



## **FINANCIAL STABILITY AND DEPOSITOR PROTECTION SPECIAL RESOLUTION REGIME**

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Comments by the Association of Business Recovery Professionals in response to the consultation document issued by HM Treasury in July 2008

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### **1. Introduction**

- 1.1 The Association of Business Recovery Professionals ('R3') represents insolvency practitioners licensed by all the professional bodies which are authorised under statute to regulate insolvency practitioners in the UK. Over 90% of authorised insolvency practitioners are members of R3.
- 1.2 In this response we have focused primarily on the practical issues which may arise in the context of special insolvency regimes, as opposed to the wider general issues of predictability, transparency and international competitiveness which are likely to be of concern to financial community generally.
- 1.3 Our comments are set out by reference to specific questions in the order in which they are posed in the discussion paper, but we include more detailed discussion on specific issues where we think appropriate.

### **2. SRR Objectives, Roles and Governance**

- 2.1 Our answers to the questions set out in this chapter are as follows:

- 2.1 Do you agree with the SRR objectives, as set out in draft Clause 4?

We agree although we question whether Clause 4(9) may be too uncertain - for example, how are conflicts between objectives to be resolved? (i.e. stability vs protection of public funds.)

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

Agree.

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

Agree.

- 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?

Agree although we find Clause 7(6) difficult to follow. Although objectives will clearly be independently assessed, they are still relevant to the exercise of power under Clause 7(1).

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

We agree, although we find Clause 8(5) difficult to follow. Its purpose appears to be that if the Treasury has provided funds, it should have input into the process. In some senses, we are not sure this is really necessary given Clause 9(3) which provides that the *'Bank of England may not exercise a stabilisation power in respect of a bank without Treasury's consent if the exercise would be likely to have implications for public funds'*, given that presumably this will constitute the vast majority of cases. One explanation may be that whilst this provision looks to the future, Clause 8(4) looks to the past.

Clause 9(3) gives the Treasury practical veto over most situations, though not in circumstances where there is a complete transfer.

Clause 10 - It is understandable that the Treasury should have final say in relation to the temporary public ownership route. That said, it is arguable that there is little practical or commercial difference between this option and the bridge bank where the bridge bank must be controlled by the Bank of England (Clause 12(1)) by way of holding all the shares, or at least a controlling interest. In a sense, both options create a temporary public ownership.

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

Agree.

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

Agree.

### **3. Chapter 3 – SRR Tools: Stabilisation Powers and Compensation**

#### **3.1 General comments**

Our answers to the questions set out in this chapter are as follows:

- 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?

These appear comprehensive, but:

- We query how effective Clauses 16(c) - (d) are going to be inasmuch as they relate to foreign property (in this regard, see Clause 20(3))
- Is Clause 17(1)(4) designed to deal with TUPE issues? It looks as though it is, in which case there is no need for further powers.
- The Clause 20 concept might be widened to include any property which has not, for whatever reason, been transferred.

- 3.2 What are your views on the nature of these powers?

They seem necessary if a quick transfer is required, subject to adequate safeguards being put in place for Human Rights, expropriation and related issues.

- 3.3 Do you consider that a company limited by shares, with the Bank of England as the sole or controlling shareholder, would be the most appropriate governance structure?

We agree, although see our comments at 2.5 above regarding the difference between a bridge bank and temporary public ownership.

We would also be interested to know how the transfer to the bridge bank would be treated for tax and stamp duty purposes, or would it be exempt?

- 3.4 Do you agree that the lifespan of a bridge bank should be limited? What do you think is an appropriate length of time?

Agree. We suggest that twelve months would be appropriate. It will also have to factor in State Aid considerations when considering timing.

- 3.5 Do you think that the extension of a bridge bank's lifetime should be subject to certain conditions? If so, what?

There must be some flexibility to extend the period, but conditions must relate to necessity, proximity of solution and Rescue and State Aid considerations.

3.6 Do you think that partial transfers increase the chances of the successful operation and sale of a bridge bank and the chances of a private sector purchase?

Yes but also potentially:

- open up the possibility of unfairness to those creditors left in the residual company in terms of relative valuation of entitlements; and
- create uncertainty for counterparties dealing with financial institutions (albeit it is noted that some attempt to address this has been made in the areas of netting, collateral and security).

