

23 April 2008

Dear Sir / Madam

**RESPONSE OF THE FINANCIAL LAW COMMITTEE OF THE CITY OF LONDON
LAW SOCIETY TO THE TREASURY, BANK OF ENGLAND AND FSA
CONSULTATION OF JANUARY 2008 ON FINANCIAL STABILITY AND DEPOSITOR
PROTECTION:STRENGTHENING THE FRAMEWORK**

Introduction

1. The City of London Law Society (CLLS) represents approximately 12,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments.
2. The CLLS responds to Government consultations on issues of importance to its members. The CLLS Financial Law Committee, made up of solicitors who are expert in their field, have prepared the comments below in response to the proposals, aimed at strengthening the framework for financial stability and depositor protection, contained in the Consultation Paper. In view of the expertise of the Committee (i.e. in matters relating to commercial banking law), we have concentrated our comments on the matters raised in part 4 of the Consultation Paper (reducing the impact of a failing bank). Members of the working party listed in Appendix 1 to this letter will be glad to amplify any comments if requested.
3. We welcome the opportunity to comment on the consultation paper and support its aims. Before turning to summarise our substantive comments on the areas of the paper on which we have concentrated, we wish to express a deep unease with the speed at which the Government intends to rush through the consultation paper and its legislative implementation, which we strongly doubt can be necessary, given the powers contained in The Banking (Special Provisions) Act 2008, which remain in force until February 2009 and could, presumably, be extended for a further period.

Excessive speed runs the risk of creating unintended consequences which could be very damaging to the London financial markets and we urge that care is taken to work through and check the effects of every element of any proposed change to ensure that no serious or irreparable harm occurs as a by product of a very well meant initiative. This is a complex area of law and commerce where great care is needed that any initiatives are soundly based and that there are no major negative impacts. It is worth taking the time to ensure a robust

set of changes and that all changes introduced are essential to achieving greater financial stability.

An important part of the preparation for any legislation is to examine to what extent change in the law (as opposed to the approach of regulators to the application of existing law) is needed at all. It will also be important to ensure that any changes are compatible with international and EU obligations binding on the UK (some of which may themselves be under review) and to have a soundly based economic impact assessment: something that can only be done when the detail of the proposed changes is clear. It would not be prudent to act in this very sensitive area to make very far reaching changes to the body of laws which have underpinned the success of UK financial markets without the most careful study of the anticipated consequences.

From a legal perspective we wish to stress that “the devil is in the detail” and therefore there needs to be time for full consultation on the actual proposals, preferably with draft legislation, and not merely on concepts.

We support the views expressed by the Financial Markets Law Committee in its letter of 7th April 2008 on the points made above. We also believe that the British Bankers Association is expressing similar views in its response.

4. By way of summary, we believe:
 - that a special resolution regime for financial institutions should be given careful consideration as one of the tools available to regulators to deal with a potential bank failure. It should, of course, be considered whether the strengthening of other regulatory measures or their application (in particular with regard to monitoring and prudential rules) would be sufficient. The proposal for a special resolution regime raises complex issues, not all of which can be apparent from the general observations in the consultation document. If a scheme is settled on, this is a case where a further round of consultation on either a fully developed scheme or draft legislation would be essential in our view, as well as a full economic and legal impact assessment: that can only be carried out when the scheme is well developed. If a scheme of this sort were introduced without the most thorough testing it would have the capacity to cause the very disruption of financial markets it is intended to avoid and could risk the attractiveness of the UK as a major financial centre: this latter effect would cause huge losses to the UK economy and could not easily be reversed. Our observations on the approach to valuing customers and to respect for principles of set-off and netting, as well as for the importance of considering financial collateral transactions in the round, are particularly important in this regard;
 - that there is no need in addition for a separate insolvency regime, which would be likely to cause confusion and with complex rules could well promote the very instability it sought to avoid;
 - that proposals for improvement of the compensation scheme should be taken forward: but these need to be realistic and achievable: they again need detailed development, both against the practicalities (which are affected by funding methodology and may also require development of common standards in bank record keeping) and against the requirements of EU Law, particularly the interaction of the proposals with the Directives on the Winding up of Credit Institutions and the operation of Deposit Guarantee Schemes.
5. In the following sections we address the detailed questions raised by the consultation. The Committee has confined its response to matters on which it believes it has something to contribute. This paper responds to certain questions arising in relation to Chapter 3, the

questions relating to Chapter 4 and to some aspects of the questions in relation to Chapter 5 of the Consultation Paper.

Chapter 3: Reducing the Likelihood of a Bank Failing

We believe that questions 3.1 to 3.7 and question 3.11 raise primarily regulatory questions, best addressed by others.

