1 SPECIAL RESOLUTION REGIME FROM FIRST PRINCIPLES

1.1 SRR addressing loss of confidence, instability and illiquidity

Proposals in the Consultation Document are too narrow in addressing solely deposit-taking firms at the exclusion of other financial intermediaries that present similar issues of loss, illiquidity and systemic disruption. Deposit-taking institutions cannot be severed from global financial markets more generally in an era of widespread securitisation and use of negotiated derivatives. In the other direction, securitisation of credit markets implies that more retail and commercial credit relationships are intermediated by securities issuance and trading, whether corporate bonds or asset-backed securitised debt. Addressing the issues raised by intermediary failures more generally will reduce the risk of loss and disruption to individuals and businesses in the non-financial economy dependent on the financial sector for savings, finance, liquidity and payment intermediation, and to the wholesale financial sector from the dissolution of a peer intermediary.

Intermediaries holding investor assets such as securities or derivatives or dealing as counterparty in negotiated markets present many of the same challenges of communicating systemic illiquidity and causing destabilising losses to investors and counterparties in the event of failure as deposit-taking institutions. More importantly, poor resolution of the failure of a securities intermediary in modern, globalised market has the potential to seriously degrade the status of London as a financial capital and the reputation of English law for protection of international investors dealing in the United Kingdom.

A further objective of the SRR may be the clarification of the roles of the Tripartite Authorities and their functions in ensuring domestic and international stability. While the Bank of England has independence in its monetary policy functions, its role in supporting troubled banks in the interests of financial stability is appropriately subject to political guidance and political interests. A Special Resolution Regime will bring valuable clarity to this policy distinction, providing an institutional expression of the public interest in failed bank resolution.

A framework which develops the Special Resolution Regime from first principles is required to address the risks to the economy of systemic disruption and widespread loss of confidence from the failure of financial intermediaries. It would also be better suited for redressing the deficiencies in UK law and practice relative to other financial capitals, promoting the continued dominance of London as a global financial capital, and diminishing the risk to reputation from poor relative outcomes of financial intermediary insolvencies in the UK.

Working from first principles, it is easier to identify the lines of business or categories of assets and liabilities which can communicate loss of confidence, illiquidity and instability to the financial sector, to non-financial businesses

(particularly small businesses) and to retail depositors and/or investors, and thence to develop appropriate mechanisms for SRR intervention.

1.2 International Best Practice

As home to the capital of the global financial markets, it is important to review any reforms to intermediary insolvency treatment and outcomes for consistency with international best practice in order to ensure that London's position relative to its peers and competitors is not adversely impacted.

The International Association of Deposit Insurers has published IADI Core Principles for Effective Deposit Insurance Schemes. This 6 page document listing 21 principles provides a valuable template for assessing the UK proposed reforms with international best practice and ensuring that reforms are comprehensive enough and flexible enough to meet future requirements. Where public policy or practicality requires that the reforms enacted in the UK differ substantially from the Core Principles, we should be in a position to clearly explain the rationale and the consequences in the interests of promoting international confidence in the reforms.

Reforms to UK insolvency laws governing financial intermediary failures should be consistent, insofar as possible, with the UNIDROIT Preliminary Convention on Substantive Rules regarding Intermediated Securities.[1] The UK lags other OECD and emerging jurisdictions in reflecting best practice for securities laws and insolvency treatment of securities entitlements clearly in its legislation, although – with some startling exceptions – practice is fairly good. The pending reforms offer an opportunity to reconcile this deficiency, at least with respect to clarifying rights of investors to assets in a failed intermediary. Such reforms will assist the UK in retaining its preeminence as a financial capital and securing the confidence of UK and international investors that insolvency resolution of investments held in the UK will be consistent with best practice elsewhere.

Legislation drawing on the UNIDROIT model law and successfully reviewed as consistent with UK law by Allen & Overy and Clifford Chance has been enacted in the Dubai International Financial Centre as Personal Property Law DIFC Law No. 9 of 2005, Part 8: Investment Entitlements. As I drafted this portion of the law, drawing on UNIDROIT model law and experience of Belgian, Luxembourg and US securities laws, I can provide further support on these issues as required.

Proposals which would impact counterparty or creditor rights such as changes to the operation of the floating charge and wholesale creditor preferences and priorities should be carefully vetted with relevant trade associations and, where pursuant to industry standard agreements, the counsel or committees responsible for drafting and maintaining documentation. It is important that the public interest in financial stability and depositor protection be weighed carefully

[1] March 2006, UNIDROIT 2006, Study LXXVIII – Doc 42.

against the public interest in preserving London's status as a financial capital. English law is often preferred because it is widely viewed as impartial and equitable in its treatment of domestic and foreign creditors, and it would be unfortunate if this perception were undermined by reforms.

1.3 SRR Practical Recommendations

1.3.1 Legal Basis

Statutory enabling legislation should provide an effective framework setting forth objectives, powers and immunities for the Special Resolution Regime. The enabling legislation should empower the Treasury, in the first instance, to promulgate regulations implementing specific reforms and provisions. Such a legal structure would be consistent with other financial law and regulatory implementations, including the Financial Services Act, but provide essential flexibility to deal with rapidly evolving conditions in global and UK financial markets. The statute should contain explicit SRR Administrator powers and immunities to override inconsistent insolvency law and practice and to pre-empt challenges by disgruntled stakeholders in firms subject to SRR administration which might impede timely action.

