LIBA

Tripartite Authorities consultation paper "Financial stability
<u>and depositor protection: strengthening the framework"</u>

<u>Submission by the London Investment Banking Association</u>

INTRODUCTION

1. LIBA is the trade association that represents investment banks with operations in and from London. Our objective is to ensure that the UK continues to be an attractive location for the conduct of international investment banking business, so we pay particular attention to the overall legislative and regulatory framework here in which our Members operate and to potential changes to it. It is from this viewpoint that we have considered the questions raised in the consultation paper and, accordingly, we have not responded on all the issues upon which the Tripartite Authorities are seeking comments.

2. Our main points are:

- We welcome the wide-ranging review of the UK's arrangements for supervision, maintaining essential banking services, and compensation following Northern Rock and market turbulence over the last nine months. *Overall*, the Authorities propose action on a number of fronts – which we support – and in many respects the proposals are mutually reinforcing as intended: in some areas, however, substantial changes to creditors' and shareholders' rights are envisaged and it will be essential to ensure that the new structure achieves the right balance between increasing the powers of the Authorities to resolve the position of a bank in difficulties whilst, at the same time, minimising unpredictable and undesirable market impacts.
- This is particularly important given London's position as an international financial centre and the fact that many of the proposals in the CP will apply just to *UK incorporated* firms and not to their competitors from other countries: given the breathing space now provided by the Banking (Special Provisions) Act, we must emphasise again the need to avoid premature legislation in some areas where there is a substantial risk of unintended consequences.
- It is essential that measures that could damage the standing of UK banks and the competitiveness of the UK financial markets are avoided; in particular, set-off and netting rights, as well as the ability to realise collateral or enforce security interests must be preserved: the consequence of not doing so would be that both capital and economic costs of transactions would increase, so a Special Resolution Regime (SRR) and bank insolvency arrangements must be designed appropriately – getting this right will require extensive consultation.
- It is important to ensure that the necessary changes are made to improve supervision so that recourse to special resolution will be an exceptional event.
- At the same time, it is essential to recognise that although the Compensation Scheme contributes to financial stability, its role is limited; in addition, changes to current arrangements for deposit protection should not be assumed to read across automatically to the Investment and Insurance schemes and there should be no increase in cross-subsidy.

- We understand that the Authorities intend to maintain the dialogue with consultees after the CP's response deadline and this too is very welcome: it will be particularly important to consult fully on draft legislation and to recognise that this may well make it necessary to revisit the legislative timetable.
- We welcome the international coordination of initiatives that have been created to examine the risk management practices and structures of firms and we will continue to participate actively in the individual work streams that arise from this. Broadly we agree that the UK authorities have correctly identified the topics on which further work must be done and we support the general direction of the work that has taken place so far. We look forward to a continuing open dialogue between the industry and the regulators in order to identify the most effective developments in this field that will enhance risk management practices and to avoid any potentially counter-productive measures.

RESILIENCE AND STABILITY OF THE FINANCIAL SYSTEM: CHAPTER 2

International Coordination and consistency and better regulation

3. A fundamental industry priority is to ensure that the development of regulatory standards is effectively coordinated. In relation to work that affects banks and investment firms it is important that work in the EU or domestically in the UK, does not move ahead of or diverge from work at the broader international level. We welcome the framework which the recent FSF report provides and, as noted below, support the initiatives arising from this. There is, however, some concern in our membership that the European Commission's potential amendments to the CRD[1] might lead to a divergence from regulatory standards issuing from Basel.[2] We would urge the authorities to use their influence to maintain parallelism between Basel and the EU in terms of timing but more critically in terms of content of regulatory proposals.

4. In the context of better regulation, it is equally important that the UK authorities continue to promote the use of robust market failure and CBA techniques at the international level to ensure any regulatory response is proportionate and appropriately targeted. Firms recognise the UK authorities and their international counterparts inevitably face calls to act quickly and decisively in response to turmoil in the credit markets, but caution that rapid regulatory responses that are not fully thought out often fail to deliver the wished for incentives.

Strengthening Risk Management by Banks

5. In debating the actions taken by the authorities so far in strengthening stress testing and risk management firms agree they support the general principles as set out in the consultative document.

6. Stress testing forms an integral component of the CRD/Basel standards. Firms have always supported the inclusion of the risk management standards in the regulatory framework and continue to support the development of such techniques and practices. Firms note that such measures have been consistent with the approaches used by banks to manage their individual risk profiles; it is not the case that Basel II has been the sole driver of stress testing developments within banks.

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[1] Commission Services (2008) - *Public consultation for potential refinements to the Capital Requirements Directive*, ec.europa.eu/internal_market/bank/docs/regcapital/consultation_en.pdf

[2] Basel Committee on Banking Supervision (2008) – *Basel Committee on Banking Supervision announces steps to strengthen the resilience of the banking system (Press release)*, www.bis.org/press/p080416.htm

7. It is therefore important that any new regulatory standards are expressed so that they fall proportionately upon firms and continue to recognise the central role of senior management responsibility.

