

## **Response to *Financial Stability and Depositor Protection: strengthening the framework***

(Bank of England, HM Treasury and Financial Services Authority, Cm 7308, January 2008).

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### **Introduction**

This Response is concerned with two aspects of the proposals for reform contained in the consultation Paper). These are the bank insolvency proposals contained in Chapter 4 *Reducing the Impact of a Failing Bank* and also the proposals relating to depositor compensation contained in Chapter 5 *Consumer Confidence and Compensation Arrangements*.

Chapter 4 *Reducing the Impact of a Failing Bank* contains proposals to introduce what is referred to as a ‘special resolution regime’ which would provide the Authorities with a range of tools aimed at achieving a more orderly resolution of a failing bank. Chapter 5 *Consumer Confidence and Compensation Arrangements* is mainly concerned with depositor compensation issues.

One of the criticisms by the Authorities of the existing law is that a troubled bank would be subject to the ordinary corporate insolvency laws in the same way as any other type of business. It is surprising that this topic was not considered to be relevant when the insolvency reforms of the 1980s were being enacted. In the Insolvency Act 1986 a new corporate rescue procedure, the administration order, was included for the first time as an alternative to liquidation in appropriate circumstances. Administration orders have been used with some degree of success in relation to banks in the past, the best-known example being the administration of Barings Bank in 1995. Under this procedure the Financial Services Authority (FSA) has power to petition the court for the appointment of an administrator in relation to a bank that is either insolvent or is likely to become insolvent.

It is our view that it would have been worth considering retaining the existing administration order procedure but with some specific provisions to cover a bank insolvency. However, it appears that this idea is now largely academic as the decision appears to have been taken by the Authorities that this special resolution regime, in some shape or form, will be introduced in due course.

It is clear from the documentation that the Authorities have studied bank insolvency laws in a number of jurisdictions to provide some guidance for what is being proposed. One jurisdiction which does not appear to have been considered is Singapore and it is suggested that the new Singaporean bank resolution framework be studied as this should provide considerable guidance.

### *The special resolution regime proposals*

- First, the ‘special resolution regime’ for banks. This Consultation Paper asks whether there should be an SRR for banks but as already mentioned above the Authorities appear to have already decided that such a process will be introduced. This in itself is a welcome development. This is in keeping with what is already done in some other places, for example the United States. What is being proposed is that the FSA would take the decision to subject an insolvent bank to an SRR after it had consulted with both the Bank of England and HM Treasury. The decision is to be based on an examination of a number of factors including the significant risk that the bank would fail to meet relevant threshold conditions, and that the available regulatory powers to manage the risk had already been exhausted and further options would be needed to protect the stability of the financial system or the interests of depositors.

Administrative versus judicial bank insolvency proceedings? This has been the subject of much debate, particularly amongst lawyers, and it is a topic which is not without controversy. In most, but not all, countries which have introduced administrative procedures there have tended to be doubts regarding the ability of the court system to deal adequately with an insolvent bank. In the United Kingdom, however, this is not the case and there is a court system which can react quickly and which has adequately trained and experienced judges to deal with such cases. See, for example, the use of the judicial process in the Barings Bank case (and others, e.g. *Re Chancery plc* [1991] BCLC 712).

There are good arguments in favour of an administrative system but there are also arguments against. Significantly the relevant Authorities failed to take the appropriate action in the Northern Rock case so it is unclear what will change with the introduction of the SRR. Would the existence of an SRR make it more likely that the tripartite Authorities would act more quickly and decisively? What evidence is there to demonstrate that such an approach would be more efficient than making an application to a judge in the Commercial Court? These are questions that need to be asked and a fundamental shift in approach from judicial to administrative is a major step which should only be undertaken after considerable consultation with all parties.

Another relevant factor is that the introduction of an administrative process necessitates appropriate appeal mechanisms and this is especially relevant in view of the human right considerations.

