IMF STAFF RESPONSE TO THE UK CONSULTATION PAPER ON *FINANCIAL STABILITY AND DEPOSITOR PROTECTION: STRENGTHENING THE FRAMEWORK*

SPECIFIC POINTS

Chapter 3: Reducing the Likelihood of a Bank Failure

3.6) Do you agree with the proposal for a new and flexible regime for payment systems oversight and, if so, how should its scope be defined?

Such a change adds to the FSA's already considerable workload and would need to assure continued flow of information to the BoE under its financial stability remit. We therefore support the intention to undertake further consultation, in particular with jurisdictions where supervision is separate from the central bank.

3.11) What would be the effect of removing the 'weekly return' reporting requirement?

We see merit in maintaining the current posture in favor of disclosure. Even temporary suspension of disclosure could add to market uncertainty. The case for disclosure is further strengthened if, as we suggest, a regime of comprehensive disclosure of quarterly bank-by-bank results is established. In this context, with the condition of banks well known, the announcement of ELA is less likely to signal unexpected difficulties and so is more likely to be well received by markets.

Chapter 4: Reducing the Impact of a Failing Bank

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

Although judgment will always be a factor, there is also need to avoid arbitrary or unclear decision-making in regard to intervention. The decision to intervene and take formal control should have a clear rules based trigger, and include quantitative measures. The consultation may be limited to instances of systemically important institutions or when public money is involved. In the event of resolution of a nonsystemic bank without use of public money, advance notification may be sufficient in lieu of broad consultation.

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?

The SRR is an important addition to the problem bank resolution framework. As a general comment on principles, the rules governing SRR need to be transparent, and its use should not come as a surprise to market participants, depositors, and shareholders. To the extent consistent with maintenance of orderly markets, enhanced disclosure and transparency

concerning the escalation of actions against a troubled institution (up until the point of a take over by the authorities), should be considered.

Concerning appeals, there should be a clear limitation in primary legislation that the courts cannot reverse a supervisory decision in conjunction with the SRR. If supervisory mistakes have been made, there should be a legal process for claims and compensation, but not recourse through the courts that suspends or reverses the SRR process.

In addition, the arrangements for directed transfers need to be clear. We see the context for these as being solely for when a bank has failed—according to the applicable definition of "failure"—and not for the purpose of maintaining the bank's franchise value (paragraphs 4.20-4.21). Specifically, purchase of assets and assumption of liabilities transactions (P&A transactions) cannot occur if the institution remains open and a restructuring officer cannot be appointed for a bank whose shareholders remain in place.

Our call for clarity also applies to bridge banks (paragraphs 4.250 to 4.32). Their purpose would not be typically "to keep the bank solvent" (paragraph 4.26, and again in paragraph 4.28). Instead, a bridge bank would be used as a vehicle to assume the assets and liabilities of a failed bank and put them into a de novo institution under temporary administration of the authorities. With all or most of the good assets and liabilities gone, it is unlikely that the residual institution will be able to survive. In this context, greater flexibility in the length of temporary administration of a bridge bank (e.g., 24 to 36 months) may be preferable to the suggested 12 months.

Furthermore, the prospect that the authorities can take "temporary ownership of all or *part of* a bank as a last resort" (paragraph 4.15) seems to imply that the remainder of the institution would stay in operation. The circumstances here would need to be clear.

The paper (paragraph 4.16) suggests that under the SRR, public guarantees or capital injections could be appropriate as temporary relief for an institution that still has original shareholders, provided there is a phased plan for returning the bank to full private ownership. In this regard, the SRR would need to clearly differentiate between (i) steps to support shareholders, (ii) provisions to facilitate the sale of a bank and (iii) resolution techniques in a failed institution.

4.31) Should the industry contribute to the costs of an SRR?
4.32) Would mechanisms other than the FSCS be appropriate for addressing such cost issues? How might such mechanisms work?

The proposal for broad coverage may be costly. Accordingly, the purpose for the resolution regime needs to be clearly stated. In this regard, the discussion of the role of the deposit guarantee fund seems to signal that it might cover deposits beyond the publicly indicated cap. If so, such intentions need to be explicit, not least to ensure that the guarantee fund is credible relative to the level of deposits.

Chapter 5: Consumer Confidence and Compensation Arrangements

5.7) What are your views on a one-week target for FSCS payment? 5.8) How feasible would it be for banks to provide instant access to the funds provided by FSCS cheques as soon as they are deposited?

Rather than specify ambitious deadlines for payouts, we suggest instead an approach whereby the actual payout of deposits should be viewed as a last resort. The alternative to sending checks to depositors (paragraph 5.21) would be to identify another bank and transfer all the deposits to the new bank along with eligible assets (i.e., cash, cash equivalents, eligible loans and securities, and a claim on the FSCS for any difference). We would support the combination of an individual account up to the maximum and then separate coverage for a customer's interest in a pension fund, retirement account, etc.

GENERAL POINTS

Chapter 2: Stability and Resilience of the Financial System

2.3) Have the Authorities correctly identified the issues on which the work on liquidity regulation should focus?

Although important parallel discussions are underway in international forums, a closer link between capital adequacy and liquidity risk should be drawn, within the context of the pillar 2 requirements of Basel II.

2.4) Do you agree with the actions being taken by the Authorities to encourage full and consistent valuation and disclosure by banks?

We welcome the proposed actions, which we see to be in line with discussions within many international forums, including the Basel Committee. We recommend consideration be given to designing a specific regulatory reporting requirement with at least a quarterly frequency, including the public release of bank-by-bank exposure information (see also response to question 3.4).

Chapter 3: Reducing the Likelihood of a Bank Failure

3.2) Are the FSA's existing powers, and in particular the application of them, clear, and how could they be further clarified?

The OIVOP powers seem appropriate. That said, the consultation paper is unclear in how the OIVOP powers are linked to the ARROW process. Although specific supervisory interventions cannot always be determined in advance, the range of actions at each stage of the deterioration could be more clearly articulated. For example, the system could specify when supervisory powers would be used to reduce or suspend shareholder dividends and equity buyback efforts, and/or require the submission of a plan to raise capital. Such an approach would be congruent with the SRR.

3.4) How effective would the new information requirement be in identifying and addressing a sudden deterioration in a bank's financial soundness?

Although ad hoc requests can never be ruled out, consideration could also be given to expanding the detailed set of routine regulatory reporting (e.g., there would be merit in routine collection of some elements of securitization exposure information). The expanded set of routinely collected information would be used to (i) reduce the need for ad hoc requests and (ii) better inform offsite monitoring and increase the likelihood of early warning of impending difficulties.

The effectiveness of an early warning system requires the ability to monitor trends and measure one financial institution against its peers on an ongoing basis. An expansion of the scope of coverage of the standard reporting requirement could help in this process, and particularly in the case of smaller, less frequently inspected, institutions. The reporting regime could moreover be aligned with proposals under consideration by the Committee of European Bank Supervisors (CEBS).

We would also suggest increasing release of financial information on individual institutions collected by the supervisory authorities to market participants. This could include balance sheet, income statement, and other financial condition information (e.g., summary off-balance sheet items, schedule of categories of loans and investments (including whether current), and reconciliation of capital calculation). This would exclude supervisory information containing customer/client information. Among the G7, this practice is followed in the United States and Canada.