



# The City of London Law Society

## Response

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The City of London Law Society (**CLLS**) represents over 13,000 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, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. **This response to the consultation document dated January 2008 entitled “Financial Stability and Depositor Protection: Strengthening the Framework” has been prepared by the CLLS Insolvency Law Committee.** This Committee is made up of a number of solicitors from City of London firms who specialise in insolvency law. The Committee’s purpose is to represent the interests of those members of the CLLS involved in insolvency law and practice.

**Response of the Insolvency Law Committee of the City of London Law Society to the consultation document dated January 2008 entitled Financial Stability and Depositor Protection: Strengthening the Framework (the Consultation Paper)**

**Introduction**

- 1** The CLLS responds to Government consultations on issues of importance to its members. The CLLS Insolvency 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 insolvency law), we have restricted our comments to the matters raised in part 4 of the Consultation Paper (reducing the impact of a failing bank). Members of the working party listed in Schedule 2 to this letter will be glad to amplify any comments if requested. We welcome the opportunity to comment on the consultation paper.
- 2** For the reasons given in this letter, we consider that the most significant concerns set out in the Consultation Paper (namely the issues of consumer confidence, the risk of a run on a bank experiencing financial difficulties and confidence in the financial system as a whole) can be addressed by focusing on the proposals set out in part 5 of the Consultation Paper in respect of the Financial Services Compensation Scheme (**FSCS**). We do not consider that a special resolution regime or a special insolvency procedure for a failing bank is necessary or desirable. In our view, provided that any concerns about the operation of the FSCS are separately addressed, the existing insolvency regime for English companies is and remains perfectly adequate to deal with an insolvent financial institution and there would be significant difficulties (in terms of commercial certainty, investor confidence and the impact on and interplay with the international arena in which financial institutions operate) in introducing new procedures.
- 3** In light of these views, we have not attempted to respond to all of the questions set out in chapter 4 of the consultation paper. Instead, we have set out our responses to those questions which are relevant in the context of our overall approach in Schedule 1 to this letter. The expression "Authorities" when used in this letter means the Bank of England, HM Treasury and the Financial Services Authority (**FSA**).

**Consumer confidence and compensation arrangements**

- 4** We consider that any concerns about consumer confidence and the risk of a run on a bank can be dealt with by reforms to the FSCS outside of any special resolution regime or special insolvency procedure. In our view, a depositor is not going to keep his or her

money with a bank experiencing financial difficulties simply because he or she is aware of a special insolvency regime that may ultimately be used. Instead, the depositor will want to know that his or her money is safe and that, if the bank is not able to repay that deposit in a timely manner, there is a scheme in place to ensure that someone else does so.

- 5 We therefore consider that the focus of the Authorities should be on ensuring that the FSCS has the ability to make prompt payments to eligible depositors up to the agreed limit (whatever that may be chosen to be as a result of the present consultation). Having made any such payments, the FSCS could be automatically subrogated to the rights of the depositor against the bank rather than being required to take an assignment of the claim as is currently the case<sup>1</sup>.
- 6 We appreciate that the ability of the FSCS to make timely payments will depend upon its having the necessary information to do so. We note the proposals in part 5 of the Consultation Paper in this regard including the potential introduction of new rules requiring banks to have readily available information on the account balances of FSCS-eligible depositors and the comment made in paragraph 5.25 of the Consultation Paper regarding the ability of the FSA to ask for relevant information through normal supervisory channels. Although we do not consider that our Committee is best placed to comment on the detail of these proposals, we consider that any improvements in the way in which the relevant information is provided to the FSCS would assist in the Authorities' objective of ensuring that the FSCS is in a position to make prompt payments to eligible depositors if the bank becomes insolvent. We do not consider that this objective requires the introduction of a special resolution regime or insolvency procedure for banks.
- 7 Paragraph 5.22 of the Consultation Paper makes the point that, in cases where the bank's systems prove to be highly unreliable, it may not be possible for the FSCS to pay depositors within the timeframe contemplated by the Consultation Paper. We consider that it is ultimately the responsibility of the FSA to ensure that the bank's records are not deficient in this regard, possibly through having the ability to carry out "spot-checks" either prior to or following the FSA becoming aware that the bank is experiencing financial difficulties. If the principal objective is to protect depositors, we consider that the FSCS (and ultimately the Government and the Bank of England as its liquidity funders) should bear the risk of the bank's records being incorrect resulting in the FSCS being unable to recover from the bank (through its subrogated rights) any payments it has made to eligible depositors.