3.7 Do you agree that guidelines, setting out when partial transfers might be used, should be provided in the code of practice?

Agree. The guidelines should cover the sharing of central overheads.

3.8 Would these guidelines provide reassurances about how the Authorities might use partial transfers?

If they clearly describe the circumstances when partial transfers can be used, yes, but this would also depend on what they actually say.

3.9 Do you agree with the situations in which it is proposed that the partial transfer powers could be exercised?

Yes.

3.10 What is the appropriate level of flexibility for the situations in which these powers can be used?

Flexibility leads to unpredictability, so the guidelines need to be very clear and to carry some statutory force if possible.

3.11 Do you think the Bank of England should have the flexibility to make subsequent transfers between a bridge bank and a residual company?

Yes – but see 3.13 below.

3.12 Do you think the Bank of England should have the power to make subsequent transfers using the stabilisation powers?

Yes – but see 3.13 below.

- 3.13 Do you agree with the restrictions the Authorities propose for subsequent transfers (that they should only occur between a bridge bank and a residual company and not involve moving liabilities from the bridge bank to the residual company)? Should there be additional restrictions?

Yes – The ability to ‘sanitise’ a balance sheet by separating out parts which have deteriorated could create uncertainty, not only for counterparties in general, but also an office holder appointed to the residual company if new transfers back from the bridge bank can occur. For example, an office holder may be ready to make a distribution, or may have already made a distribution, when the transfer of new liabilities or assets alters the level of distribution which ought to have been paid so that the officeholder has paid too much too soon.

- 3.14 Do you think that the bank resolution fund is an appropriate means for compensating creditors left in the residual company?

The consultation document is vague about how the bank resolution fund will actually work, so it is difficult to judge how it would compensate creditors in any particular case. Where the resolution fund order includes a compensation scheme order, the basis of valuation will be key. Creditors of the residual company should be compensated on the going concern value of the part of the bank transferred. Unfortunately the outcome of the resolution fund and the compensation scheme are matters outside the control of the special bank administrator. We comment further on this in paragraphs 3.2-3.4 below.

- 3.15 Do you agree that an explicit safeguard to protect set-off and netting arrangements is required?

Agree.

- 3.16 Do you agree with the risks of adopting a complete master netting arrangement safeguard?

Agreed.

- 3.17 Should the qualifying financial contracts approach be adopted, what do you think should be defined as qualifying financial contracts?

We have no fixed views, but presumably they should include swaps, repurchase agreements, forward contracts, and other similar non-exchange traded financial contracts. We agree that they should be specifically listed in secondary legislation, although there will be some significant problems with definitions given the multiplicity of types contractual arrangement which will need to be covered.

3.18 Can you suggest any alternative options for how the safeguard might be framed in a sufficiently wide but workable way?

We have no fixed views on this.

3.19 Do you agree that an explicit safeguard to protect structured finance arrangements is required?

Agree.

3.20 Do you have any workable suggestions for how the safeguard might be framed in a sufficiently wide but workable way?

We have no fixed views on this.

3.21 Do you agree that a safeguard to protect all security interests could make a partial transfer practically difficult?

Yes.

3.22 Which security interests should not be covered by this safeguard?

Floating charge over all assets, albeit as stated in the document, this type of security will only be granted by a credit institution in exceptional circumstances.

3.23 Do you consider that where part of a failing bank's business is transferred to a bridge bank, a special bank administration procedure may be required to deal with the residual company?

We suspect it might be slightly confusing, given that there is also intended to be a separate insolvency procedure for banks, in addition to all other procedures available. If modifications are required to existing processes, that may be an alternative way to proceed, although we can see the attractiveness of a special procedure.

3.24 Do you think that this special bank administration procedure should be confined to the residual company where a partial transfer is effected to a bridge bank or should it also apply, with any necessary modifications, where a partial transfer is effected to a private sector institution?

We believe it should be extended for consistency although continuity of services should be on commercial terms to benefit the administration .

3.25 Do you agree that the special bank administration procedure should have specific objectives?

Agree.

- 3.26 Do you agree with the objectives and their priorities as proposed above? In particular, do you agree that the objective of supporting the bridge bank should take priority?

