

Memo



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To Banking Reform Team

From Paul Smee, Chief Executive
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DRAFT RESPONSE TO CONSULTATIONS ON FINANCIAL STABILITY

Introduction

The Payments Council, in conjunction with the payment schemes with which it has a contractual relationship, is pleased to offer the following comments on the Further Consultation on Financial Stability and Depositor Protection; and on the specific consultation on an SRR. Our response focuses on the possible impact of the Tripartite's proposals on the payment systems.

Summary

Our key points are:

- i) We welcome the proposal that there is a single statutory overseer for payment systems and believe that the proposed method by which oversight will be exercised is proportionate and appropriate.
- ii) It is important that the overall integrity of the payment systems cannot be inadvertently undermined by the operation of the SRR or any other measure in the forthcoming legislation. We are keen to see the position of the payment systems protected and would especially hope to see the settlement agreements which underpin each payment scheme preserved under all circumstances.
- iii) We have identified that there are particular complexities and risks for payment systems when the business of a bank is partially placed in an SRR. We appreciate that the authorities want to have legislative backing for any possible circumstance; but we question the practical viability of a partial transfer in any situation. We believe that the authorities need to be very specific about the occasions on which they would anticipate using such a power; and should appreciate the added complexity which it brings to the legislation.

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- iv) We are working with the British Bankers Association to establish the practicalities of maintaining limited access to payment systems post-insolvency, as a means of facilitating controlled access by depositors to their funds. If technical connection is possible there will of course be a need for assurances that the settlement obligations of the failed bank will be met.
- v) We will of course work with those running an SRR to make any transfer of bank accounts as painless and seamless a process as possible (building on the processes which schemes and the industry have already in place). But we believe that, as far as possible, depositors should select the destination for their own accounts, facilitated by the operation of the SRR.
- vi) As further work on the detail of the SRR continues, we look forward to cooperating with the authorities in its development. We will endeavour to take steps to harmonise the governance and settlement arrangements with the aims of the proposed SRR, but recognise that it will take time to analyse the changes required to bring this about.

Our more detailed comments follow.

Further Consultation on Financial Stability and Depositor Protection

Oversight of Payments Systems.

The Payments Council believes that the current non-statutory oversight of payment systems has worked well and is pleased that the proposed statutory framework will essentially build on what is already in place. We are also pleased that oversight is not going to be split between different regulators as this would have complicated the handling of cross-scheme issues and would have introduced inefficiencies. We agree with the Tripartite that given that decision the logical place for a single overseer is at the Bank of England. We will work constructively with the Bank as it develops its oversight regime.

We are also pleased to see that the Bank will continue to use its existing oversight tools, whatever additional powers are available in the legislation. We do not believe that the existing regime has exposed any deficiencies in the current tool set.

As for the recognition process, we had no particular preference for the institutional route to be followed, provided that it delivered suitable transparency and clear overall responsibility; so we are happy with what is proposed. We are also happy with the suggested criteria for



recognition. We note that the payment schemes with which the Payments Council has a contract all meet the criteria for recognition – with the exception of the Belfast Cheque Clearing, the US Dollar Clearing and the Cheque Card Guarantee Scheme. This accords with our view of the systemic significance of these schemes.

We note that the Tripartite has decided that there will be a distinction between schemes which require recognition and those which do not; and has rejected our idea that all schemes should be recognised and then regulated proportionately. There should be no competitive advantage created for a scheme because of its recognised (or non-recognised) status. This, in our view, emphasises the need for regulation to be proportionate.

We note that credit and debit card schemes are outside the proposed scope. We would be interested in the reasoning for this being spelled out, given the significance of card payments to overall economic life in the UK. We also note that there is no reference to the scheme in accordance with which notes are handled.

We agree that the list of recognised systems will need to change over time. The Bank of England will need to keep under review those businesses which offer payment facilities but are not regarded as schemes because of their low volumes and consumer impact. If these providers expand, they may well fall within the scope of regulation and it would indeed distort the market if they did not.