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<sup>1</sup> See the FSA Handbook, COMP 7.2. It is not clear why the position is different for the FSCS in this regard when compared with the position in relation to the National Insurance Fund where there is an automatic subrogation of the employee's claim to the Secretary of State (see paragraph 12 below).

- 8 Paragraph 4.37 of the Consultation Paper proposes that the statutory objective of the special insolvency regime being proposed for banks should be for the insolvency practitioner to assist and co-operate with the FSCS to coordinate rapid payments to eligible depositors or to effect a transfer of accounts to a third party (the principal objective) with the duties to the creditors as a whole being subordinate to this principle objective. In practice, an insolvency practitioner is likely to assist the FSCS in any event as it will be in the interests of one set of creditors (i.e. depositors) for him or her to do so. If it were considered necessary to legislate for such a duty (which we do not consider to be the case), this could be done by adding a duty to assist and co-operate with the FSCS to the existing insolvency legislation; it does not require the introduction of a special insolvency regime. Furthermore, even though we accept the importance of protecting depositors for the reasons given in the Consultation Paper, we do not consider that any duty to assist the FSCS should be at the expense of the insolvency practitioner's duties to the creditors as a whole. Where such creditors include employees or pension funds, there are equally valid public policy reasons for protecting their rights.
- 9 We understand that concerns have been raised in relation to the resources of the FSCS and its ability to cope with the large number of claims that it may need to process if a major financial institution were to become insolvent. Ultimately the resourcing of the FSCS is a matter for the Authorities but in our view, there must be other solutions to this issue than introducing a new principal objective in a special insolvency procedure requiring the insolvency practitioner (or the bank's employees) to assist with handling claims. We note that, when the Pensions Regulator and the PPF were established, people were seconded from banks, accountancy firms, law firms and other institutions to deal with the large volume of work that it was anticipated would be generated by the new legislation. We wonder whether there may be a precedent here (together with secondments from the FSA)?
- 10 We also note that the Authorities are considering whether the FSCS should make payments on a gross, rather than a net, basis to facilitate quicker payments to depositors. It has been suggested by the Authorities that, if this approach were to be taken, it might be necessary to make changes to the insolvency set-off rules. This could clearly have a significant impact on the financial markets generally and close-out netting in particular. As the Consultation Paper did not go into any detail regarding the proposed changes to the insolvency set-off rules, we have not considered this issue in this paper but we would welcome the opportunity to meet with the Authorities to discuss the implications of any such changes. We have been offered such a meeting by Mr Lee Hewlett, currently with HM Treasury, and hope to meet with him in the next few weeks.

**Reasons why special resolution / insolvency regime is neither necessary nor desirable**

- 11 As referred to above, we do not consider that a special resolution regime or a special insolvency procedure for banks is necessary in order to deal with the stated concerns regarding consumer confidence and financial stability. Indeed, we consider that the legal uncertainties that would arise from such procedures (in respect of their potential impact on investor and creditor rights) could contribute to a lack of confidence in the system and greater financial instability as a consequence.
- 12 In relation to the FSCS, we consider that an analogy can be made with the National Insurance Fund out of which the Secretary of State for Trade & Industry makes payments to the employees of insolvent employers under section 182 of the Employment Rights Act 1996. Upon the making of the payment, any rights and remedies of the employee in respect of his or her debt automatically become rights and remedies of the Secretary of State (section 189(1) of the Employment Rights Act 1996). The Secretary of State also has the right to require information from the employer for the purposes of making the payment to the employee (section 190). These provisions do not require a special insolvency regime nor any amendments to the objectives of the insolvency proceedings or the duties of the insolvency practitioner to ensure that the public policy objective is met of ensuring that employee claims are dealt with in a timely manner.
- 13 We consider that the existing English insolvency procedures (especially schemes of arrangement, company voluntary arrangements and administrations) are very flexible and have proved perfectly adequate for dealing with complex companies with multiple stakeholder groups. We cannot see why a financial institution should be any different or should merit a special procedure, especially once concerns about customer deposits are dealt with through a review of the FSCS. We are concerned that a proliferation of special or modified insolvency regimes could lead to what is sometimes referred to as "carve-out complexity". There are now at least 22 different insolvency processes (or modified insolvency processes) for corporates, regulated entities, partnerships and non-corporate entities. This proves confusing even to an English practitioner; the regimes are even harder to justify and explain overseas. In our view, this jurisdiction should be setting an example to others in having a clear, comprehensible insolvency framework. A multiplicity of insolvency proceedings (especially where these are not necessary) simply leads to a lack of legal and commercial certainty as to the regime that will apply in a particular case.
- 14 Clearly there are cases where a special insolvency regime has been introduced such as for protected railway companies (as was used in the case of Railtrack) and for PPP companies (as is currently being used in the case of Metronet). In each case, these special procedures are intended to protect a public service or utility (such as the rail or tube network) where the consumer may have little choice as to the alternatives. This is