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?

Most banks seek to avoid having any charges registered against them. However, many activities within the financial markets will result in the creation of security which will only be valid if it is duly registered and banks may need to create such charges. The extent of this is greater in the UK than in many other Member States because charges over money and securities created to support financial market operations are likely to be characterised as floating charges (see the decision of the House of Lords in *Spectrum Plus* [2005] UKHL 41) and the prudent view is that the UK implementation of the Financial Collateral Directive does not provide certainty that these charges would be exempt from registration. This Committee has submitted to the Treasury on a number of occasions that legislation should be introduced at least to give the benefit of the exemption from registration and of ease of enforcement to charges made directly in support of financial market transactions, such as system charges and market charges, in order to ensure that the spirit of the Directive is followed through in the UK. In practice, although these charges are liable to be recharacterised, they are over discrete packages of financial collateral identifiable at any one time. We therefore believe that these transactions should be exempted from the requirement for registration of charges, in which event, the requirements of the Companies Act for the registration of charges would cease to have significant relevance to most banks.

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?

We consider that all charges over financial collateral given by banks in the course of their financial and securities markets activities, including to the Bank of England should be exempt. If the Bank of England would be likely to seek a charge over a wider category of assets, then consideration could be given to providing for all charges to support ELA being exempt from registration.

In addition, although the nature of the business of a bank is such that the majority of its assets are financial collateral (as that term is used in the Financial Collateral Directive and its UK implementation). We are not convinced that there would be any need to exempt a simple charge in support of other activity: e.g. a charge over land to secure funds for the development of a bank's own offices or a general "mortgage debenture" supported by a floating charge (although it is unlikely that a bank would issue mortgage debentures).

There is also a question whether it will be enough to exempt charges by banks (EU terminology "credit institutions"). Non-banks participate in the financial and securities markets and the stability of those markets means that charges over their assets in support of market activities should also be exempt. The use of the definition of "financial institution" as found in the Financial Collateral Directive might be a useful in arriving at the appropriate scope for the exemption.

As regards the operations of banks, charges may be given by non-bank members of a banking group to support the market activities of a bank member of the same group. Consideration should

be given to whether these should be exempted whenever the bank gives a charge to secure the same obligation which is also exempt.

We therefore would welcome the inclusion in any new primary legislation an enabling power to make new legislation or amend existing secondary legislation in order to deal with the technical but important shortcomings to which we have previously drawn the attention of the Treasury. Appropriate amendments will reduce legal uncertainty and strengthen stability and systemic integrity in the financial markets.

In particular, it would be helpful if the enabling power permitted changes to be made to the legislation underpinning the special statutory regimes which are designed to protect the financial markets, such as the Financial Collateral Arrangements (No 2) Regulations 2003 and the Financial Markets and Insolvency (Settlement Finality) Regulations 1999. Ideally, the enabling power should be wide enough to address any shortcomings in the 2003 Regulations and also give a statutory basis which enables the legislation to cover certain floating charges commonly used in UK financial markets and achieve the full spirit of the Financial Collateral Directive.

Most of the relevant issues are explained in the Note sent by the Financial Collateral Working Group of the CLLS Financial Law Committee to the Treasury in September 2007 and we should be happy to discuss further the form of primary and secondary legislation in this area.

3.10) Would extending the 21-day period be a viable, alternative proposition?

We do not consider this would be a viable alternative in relation to the solution that we see is needed as regards charges supporting financial market operations. We also do not see that it would be an appropriate alternative to an exemption as regards charges to support ELA only. Registration of a registrable charge is, in effect, part of the perfection of the charge under English law: unless duly registered the charge will be void against a liquidator – i.e. in the very circumstances where it is most likely to be of value to the chargee(s). If the Bank of England were to have an effective charge in respect of ELA then it needs perfection from the outset. Removing the obligation to register removes the perfection requirement and the sanction of voidness. Delaying registration, simply delays the perfection point – perfection once an insolvency has started may be open to challenge.

So far as the other purpose of registration is to advertise to other lenders that a particular creditor will have priority, the effect of delayed registration is likely to be that it simply creates a panic when the charge is eventually registered – or if the existence of an ELA charge becomes public before it is registered - unless the chargor bank is already in an insolvency process. Where there is an exemption, unsecured creditors understand that they may not be first in line, at least as regards assets covered by the exempted class of charge. There is no "moral" gain from a much delayed registration over an exemption.

3.12) Do you agree that the Bank of England should be provided with statutory immunity for any acts or omissions which relate to its role in providing financial stability and central banking functions?

We believe that this is appropriate when the Bank of England is carrying out a regulatory function: the Bank previously enjoyed such immunity under the Banking Acts 1979 and 1987.

