

HM Treasury

Financial Stability and depositor protection: strengthening the framework

The Law Society of Scotland's Response

April 2008

INTRODUCTION

The Banking Law Sub-Committee of the Law Society of Scotland ("the Committee") welcomes the opportunity to consider the HM Treasury Office's consultation on financial stability and depositor protection and has a number of comments to make on some of the issues raised in the consultation, which are set out below.

CHAPTER 1

The Committee considers this is an important consultation with significant consequences for the banking industry. The important issues raised in the consultation are justified by the seriousness of recent events in banking and the new provisions proposed may prove to be useful tools in such situations in the future. The Committee would, however, express a general reservation that there is a possibility that if regulators are perceived as interfering with the management of banks, this may trigger the lack of confidence in banking institutions which the proposals seek, in part, to avoid. The Committee considers that, in many cases, the existing regulatory regime provides many useful protections which, if properly used and enforced, could avoid some of the more extreme measures set out in the consultation.

CHAPTER 2

The Committee agrees with the position put forward in the consultation that there should be further emphasis on stress testing by banks and other financial institutions. The Committee considers, particularly, that when considering risk management in the context of Basel II there has not been adequate focus on the need to manage legal risks, which has left some banks

over-exposed to the possibility of failure.

CHAPTER 3

3.8 To what extent is the current provision to register charges at Companies House relevant to banks? Do you agree that it is appropriate to amend it?

3.9 Should any exemption for banks only apply to receipt of ELA, or should there be a more general exemption for all types of lending?

The Committee acknowledges the potential difficulties surrounding the publication of charges at Companies House and within the company's own register in the event of ELA being received, which could at the worse extreme, lead to a run on the bank. The Committee does not consider, however, that this should lead to a change in the current requirement on the registration of charges. The requirement for public registers to be kept complete and up-to-date and public trust in the accuracy of these registers are important elements in the proper functioning of both the legal system and the market. As the consultation acknowledges, any departure from that norm could leave third parties acting in good faith exposed to inappropriate risk, and may raise the possibility of a detrimental effect on the level of public trust in the registers. Therefore, if such charges are granted in the context of ELA they should be subject to the same requirements to appear in the public registers

As an additional point, the Committee considers that, while it is reasonable for such security to be required, this should only be applied to new advances, as otherwise it would give the Bank of England priority over other creditors.

CHAPTER 4

The Committee has a number of comments with respect to the special resolution regime the framework for which is set out in Chapter 4 of the consultation document. In general terms, the Committee acknowledges the purpose of the regime and the need for a mechanism in this area but has some concerns about the operation of the scheme as elaborated in the consultation.

Question 4.1

Do you agree that there should be a special resolution regime for banks?

The committee notes that the Financial Services Authority already has wide-ranging powers to deal with many of the issues arising in the context of a potential bank failure. These have not always been used to their full extent and the committee considers that a number of useful tools are already at the regulator's disposal without any further regimes being put in place. The Committee considers that this is an extremely important issue, given the far-reaching nature of the Special Resolution Regime, the considerable powers which it will confer on the Authorities and the potential effects of its application. An SRR should only be triggered therefore as a very last resort, once all other interventions had failed, and the Committee elaborates its views on that trigger mechanism in the following paragraphs.

The Committee further considers that the sorts of tools offered by the SRR should be used only on a strictly temporary basis, to deal with acute situations. If they are operated on anything other than that basis, then there exists the risk of prejudice to a number of other parties.

Question 4.2

Do you agree that the trigger for a bank entering a special resolution regime should be based on a regulatory judgment exercised by the FSA after consultation with the Bank of England and HM Treasury?

The Committee has particular concerns about the proposed triggers for a special resolution regime and

The Committee notes the terms of paragraph 4.10 of the consultation which sets out the circumstances in which the SRR could be triggered. This paragraph raises a number of concerns for the committee, particularly in regard to the factors which regulators are to take

into account when making a decision whether to initiate any tools in the SRR. These are as follows:

1. The first factor which may be taken into account is that there is “a significant risk that the bank concerned would fail the relevant threshold conditions in the future (in particular, the conditions of adequate resources or suitability).” The Committee is of the opinion that this is a far too subjective test which places too much discretion in the hand of the regulator. Questions such as what constitutes a “significant” risk in the “future” are bound to occur and could give rise to very different interpretations on the part of the Authorities and on the part of the bank.
2. The Committee notes that the factors set out in paragraph 4.10 are intended to be considered as separate issues, any one of which could trigger the SRR. The Committee considers that that is inappropriate and that the conditions should be required to be read cumulatively so that the significant consequences of the SRR could only occur in a situation where there is a significant risk of failure in the future **and** the available regulatory powers have been exhausted **and** further options were needed to protect the stability of the financial system or the interests of depositors. Applied as set out in the consultation in the Committee’s view, only one of these factors arising could trigger the SRR.
3. Paragraph 4.10 indicated that “the detailed circumstances for initiating any of the tools in the SRR would be described in guidance, such as that sets out in the FSA Handbook, including quantitative and qualitative criteria”. The Committee considers that, given the repercussions of the initiation of SRR tools, care should be taken to ensure that the terms of such a trigger are set out at the appropriate legislative level. The Committee assumes that, given the effect of the SRR on the rights of shareholders, directors, creditors and other and the requirement to set aside the normal rules governing insolvency, these provisions will be set out in primary legislation. In that case, the Committee considers that as much as possible of the detail of the scheme be set out in secondary legislation or a statutory code. Wide consultation on the terms of such guidelines will also be required.

4.12 Is judicial review the correct mechanism for challenging a decision to transfer to a bridge bank?

The consultation correctly identifies the various rights which would be affected by the requirement of a transfer to a bridge bank, which would without a doubt be a hugely significant event in the banking system. It is clear that some mechanism for challenging such a decision is required. The Committee notes however the limits in the functioning of judicial review and feels that some consideration at least should go to creating a statutory appeal on specified grounds.

CHAPTER 5

Client accounts

The Committee notes the comments at paragraphs 5.15 to 5.17 on the position of client accounts with the Financial Services Compensation Scheme. As the statutory regulator of solicitors in Scotland, the Law Society of Scotland would welcome the opportunity to engage with HM Treasury to discuss the repercussions of the Treasury's proposals on solicitor client accounts in Scotland whenever such consultation takes place.

5.7 What are your views on a one-week target for FSCS payments?

The Committee is of the view that a one-week target for FSCS payment is unrealistic. The ingathering of funds and the calculation how much is to be paid and contacting each customer is a substantial task and probably not achievable within one week.