We agree that the Bank of England should publish principles for those who run payment systems. We would expect them to reflect the Core Principles, with any appropriate and minimal modification and amplification. We would expect the overseer to be under a duty to consult before making or changing such principles. We would hope that, given the history of payment system oversight, there would be no need for over-prescription and embellishment of any principles.

As for the proposed powers of the overseer, we note the intention that these should be exercised only after more informal approaches had been tried. This seems to us to be exactly the right way to deploy these arrangements.

We think that the power to disqualify a scheme manager is extremely unlikely to be used and we question whether it is really necessary, given the governance and oversight arrangements which are in place. In the same spirit we caution that a payments system could not in practice be closed until a substitute system was in place to take over.



The Special Resolution Regime

Principles of the SRR

The Payments Council supports the principles behind an SRR, especially the idea of intervention at a pre-insolvency stage to stabilise a failing bank and to maintain or restore some net worth, if at all possible. Our comments are not about the governance of the systems and are primarily concerned with their practical impact. We note the authorities' concern that depositors should not be deprived of access to their accounts and we will make practical suggestions about how this can best be achieved, as the payment systems can make a major contribution to this objective.

We consider that the SRR will work in the most effective manner if the failing bank's payments and account management infrastructure are left untouched as far as possible. The prime role of the regime would thus be to inject new management and/or financial resources into the existing organisation, whilst allowing services to be provided to customers by the same means as before. Any forced change in the provision of account services will both rely on the adequacy and robustness of existing systems (which cannot be taken for granted) and take time to deliver.

We note that there will be a further code of practice concerning the use of the SRR tools. We suggest that it would be useful for this document to cover the relationship of the SRR to the financial infrastructure, including the payment systems.

We welcome the decision not to create a special insolvency regime for banks, as we believe that it would have caused considerable difficulties for the operation and integrity of the payment systems.

Partial Transfer of Business

We appreciate that the authorities will wish to have a wide range of powers and regulatory tools at their disposal as they construct the SRR. But we do feel obliged to highlight the considerable difficulties which a partial transfer of a failing institution's business raises for payments.

In the payment systems, banks are recognised by sort code on a whole bank basis; accounts are identified by account number underneath the sort code. Different banks manage the relationship between account number and sort code differently. Some have



developed a strategy where types of business are allocated a particular range of sort codes; others are allocated on different bases. To sort out particular types of customer by sort code and account number would be a task of considerable magnitude. It would be almost impossible in a short time to allocate a range of sort codes to identify one part of a bank and a similar range of sort codes to identify another. So the split of accounts between two destinations would be fraught with difficulty and there could be no guarantee of complete accuracy. The risk is that accounts would be duplicated in two different institutions which would not be a tolerable situation for customers, especially as it would appear that different rights accrue to customers, depending on where their accounts end up. The authorities should not think that, even were this power to be available to them, it could be safely used, even in the most exceptional circumstances, without high risk of error and confusion.

Transfer of Accounts from Failing Banks

The mass transfer of accounts from a failing bank to an alternative institution could be done but it would be time-consuming and open to risk. It has been done, for example in the case of ex-building societies merging with banks, but it has been a slow process. It also depends crucially on there being sound records on which to base the transfer; as we have noted in previous responses, there is no guarantee that a failing bank will have maintained wholly accurate records and a transfer could only be contemplated after that exercise had been completed.

Additionally, if customers' accounts are moved to a new bank, new debit cards and possibly cheque books would have to be provided. This would take time and the task could not begin until the new accounts had been opened. Distribution of the cards and associated PINs separately would take further time. The fraud risk in a large scale enterprise of this kind would be significant.

This reinforces our belief that every effort should be made to avoid this movement of accounts and to allow customers to use their existing arrangements until each can make their own decision on a transfer and we recommend that the authorities normally rely as far as possible on the maintenance of existing accounts and existing account numbers within an appropriately managed institution.

We believe that the banking industry has worked hard over the past few years to provide customers with the ability to move simple banking business between banks (creating for example an agreed set of standards for providing basic bank accounts and for transferring



Direct Debit and standing order information directly between banks). We are committed to continuing co-operation in this area and we believe that it can work in the circumstances of a failing bank, if confidence has been restored by the introduction of new management and new ownership arrangements.

