

INSOLVENCY LAWYER'S ASSOCIATION

FINANCIAL STABILITY AND DEPOSIT PROTECTION : STRENGTHENING THE FRAMEWORK: A TREASURY CONSULTATION PAPER

1 General

The Insolvency Lawyer's Association (ILA) is pleased to have the opportunity to comment on the HMT consultation paper entitled "Financial Stability and Depositor Protection".

The ILA was formed in 1989 as a special interest group to promote the role of lawyers in the insolvency profession and to advance the theory and practice of insolvency administration. The ILA provides the forum for lawyers practising insolvency law to co-operate on matters of professional interest and to represent the ILA's view to Government and to other professional bodies having an interest in insolvency practice.

The ILA seeks to confine itself to those matters in Chapter 4 relating to insolvency issues. Others may be better placed to deal with banking policy issues in the other chapters.

As a general proposition, we are supportive of an SRR regime pre-insolvency to give effect to any necessary intervention or directed transfer. However, we are doubtful whether a new insolvency regime, such as a special administration regime, is necessary. We consider that the current statutory regime might be amended so as to encompass the mechanism for directed transfers or other bespoke remedies, but do not consider that a freestanding wholesale insolvency regime for banks is desirable. Insofar as an objective may be to facilitate payments to and by the FSCS, we believe this purpose could be achieved more simply by changing the FSCS rules. We also have concerns as to whether any of the measures specified in Section 4 as part of the SRR regime could actually prevent a run on a bank.

Our preliminary comments are set out below, but they are subject to seeing more detailed proposals.

2 Responses

New SRR tools – directed transfers

We agree that Part VII of FSMA is too cumbersome. We support the proposal for directed transfers. However, it will be necessary to give detailed consideration to the wider tax and employee implications. It may be possible to adapt the procedure outlined in section 217 FSMA which might achieve the required objective without the need for more complex proposals.

We consider that it is currently difficult to comment in greater detail as the proposals are drafted very generally. For example, section 4.23 mentions the possibility of temporarily suspending rights of counterparties to treat the Authorities' actions as an event of default, but we have a concern as to the consequential effect of any suspension of counterparties' rights.

Question 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?

In principle, the power to direct a transfer is sensible but we are concerned that given the interlinking of banking relationships, the consequential effects of suspending counterparties' rights could be problematic and challenging. Overriding the wishes of directors and shareholders is of less concern. In times of financial crisis directors are often concerned as to

their duties and liabilities and we can see they might welcome intervention. The suspension of shareholders' rights in circumstances where their equity interest may be doubtful is not unreasonable.

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

We believe there should be some form of remedy for aggrieved parties but, whatever the process, it should be directed purely to provide compensation. If legislation is to provide for a directed transfer, one cannot allow the possibility of injunctive proceedings being deployed as a challenge to the process. This would introduce a level of uncertainty in the scheme which would make it unworkable. It would also risk allowing aggressive shareholders or indeed creditors to challenge the procedure just to create leverage in the reconstruction. As the directed transfer would be an administrative act, we consider judicial review to be the correct mechanism for any challenge.

Question 4.9 : Is the Financial Services Markets Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds amongst stakeholders?

Presumably this is suggested to ensure a speedy resolution but we are unsure that proceedings before this forum would necessarily have that desired result.

New SRR tools – bridge bank

The proposal document seems to suggest that some or all of the assets of the failing bank would be transferred but it is not clear how the transfer would be effected in practice. The current proposals are general and it is not evident what the purpose of the bridge bank would be.

We doubt:

- whether this procedure is necessary.
- whether the creation of a bridge bank would be workable in practice. This would entail all the usual business transfer liabilities such as tax and employment considerations. It seems that the bridge bank could only work if the transfer included not only the business of the failing bank, but also its employees.
- whether it would be practicable to transfer some branches or other operations of the failing bank and not others. It is unclear what the criteria would be for transferring part of a bank's business.

We do not consider that ECHR compensation is a realistic solution of aggrieved parties as it does not really address the proper issues of compensation that would arise.

We are doubtful as to whether it is desirable to have the separate bridge bank procedure, if there is to be a right to transfer under the directed transfer provisions.

Question 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 some flexibility in the description of these circumstances is also desirable?

We are not convinced that there is a need for the creation of a bridge bank procedure. In addition, we see real practical difficulties as to how this would operate.

Question 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 accept the creation of a bridge bank could only work if there were provisions for the removal and suspension of stakeholders' rights. The issue as regards creditors is whether the suspension of their rights could have unforeseen consequences.