3.13) Do you agree that it is appropriate to ensure that the Bank of England's security is fully effective whenever carried out?

If this is means that the Bank would have "super-priority" over pre-existing charges or set of right over the same assets, we do not agree that this would be right. This would cut across the purposes of existing rules to protect stability in the financial markets and could even occasion failures among counterparties relying on their own pre-existing charges and rights of set-off/netting.

The same concerns probably apply also to specific charges over assets charged to the Bank under a general floating charge which are granted in support of financial market operations by the failing bank during the period after it had granted a charge to the Bank and before it becomes insolvent. Where the Bank has an unregistered charge over a broad group of assets to support a loan of working capital which allows the failing bank to trade apparently normally and to grant specific charges in the course of market operations, it is difficult to see on what principle the Bank should be entitled to be in a better position than a high street bank that provides a working capital facility to a trading business with a floating charge.

The breach of any pre-existing negative pledge will also have to be borne in mind.

Provided that there is no effect on usual priority rules for third parties dealing with the bank prior to the creation of the Bank's charge or taking a fixed charge that would rank ahead under normal rules, we agree that it would be appropriate that the charge would not have to be registered in order to be perfected and that other rules on the avoidance of floating charges, such as those relating to transactions at an undervalue, fraudulent preference etc. should be excluded..

3.14) *Do you agree that funds provided by the Bank of England should be exempted from calculation of building societies' wholesale funding?*

We note that this approach is being taken in subsidiary legislation under the Banking (Special Provisions) Act 2008.

3.15) *What risks are there to building societies granting floating charges over their assets to the Bank of England?*

We note that shares in building societies which are redeemable or otherwise of a non-capital nature are to be treated as deposits for the purposes of the deposit protection scheme (see Directive 94/19/EC, Article 1. 1.

Chapter 4: Reducing the Impact of a Failing Bank

4.1) *Do you agree there should be a special resolution regime for banks?*

We believe that a limited special resolution regime could, with careful structuring, be a useful step in dealing with prudential concerns, ahead of actual insolvency and so avoiding both a run on the bank and the need to make payments under the depositor protection scheme or otherwise.

We see 6 key issues in deciding whether such a scheme is practicable and in addressing its mechanics:

1. The level at which intervention would be appropriate. This could be:
 - to deal with a banking group as a whole (apart from any parts regulated elsewhere in the EU, for which reconstruction measures are reserved to the authorities in their country of regulation, pursuant to the Winding Up Directive); ,
 - to deal with regulated businesses only at corporate or group level;
 - to deal with relationships with third parties within either of the above;
 - to deal with individual contracts within either of the above;
 - to deal with rights and obligations, even in the same contract, within either of the above.
2. The relationship to capital adequacy regulation;
3. The relationship to the control of interbank exposures operated by banks;
4. The interaction with contract law and practice in drafting financial contracts;
5. The relationship to insolvency law;
6. What types of relationship may be regarded in banking as an asset to a banking business.

These issues are interrelated. In deciding when any special pre-insolvency process is triggered, it would be necessary to use measures related to capital adequacy and other prudential measures. As we understand it these are frequently measured on a group basis, or at least a credit institution group basis. This suggests that intervention should also be related to the regulated group level, which may include the holding company of that group and/or include subsidiaries that are not themselves credit institutions.

Care also needs to be taken to have regard to the prudential measures used within banks: we understand that credit limits are normally measured by net exposures to counterparties (both banks and others) on a group basis (both for the bank applying the limit and its counterparty group). This reflects arrangements on netting and set-off available in the market (and supported under the Financial Collateral Directive), but not the operation of insolvency law strictly at a corporate level. This suggests again that intervention should be at the level of a group or regulated group.

The concentration of banks on relationships suggests that any intervention in the business should be at that level: e.g. if parts of a business were to be transferred to a bridge bank for sale, transfer should be at no level lower than the overall relationship. Even at this level provisions to prevent reliance by third parties on events of default arising from change of control or a material deterioration in financial position will be needed (c.f. the Banking (Special Provisions) Act 2008, Schedule 2, para 2(1)(c)).

Contract law treats contractual relationships as unitary and it would be very unusual for a contract to provide for continuation of an obligation on one party in the face of serious breach by the other. This is particularly so in financial contracts. It would be a major change overriding contract law to seek to institute a regime in which obligations to perform continue on a third party, while the bank is relieved from its obligations: in addition this must carry domino risks in relation to the business of an affected third party. We refer to our letter to the insolvency service dated 18 February 2008, commenting on this issue attached at Appendix 2. While we understand the chapter 11 process in the USA has this effect, we note that there is priority given to the third party in relation to post insolvency performance. In this case, however, if the aim were to “cherry pick” assets, this would not occur. Such uncertainty would be created for all counterparties dealing with UK regulated banks that this would be in itself a source of instability. We are strongly of the view that intervention in the integrity of contractual relationships would be seriously damaging. It also appears to run counter to the requirements of the Financial Collateral Directive as regards contracts involving financial collateral.