- Second, is the proposal to give the Authorities power ‘ to direct and accelerate transfers of banking business to a third party, in order to facilitate a private sector solution’. (Para 4.20). This is an attempt to introduce into the UK what is referred to in the United States as a ‘purchase and assumption’ transaction. This is also aimed at being a least cost solution to the problem. The flexibility provided by such provisions would be welcome provided the provisions are well designed and appropriate. The power to make such a transfer would be given to the Authorities and it would be made without judicial involvement so the issue referred to above would once again be relevant. Traditionally in the UK property rights are only interfered with or removed by court order (or by the agreement of the parties contractually). This raises a number of legal issues especially in relation to human rights considerations. The Consultation Paper does recognise this and it is proposed that appropriate mechanisms for ‘challenge to the use of the power and the calculation of value or its distribution would be included’. (Para 4.24). This is a potentially problematic and tricky area. It is again unclear why an administrative rather than the judicial process would be more appropriate here as the UK courts, unlike courts in some countries, have never proved to be obstructive in this respect.
- A third feature is the proposal to introduce powers ‘to take control of all or part of a bank (or of its assets and liabilities) through a ‘bridge bank‘. (Para 4.25). It is recognised that to give power to establish a bridge bank under public sector control will require primary legislation. While the introduction of bridge bank powers may seem to be appropriate in reality the use of bridge banks is both complex and expensive. They require expertise to operate and are often difficult to dispose of. Consideration should be given as to whether we really need provisions for a bridge bank or whether the other proposals would suffice.
- Fourth, there is a proposal to introduce what is described as a ‘modified’ insolvency process for banks which is intended ‘to facilitate fast and orderly payment of depositors’ claims under the Financial Services Compensation Scheme’. This is designed for the situation where, after the bank has been taken under the control of the Authorities, an examination of the state of the bank has led to the conclusion that there would be no alternative to liquidation. This procedure is contained because it is felt that current liquidation procedures ‘appear to have significant weaknesses in relation to banks’. Unfortunately the Consultation Paper does not provide details of what these significant weaknesses are. The primary objective of this procedure is stated as ‘to facilitate fast FSCS payout and provide the Authorities with control over entry to the procedure once they have determined that other SRR tools are not appropriate’. It is proposed that the liquidator of the bank would ‘assist and co-operate with the FSCS to

coordinate rapid payments to eligible depositors to effect the transfer of accounts to a third party'. This is described as the principal objective.

It is not entirely clear why such a procedure should be necessary and nor is it clear whether such procedures should indeed be desirable. It seems that the existing corporate insolvency law on liquidation would not present any significant barriers to rapid payouts.

The Authorities have decided that it would not be appropriate to give depositors any priority on the insolvency of the bank. Therefore the claims of the deposit insurer as well as depositors with uninsured deposits will rank alongside the other unsecured creditors.

- A fifth issue is the governance and operation of the SRR. Views are sought on how best this should be done. It will obviously be necessary to appoint someone to take control of the bank and to carry out everything necessary for the successful use of the SRR. The process will have to be overseen by the Authorities (it is not clear which one it will be or how it will be done). This will require a significant amount of specialist expertise and it is unclear exactly where this could come from. It is also recognised in this Consultation Paper that suspending the operation of the normal governance provisions of the company is a significant step with a number of legal consequences. For example it will be necessary to suspend the rights and powers of the directors. These are issues that need to be carefully thought through before implementation.
- A sixth issue is the funding of the SRR. The government is seeking views on whether the industry should be required to contribute to the funding this. It is also considering allowing the deposit insurer to contribute to the funding. It is recognised that in a number of jurisdictions the there deposit insurer is able to use funds to support bank resolution efforts.

There are arguments for a special resolution regime, but it is vital that these are not rushed through Parliament. Time should be taken to draw up a regime, borrowing from international experience (of which there is a good deal, and not just in the US). Time should, however, be taken to identify why administration would not work satisfactorily.

#### *The depositor compensation proposals*

It is recognized in Chapter 5 that effective compensation arrangements form an essential part of a system for protecting consumers. It was also admitted in the Consultation Paper that at the time of the Northern Rock problems the depositor compensation scheme in place within the UK was defective in a number of respects. It is now recognized that this

must be addressed. One particularly important issue was the public perception, once the details of the scheme became commonly known, that it provided insufficient cover in terms of the amount of compensation payable (largely due to the use of co-insurance) and also that it would be very slow in providing that compensation.