8. We caution against the imposition of any rigid, pre-determined stress tests, but instead encourage the regulators to continue to support firms' development of stress testing and risk management practices in ways that are most appropriate for the individual firm in question. We believe that the Pillar 2 framework provides the appropriate context for such dialogue (and where necessary challenge to the firm) bearing in mind that the Pillar 2 framework also creates an expectation and need in firms that the regulator will have the depth and breadth of skills and resources to enter the dialogue. As part of this process it is important to have clarity on what the regulator expects from the firm as a legitimate/reasonable response to the results of the stress/scenario. It is essential to avoid any exacerbation of the firm's condition or of the system more broadly as a result imposition of rigid stress testing requirements.

International focus of work on risk management

9. We support the general areas of focus set out by the authorities and agree that it is important to examine inter-dependencies between markets and to be alert to less obvious risks, such as off balance commitments and legal and reputational risks. It is particularly important that this work should take place at international level and the outcome of this work should also be applied at group/global level. We have welcomed the reports issued by the FSF which have clearly set out the focus and objectives for continued work.

10. With respect to stress testing, we note that the authorities suggest that ever more extreme scenarios should be incorporated into stress tests. In principle this is reasonable; it is important to foster a climate of alertness and for firms to consider catastrophic scenarios. However, it is equally important to recognise that firms cannot exist in a perpetual state of red-alert and regulators need to accept that firms should focus on the more plausible range of stress events; they cannot (and should not) exclusively consider the more extreme scenarios. It will be necessary to develop a range of tests and scenarios for the firm and to which the senior management can respond.

Liquidity Risk Management

11. We agree that there should be focus on enhanced risk management of liquidity risk management and support greater recognition of the use of internal liquidity risk models by firms. We support the greater international consistency of regulatory approaches and we support initiatives to enhance existing best practice guidance on liquidity risk management, including stress testing and contingency funding plans. We do not, however, suggest that there should be harmonisation of quantitative liquidity requirements.

12. More specifically with respect to liquidity risk management, industry is working with and responding to initiatives from the Basel Committee and the FSA. Liquidity risk stress testing is a crucial component of any firm's risk management strategy. However, it is critical to separate stress testing for capital purposes (Basel II) from liquidity stress testing. Stress testing in relation to liquidity risk should not be linked to capital requirements. Capital is not a suitable mitigant for liquidity risk.

13. Additionally, we caution against prescription in liquidity stress testing as behavioural adjustments need to be tailored to individual firms. More generally we do not support "hard-wiring" specific liquidity requirements although we support greater consistency of approach between different jurisdictions as firms need to be able to plan and manage their liquidity needs on a global group basis and the creation of trapped pools of liquidity should be avoided. We think that greater

supervisory resources will need to be devoted to liquidity risk and in terms of more intense supervisory oversight we expect supervisors will consider levels of excess liquidity within firms, funding strategies and governance structures. We elaborate on these issues in our response to the recent FSA Discussion Paper on Liquidity Risk Management for Banks and Building Societies.

14. In terms of international coordination, we strongly advocate the UK authorities working within the Basel/FSF context so that solutions can be global and meet the needs of banks and investment firms. It would not be helpful if the UK or the EU were to create new standards, whether quantitative or qualitative, before the international debate has come to fruition.

15. We understand that the Basel Committee now plans to release its consultation in July.

Valuation and disclosure – general

16. Valuation of complex financial instruments, particularly in the current climate, inevitably involves professional judgement and there will be no perfect solution. Clearly firms must implement robust valuation processes, including in circumstances where markets become illiquid. However, while uncertainties around valuation are an important focus it is also necessary to ensure that any prospective changes focus on material issues rather than requiring extensive additional reporting requirements that might serve to stifle innovation.

17. Authorities should focus on spreading good practice around valuation procedures within the industry. This would be more fruitful in terms of improving market valuations of structured products. Measures should be geared to addressing differences in good practice around issues such as: governance; internal control and price verification procedures; and internal and external audit processes.

18. We agree with allowing the markets to find ways to increase access to information and transparency of valuations. There have recently been announcements by NYSE-Euronext and Reuters, as well as Markit Group's multi-dealer valuation platform. Clearly we support initiatives to allow buy-side clients the opportunity to compare valuations and increase market transparency.

19. We agree that it is important to ensure markets have had time to adjust and for the impact of new accounting standards to be determined before changes are made. As in other areas it is of course important to continue to support and work within the international accounting and regulatory communities to seek consistent implementation of accounting standards and prudent valuation guidance. We note that the Global Policy Committee (representing the six largest global accounting networks) helpfully provided a report summarising key IFRS principles and risk disclosure and the UK Financial Reporting Council's work in relation to Audit Committees has also been useful.