Agree, subject to appropriate sharing of overheads and costs.

- 3.27 Should the grounds for commencing or applying for special bank administration be linked to the partial transfer of assets and liabilities to a bridge bank?

Yes, subject to the response to 3.24 above.

- 3.28 Should any other grounds be included in the legislation?

We are not sure what these would be.

- 3.29 Should the special bank administration procedure be commenced by an order of the court or initiated automatically by the direct appointment of a special bank administrator by the Bank of England?

We believe that court oversight would be advisable. We also believe that it would be helpful if the company and its board could apply for special administration.

- 3.30 Should the special bank administrator be an officer of the court, or in the interest of promoting the objectives of the SRR should he or she be subject to overall direction by the Bank of England, with the court ruling on any disputes arising in the resolution?

He should be an officer of the court.

- 3.31 Are the moratorium provisions outlined above sufficient for the purposes of a special bank administration procedure? If not, what additional measures would be required?

Yes – they are very similar to those found in special administration regimes for utility companies. There is a question of whether ordinary administration should be prevented.

- 3.32 Do you think that the existing powers of an administrator would be sufficient for the purposes of special bank administration?

Yes.

- 3.33 Should the special bank administrator be given any additional powers, including some or all of the powers of a liquidator outlined above? If so, what extra powers do you consider would be appropriate?

Yes. See comments in paragraphs 3.2-3.11 below.

- 3.34 Do you agree that the Bank of England should have a key role to play in the special bank administration procedure to facilitate the successful resolution of a bridge bank and to assist in the winding up of the residual company in the interests of its creditors generally?

Yes.

- 3.35 Should the Bank of England rather than an initial meeting of creditors be responsible for considering and agreeing to, with or without modification, the special bank administrator's proposals?

Yes (in common with the function of the regulator in other special administration regimes), but query also whether the Treasury also needs to be involved.

- 3.36 Should the Bank of England rather than creditors fulfil the functions of a creditors' committee?

Yes (in common with the function of the regulator in other special administration regimes).

- 3.37 Should the rights of creditors to challenge the conduct of the procedure be subject to restrictions to ensure that the principal objectives are not jeopardised?

It is not clear what is meant by 'the right to challenge the conduct of the procedure.' We agree that creditors should have the right to apply to the court, for example on the grounds of expropriation or for other reason where they believe they have been disadvantaged by the process. However, as we argue in paragraph 3.4 below, they should not have the right to attack the administrator personally for actions which he has taken in good faith, given the administrator's limited powers and role.

- 3.38 Do you agree that there should not be any substantial change to the ordinary statutory order of priority of creditors in this special bank administration procedure?

Yes.

- 3.39 Should any special provisions relating to statutory set-off be introduced within a special bank administration procedure?

Yes. See further our comments in paragraph 3.7.

3.40 Do you agree that the procedure should only be terminated where the Bank of England provides consent?

Yes.

3.41 Do you think the provisions should be made for a variety of ways to bring the procedure to a close, including conversion to ordinary insolvency procedures?

Yes.

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

Yes.

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?

Yes.

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?

Yes.

3.45 Do you agree that the bank resolution fund should comprise only the net proceeds of resolution (that is, less the costs of resolution)?

This seems sensible if the bridge bank is viewed as a 'look through' vehicle. However, see our comments in response to 3.14 above and in paragraph 3.3 below. What will the position be if it is not possible to sell the bridge bank on?

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

Yes.

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?

Yes.

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

There are no real principles set out here, only vague parameters, so it is difficult to comment. But see also our comments in response to 3.14 above, and in paragraph 3.3 below.

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

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

Agreed, but how would this be managed if there was a private sale following a partial transfer to a bridge bank, and how would this tie in with the bank resolution fund in such circumstances?

3.51 Should any of the costs described above not be covered by the FSCS, under the Authorities proposals? Please explain why?

We have no fixed views on this.

3.52 Are there any additional costs of resolution which could be borne by the FSCS?

We have no fixed views on this.