Both UK insolvency law and the Financial Collateral Directive enshrine rights of set off (bi-lateral netting) of financial obligations as between legal entities. A system which respects this (i.e. one that does not intervene below the level of relationships) will automatically respect these rights as well as preserving confidence in the measurements of net exposures used in prudential controls.

Finally, it must be borne in mind that, even where there are net liability relationships – e.g. to a holder of deposits with no other relationship with a bank, these would normally be regarded as an asset of an ongoing banking business and would be matched with net claims against financial market counterparties in considering whether they should be transferred to a bridge bank.

We note that some of the uncertainties described above arise from the existence of the Banking (Special Provisions) Act 2008 and that qualifications to legal opinions dealing with the financial obligations of UK regulated banks may now be appropriate in certain transactions. While this situation is tolerable in a limited life measure, it is important to restoring long-term market confidence that any long term solution is robust and does not give rise to the need for such qualifications.

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

We believe that there needs to be a clear process of decision taking in a very short timescale. This militates against more than one party taking the decision. We do not have strong views on which is the appropriate party, but it should normally be the party which is going to manage the process set in train, not necessarily the prior regulator.

4.3) Do you agree that the trigger should be linked to regulatory guidance material?

Given that the action to be taken in a special resolution regime may affect the rights of shareholders, creditors and contractual counterparties of the affected bank, it is essential that there is a clear statement of the considerations that would lead to the decision to commence a special resolution regime and that banks that are regulated by the FSA are required in the regulatory process to accept that having the FSA as lead regulator involves acceptance of this regime and that this is fully disclosed to investors and counterparties. As indicated above we believe that the process and triggers should be firmly linked to capital adequacy, liquidity and other prudential rules. Any

arrangement that interferes with property interests will need to be fully justified by reference to permissible considerations under the ECHR.

4.4) Do you agree with the special resolution regime process as outlined?

We do not consider that there is sufficient detail given to reach a conclusion on this. We do not think, however, that a separate insolvency regime is necessary. If the business of the bank cannot be saved at all - a conclusion which involves a decision that the transfer of all or part of the business to a bridge bank is impractical, then the bank should be put into ordinary insolvency processes. We have noted above the lack of provision in UK law for handling insolvency on a group basis, where necessary and appropriate. This is, however, a complex topic in itself and is of relevance to all failed groups of companies not simply to banks. We would support a separate initiative in this area, unconnected with this legislative initiative. We believe the only possible adjustments to the standard rules to accommodate a speeded up operation of the FSCS compensation scheme would be to provide in the case of a bank insolvency for the preservation of access to records, staff and contracts necessary for the application of the FSCS scheme as amended and (if this is thought appropriate from a policy perspective) for there to be a provision for the costs of administration (not the costs of compensation, which are a matter for the FSCS to fund) to be treated as the costs of the administration/liquidation.

We observe that if the conclusion is that a banking business cannot be saved, even in part, as a going concern, then an administration would not be an option since its statutory purposes evidently could not be met and these purposes of preserving the company or the business as a going concern are also common to all existing special administration regimes. If the Bank of England had advanced ELA (which would be probable) and held a floating charge over substantially all the assets and such a charge were exempt from the prohibition on the appointment of an administrative receiver, then receivership could be used to provide extra flexibility in dealing with the administration of the scheme outside of court processes. This would require a change to the exemptions to the prohibition on the appointment of administrative receivers introduced by the Enterprise Act 2002.

4.5) Do you agree that the potential abridgement of property rights in the special resolution regime can, in principle, be justified with a suitable public interest test?

We consider this requires detailed examination of the justification and of the compensation regime that could be provided. Any interference should be the minimum necessary to achieve the statutory objectives and only if it does not have any wider adverse ramifications for confidence in the financial markets and for UK regulation, would we agree with this proposition. We note that an efficient and clear FSCS deposit protection scheme is just one of the tools for that purpose and not an objective in itself.

Importantly, we note above that interference in the rights of creditors so as to change their risk profile would not engender confidence in the system. Therefore we consider intervention below the level of whole relationships would be inappropriate.

Care must also be taken to respect the requirements and principles of the Financial Collateral Directive or the potential for interference with property rights of market participants will seriously damage the attractiveness of participation in the UK financial markets and encourage the use of other regulatory and legal systems.