Valuation and disclosure - structured p*roducts*

20. In this area there is a need to assess the lessons learned so far in order to determine whether the current rules are fit for purpose. Work that should be taken into account includes the IASB's and FASB's work on fair value. It is also important to recall that the questions raised by fair value for new products are not limited to structured finance and there will be lessons to glean from other products. Similarly, we would encourage the UK authorities to consider the practical aspects of further disclosures – for example, it is unclear what usable information firms could disclose on the impact of "unexpected correlations" on valuations.

21. More generally with regard to the improved functioning of the securitisation market, we support the implementation of the Basel capital framework and note that any possible changes to this

framework should retain the principles of proportionality, avoid perverse incentives and have regard for the level playing field.

Credit rating agencies

International work on credit rating agencies

22. We agree that work should be co-ordinated with the FSF, IOSCO and CESR. A non-coordinated international approach would be extremely unhelpful. Issues that should be considered are conflicts of interest, transparency regarding models used and remuneration structures, staffing arrangements and monitoring, and information on volatility.

23. One aspect of the credit rating process that we would like the authorities to treat with care relates to the dialogue between the rating agency and the client. In issuing a structured product, issuers will put forward a number of alternatives for rating agency consideration. The rating agencies will outline the impact of the various structural options. This exchange is a part of the rating dialogue process and should not be regarded as advice and does not constitute a conflict of interest. It is important that such dialogue is allowed to continue if efficient structures are to be created which allow issuers to bring them to market in a reasonable timeframe.

Information content of credit ratings

24. In our view investors need to take ultimate responsibility for appropriate due diligence; while credit ratings provide a useful information source, they are not and cannot be a substitute for due diligence. However, we accept that rating agencies can probably do more to ensure that users understand what the ratings represent (i.e. opinions on credit risk not liquidity and market risk), by way of investor awareness.

25. We do not think it would be appropriate for ratings to incorporate other risk measures (e.g. liquidity risk). Credit ratings are opinions on credit risk. Not only would this be a major shift in the scope of the credit rating but the scope for incomplete understanding of the information content of a rating, and the context in which that rating must be interpreted and could reasonably be relied upon would increase. If additional risk factors are to be considered, there should be a separate rating process. This would support clarity of information and hopefully avoid perverse effects.

26. We do, however, think it would be helpful to provide more information on the potential volatility of ratings assigned, outlining factors that would impact the rating, and for more detailed information to be provided by the rating agencies with respect to assumptions and methodology. We do not think it would be appropriate to have a separate rating scale for structured products.

Restoring confidence in ratings of structured products

27. We support continued efforts to improve market responses as well as renewed examination of the IOSCO Code of Conduct. We are in favour of self-regulation and do not believe that formal regulation of rating agencies is appropriate as this would be likely to reduce the ability of new entrants to join the market. Were regulation to be considered, it would be important to ensure that the objectives of regulation were clear. There is a risk that the regulators would be seen as having underwritten the assessments of the agencies and this would have to be addressed. We agree that the IOSCO code is an appropriate way of addressing the issues arising, for example over conflicts of interest. Investors need to have in place appropriate policies and procedures to undertake due diligence.

Transparency of banks and exposure to off-balance sheet vehicles

28. Securitisation is important both as a source of funding and as an effective risk management tool, therefore any response must be proportionate. One point we would emphasise is that although the regulatory and accounting answers may differ in relation to off balance sheet activity, there are other mechanisms to ensure that the risks are appropriately captured. We would agree that it is not appropriate to regulate the SPVs themselves if they are truly off-balance sheet.

29. The revised capital adequacy framework (Basel II and CRD) addressed securitisation for the first time and the recent market turmoil of course pre-dates the implementation of the new regulation. Significant changes introduced by the new framework include enhancing risk sensitivity, thus removing perverse incentives for securitisation activity, attaching capital requirements to the considerable majority of liquidity facilities as well as a greater focus on risk management surrounding securitisation and Pillar 3 disclosures. As with all other areas of recently implemented legislation, it is important first to assess the effects of the new regulation before making any further changes.

CHAPTER 3: REDUCING THE LIKELIHOOD OF A BANK FAILING

Strengthening the regulatory framework - Regulatory interventions

The FSA's existing powers

30. The FSA has considerable powers to intervene to reduce the likelihood of failure of a bank. There is no evidence to suggest that new powers are required. Timing of intervention is crucial, however, and this cannot be prescribed or legislated for in the abstract. There needs to be the exercise of judgement and discretion and willingness of the authorities to be ready to act. In order to do so, the authorities need to have a solid basis of information and the skills located within the relevant authorities.

31. In terms of clarity and application we agree that the FSA's powers are clear, but we do think that they could be better communicated. Moreover, the FSA could usefully review its application of its ARROW processes to ensure greater consistency in peer group reviews. Internal reviews of ARROW assessments might also enhance the quality of the oversight process.

