



FINANCIAL STABILITY AND DEPOSITOR PROTECTION: STRENGTHENING THE FRAMEWORK

Comments by the Association of Business Recovery Professionals ('R3') in response to the consultation document issued by the Bank of England, HM Treasury and the Financial Services Authority in January 2008

Introduction

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.
2. Our response is confined primarily to the matters discussed in chapter 4 of the consultation document on reducing the impact of failing banks, as this is the area with which our members are most familiar in the course of their professional work.

Summary

3.
 - The primary policy objective when dealing with the problems caused by a failing bank should be maintaining the continuity of essential banking services.
 - To this end we agree that there needs to be a special resolution regime.
 - Whether there also needs to be a special insolvency regime is less clear-cut, and depends to a large extent on the nature and scope of the proposed special resolution regime. It is unlikely to be possible to maintain the continuity of banking services once the bank has entered a formal insolvency process, unless exceptional provisions are made, as indicated in paragraph 11.
 - The expedited payment of depositors' claims is an important objective, but may be secondary to that of maintaining the continuity of banking services.
 - In order to achieve this objective, the efficiency and robustness of banks' internal systems is more important than the statutory purpose of any special bank insolvency regime.
 - Some of the proposals put forward in the consultation document need to be worked out in further detail in order to gain a clearer idea of how they would work in practice.

The Special Resolution Regime

4. Where a bank is failing, the most important thing is to keep essential banking services functioning. This means allowing customers to continue to be able to operate current accounts and have access to the services which these make available, such as direct debits, receipt of salary payments etc. Inability to access such services could paralyse the financial affairs of most of the bank's customers and cause considerable hardship. We agree that there should be a special resolution regime in order to maintain the continuity of such essential services. However, once a formal insolvency process has begun, it is unlikely to be possible for the insolvency office holder to maintain the continuity of banking services unless exceptional provisions are made, for the reasons we set out in paragraph 11. We therefore assume that the first two elements of the special resolution regime (the directed transfer and the transfer to a bridge bank) are intended to be used as the principal mechanism wherever possible.
5. We agree that implementation of the special resolution regime should not be circumvented by the commencement of normal insolvency procedures. Under existing arrangements it is not possible to enter a formal insolvency process without first giving notice to the Financial Services Authority. In practice, though, this does not provide much protection given the speed at which a bank can fail and given the urgent and overriding need to protect investors and the markets.
6. It is also important to ensure the prompt payment of compensation, but this may be secondary in our view to the need to maintain essential services. There may be a conflict between these two objectives if they are to be simultaneously attempted within a single procedure. However, this depends on how it is intended that the special resolution regime will be structured and operated, which is not entirely clear from the consultation document.
7. The proposal that the special resolution regime should include an expedited transfer of the failing bank's business to another institution or to a bridge bank is clearly sensible, and in theory should achieve the objective of maintaining essential services. However, the consultation document talks of the transfer of 'all or part' of the failing bank's business. It is not clear exactly what is meant by this. Presumably the transfer of all of the bank's business would remove the need for the payment of compensation by the FSCS, as all depositors would be safeguarded under the transfer arrangements. However, if only part of the business was transferred, presumably there might still be the need for the payment of compensation to unprotected depositors. This needs more detailed consideration, particularly as, whatever the extent of the transfer, a run on the bank is going to be very difficult to avoid. The considerations are clearly very different in the case of a retail/mortgage bank as opposed to an investment bank, and it is worth considering whether the same framework is appropriate for both.
8. It is not clear from the consultation document whether the implementation of the special resolution regime is intended to be a public act. Even if it is not, it will in practice be impossible to prevent the information from getting into the

public domain. It will therefore be a matter of public knowledge when a bank enters a special resolution regime and this is likely to trigger a run, all the more so if there are any depositors who are not protected by the transfer arrangements. This would further exacerbate the bank's liquidity problems. It may even happen before the special resolution regime is put in place, because news of the preparations may well escape and fuel market rumours. We do not know what the answer to this is, but it is an important point that needs more detailed consideration.