The splitting of unitary contracts so as to change the risk profile from that which would otherwise apply (eg by prohibiting set-off or netting, or taking the benefit but not the burden of a stock

lending agreement) would not be justified and would also cut across the principles of prudential regulation by removing reliance on net exposures and effectively creating a "gross exposure" risk regime. This would seem to carry instability risks and also put the UK far out of line with other developed markets and its Treaty commitments. By focusing on net exposure, actual interference with property rights would be minimised, since relationships in their entirety would either (assuming the bank requires reorganisation measures) be transferred to the bridge bank and operate in accordance with their terms or pass into the liquidation where well established rules of set off apply and parties will share in assets to the full extent of their entitlement where set-off does not apply in accordance with normal rules. This will also be most likely to result in available assets flowing to the benefit of creditors and (if sufficient) shareholders.

Another serious issue for contractual counterparties (both banks and non-banks) if contractual situations are partitioned is the fact that the counterparty might be expected to give continued performance (lend money, provide services) with no prospect of repayment of existing loans/payment for work already done and possibly no right of termination. Clearly this carries "domino effect" risk while being fundamentally unfair compared with the situation of a contractual counterparty in an insolvency and causing inherent uncertainty for counterparties of entirely solvent banks potentially subject to this regime if their situation should change during the life of a contract. This militates against attempting to split contractual obligations.

4.6) *What safeguards and appeal processes would be needed to support a public interest test for the special resolution regime?*

The special resolution regime would raise 3 questions:

- whether there is at any stage – immediately or on creation of the bridge bank an appropriation of assets giving rise to a right to compensation. If that is the case proceedings to value and award compensation will arise and we believe that human rights requirements mean that these must be permitted;
- what is the appropriate standard of review in relation to the public interest test, bearing in mind that that the process may involve an appropriation of assets. The relevant issues are discussed below;
- whether there should be any risk that a legal challenge could prevent the regime being put into effect: we believe that speed and clarity would be important to any such process and therefore the possibility of the courts holding up the transaction or causing it to be reversed may need to be excluded: in such event there would need to be provision for damages/increased compensation if impropriety in initiating the process were established.

In some cases, e.g. competition law, there is a pattern of regarding judicial review as adequate. However, most divestment cases in that regime, arise from the affected parties choosing to acquire a business or an interest in a business without first seeking clearance. In that case they are well aware of the risks they run. In the case of a divestment under the market review regime, the appropriateness of this process is untested: under the previous regime where the Secretary of State was the deciding party, the requirement was for a positive resolution of both houses of Parliament to effect a divesting order: used e.g. following the 1989 inquiry into the brewing industry. This was in addition to a right of judicial review, but there was no provision for a rehearing by a higher court.

The case *Tsfayo v United Kingdom* (no. 60860/00) [2006] All ER (D) 177 (Nov) indicates that if there is an issue of the credibility of a witness, or possibly of the evidence as a whole and the deciding body can be regarded as acting in its own interests, then a full rehearing is required. The judgment of the ECHR at paras 47/48 states: "*Whilst the High Court had the power to quash the*

decision it is considered, inter alia, that ... there was no evidence to support the HBRB's [HBRB is a local authority body of a London borough] factual findings, or that its findings were plainly untenable, or that the HBRB had misunderstood or been ignorant of an established and relevant fact ... it [the High Court] did not have jurisdiction to rehear the evidence or substitute its own views as to the applicant's credibility. Thus, in this case, there was never the possibility that the central issue would be determined by a tribunal that was independent of one of the parties to the dispute. It follows that there has been a violation of Article 6(1)."

If the decision is taken by the FSA as regulatory body, there may be more risk that it will be regarded as acting in its own interests as regulator, than would other possible decision takers.

4.7) *Do you agree that the Authorities should have the power to direct a sale of all or part of a bank's business, possibly against the wishes of the directors or shareholders?*¹

Yes, assuming that the relevant public interest test is met, this is the only available course and the risks to financial stability are sufficient to justify the action. We are of the view that intervention should be at group, corporate or relationship level, and that splitting of rights and obligations which are netted for prudential reasons, capable of legal set off or are unitary in nature (derived from a single contractual relationship) should not be capable of being divided in any such process. This is because such a possibility would create legal uncertainty and undermine prudential regulatory tools in the financial markets. Merger control regimes provide numerous examples of forced sales to meet a higher public interest in the preservation of competitive markets, although obviously the actual circumstances would be very different.

4.8) *Is judicial review the correct mechanism for challenging a decision to institute the directed transfer?*

The principles are the same as discussed in response to question 4.6.