FSA supervisory information requirements

32. We strongly suggest there needs to be a discussion regarding the quality of information that a firm might have to provide at short notice. Firms are keen to be responsive to requests and particularly so at times of stress. Nevertheless, the needs of the regulator to have access to the requisite information to carry out its duties have to be balanced with the ability of the firm to be able to respond to any and all requests in timely fashion. It would be useful to know whether such information provision mirrors (or exceeds) demands in other jurisdictions. Firms are keen to support regulators' ability to carry out their functions, but we ask that the authorities remember that excessively burdensome information requirements would affect the desirability of London as a financial centre.

33. In practical terms, however, given that the FSA already receives considerable information from firms in the normal course of business, we also think that there should be an onus on the FSA to demonstrate that the "new" information is not already supplied, or that such information needs to be updated to reflect a potentially swift moving situation. There have been instances (both over time and more recently) in which the FSA has asked firms for information which had already been supplied. Equally, we would expect FSA to be able to justify how any additional information

will be used in practice. Firms note that the FSA has identified the need to improve the "use of information and intelligence in its supervision";[3] this is not the same as gathering reams of data speculatively.

34. We would assume, although it is not clear, that such information requirements would be very likely to extend from banks to other financial institutions. It would be helpful for our understanding to be confirmed.

35. We do not find it possible to quantify the cost of provision of information as the question is somewhat abstract at this stage. We would be happy to have a more granular conversation when ideas and proposals have more substance. We would emphasise that providing data – including management information – is not cost free and hence all routine requests should be justified by CBA.

Effectiveness of new information requirement

36. Under Section 165 FSMA the FSA has sufficient powers to demand any information from a bank, hence it is not clear that new powers are needed or that the new powers would yield information not otherwise obtainable.

37. It is not clear that a new information requirement would be effective in early identification of a deterioration. Addressing a deficiency within a bank is a function of supervisory action not of passive receipt of information (even if the ability to act effectively does itself depend on timely information of good quality).

38. An information requirement might support the FSA in monitoring, understanding and addressing a deterioration but (as above) it is not clear why a new power is actually necessary, unless the intention is that firms will organise their MIT so that they would, in any event, be readied to prepare and present such information. We think that the internal systems within the FSA so that data can be collated and examined should be reviewed for further potential improvements and we also note that an abundance of information provided to the authorities is relatively useless if the supervisors are themselves not suitably supported by commensurate skills and resources.

Information sharing by the FSA

39. We support the open exchange of information between the authorities.

Statutory immunity for the Bank of England

40. Moreover, consistent with the immunity granted to the Bank in respect of its banking supervisory duties under the Banking Act 1979 and the Banking Act 1987, we agree it is appropriate for the Bank to be provided with statutory immunity.

CHAPTER 4: REDUCING THE IMPACT OF A FAILING BANK

41. In our previous response – to the "Banking Reform – protecting depositors" discussion paper – we confirmed that we understood why the Authorities would wish to explore the introduction of a SRR facility in the UK and, as part of this, we noted the limited role that we believe that compensation arrangements have in maintaining stability if depositors develop a concern that their bank is in difficulties. A system that provides certainty of provision of critical banking functions will avoid the dislocation and ensuing damage that follows if access to banking services

[3] FSA (2008) – Recommendations & Actions [to enhance supervision in wake of Northern Rock], www.fsa.gov.uk/pubs/other/recommendations.pdf

is denied, and it may well also significantly reduce the risks of depositor anxiety prompting a run on a bank which is solvent in net asset terms but which is rumoured to be in trouble. At the same time, though, it must be appreciated that the operation and impact of a SRR for UK banks would, by definition, be untested so that the effect as regards quelling incentives for bank runs cannot be assumed. Given the uncertainty about the benefits *in practice* of a SRR, it is all the more important to ensure that to the maximum extent the regime is designed to minimise "bad impacts" for non-retail business: as one of our Members has commented, it is important to ensure that the effects of the medicine are not worse than the disease, and it is essential to be certain that the banking services continuity benefit cannot be achieved through amendments to the law on administration before the final decision is taken to bring forward legislation introducing a SRR for the first time. Specifically, the impact on the various contractual arrangements and the consequences these have on counterparties and bank credit ratings must be sufficiently thought through in advance. The mere act of putting in place legislation providing powers to invoke SR for a bank could significantly raise the capital and economic cost of transactions. This would potentially reduce the attractiveness of London compared to other financial centres.

42. The main elements of the SRR for UK banks discussed in the consultation paper are as follows:

    (a) powers to allow the Authorities to direct and accelerate transfers of banking business to a third party in order to facilitate a private sector solution;

    (b) powers to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a 'bridge bank';

    (c) powers to allow the Authorities to appoint a suitable person, or 'restructuring officer', to oversee the bank to carry out the resolution; and

    (d) should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank is appropriate, a modified insolvency process for banks – a 'bank insolvency procedure' – to facilitate fast and orderly payment of depositors' claims under the FSCS;

    (e) in addition, existing tools for the provision of financial support to a failing bank through a public sector liability guarantee or public sector capital injection will be maintained.