We believe that this is the “bridge bank” envisaged by the authorities in their references. We see it as the most appropriate and convenient vehicle for maintaining the desired access of customers to their funds and for giving them the scope to select an alternative provider and to transfer their money to a new account. We would be content with a model where the Bank of England acted as sole shareholder of such an institution.

Bridge banks

It is possible that a failing institution could be a member of a payment scheme and that the authorities and the new management would wish to continue that membership. That would, after all, be in line with the principle of maintaining access to accounts for customer sand allowing “business as usual”. But it does raise some difficult issues. System operators and other members of the scheme would have to be assured that the bridge bank was suitably backed so that it could meet its obligations; and equally, its position under the loss-sharing agreements would have to be assessed. If the authorities decided to remove the bridge bank from participation in a scheme, there could be no question of its obligations being picked up by the other participants. The bridge bank would have to have a settlement account at the Bank of England and be accepted into membership of the schemes concerned (having agreed to sign up to the rules of the scheme(s), demonstrate technical ability to use the systems, provide certain legal assurances etc). We do not think that the existing membership of the failing institution could simply be switched to the bridge bank and there would have to be assurances from the authorities concerning the standing of the bridge bank. The operators of the scheme would need protection from liability if they were to work with the bridge bank. This process would inevitably take time. Were membership of the cheque clearing to be contemplated, contracts would have to be created with cheque processors who are not part of the payments system infrastructure and this would be protracted.

Given these additional complexities, it may be preferable for a bridge bank not to become a direct member of the payment systems but to use other members of the clearing schemes as appropriate. We will consider whether changes to the rules of the relevant payment schemes would facilitate the bridge bank being accepted into membership if the authorities were prepared to take on the obligations of membership.



As we understand the proposals, there would be no question of the failing bank being put into insolvency/administration as part of the process of creating the Bridge Bank. This is the right way forward and an important point. As mentioned in previous responses, all the payment systems contain provision for the system operators to suspend or exclude members in the case of certain events of default (of which insolvency or inability to pay debts or making arrangements for the benefit of certain creditors are some).

Qualifying Financial Contracts

Members of Bacs, C&CCC and Faster Payments have adopted the schemes' rules and have entered into agreements which govern the membership rights and obligations of members, the way in which payments obligations are calculated in a multilateral net basis and settled in arrears at the Bank of England, and also the arrangements to maintain orderly settlement in the event of the failure of a member (together "settlement documentation"). This settlement documentation has been put in place as a co-operation between the members concerned in response to the publication of the Core Principles¹, especially the Principles concerned with multilateral systems. Although they are not statutory instruments the documentation is designed to give certainty to an area of insolvency law which would otherwise still contain uncertainties (especially as applied to multilateral net settlement which is the basis used in Bacs, C&CCC and Faster Payments) and comprises legally binding contracts. It also sets out a process under which payments which are working their way through the systems (which takes up to three days) can continue through to settlement.

These arrangements should not be capable of being unpicked or over-ridden by those operating an SRR (or by those seeking to challenge an SRR). We therefore strongly request that the settlement documentation should be included within the list of QFCs and their status – and the ability of the payment systems to continue to operate – is put beyond dispute.

1 The Core Principles for Systemically Important Payment Systems
(<http://www.bis.org/publ/cpss43.htm>)



Further Consultation on Financial Stability and Depositor Protection

Faster Compensation payments

We note the authorities' commitment to a target of seven days for providing depositors of a failed bank with access to (a proportion) of their funds. We are concerned that this target raises significant practical difficulties for individual banks, in particular:

- i) the target may not be achievable in all circumstances, for example where the cause of the bank's failure is a catastrophic failure of its systems;
- ii) even where the bank's systems are reliable, it will take time to establish the true balance on qualifying depositor's accounts. For example, payments in flight in the bulk payments systems take up to three days to be cleared and settled;
- iii) many customers have several different types of accounts with their bank to provide savings, mortgages, and insurance as well as standard current account services. It will take time to aggregate these into eligible compensation balances and the difficulties will be compounded in cases where the services are spread across different brands within a banking group;

