Authorities would be enhanced – and the principle of the single regulator better preserved - if the FSA took an active supporting role in the operation of any SRR and if it were to participate in the Bank of England's Financial Stability Committee (see below).

2.5 Do you agree with the role of the Treasury as set out in draft clauses 8(4), 8(5), 9 and 10?

We understand that the Treasury's obligations to the taxpayer require it to have power of decision where public money is involved. We are concerned, however, that the definition of public interest remains vague, while the Treasury's powers under this clause would be sweeping. We consider that there is a need for greater clarity of what constitutes public interest as opposed to the political interests of the government of the day. It is important that the concept of public interest is properly defined (see comments on systemic risk above).

2.6 Do you agree that the SRR objectives should be supplemented by a code of practice?

Yes, provided that the aim of the code is to give clarity as to how the legislation will operate in practice and that it does not create additional leeway for reducing safeguards applied to existing stakeholders. To this end, a draft Code should be presented at the time the Bill is published. There should subsequently be a full public consultation on the contents of this code.

2.7 Do you agree with the proposed areas to be covered in the code of practice?

Yes, with the proviso that there is particular need to develop understanding of the definition of public interest and of the safeguards to be applied when an SRR is in place.

3.1 What are your views on the breadth of the property transfer powers in clauses 14 to 23? Are there particular powers that are lacking?

We remain of the view that a special insolvency regime for banks would be preferable to an SRR regime precisely because it would enter force only after it was clear that the bank was failing and because it would be administered by the courts without risk of political interference.

Were this approach to be adopted there would be no need for the Authorities to acquire such sweeping powers of property transfer. Particularly worrying is the statement in this section of the consultation that the Authorities could use their powers to intervene in a failing bank “while it still has some net worth.” Given the inadequacy of the compensation arrangements, this is very damaging to confidence.

3.2 What are your views on the nature of the [share transfer] powers?

Our answer is the same as that to question 3.1 above, with the additional comment that it is vital that the hierarchy of capital structure be respected with regard to compensation. The government’s failure to clarify the situation with regard to Northern Rock preference shares continues to have an impact on confidence in the bond market.

3.3- 3.14 Structure and operation of a bridge bank

This group of questions is particularly sensitive because the bridge bank operation involves extracting better quality assets from the bank and placing them alongside certain liabilities, basically the retail deposit book in a “bridge bank” that may subsequently be sold off in the market. The consultation document makes it clear that the assets transferred would be greater in worth than the liabilities in order to capitalise the bridge bank.

This aspect of the SRR leaves the shareholders and lenders to the original bank particularly vulnerable because the Authorities can essentially cherry pick its assets and will even be able to return to the residual bank assets that subsequently turn out to be of lesser quality. This will not only place the shareholders at a disadvantage; depositors and other lenders to the residual bank will also find their funds backed by a lower quality of assets than those fortunate enough to have had their deposits transferred to the bridge bank. Our members have said that they will withdraw wholesale deposits from banks facing this sort of treatment.

The compensation arrangements are thus absolutely crucial. Whereas stakeholders in the residual bank will be able to derive some comfort from the proposal that a resolution fund would be established to channel back to the residual bank any net proceeds from the sale of the bridge bank to a third party, there is no obligation on the authorities to maximise value created in

this way. Such an obligation must be an integral part of the objectives of an SRR, if the process is to command confidence.

It should be clear also that once the creditors in the residual company have been paid off, any remaining funds belong to the shareholders. Their interests are ignored in the document, as is the need for administrative costs of the process to be kept under control.

3.15-3.41 Offsetting and netting, safeguards of security interests, special administration procedure for bridge banks

We are concerned that any arrangements for offsetting and netting will weaken unfairly the position of bondholders, as their security will be reduced.

3.42 Do you agree that temporary public ownership should be subject to similar public interest tests as the banking (Special provisions) Act 2008?

The criteria of financial stability and public interest are the right ones. They need to be clearly defined, however. In particular, as already noted, there is a need for a proper understanding of systemic risk.