43. In considering the proposals our Members have focused on the second of these – the introduction of "bridge bank" arrangements – because of the potential implications for the market that will flow from the knowledge that only "part of a bank" (or of its assets and liabilities) may be transferred. We would note, however, that this proposal, together with the proposal to allow the Authorities to direct and accelerate transfers of banking business to a third-party, have important implications for shareholders too, and we will be exploring with the bodies that represent investors whether there are ways to mitigate the impact. We also comment below on the proposals for a modified insolvency process for banks (point (d)).

44. *Overall*, and as stressed already, the introduction of a SRR has potentially wide-ranging implications for wholesale business undertaken with British banks, so it is essential that sufficient time is provided to allow the consequences to be fully thought through: if the SRR proposal is proceeded with, then consultees should have the opportunity to comment on draft clauses before legislation is presented to Parliament. Our Members are particularly concerned about the potential disturbance of set-off and netting arrangements. Uncertainties around the ability to close out contracts against a defaulting counterparty on a net basis would significantly increase credit risk. This would also increase regulated counterparties' capital requirements (and therefore costs) associated with dealing in derivatives and securities financing arrangements. Equally important is

the ability of counterparties to realise collateral held by way of title transfer against the bank, and the ability of counterparties to enforce security interests (legal charge, lien etc). It is important that any disturbance of these rights should be kept to an absolute minimum, if at all. (We comment further on this aspect in the Other Safeguards section below.)

The bridge bank proposal

45. The decision to establish a bridge bank would be taken at the pre-insolvency stage. In the case where only parts of a bank's assets are transferred, the wholesale creditor whose claims are not transferred will inevitably be potentially disadvantaged where only assets of a better quality are transferred to the bridge bank. The knowledge of this possibility could affect credit ratings and seems likely to affect counterparty assessments when dealing with a UK bank as compared to, say, an EU bank with a branch in London: we have therefore considered what safeguards can be provided to address the potentially negative implications, in particular as regards SRR "triggers". (This discussion is also relevant to the directed/accelerated transfer SRR tool in the case where it is decided that only part of the business should be transferred.)

46. Clearly, a very important element will be achieving supervisory arrangements that make the need for a special resolution outcome highly unlikely. But more needs to be done, and we have considered the extent to which lessons can be learned from the US experience. In many respects the US regime is significantly more prescriptive than the framework outlined in the CP, both in terms of the criteria that have to be met before a special resolution is triggered – although we understand that one criterion is that a bank is not being operated in a safe and sound manner – and in terms of the objectives of special resolution (the FDIC is obliged to pursue a least-cost resolution objective except in the case where the systemic risk override should be applied, and we understand that the latter – which requires notification to the President – remains untested).

47. These conditions provide a framework in which wholesale counterparties can at least start to make judgements about the potential implications of the US rules for the banks with which they deal. On the other hand, the disadvantage of such arrangements, of course, is that they could rule out particular regulatory steps that would, in fact, be in the best interests of a bank's creditors as a whole and, in addition, they are not obviously compatible with the UK's principles- and risk-based regime – hence, no doubt, the Authorities' proposal to establish much more discretionary arrangements in spite of the greater uncertainty to which they will give rise.

48. Against this background, we would urge the Authorities to consider and discuss with consultees ways to clarify in the legislation (and as necessary elsewhere) the criteria in addition to the factors referred to in paragraph 4.10 that will be applied in determining that special resolution is appropriate, although we recognise that in order to maintain the discretion to act in unforeseen circumstances, the provisions – depending on the generality of the drafting – are likely to have to be non-binding. Thus the criteria should establish the circumstances in which special resolution could be triggered but would not oblige the Authorities to resort to special resolution if it was considered that an alternative way forward should be pursued. A particular issue is whether the legislation should establish a framework in which the decisions for triggering a special resolution and for determining that *only part* of the business should be transferred to a bridge bank are distinguished. This is important because, rather than the decision to transfer a bank's business, it is the possibility that it will be decided that *only* the better assets and retail deposit claims will be transferred to the bridge bank that contributes to wholesale creditor concern that they could well be disadvantaged under a SRR framework compared to the current position (assuming that the issues as regards netting, collateral and set-off can be satisfactorily addressed). Recognising that transferring just a part of a bank's business will almost certainly involve the abridgement of property rights of those whose claims are not transferred, it would seem to be essential to see whether clear criteria for determining when a "partial transfer" decision is appropriate can be

established. We would hope that the Authorities will agree that this is a modification to the framework proposed that should be explored fully before new legislation is brought forward.

49. Other safeguards must be included if the SRR proposal is proceeded with, and these are discussed further below. One more general suggestion is that legislative provision should be made under which an additional SRR principle would require the powers to be exercised as far as possible so as not to cause substantial prejudice to any creditor.

Other safeguards

- *SRR governance and related issues*

50. There will be two key decisions to be taken under the proposed arrangements, namely whether a special resolution should be initiated and, if so, what the appropriate resolution tool should be. The CP proposes that the FSA, after consultation with the Bank and Treasury, would take the first decision but the Authorities' proposal on the second is unclear to us.