- Awareness of the compensation limits has long been known to be poor. In the past, this may have been beneficial for financial stability, with some depositors feeling they were better protected than they were. Now that protection is 100% of £35,000 this is a good argument for putting resources into the raising of awareness. Of course, Northern Rock will probably have raised awareness of the limits, but it is still appropriate to think that awareness will be poor. Also, the issue of how best to communicate to depositors that balances held under different branches of one bank will be aggregated is a difficult one and this needs to be thought through.
- The use of co-insurance has already been removed (October 2007) and the Consultation Paper makes it clear that the Authorities do not intend it to be reintroduced in the future and this is to be welcomed. The concept of co-insurance was always questionable and it is right that protection should be at 100% up to a specified limit. Although there is an argument for putting the compensation level at £50,000 (roughly in line with the United States) the evidence provided in charts 5.2 and 5.3 suggests that 100% to £35,000 is a reasonable level of protection and should remain. The “per person per bank” approach for assessing entitlement should continue.
- Another issue of particular interest is the question of coverage on balances above the compensation limit. The FSA intends to consult on a number of options with relation to this. It appears that for the majority of depositors a ceiling of £35,000 is sufficient, especially as this is doubled for a joint account.
- Faster compensation payment is essential if consumers are to have confidence in the scheme. The United States offers a useful model here with the Federal Deposit Insurance Corporation ensuring that payouts are made promptly. There appears to be some evidence that the prospect of delays in payouts would provide an incentive to some depositors to initiate or join in a run. The Northern Rock case demonstrated clearly that depositors found the prospect of lengthy delays unacceptable and this appears to have been a factor in the escalation of the bank run. There has been some overdue recognition that joining in a run on the bank, far from being evidence of irrationality or panic, is entirely sensible. As Mervyn King noted with commendable honesty “once the run started it was rational for other people to join it”. Given the lack of certainty as to whether Northern Rock's problems were shared by (or, indeed, might have been perceived as being shared by) other banks, it would have been possible for other banks to have faced runs, even if they were themselves well managed. The major proposal in this respect is that the deposit insurance scheme in the UK should aim to make compensation

payments within one week of a bank closing (Para 5.19). This is considered to be an ambitious goal but it is one which should be achievable in a sophisticated banking sector. Such a target would not be seen as overly ambitious in, for example, the United States.

- A number of matters need to be addressed if this target is to be achievable. It is recognized in the Consultation Paper that these include: a new process to enable the speeding up payments; early access to information by the compensation provider; simplification of eligibility criteria for payments; allowing gross payments to be made; streamlining the claims process; funding for the compensation scheme and finally speeding up ways of opening new accounts at other banks.
- Funding of the scheme is of singular importance. It is recognised that the compensation scheme needs to have access to immediate liquidity. This can be done both by borrowing from the relevant Authorities or by ex-ante funding. So far UK banks have successfully managed to avoid having to pay into a pre-funded scheme. The Consultation Paper recognises that there are advantages to having a pre-funded scheme. It is also suggested that there are disadvantages especially the fact that it could take a number of years to build up a fund of significant size. This should not, however, prevent the introduction of a pre-funding basis for the UK scheme. This is the approach used in most countries. (There are several options for designing the methods of pre-funding and these include fixed and risk-based premiums).

### *Moral Hazard*

It is important for policy makers to recognise that arguments about moral hazard are overstated and, indeed, inappropriate where deposit taking is concerned. High levels of deposit protection do not generate high levels of moral hazard on the part of depositors because depositors are not in a position to identify and monitor the risks posed by financial institutions. If they were able to exercise care then there would be an argument for requiring them to do so, but they cannot, and so should not be expected to.

While moral hazard is (as suggested above) overstated where depositors are concerned, this cannot be said for bank management. There is a danger that saving failed banks (and nationalisation must be seen as an example of this) generates moral hazard for a number of stakeholders, such as creditors and employees (particularly senior employees who benefit most from risk taking). Where banks fail, shareholders should lose their stake (as noted above) and senior management should (generally) lose their jobs.

### *Shareholders*

Any protests of shareholders in a failing bank must be dealt with firmly. It is important to be honest about this. Northern Rock was worthless without Government intervention – it

had no shareholder value in any true sense. Litigation may determine what compensation (if any) shareholders should receive, but there is a strong argument for recognising that when a bank fails, shareholders should take the consequences.

### **Some concluding observations and remarks**

Although we are still in the consultation process period it appears certain that both the special resolution regime and the reforms to the insurance will take place, probably before the end of 2008.

That both the need for a better bank insolvency law framework and that the system for protecting depositors requires strengthening have been recognised are welcome developments.

There are still some matters of concern however especially in relation to the ways in which the relevant Authorities will work together. The division of power and responsibilities is not clearly set out and this was problematic in the Northern Rock crisis. It is also unclear exactly how the compensation scheme is to operate and with some of the proposals, for example to inject money in certain situations, directly affecting it this needs to be discussed further and clarified.

It still remains the case that the decision to invoke an insolvency procedure has to be taken by someone and the FSA is the body which is likely to be given this responsibility. Is this the most appropriate body to undertake this role or is the central bank, the Bank of England, a more suitable choice? Further thought should be given to this.