The Bank Insolvency Procedure

9. The third element in the proposed special resolution regime is the bank insolvency procedure. It is not entirely clear from the consultation document how this is intended to relate to the other elements of the regime, i.e. whether it would run in conjunction with a transfer of all or part of the business, or in succession to it, or as an alternative where for some reason no other remedy has proved possible.
10. We have mentioned that it is unclear how the transfer elements of the special resolution regime would work. If the idea is that all customers would be protected so that there would be no need for compensation under the FSCS, then existing insolvency procedures would be adequate to deal with the failed bank's residual business and assets. On the other hand, if there would still be a need for the payment of compensation under the FSCS, the easiest way to expedite this would be to change the FSCS rules to make entry into the special resolution regime an automatic default for FSCS purposes. This would obviate the need in these circumstances to implement a special insolvency regime simply to enable the payment of compensation.
11. If the bank insolvency procedure is intended to be used as a last resort when no other course of action has proved possible and the other elements of the special resolution regime cannot be brought into play, which seems to be suggested by paragraph 4.35 of the consultation document, then there are two points to note. First, unless special provisions are made, the insolvency practitioners will be unable to run the bank in the insolvency because no other bank will be willing to do business with the failed bank, and payment systems will therefore have ceased to function. It will therefore not be possible to maintain the continuity of essential banking services for customers. The social harm which would be caused by the denial of access to banking services could be mitigated, but only by a policy commitment to make wholesale changes to insolvency law to enable the insolvency practitioner to operate the bank. This would probably need to include, for example, indemnities by the authorities to the insolvency practitioner and other participants in the clearing systems. However, such measures are beyond the scope of the present paper.
12. Secondly, in so far as the primary purpose is to facilitate the payment of compensation, the efficiency and robustness of the banks' own systems are just as important as the statutory purpose of the insolvency procedure. Prompt payment of compensation is only possible if accurate information can be extracted quickly from the bank's internal systems, and if the systems are

capable of dealing with the heavy demands placed upon them in these circumstances. All banks should be required, as part of the general regulatory regime, to have systems which can perform to the required standard in the event of default. We understand that this is the intention of the tripartite authorities.

13. In these circumstances, we can see the logic of having a special insolvency regime with the specific statutory purpose of assisting the FSCS to pay compensation to depositors, as the normal statutory purposes of administration probably do not accommodate this. As stated above, the most serious effect on the public (both individual and corporate) in our view, is the suspension of access to banking services, and we would expect a special insolvency regime to provide the appointees with a duty to assist with the transfer of accounts to the designated bridge bank or other third party institution.

Speeding up compensation payments

14. The consultation document suggests in Chapter 5 that the FSCS should aim to make compensation payments within seven days. The FSCS is not presently sufficiently resourced to process large numbers of claims this quickly, and to meet this target there would need to be much more resource combined with the requirement for the necessary electronic systems to be in place. We also have doubts about whether depositors should receive compensation before they would be entitled to withdraw the funds on deposit under the terms agreed with the bank.
15. In the context of the proposed bank insolvency regime, arrangements could be made for the insolvency practitioner to use the bank's own systems to make the payments with funds provided by the FSCS. We do not recommend a same-day mass mailing of cheques; rather, the system should be designed to facilitate access to funds in the way that the account has traditionally operated, e.g. internet electronic transfer etc. To go to great lengths to break a deposit in order to send a cheque in short order to a person who has no bank account into which he can pay it, and thereby risk misappropriation of the cheque, identity theft and a host of other such dangers, does not seem desirable to us.
16. We agree with the suggestion that compensation payments should be made gross for the reasons given in the consultation document. As the document acknowledges, this would require special set-off provisions to be applied in the bank insolvency regime to deal with the treatment of the FSCS's subrogated claims. We should be grateful if we could be included in any further consultation on this point.

Other matters

17. Money laundering

In order to ensure continuity of banking services, there should be no delays caused by the 'know your customer' rules when accounts are transferred to another institution under the special resolution regime. The new bank should

be able to rely on the failed bank's identity checks, as suggested in paragraph 5.62 of the document.

18. Tax-efficient savings vehicles

Customers with tax-efficient products such as ISAs and TESSAs should not be penalised if the accounts are terminated by reason of the bank's insolvency.

Conclusion

19. We agree with the overall thrust of the proposed special resolution regime set out in the document. However, the proposals as currently formulated leave a number of questions unanswered, and more detailed consideration needs to be given to how the special resolution regime would work in practice, and how the bank insolvency regime should operate and interact with the other elements of the regime.

20. We presume that the proposals will be developed in greater detail through subsequent discussion papers, and we should be grateful if we could be kept informed of progress and included in any further consultations.

Association of business Recovery Professionals
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