51. Given that a key element of the decision to initiate special resolution is that heightened supervision has not had the desired effects, we believe that the first decision should rest with FSA (albeit after consultation with the other Authorities as proposed, and also recognising that Ministerial approval will be needed if public financial support is involved).

52. We have considered which institution should oversee a special resolution once the decision to initiate the procedure has been taken. Our provisional view is that of the four Authorities that could take on this role, the best qualified are the FSA and the Bank but that there is a problem in the former case because of the apparent need for FSA to continue to supervise a bank once it is subject to special resolution. The Bank, in addition, is a market participant with the appropriate skills.

53. There remains, then, the question as to which Authority should determine which resolution tool is appropriate in any given case and the "full or part" transfer decision. Given that we envisage the Bank being involved in the first decision – to initiate a special resolution – we suggest that perhaps the best way forward would be to establish a special resolution committee/board for this purpose: the committee would represent the Bank and FSA at the highest level (for example the Governor, the Deputy Governor responsible for financial stability and the FSA Chairman or Chief Executive). Given the Treasury's involvement in the initial consultation on whether special resolution should be initiated in a particular case, it would not seem to be necessary for them to participate in this committee (whose remit would be limited to the judgement about the resolution tool to be used.)[*]

54. The CP also asks whether the triggers should be linked to regulatory guidance material. From the discussion above, it should be clear that we hope that the most important criteria can be set out in the legislation, but if a further articulation of how the decisions to initiate special resolution will be taken in practice can be provided in separate material that can only assist a better market understanding of the Authorities approach. There is a question, however, about whether regulatory guidance material will provide a suitable vehicle given the reductions in the Section 157(3) consultation requirements in FSMA that were introduced by the Regulatory Reform Order.

55. For bridge banks, an additional procedure is envisaged: the CP (paragraph 4.32) states that although the power to establish a bridge bank would be established through primary legislation, the exercise of that power with respect to *any particular bank* would be taken forward through a negative resolution procedure statutory instrument. Although we welcome the acknowledgement that the implications of exercising this SRR tool are such that additional safeguards may be

[*] On this aspect also see our comments below on the suggestions in paragraph 4.32 of the CP.

necessary – and we understand that in the US a special resolution is subject to court supervision – we believe that introducing political issues potentially in to special resolution decisions about particular firms is undesirable. Accordingly, except in the case where a resolution tool involves public money, Parliament and Ministers should not be involved in the decisions (this also follows from the fundamental FSMA structure under which FSA is required to take decisions about whether individual firms' conduct satisfies the threshold conditions – and are therefore able to continue to undertake regulated activities – but within the *overall framework* for the regulator's objectives and duties established by Parliament in the legislation).

56. The CP also raises the question of appeals and we are continuing to consider aspects of this matter further: our initial view is that the Financial Services and Markets Tribunal is not qualified to assess the transactional issues, such as valuations, referred to. More generally, it is stated that additional arrangements will be provided to ensure that the fundamental rights of stakeholders – including the shareholders and counterparties of the failing bank – affected by use of the SRR tools are protected. In this context, however, it is also noted that in considering appropriate arrangements "it is necessary to bear in mind that the tools would be deployed to secure the wider public interests in mitigating the systemic damage that could arise from a bank failure", and we are not clear how this is compatible with the second part of the third SRR criteria referred to in paragraph 4.10 (which indicates that the "interests of depositors" alone could be the basis of triggering a special resolution in the absence of the need to protect financial stability).

- *Client accounts*

57. Given the "all or part" provisions, if the SRR regime proposed is proceeded with, the legislation should make clear that client account balances *would* be carried over in the bridge bank (we comment further on this aspect – see Chapter 5 below).

- *Position of particular contracts*

58. We have already commented on this aspect. In addition, it will be important to ensure that the SRR is compatible not only with EU company law and winding up measures, the Market Abuse Directive, and the State Aid rules, but also recognises in terms Article 7 of the Financial Collateral Arrangements Directive. In particular, it must be clear that the "all or part" provisions on the treatment of assets could not prevent a financial market master agreement being transferred in whole so that close-out netting would not be disrupted.

59. A further concern is that, unless sufficient certainty as to the operation of the SRR is achieved, wholesale creditors may well seek to revise documentation so that pre-insolvency special resolution intervention would be held to be an event of default. Such provisions would enable credit lines to be withdrawn, almost inevitably precipitating the insolvency that the regime is designed to avoid. The CP appears to recognise this risk – it is suggested that the Authorities might be given the power temporarily to suspend the ability of counterparties to treat special resolution action as an event of default – but establishing a regime under which the Authorities had the power to override validly concluded contracts as this seems to suggest appears to be less than optimal from the point of view of London's competitiveness.