not the case with a financial institution where a customer is free to move his or her monies to another bank or to choose another bank to perform the relevant services. Furthermore (perhaps unusually for the size of company involved) the operations of the regulated companies that are currently subject to special insolvency regimes (such as protected railway companies, PPP companies, water and sewerage undertakings and air-traffic services companies) tend to be domestic to the UK. This means that it is not so important to consider the cross-border implications of having special regimes in relation to such companies. A financial institution of any significant size, on the other hand, is much more likely to have cross-border dealings. We have considered in the next paragraph why the introduction of a special resolution regime or special insolvency procedure could have undesirable consequences in an international arena.

- 15 Unless the introduction of a special insolvency procedure is looked at in the context of the wealth of recent legislation with a cross-border aspect, there is a risk that any change to the regime in the UK could have unintended consequences outside this jurisdiction. For example, the proposals would need to be considered in the light of Directive 2001/24/EC on the reorganisation and winding up of credit institutions, The Credit Institutions (Reorganisations and Winding up) Regulations 2004, Directive 2002/47/EC on financial collateral arrangements, The Financial Collateral Arrangements (No 2) Regulations 2003 and the legislation in other jurisdictions implementing the UNCITRAL Model Law on Insolvency Proceedings (to the extent that such legislation is applicable to credit institutions). This legislation is not considered in any detail in the Consultation Paper. To give an example of the types of question that might arise, it is unclear whether the special resolution regime or the special insolvency procedure (which both appear to be largely regulatory driven) would fall within the definition of winding up proceedings or reorganisation proceedings in Directive 2001/24/EC so as to achieve recognition across the EEA. Furthermore, consideration should be given to the impact of the commencement of a special procedure on the rules of international clearing systems or events of default under netting and other agreements. Although it may be possible to legislate in this jurisdiction for a suspension of such events of default, there is no guarantee that such legislation would be effective in other jurisdictions.
- 16 We are also concerned that the introduction of new regimes which could adversely affect the rights of creditors and investors will create an unlevel playing field across the EEA. This may result in an overseas bank choosing to establish an authorised subsidiary in, say, Germany (in order to make use the EEA passporting provisions for accepting customer deposits) rather than in the UK in order to avoid the special resolution regime. Any measure which may have the affect of driving companies away from the UK is surely undesirable to the economy as a whole.

- 17 Finally, we note that comparisons have been drawn throughout the consultation process to the regime that applies to banks in the US under the Federal Deposit Insurance Act. It should be noted, however, that this regime has largely been used in relation to small, domestic banks and there are real doubts as to how the regime would fare if a major bank with substantial non-deposit liabilities, complex non-traditional on and off-balance sheet activities and international operations (including potentially an overseas holding company) were to become insolvent<sup>2</sup>.

**The Insolvency Law Committee of the City of London Law Society**

**21 April 2008**

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<sup>2</sup> See for example Robert Bliss and George Kaufman, US Corporate and Bank Insolvency Regimes: an Economic Comparison and Evaluation, 10 January 2006, WP 2006-01.

## Schedule 1

### Response to specific questions in part 4 of Consultation Paper

Question	Response
4.1	<p>For the reasons given in the main body of this letter, we consider that it is unnecessary and positively undesirable to have a special resolution regime for banks. We can see no reason why the concerns set out in the Consultation Paper could not be addressed through changes to the FSCS or minor amendments to the existing insolvency proceedings. For this reason, we do not intend to respond to questions 4.2 – 4.4.</p>
4.5 – 4.6	<p>We do not consider that the potential abridgement of property rights in the special resolution regime can be justified as the public interest can be met by other means (i.e. changes to the FSCS). We are concerned that any such abridgement could result in the lack of commercial and legal certainty for creditors of and investors in banks and that this could ultimately result in the investment in banks being reduced.</p>
4.7	<p>A procedure already exists under Part VII of the Financial Services and Markets Act 2000 in relation to the transfer of a bank's business (including its deposit-taking business). If the Authorities are concerned about the publicity surrounding an application for such a transfer scheme, views could be taken as to whether it might be appropriate (in extreme cases) to allow applications under Part VII to be heard <i>ex parte</i> provided that creditor rights are not affected. We consider that it is essential in terms of the fairness and transparency of the regime that any creditor whose rights are adversely affected is entitled to be heard by the court in relation to the proposed transfer.</p>