4.9) *Is the Financial Services and Markets Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?*

We believe that the Court should retain its inherent jurisdiction to deal with these matters: if the FSMT is involved then we think it that appeal should be more than judicial review and involve a full appeal in order to respect the rights of parties deprived of their property.

4.10) *Do you agree that, in tightly defined circumstances, the Authorities should be able to take control of a failing bank through effecting a transfer of some or all of its assets and liabilities to a bridge bank? Do you agree that that some flexibility in the description of these circumstances is also desirable?*

As indicated above, we do not consider that any intervention should allow splitting of rights and obligations under single contracts, capable of set off or managed/regulated on a net exposure basis. We believe this is important for legal certainty. We agree that intervention at a higher level should be permitted. We anticipate that the Authorities would need to take supervisory control of the management in advance of such a transfer in order to identify the assets and liabilities to be transferred. The review should be on the basis of transferring a viable business: this would include

¹ We note that this is an example of divergence between the question as summarised at the end of the paper and as it appears in the test. It should be noted that the form of question responded to may affect the response

net depositors (i.e. net creditors of the bank) where these would be desirable customers of the new business and should normally include all credit worthy net debtors to the business.

4.11) Do you agree with the removal of shareholders' and directors' rights and temporary suspension of creditors' rights under this bridge bank proposal?

We are not clear why creditors' rights should be suspended on the transfer to the bridge bank. The accounts transferred should constitute a viable banking business with appropriate funding. The point of suspension, if any, should be for a short time after the intervention while the bridge bank is set up. It will be important to have a clear regime for the adoption of contracts to be performed by counterparties during the period of suspension, which protects their financial position, or to allow parties to suspend performance.

The rights of creditors which remain with the failed bank after creation of the bridge bank will be affected in the normal way by the insolvency of that institution, but this does not require special rules.

A proposal that involves a moratorium in relation to financial market contracts and splits rights and obligations under contracts enters uncharted waters so far as UK practice is concerned. We think that any effort to temporarily suspend the rights to creditors (presumably secured as well as unsecured) carries serious hazards which are not discussed in the consultation document. These are not easy questions and the impact, legal, including in relation to the Financial Collateral Directive, and financial, requires the most careful consideration.

The key rights to consider are (i) rights of set off; (ii) rights to exercise security over financial collateral, (iii) the right to terminate contracts for change of ownership or control and (iv) the right to refuse to continue to supply. If these are suspended the following questions (and possibly others) arise:

How will counterparties be given confidence in dealing with an institution where such an intervention may interfere with their net exposure to the institution? This affects all banks subject to the regime and impact on the attractiveness of UK financial markets needs to be examined as all key financial players would carry any uncertainty created. The issues are not just legal and depend on consideration of the detail of any proposed legislation.

How does this fit with the regulation of credit institutions on the basis of net exposures?

How long would this moratorium last? If it could continue for more than a strictly limited short space of time it could carry risks of domino effects on counterparties because they cannot enforce their rights or be relieved of their obligations. We have recently commented to the insolvency service on this point (see Appendix 2).

How could a moratorium cutting across rights of set-off, netting and the exercise of security by financial counterparties be made consistent with the Financial Collateral Directive which is designed to protect the integrity of financial markets by giving security of execution in relation to financial market transactions?

What compensation would be given, if any, and by whom?

What happens when the moratorium comes to an end?

What could be done to prevent parties becoming even more risk averse and taking early action to close out positions – so possibly deepening the crisis the process is intended to ameliorate?

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

See 4.6 above.

4.13) Is the Financial Services Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?

See response to 4.9 above.

4.14) Should a new bank insolvency procedure be introduced for banks and building societies as an option for the Authorities instead of normal insolvency procedures?

As indicated at 4.4 we do not see a role for a special administration regime where the special resolution procedure concludes that there is not a saveable business (ie the whole or part of the pre-existing business).

As regards a special process as an alternative, we do not think this is necessary if all that is desired is to obtain quick and cheap access to the failing bank's records and staff to facilitate a prompt payment to eligible depositors under the FSCS scheme. This does not require a special regime in which the business continues (cf Rail and PPP special administrations) but simply a requirement that relevant records/staff will be available and the cost of this availability (not of the substantive payments to depositors) will have the priority of an expense of the insolvency/liquidation. It does not seem to us that the normal purposes of those processes are otherwise affected.

4.15) Do you think that there ought to be provision in the bank insolvency procedure for continued trading of some of the bank's business in the interests of depositors or other creditors? If so, how do you think this might work?