Special bank insolvency procedure

60. As regards the proposed special bank insolvency procedure, we are not sure that a self-standing arrangement is strictly necessary although it may be the case that a separate regime could be "legislatively convenient" with regard to the introduction of future amendments. On the assumption (i) that the proposed bank liquidator's objective to assist/co-operate with FSCS "to co-ordinate rapid repayments to eligible depositors/effect transfers of accounts to a third-party" is a reference just to focusing on *administrative arrangements* (as confirmed at the Treasury workshop and see paragraphs 4.37 and the end of 4.42), and (ii) that depositor preference will not be introduced, it is not clear why introducing a limited range of special arrangements for banks

within the existing regime for companies at large will not suffice. From what is said in the CP, it seems that the number of special provisions to be incorporated would be limited, covering matters such as the need to deal with the Authorities' control over entry to the procedure once it has been determined that other SR tools are not appropriate, voluntary liquidation restrictions, appointment of the liquidator/creditor meetings, bank liquidators' powers (including decisions on deposit repayments funded from insolvency), and both the notice period and the "without-notice" procedure. There is also a question about whether the introduction of an entirely separate regime could give rise to an exaggerated impression about the extent to which the UK was making fundamental changes to its generally "creditor-friendly" arrangements.

61. In addition, although not referred to in Chapter 4, it seems that the Government will need to consider including provisions on set-off in the proposed bank insolvency procedure to ensure that FSCS *gross payments* to eligible depositors will not prevent "a fair result for different customers and the FSCS" – we comment further on this aspect below – and a question is also raised in the CP about whether the insolvency procedure should allow for continued trading of some of a bank's business "in the interests of depositors or other creditors": we do not understand precisely what is envisaged here.

Other issues

62. The CP asks about the financing of the SRR and possible contributions by the FSCS. Our Members are assuming that any FSCS contribution would be financed only from the Banking scheme to ensure that there is no further extension of cross-subsidy.

63. With regard to the proposal to introduce a power for secondary legislation in relation to financial collateral arrangements, our Members are uncertain precisely what new measures the Authorities consider might be needed but, in principle, we support this suggestion. There is a question, though, about whether the power should provide for positive or negative resolution procedure. The advantage of the former is that it would provide the opportunity for Ministerial clarification of the objectives of the legislation which could help to address market concerns. (A similar point arises in respect of other order-making powers in the new legislation.)

CHAPTER 5: COMPENSATION ARRANGEMENTS AND CONSUMER CONFIDENCE

Role of compensation, limits and related structural issues

64. Given the investment banking focus of our work, our Members have asked us to comment only on some aspects of the proposals discussed in Chapter 5 of the CP.

65. In our previous submission on the "Banking Reform – protecting depositors" discussion paper we explained why we thought it was important not to over-emphasise the role of compensation schemes in providing stability (as noted above). This is in part because, except in the case of an insolvency of a small bank, there will be depositor anxiety about whether industry financing of compensation payments will be adequate unless it is clear that the Government will provide top-up finance as necessary (pre-funding would only help to address this point to a degree, and only if a very large fund was established with all the opportunity costs to which that will give rise). On this aspect, we also made the point that the Directives envisage a limit to the amount of compensation finance that can be raised from firms.

66. In addition, we suspect that even the seven day payout that the Authorities have in mind will be regarded by many depositors as too long a period – so that even if depositors are confident that 100% of their deposits will be recovered through the FSCS, they may still seek to withdraw their money at an early stage if rumours about their bank start to emerge. The Authorities must also

bear in mind that the costs of compensation provision should not be disproportionate relative to the benefits and that it is important that the system does not fail to provide some incentives for diversification.

67. For these reasons we conclude that the 95% coverage of deposit accounts that is provided under the current rules should be maintained for the time being, but we recognise that further work may be needed on this aspect in the light of the work to be undertaken on developing international principles for deposit insurance systems following the Financial Stability Forum's report of earlier this month.

68. It is also important that changes in deposit protection arrangements following the consultation do not reopen the debates about FSCS financing cross-subsidy: this, though, does not seem to be implied by the discussion in the CP.

Other issues

69. With regard to the additional questions raised in Chapter 5, our Members have asked us to comment on four other points.

- *Position of other products*

70. Due to the importance of maintaining access to banking services, bank deposit compensation arrangements are of a different kind to the arrangements for investment products, and the FSCS arrangements need to take this into account. In particular, it should not be assumed that the 100% cover provided for bank deposits should automatically be read across into the coverage provided by the FSCS Investment scheme without the merits of such an amendment being examined in their own right. Similarly, the *maximum* level of cover provided by the Investment scheme is greater than the Deposit scheme, but there is no intrinsic reason why they should be the same and, certainly, an increase in the deposit limit should be avoided if the result of this would be to distort consumers' investment decisions (we understand that the Association of British Insurers has been examining this aspect).