### **Partial transfer to bridge bank – additional comments**

#### **Special bank administration procedure**

3.2 The proposed special bank administration procedure for the residual company raises a number of questions. The role of the administrator in the process would appear to be quite circumscribed, and his powers limited. We can understand the need to ensure the continuation of the residual company in order to facilitate and support the operation of the bridge bank, but this is largely an administrative function. What is not clear to us is the extent to which the administrator will be able to influence the eventual return to the creditors of the residual business. There may still be assets in the residual company for the administrator to realise, but it would appear from the proposals set out in the document that these are likely to be the most impaired. It appears that the eventual return to the creditors will depend mainly on the proceeds from the bank resolution fund once the bridge bank has been sold on. The outcome of the bank resolution process will be outside the administrator's control, and he will effectively just act as a conduit for distributing the resulting proceeds to the creditors of the residual company.

- 3.3 The consultation document is vague about how a resolution fund will be structured and will operate. It appears from the draft Clauses, in particular Clauses 24 and 31, that it will have to be tailored specifically to the circumstances of each case, and this may be why there so few details set out in the document. Furthermore, a resolution order may also include a compensation scheme order, which will involve an independent valuation. In such cases the outcome will be affected by the valuation principles adopted by the valuer. For example, if the valuation is conducted on the basis that the bank is being wound up, the amount of compensation accruing to the transferor will be less than if it is conducted on the basis that it is a going concern.
- 3.4 In view of the fact that the creditors of the residual company may suffer a worse outcome than if they had been transferred to the bridge bank, and in view of the fact that the outcome of the bank resolution fund (with or without a compensation scheme) is outside the administrator's control, we would like to see some statutory protection for the administrator against claims by creditors that they have been prejudiced by the special administration procedure. This could take the form of a provision that the administrator is not liable in respect of actions taken in good faith.

### **Additional powers of administrator**

#### **Disclaimer**

- 3.5 We agree with the suggestion that the administrator should have the power to disclaim onerous property. This would help to minimise the danger of associated costs having to be paid as an expense of the administration to the detriment of creditors.

#### **Power to bring proceedings**

- 3.6 We have no difficulty with the suggestion that the administrator should have the power to bring proceedings for fraudulent trading and wrongful trading. However, thought would have to be given to how such proceedings should be funded, and how such funding should be approved.

#### **Power to make a distribution to unsecured creditors**

- 3.7 We also have no difficulty with the suggestion that an administrator should be able to make a distribution to creditors. However, the Financial Markets Law Committee (FMLC) has recently issued a paper drawing attention to difficulties arising from the application of the set-off rules in cases where an administrator makes a distribution.\*

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\* *Issue 108: Administration set-off and expenses – Legal assessment of rule 2.85 of the Insolvency Rules 1986 and its interplay with other insolvency provisions in respect of post-administration liabilities owed to counterparties*, November 2007

- 3.8 This is because of the statutory set-off provisions which come into play when the administrator gives notice of his intention to make a distribution. The rules provide that where there have been mutual dealings between the company and a creditor, the amounts due from each to the other shall be set off and only the balance will be due. However, they also provide that the mutual dealings taken into account when calculating set-off do not include debts arising out of obligations incurred after the company went into administration or after the creditor had notice of an administration application or notice of intention to appoint an administrator. In other words, the cut-off date for set-off purposes is the date of administration or earlier date of notice of the administration. The policy behind the cut-off date is to prevent the creation of claims, or the trafficking in claims, after the creditor knew, or should have known, that an administration was imminent. However, these provisions only apply if the administrator gives notice that he proposes to make a distribution to creditors. If the administrator does not propose to make a distribution, then the administration set-off rules will not come into play.
- 3.9 The FMLC points out that this makes it difficult for a counterparty to determine which set-off rules will apply to it, and whether any liabilities incurred by the company after the beginning of the administration will be available for set-off. A counterparty which has dealings with the company may have independent or contractual rights of set-off on which it can rely in its normal course of dealings. However, such a counterparty may not know at the outset of the administration whether the set-off rules will come into play. If they do not, then the counterparty will continue to be able to rely on its existing set-off rights. On the other hand, if the administrator decides to make a distribution, thus bringing the set-off rules into play, then the cut-off will be back-dated to the commencement of the administration (or earlier notice) and any claims incurred or acquired after that date will not be available for set-off.
- 3.10 The FMLC puts forward various proposals for dealing with this, including allowing administration expenses incurred before the administrator gives notice of his intention to make a distribution to be treated as mutual dealings for the purposes of set-off. Further thought will need to be given to this question if this proposal is to be adopted.
- 3.11 In paragraph 3.120 the document states that where the special bank administration is converted to a voluntary winding up, set-off would apply from the date the liquidation proceedings commenced. It is true that statutory set-off would apply as at that date (or rather the date the company goes into liquidation, which is technically different). However, Rule 4.90 of the Insolvency Rules 1986, which deals with liquidation set-off, states that debts arising out of obligations incurred during a preceding administration, or when a creditor had notice of an administration application or notice of intention to appoint an administrator, are not to be taken into account for the purposes of statutory set-off. In other words, in a liquidation which is preceded by an administration, the cut-off date for set-off is back-dated to the commencement of the administration (or earlier notice), and the problem identified by the FMLC will still apply.