This is surely something to be done in the special resolution regime. If a liquidator finds that part of the business is saleable, we consider he would have the power to hive down to a subsidiary which could trade. An administrative receiver or an administrator clearly has the power to do this, although we have indicated that where a special resolution process has failed to identify a saveable business it seems unlikely both that there would be a basis for appointing an administrator or, indeed, a part of the banking business that could properly continue trading.

4.16) Should the objectives of a bank liquidator be limited to assisting a rapid FSCS payout to eligible depositors and then winding up the affairs of a failed bank? Should the proceedings have any other statutory objectives?

We think that there should not be any other statutory objectives in a bank liquidation on top of those provided for the liquidation of any corporate entity.

4.17) Should a bank insolvency procedure be subject to the overall supervision of the Authorities?

We do not think this would be appropriate or necessary. The High Court would supervise an insolvency process (as it does under both the normal and special regimes that exist, such as the PPP regime under the GLAA). It is clearly the appropriate body to protect the rights of all stakeholders.

4.18) Should a bank insolvency procedure be a stand-alone regime in which the bank liquidator has the combined powers of an administrator and liquidator? Are any other powers required?

We believe that a liquidator presently has adequate powers. There is not need to blur distinctions between an administrator and a liquidator. If there is a need for a role which can operate outside of liquidation, without the primary duties of an administrator (which are often inappropriate) then the ability for the Bank of England to appoint an administrative receiver would address this need, without any requirement for a special regime.

4.19) Should the FSCS cover any additional costs that a new bank insolvency procedure may incur?

We think that this question assumes an over-complex and novel arrangement. Issues of State aid may arise if it does so with the benefit of public money, unless these costs are fully recoverable. We have suggested the appropriate ranking for costs directly related to the operation of the compensation scheme, and we believe that it is only as regards those costs that there should be any question of the FSCS providing loans or bearing costs if assets are inadequate. FSCS (aided by a loan from the Bank) should bear the cost of compensation, and have the right to recover this through levy on the industry and to then repay the Bank. State aid issues will need to be cleared with the EC Commission.

4.20) Should further consideration be given to the introduction of depositor preference?

We think that this would tend to create instability as regards those outside the benefiting class of depositors, or within the class and having deposits too high to benefit. We would not favour giving this further consideration.

4.21) Do you agree that commencement into insolvency should be controlled by the Authorities, for example through requiring 14 days prior notice be given to the FSA? Should normal insolvency proceedings be retained alongside the bank insolvency procedure?

We do not favour this approach as we do not see the need for any special insolvency procedure.

4.22) What should the governance arrangements for the SRR be?

The processes will need to demonstrate gathering of appropriate evidence, its proper assessment and appropriate appeal/review processes. This question cannot be answered until the scheme is fully developed and should be the subject of further consultation. Particular issues arise regarding the role of the restructuring officer, if there is one:

- is he, or the board he has displaced, liable for wrongful or fraudulent trading (or neither of them after his appointment) in respect of the period prior to establishment of a bridge bank?
- What disclosure regimes apply?
- What steps can be taken to prevent the appointment precipitating the crisis it is intended to address?
- What is the position of the management of the bridge bank once established? There seems no reason why they should not have ordinary duties under company law.

4.23) Do you consider that introducing the office of the restructuring officer as part of the SRR would be a helpful and necessary development?

See the comments in response to question 4.22.

4.24) Do you have any comments on the specific implications for shareholders, creditors or directors from the appointment of the restructuring officer over and above those already raised by the other resolution tools?

It is not the creation of the office of restructuring officer, but the role assigned to him (e.g. whether he displaces the board) and the procedural and evidential safeguards that are introduced which will affect the classes of stakeholder mentioned in the question. Whether these are adequate cannot be considered until there is consultation on a detailed scheme.

4.25) Should the Government have the power to take temporary ownership of a failing bank, in order to facilitate a more orderly resolution? Under what circumstances would it be appropriate for this power to be exercised?

As this has proved necessary in the case of Northern Rock, it is obviously an issue that requires serious consideration. However, we understand that the special resolution scheme is intended to reduce the need for such intervention and it may be better left to new measures in the light of particular circumstances.

4.26) Do you agree that the special resolution regime should be extended to building societies but not other mutuals?

4.27) Do you agree with the proposals for a new accelerated directed transfer procedure for building societies, similar to that proposed for banks?

4.28) Do you believe a form of temporary public sector control through a bridge bank should be provided for building societies?

4.29) Do you agree that a building society insolvency procedure should exist for building societies alongside a similar model for banks?

4.26-29 We consider, in principle, that any arrangements introduced should apply to all credit institutions, which we believe would include building societies.

4.30) Do you agree that the Treasury should make an Order under the 2007 Act to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members?