71. There are also important consequential issues on the funding side. If the proposal to provide coverage for corporates is proceeded with, it is important to consider the consequences for the financing rules (currently deposits can be excluded from the levies calculation if they are not compensatable). In addition, for the Investment scheme, FSA has decided to proceed with changes to the levy rules to ensure that *only* a firms' *compensatable business* is to be taken in to account – there will be major changes in industry financing of the Investment scheme if eligibility was to be broadened to cover wholesale clients with serious implications for the competitiveness of UK firms given that, under the Directive, EU firms cannot be required to contribute. (On this aspect, we would also note that urgent payment is less necessary for business protected under the Investment scheme, so that there is less need to simplify the eligibility criteria: a question is not raised on this aspect in the CP but paragraph 5.41 touches upon the point.)

- *Large balances arising for transaction purposes and client accounts*

72. We agree that special arrangements need to be made for large balances arising for transaction purposes and client accounts. On the latter, in particular, it is important that the protection that segregation is designed to achieve is not undermined by the insolvency of the bank holding the client account. (MiFID provisions, of course, require Member States to have segregation arrangements in place designed to prevent losses arising from an investment firm's insolvency.)

- *Gross payments and set-off issues*

73. A system of gross payments should simplify – and therefore speed up – compensation payments, but it will be important to ensure that a gross payment arrangement does not undermine set-off arrangements in an insolvency. (The CP comments that the Government will consider including

provisions on set-off in the proposed bank insolvency procedure to ensure that making gross payments to eligible depositors "will give a fair result for different customers and the FSCS", and it would be helpful to us to understand precisely what the Authorities have in mind.) In addition, we would remind the Authorities of the need to address the issues already raised by the Financial Markets Law Committee as regards bringing forward the legislation needed to confirm statutory set-off for building societies and friendly societies.

- *Single view of the customer*

74. There are significant practical and cost implications from the proposal for a single customer view. We recommend that the Authorities undertake a detailed review of the potential cost implications and lead time this would take, drawing on the information that the BBA has already provided. Our expectation is that the analysis could well show that the costs significantly outweigh the potential benefits.

CHAPTER 6: STRENGTHENING THE BANK OF ENGLAND

Bank of England's objectives

75. We support the formalising in statute of the Bank of England's role in the area of financial stability and we also agree that it is wise to create an *oversight* role for accountability purposes and that this should be granted to the Court of the Bank. In addition, creating a formalised responsibility for the Bank in financial stability, the Bank will have to take a wider and more nuanced view of the economy and factors influencing it in the work that it undertakes (although, presumably, the MPC's terms of reference would be maintained). Furthermore, resources devoted to financial stability issues will need to be strengthened.

Governance of the Bank of England

76. We support the proposals to formalise the current arrangements, namely that the Chairmanship of Court will fall to the Senior Independent Non-Executive Director. We also support the initiative to improve the expertise of Court members. Notably we support the need for a minimum level of experience in financial services, as well as broader economic issues among the members of Court.

CHAPTER 7: EFFECTIVE COORDINATION

77. In general terms we would emphasise that the clarity of tripartite arrangements is central to more effective coordination at the domestic level. Internationally, cooperation and communication cross border is essential and any obstacles to this need to be removed.

Coordination in the UK

78. We support the details of the proposals as stated in the document, namely the clarification of roles in the Tripartite arrangements and the enhancement of communication strategies. We agree that the distinction between normal and stress/crisis situations will be important, as the appropriate degree of involvement by the non supervisory authorities in supervisory matters during "normal" situations needs to be considered and carefully judged. The authorities will be keen to avoid any possibility of "shadow supervision."

International arrangements

79. We entirely support proposals to enhance cooperation and coordination between the FSF and IMF. It is important to avoid trapped pools of information. We note the proposal that the FSF carry out a strategic oversight and coordinating role. In principle we think this worth exploring, but are concerned by the increased "layering" of bodies at the international level and think it important that the key bodies in the relevant fields retain right of initiative, rather than being subsumed into a supranational, cross sectoral, cross-discipline body. Clarity and communication of the functions of the bodies to the wider financial community will be vital.

80. We suggest that the FSF enhance its transparency of practices and ensure that any proposals made at this "oversight" level are subject to better regulation practices including openness of dialogue, consultation and early contact with market participants

81. We support proposals to enhance cross border coordination and information exchange; this is an essential basis for effective supervisory practice. However, we query/caution against any proposals or arrangements that would lead to lack of clarity in responsibility. We also advise caution regarding proposals that would or could lead to a uniform analysis of assessment of systemic implications of a potential crisis. It would be unfortunate if the early warnings of a potential crisis were missed because there was a uniform analysis that there were no concerns emerging.

Managing cross-border crises

82. We support proposals for the UK to work with international counterparts and in particular we support the proposals identified by FSF/UK to enhance cross-border crisis arrangements.

CONCLUSION

83. Overall, although we can support many aspects of the Authorities' proposals in the consultation paper, certain elements have the potential to seriously damage financial services markets in the UK so that the Authorities must proceed with caution and full consultation with firms and their associations must be maintained: in particular, draft clauses must be consulted upon before new legislation is presented to Parliament. This may well involve revisiting the legislative timetable or bringing forward the legislation in two stages.

London Investment Banking Association
23rd April 2008