## 4. Chapter 4 – SRR Tools: Bank Insolvency Procedure

### 4.1 General comments

In our response to the January 2008 consultation document *Financial stability and depositor protection: strengthening the framework*, we argued that the easiest way to expedite compensation payments to depositors would be to change the FSCS rules to make entry into the special resolution regime an automatic default for FSCS purposes. We suggested that this would obviate the need in these circumstances to implement a special insolvency regime simply to enable the payment of compensation. We continue to believe that this is a viable alternative approach.

Subject to this overriding proviso, our answers to the questions set out in this chapter are as follows:

- 4.1 Do you agree with the provisions for entry into the bank insolvency procedure, as set out in draft Clauses 38-41, 60 and 62?

Agree, but should it not be a condition that none of the stabilisation powers apply or are workable?

- 4.2 Do you agree with the provisions for the appointment and objectives of the bank liquidator, as set out in draft Clauses 37, 42, 46 and 47?

Yes, subject, in the case of Clause 42, to our overriding proviso concerning the need for this procedure set out above.

- 4.3 Do you agree with the provisions for the powers and responsibilities of the bank liquidator, as set out in draft Clauses 47, 48, 61, 63 and 66?

Clause 61 – This seems unobjectionable, but we wonder why these restrictions imported from the administration procedure are required.

Clause 66 – Why is this necessary?

- 4.4 Do you agree with the provisions for the liquidation committee, as set out in draft Clauses 44 and 45?

Yes, but we query why a formal committee is needed if this is just to give the FSA, Bank of England and FSCS oversight. If a fuller committee is appointed, do these entities' powers become diluted?

- 4.5 Do you agree with the provisions for the end of the bank insolvency procedure, as set out in draft Clauses 50-58?

Yes.

## **5. Building Societies and Other Issues of Scope**

5.1 Do you agree that the objectives, roles of the Authorities and governance of the SRR should not differ for building societies and banks?

Yes.

5.2 Do you agree that the Authorities should have powers to disapply statutory requirements including the principal purpose and lending and funding limits, for the residual element of a building society following a partial transfer?

Yes.

5.3 Do you agree that there should be a special building society administration procedure for building societies in the event that part of a building society's business is transferred to a bridge bank?

See comments above.

5.4 Would temporary public ownership be a useful tool for resolving a failing building society in some circumstances?

Yes, but see comments above in relation to bridge bank.

5.5 How would this tool best be improved in the case of a building society, given the lack of applicability of the share transfer power?

By taking actual control of board mechanisms.

5.6 Should a set of principles be established to determine how compensation is distributed between members of building societies? If so, what would be the most appropriate fair and equitable principles?

We would have thought that compensation to building society members should be shared on the same basis as shares are allocated to building societies which de-mutualise, for example in proportion to deposits, balances etc.

5.7 What are the risks in creating a pre-determined set of principles for distributing compensation?

We have no fixed view on this.

5.8 Should the former members have a say in how compensation is distributed?

5.9 Do you agree that the Government should legislate to enable the Treasury to create, alter or nullify contracts between group companies, and introduce duties for group companies (where necessary) to cooperate with the use of these powers?

Agree, especially where there are service companies within bank groups dealing with employees, IT, etc.

Association of Business Recovery Professionals  
15 September 2008