Assuming the true nature of the membership shares in a building society are those of a deposit and not those of equity, then this would be right (as recognised in the Directive dealing with deposit protection schemes) and recognise the mutual nature of building societies.

4.31) Should the industry contribute to the costs of an SRR?

We note that this is the case in the USA where the fund used to manage the regime has been built up by industry contributions over many years. The FSCS also was established on the basis of industry contribution although subject to limitations and on a case by case basis. However an SRR is quite different from a compensation scheme. Funding of liquidity for a bank in SRR is unlikely to be available except from public funds given the sums involved. Funding of the actual costs of paying an official such as a restructuring officer would naturally fall on the bank and may need to be given priority in a subsequent winding up.

4.32) Would mechanisms other than the FSCS be appropriate for addressing such cost issues? How might such mechanisms work?

See the response to question 4.31. It very much depends on the roles assigned and the scope of action given to the FSCS, whether its involvement would be appropriate. If the SRR process is intended to prevent claims by depositors on FSCS (which would surely be the prime aim) then it is not clear why the FSCS would be involved.

4.33) Are there any other mechanisms available to secure access to payment systems for agency banks in the event of a settlement bank failure?

Could banks be required to have a “reserve” arrangement that could be activated if their settlement bank were to fail.

4.34) Are there contingency measures that banks could adopt to ensure that their organisation and structure are compatible with the tools proposed in the special resolution regime

See answer to 4.33.

4.35) Do you agree that the Government should take a power to enable it to make secondary legislation in relation to financial collateral arrangements, and with the proposed definitional scope? If not, why, and what would you suggest?

The Government needs powers to achieve the spirit of the Financial Collateral Directive. We agree that, given the use of floating charges in UK financial market transactions, it is highly desirable that the Government takes such powers. They cannot, however, be used to reverse the effect of the Directive, so that access to relevant collateral must be given at all times.

4.36) Do you have any suggestions as to future revisions to the financial collateral regime that should be considered?

We refer to our submissions to the Treasury of September 2007 and our response to question 3.9 above.

Chapter 5: Consumer Confidence and Compensation Arrangements

As indicated in the introduction, we consider that improvements to the compensation scheme are important to consumer confidence in the banking system. However, the operation of the scheme is not our area of expertise and we therefore confine ourselves to points which relate to our expertise, interlink with other issues discussed or relate to European law, where we have looked at the issues raised, which will be important in framing improvements.

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

This seems very difficult to achieve bearing in mind that equal treatment must be given to depositors in EU branches of UK regulated credit institutions and to depositors in branches of non-UK regulated institutions trading in the UK who are members of FSCS. The UK cannot wind up credit institutions that it does not regulate, but would raise a barrier to establishment, if it did not accord their depositors at their UK branch absolutely equal treatment. See Appendix 3 for a more detailed discussion of the EU issues arising from the applicable directives.

5.9) Are there other means to ensure consumers have access to funds within one week, including alternative payment methods to cheques?

Use of direct payments to another bank account if the depositor has one, eg BACs or Swift if the remittance is overseas.

5.11) How quickly could banks make the changes to have the necessary information readily available on account balances of FSCS-eligible depositors, and what would be the cost to them?

This is a matter for individual banks. Note that the Competition Commission has carried out a detailed study as regards banks trading in Northern Ireland with regard to changes it considers would increase competition between banks in that part of the UK and this may be helpful experience. The Commission mandated changes that require investment in IT.

5.18) What are your views on the link between FSCS gross payment and set-off?

5.18 If payments are made on a gross basis, then the customer will receive potentially more cash than he or she would receive in an insolvency in which the set-off rules are applied. However, to the extent the customer has not received a full payout of his deposits, then the set off rules would apply to the balance as against any liabilities to the bank. Ideally this disparity should not exist. The main issue with gross payments arises, however, when FSCS seeks to claim in the insolvency of the failed bank, since its claim will be different from that which would have existed if set-off had been applied.

It would therefore be desirable (given that set off is central to UK insolvency processes) to work on a net rather than a gross basis. If this is impractical, the non-application of set-off should be limited to claims by FSCS in respect of payouts and by way of adjustment of compensated depositors' rights to the extent they have received a gross payout.

In particular the stability of the financial markets requires that set off (which is essentially two party close out netting) must be allowed as between market participants, including the failed bank. Otherwise it would not be possible to regulate on the basis of net exposures or to comply fully with the Financial Collateral Directive.

5.23) *What are your views on whether the FSCS should be permitted to borrow from the Government or the Bank of England?*

It seems inevitable this would be needed, unless and until there were a well funded levy fund. The USA fund has built up over more than half a century. Obviously State aid considerations will need to be taken into account in use of this power.