3.43 Do you agree that the Authorities should have the power to put in place a bank resolution fund for a bridge bank and temporary public sector ownership?
3.44 Do you agree that the bank resolution fund should be mandatory in the case of the bridge bank tool, but optional in the case of temporary public ownership?
Do you agree that the bank resolution fund should comprise only the net proceeds of resolution (that is less the costs of resolution)?

With temporary public ownership, as with the bridge bank, it is vital that the Authorities take account of the need to maximise enterprise value. Provided there is a clear obligation to maximise value, then it does not matter whether the route chosen is via a resolution fund or alternative compensation arrangements for shareholders and creditors.

It is not sufficient to argue, as the consultation paper does in paragraph 3.138 that the government would have a "secondary duty not to act in a way which recklessly led to the destruction of value in the potential proceeds of a resolution." Recklessness requires a very high burden of proof, while the consultation document states elsewhere that the Authorities will take banks into an SRR when they are solvent (i.e. when there is some residual value). They must assume responsibility for loss of value that occurs after that point, even if no recklessness is involved. This loss cannot simply be charged to the original shareholders who no longer have any control rights.

Indeed, the government has an obligation to those whose rights it has overridden in taking bank into temporary public ownership as well as to the

broader public. This obligation should be fully recognised in the operation of this SRR tool and should be a primary, not a secondary duty. For example, fees for guarantees and the administrative costs of the SRR, including fees charged by external advisers, should be reasonable. Independent verification should be provided that costs have been kept within reasonable limits.

3.46 Do you agree with the mechanisms for compensation and appointing an independent valuer in the circumstances set out above?

It is important that the valuer be independent. We are concerned that the proposed arrangements whereby the Treasury will appoint the valuer and set terms of reference may stand on the way of such independence. The document states that the valuer should be "ultimately" accountable to the court. We consider the valuer should be accountable to the court and, indeed, appointed by the court.

3.47 Do you agree with the proposals to confer specific powers on an independent valuer, and the nature of the powers described above and provided for in draft clause 28?

The power of the valuer to share information with the public authorities without requiring the consent of the person who provided that information needs clarification. It is clearly reasonable that the authorities be informed of criminal offences such as money laundering and insider trading. It is less clear that the Treasury should be able to specify by order the circumstance in which the power to share information may be used. It is also not clear whether the valuer may or *must* use such power.

3.48 Do you agree with the principles of valuation set out in draft clause 30?

No. The valuation principles must state clearly that the valuer must respect the hierarchy of the capital structure. Moreover, the valuer should be obliged to take account of the existence of any balance sheet surplus and not focus merely on the theoretical assumption that official financial assistance has been withdrawn. If the valuer is not able to take account of the balance sheet surplus, the Treasury may be in a position to break up the bank and appropriate that surplus for itself.

3.49 Do you agree that the Treasury should have power to provide for the reconsideration of the independent valuer's determination and appeals from the valuer to a court or tribunal?

Yes, but only if the original creditors and shareholders are also able to provide for such reconsideration. The power as presented in the document is distressingly one-sided.

3.50 Do you agree that alternative compensation arrangements are needed for a private sector purchaser tool that would not involve an independent valuer?

Yes, but only if the authorities have a legal obligation to maximise enterprise value. We do not believe it would be sufficient for those who would receive compensation to be able to challenge the process or the price achieved through judicial review. The Authorities should be accountable to the courts for ensuring that the price achieved is a fair one.

3.51 Should any of the costs (of the SRR) described above not be covered by the FSCS, under the Authorities proposals? Please explain why.
3.52 Are there any additional costs of resolution, which could be borne by the FSCS?

The costs of the SRR should be met by the institution affected and not charged to the FSCS. In particular, we do not consider that it is appropriate for the FSCS to pay for the administrative costs of an SRR, for the cost of government guarantees to creditors or for any compensation payments to shareholders and original creditors.

The lack of automatic reimbursement would moreover provide an incentive to the Authorities to ensure that unnecessary costs are not incurred, for example through over-payment for advisory services. We are further concerned that an objective measure should be required for calculating the market value of any guarantees provided by the Authorities to the creditors of the bank in the SRR if these are to be included among the costs to be covered.

As with other aspects of the arrangements the Authorities should have as one objective the requirement to maximise enterprise value.

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