In addition, the settlement documentation referred to above provide that an insolvent bank should be prevented from participating further in the system. Whilst it would be technically possible to reconnect an insolvent bank to a system, this would require suitable authoritative assurances that the failed bank would perform its financial and technical obligations and that the system itself would not suffer and, again, suitable protection from liability for the system operators. With the exception of Faster Payments, it is not possible to block payments traffic in one direction only, so that payments could flow into an insolvent bank as well as out. And because Cheque and Credit relies more than the other systems on manual processing the blocking and re-connection of an insolvent bank in this system would be slower and less reliable.

We support the work that the British Bankers Association is doing to evaluate the hurdles to swift payout of qualifying compensation payments and will continue to provide payments systems input.

Agency Banks

We note that the FSA will work with indirect members of payment systems to ensure that contingency plans are in place, in case a sponsor bank fails. The Payments Council and the payment systems are ready to contribute to such work as appropriate; we do not



believe that there are significant obstacles to the authorities' objectives in the way in which systems currently operate.

Floating charges (paragraphs 3.79ff).

Certain banks operate as settlement banks in CREST² and frequently give credit to their customers to enable them to purchase securities. This credit is often secured by means of a floating charge over the customer's assets held in CREST and underpinned by the principles contained in Part VII of the Companies Act 1989. If the customer is a bank subject to a SRR it would be important to ensure that no damage is done to this arrangement if a transfer or partial transfer of property is contemplated.

Special bank administration procedure (paragraphs 3.80ff).

It is unclear what advantage there is in confining the special procedure to the residual company where a partial transfer is effected to a bridge bank and not where a partial transfer is effected to a private sector institution. Could there be clarification, please?

Banks which are part of larger groups (paragraphs 5.36ff).

We repeat how difficult it is to separate a single institution's customer account identity systems between two or more institutions. If the deposit taker within a group shares accounts identity systems (for example sort codes) with other group service providers it would be difficult not to keep that system open across the whole group.

Position of Building Societies

We note the intention of the authorities to make provision for building societies as part of this legislation. Building Societies can, of course, be members of payment systems.

There is one specific change which we believe should be encompassed within these provisions:

Charges for Building Societies

² The securities settlement system, managed by Euroclear UK and Ireland, that settles transactions in UK securities (UK gilts, commercial bonds, equities and money market instruments) traded in London.



We have mentioned above the settlement documentation used in Bacs, Cheque & Credit and Faster Payments. This documentation provides for members of these systems to put up collateral as part insurance against their own failure. Where the member is a building society there are significant legal barriers to its ability to put up collateral in the same form as the bank members. Payments Council urge the Authorities to extend the ability of building societies to grant a floating charge over assets in relation to the provision of liquidity support by central banks (provided for in The Building Societies (Financial Assistance) Order 2008) to include the kind of public benefit arrangements afforded by the settlement documentation.

Registration of legal charges

Such a change could usefully be extended to the registration of legal charges. The settlement agreements mentioned above provide that the charge over collateral put up by members of Bacs, Cheque & Credit and Faster Payments should be registered at Companies House. Although it is unclear that such a registration is strictly necessary under the regulations governing the registration of fixed or floating charges, members and the systems overseers consider it preferable to err on the side of caution. Payments Council urge the Authorities to remove this lack of clarity by specifically extending the exemption from registering charges granted against receipt of liquidity assistance from the Bank of England to the kind of public benefit afforded by the settlement documentation.

Liquidity support

It follows from our comments that we much welcome measures which facilitate the efficient management of the Bank of England's mechanisms to provide liquidity support, both in a business-as-usual context and in emergencies. Payments Council members welcome proposals that will enable them to take advantage of the Bank's facilities from time to time without adverse publicity and/or unwelcome speculation.

Strengthening the Bank of England

We have no comment on the proposed changes to the Bank of England's governance or the new policy instruments to be made available to it. We broadly welcomed these proposals in our response to the last consultation.

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