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

See response to question 4.8 above. The remedy must be solely directed to compensation – an aggrieved party should not be able to impede the process as a tactic to creating leverage.

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

See response to question 4.9 above.

New SRR tools – bank insolvency procedure

We consider the stated primary objective of the bank insolvency procedure could be achieved more simply by changing the FSCS rules, so that its ability to make prompt payment triggers on the usual insolvency procedures. More legislation is unnecessary and undesirable. The proposals seem to advance the interests of the FSCS, and behind them the depositors, possibly at the expense of other creditors. We appreciate the need to maintain confidence in the banking system, but we consider these proposals go too far. A liquidator's duties are far wider than facilitating FSCS payments and any amendment to the regime needs to recognise the principle of all creditors being treated fairly.

The proposal document suggests that there are weaknesses in the current insolvency procedures, but it does not identify those weaknesses. We do not consider that any current difficulty with the FSCS payment regime is caused by the different types of insolvency procedure currently available. We understand that the FSCS may not be willing to pay depositors until they receive an assignment of the underlying claim or until a final dividend is declared but there have been cases where the FSCS has nonetheless been able to pay out very quickly, for example, when it dealt with the mesothelioma sufferers in the failed Chester Street insurance provisional liquidation. We do not consider that the delay in making payments is an inherent weakness caused by the current insolvency regime and believe that a change in the FSCS rules could achieve the desired purpose.

We consider that the proposed duties of a liquidator as articulated in section 4.37 are in the wrong order; the primary duty of a liquidator should be to safeguard the interests of creditors as a whole. In this regard we note that section 4.42 states that the Authorities do not consider that depositors should be made a preferential class of creditor.

We believe that any special insolvency regime should also allow schemes of arrangement for a bank as an exit route, in addition to company voluntary arrangements.

Question 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?

No. We believe that it would be possible to alter the existing procedures to include banks with the specified new purposes.

Question 4.15: Do you think that there ought to be provision in the bank insolvency procedure for a 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?

Yes. In the same way that current insolvency legislation allows for continued trading with other companies, any bank insolvency procedure should also allow this.

Question 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?

No. We consider that the bank liquidator should have as his primary objective the furtherance of creditors' interests as a whole.

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

We do not think the proposal is sufficiently clear. A liquidator has to fulfil his role in line with his duties. If there is a tension between regulatory supervision and the liquidator fulfilling his duties, one would need to articulate very clearly the extent to which compliance with any supervisory requirement should override the liquidator's general functions.

Question 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?

No. See response to question 4.14.

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

We do not have a view on this.

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

No.

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

A 14 day notice period would be acceptable subject to the possibility of the parties being able to consent to short notice.

Governance and the operation of a special resolution regime

If the Bank of England is to have statutory immunity in respect of the proposed regime, it seems prudent that any restructuring officer put in place by the Authorities should also have statutory immunity, particularly if he is to have the power to override the directors' functions. Any insolvency practitioner offered an appointment in the circumstances envisaged would doubtless require an unlimited indemnity from the Bank of England, and therefore unless he too had statutory immunity there would be a likelihood that his indemnity would derogate from the immunity afforded to the Bank of England.

Question 4.22: What should the governance arrangements for the SRR be?

We have no comment, save that it would be helpful to have a focal point for directing the transfer or directing the bridge bank proposals.

Question 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?

We think this would be helpful.

Question 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?

Any restructuring officer put in place has to have the ability to fulfil his role, which may mean constraining the rights of stakeholders.

Temporary public ownership

Question 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?

If the proposals could streamline the nationalisation process, then we see this may be of assistance. If a new regime envisages the power to make a directed transfer or transfer to a bridge bank then we do not consider that this separate power would be necessary.

Resolution of building societies and other mutuals

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

We see no reason why the proposed regime should not be extended to building societies.

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

See response to 4.26.

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

See response to question 4.26.

Question 4.29: Do you agree that a building society insolvency procedure should exist for building societies along a similar model for banks?

See response to question 4.14 above. However, if a procedure is introduced for banks, we see no reason for the procedure not to extend to building societies.

Requirements on Banks

The ILA has no view on whether the industry should contribute to funding the special resolution regime. We believe this is an issue for the banking industry to comment on.

Financial collateral arrangements

Question 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?

We see that if there are proposals which would help the smooth running of the system, then these would be advantageous. It is not clear to us from the consultation paper what these proposals might be.

Section 5.21 – New Process

The timetable for making payments seems to us to be wholly unrealistic. We believe neither the FSCS nor any liquidator could move as quickly as is outlined, and that any assistance that the liquidator could provide the FSCS would be in terms of months rather than days.