	<p>Furthermore, if the directed transfer is intended to facilitate a sale to a third party purchaser, we understand that one of the issues that arose in relation to Northern Rock was that the Bank of England was unable to fund one of the potential bidders due to State aid issues. There is not sufficient detail in relation to the proposed special resolution regime for us to be able to comment on any State aid issues arising from a directed transfer <i>per se</i> but if and to the extent that a purchaser requires funding from the Bank of England, we cannot see how the proposals would address these issues.</p>
4.8 – 4.9	<p>We consider that the Companies Court is the best place for any disputes in relation to a transfer scheme to be heard. This court has extensive experience in dealing with the types of issue that are likely to arise. If the Financial Services Tribunal were chosen as the appropriate forum, there may be a conflict of interests (or perceived conflict) in view of the responsibilities of the FSCS.</p>
4.10	<p>For the reasons given in the main body of this letter, we also consider that it is unnecessary and positively undesirable for the Authorities to 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.</p>
4.11 – 4.13	<p>See our response to 4.7 – 4.9 above.</p>
4.14	<p>For the reasons given in the main body of this letter, we also consider that it is unnecessary and positively undesirable for a new bank insolvency procedure to be introduced for banks and building societies. The existing procedures are perfectly adequate for dealing with such institutions and the potential impact of private law rights and commercial certainty could have a detrimental impact on financial stability. In the circumstances, we have not</p>

	responded to questions 4.16 – 4.19.
4.15	An administrator already has extensive powers to continue trading all or any part of the business in the interests of creditors.
4.20	If the proposed changes are made to the FSCS, we do not consider that it would be necessary to introduce the concept of depositor preference and serious thought would need to be given to a bank's on and off-balance sheet activities (including for example any securitisations) if this concept were to be introduced. We note, however, that if a decision is taken to introduce such a concept, this can be done without the need for a special insolvency regime. In the case of insurance companies, policyholders were given preference by virtue of the Insurers (Reorganisation and Winding Up) Regulations 2003 without wholesale changes being necessary to the insolvency legislation relating to insurance companies.
4.21	<p>We are very concerned about the idea of a 14 day moratorium in which the directors would not be able to commence insolvency proceedings and creditors would not be able to enforce any security (even though, presumably, depositors would be entitled to withdraw their deposits, notwithstanding that security over those deposits may have been granted to third parties). In our view, there would be a significant risk of a run on the bank during the 14 day notice period, particularly in view of the uncertainty as to the final outcome.</p> <p>Such proposals may also discourage anyone from taking an appointment as a director of a bank as there is no suggestion that the fiduciary duties, or potential wrongful trading liabilities, of a director would be suspended during this period, even though the director would be powerless to take any steps to protect creditors by commencing an insolvency process.</p>

4.22 – 4.24	<p>In our view, the proposed role of the restructuring officer sits uncomfortably between that of a director and that of an insolvency officeholder. Although the Consultation Paper appears to envisage that the appointment would be part of the special resolution regime (and therefore a pre-insolvency step), the suspension of the management powers of the directors in favour of those of the restructuring officer is more akin to the commencement of a formal insolvency process. We consider that the role of an administrator or liquidator (and the duties owed by such a person) are clearly understood whereas there is the potential for confusion to arise over the role and duties of such a restructuring officer.</p> <p>As referred to in our response to question 4.21, it would also be necessary to address the potential liabilities of the (now powerless) directors during the period in which the restructuring officer was appointed.</p> <p>Finally, careful consideration would need to be given to the impact of such an appointment on events of default and other triggers in netting agreements, clearing house rules and other arrangements (particularly those with an international dimension) in view of the overlap between the role of the restructuring officer and that of an insolvency practitioner.</p>
4.25	<p>We do not consider that the nationalisation of a bank would, in every case, be a more orderly resolution than (for example) a sale through an administration. In any event, as the Government has the power to pass emergency legislation in this regard on a case by case basis (as has been demonstrated recently in respect of Northern Rock), we do not see why a general power is needed. We are also unclear what such a power is seeking to achieve in terms of increasing customer confidence.</p>
4.26 – 4.30	<p>Special issues arise in relation to building societies (where the depositors are also members of the society), especially in relation to any transfer of the assets to a corporate entity. Until there is more clarity in relation to the</p>

	regime that is being proposed, we do not consider that we are in a position to comment in any detail on this series of questions.
4.31 – 4.34	As we do not support the proposals for a special resolution regime, we have not considered where the costs of such a regime should fall.
4.35 – 4.36	It is not clear to us from the Consultation Paper what financial collateral arrangements are being contemplated in this respect and, without more detail, we do not consider that we are in a position to comment.