The Treasury is the preferred authority for making regulations as the SRR is fundamentally an expression of the public interest in overriding privately negotiated commercial and financial contracts, obligations and risks in the interests of preserving overall stability and confidence in the financial sector. This interest is distinct from the role of the Bank of England in preserving currency stability and the role of the FSA in prudential supervision.

1.3.2 Governance

In accordance with best practice, the SRR and SRR Administrator should ideally be independent of the system for prudential supervision under the FSA, perhaps being combined with the FSCS or subject to the direction of the Bank or Treasury.

Independence of the SRR will promote more objective assessment of the legal, accounting and regulatory issues which may contribute to financial failures. There is also a risk that combining the functions of prudential supervision and failed firm resolution can result in delayed intervention, colloquially described in regulatory circles as "forbearance", which can delay necessary adjustments in the financial sector and economy and so damage long term growth prospects. As a result the SRR should either be a separate authority (perhaps combined with FSCS) or a function of the Bank of England (which will likely have substantial exposure to any failing bank). If the SRR function is within the Bank of England, the Bank has the advantage of having expertise and personnel for

assessing and managing bank operations where the FSCS is reliant on outsourcing to accountancy firms and/or insolvency practitioners.

Independence of the SRR from the FSA would provide the additional advantage of securing institutional checks and balances against the dominance of the FSA in all financial regulation in the UK. From a large array of self-regulatory authorities at the time of the enactment of the Financial Services Act in 1986, the UK has concentrated rapidly into the umbrella FSA. If competition, sectoral specialisation, innovation and fragmentation are good for ensuring high standards and responsiveness in markets, it is worth considering whether the high concentration in FSA now requires the institutional counterpoint of an independent or separate SRR to provide review in the case of financial failures.

Consideration should be given to combining the SRR with the existing FSCS, in keeping with international best practice combining financial receiverships with deposit insurance functions. Although the SRR scope will be more limited than the existing scope of the FSCS, the SRR will only be invoked infrequently (we hope), and the SRR functions will be an important backstop to public confidence in large intermediaries. Combining the two functions institutionally may also accelerate establishment of the SRR as it would leverage FSCS existing powers to levy operating costs and administrative and operational personnel.

The SRR should operate under clearly defined operational and administrative principles, with clearly defined responsibilities for co-ordinating between and reporting to the Tripartite Authorities of HM Treasury, the Bank of England and the Financial Services Authority, both on an ongoing basis and during a crisis.

1.3.3 Scope

The SRR Regulations should encompass:

- Categories of intermediary eligible for SRR administration, initially including deposit-taking firms (banks and building societies) and investment brokers administering nominee, margin and client money accounts;
- Classes of SRR-eligible assets and liabilities, roughly corresponding to defined lines of business, initially including:
    - Retail current accounts and savings accounts;
    - Nominee accounts holding investor securities;
    - Client money accounts;
    - Margin accounts and margin collateral.
- In the discretion of the SRR Administrator, in consultation with the Tripartite Authorities, any assets and liabilities which if subject to standard insolvency practice would lead to major, irreparable harm to the financial sector through disruption to markets and/or contagion effects for clients and/or counterparties.

The SRR should reduce systemic disruption by facilitating the transfer of defined assets and liabilities from failed firms to healthy firms, known in deposit insurance as Purchase and Assumption ("P&A") transactions, or creation of a Bridge Bank to undertake operations of the failed firm pending further resolution.

It is important to appreciate that runs on banks are driven by both the fear of loss and the fear of illiquidity. Few people in modern Britain can survive for three months (the usual period for deposit insurance payment) without access to funds in the bank. Unless they have accounts at multiple banks in amounts sufficient to cover their outgoing expenses, they are likely to be in default on many obligations, increasingly incurring penalties and escalating interest charges, by the time compensation for claims is approved and paid. Similarly, pensioners and other direct and indirect investors dependent on the income from bonds or stocks in a nominee will likewise find the loss and illiquidity arising from a broker failure will cause substantial financial distress.

Adding to the urgency of bank resolution in the UK is the dependence of the UK on automated payments, including direct debits and standing orders for the majority of recurring payment transactions such as loan repayments, utility bills, etc. Even a very short delay in making payment on these liabilities may incur relatively large financial penalties for consumers as penalty fees and, in the case of more and more credit cards and unsecured loans, higher finance costs.

The SRR enabling legislation should permit extension of SRR scope by regulation to adapt to evolving circumstances in globalised financial markets and complex UK financial linkages among intermediaries. Where an intermediary's collapse has systemic implications for wholesale markets, the SRR Administrator should have authority to effect resolution of any assets and liabilities which are critical to the smooth function of the financial markets. This exceptional authority should be subject to ex-ante and ex-post checks and balances to ensure that the SRR mechanism does not present a temptation to the banking industry to "privatise profits and socialise losses" arising from mispricing of risk or poor exercise of judgement.

1.3.4 Operations

The SRR Administrator should have powers consistent with international best practice to effect Purchase and Assumpiton (P&A) transfers of portfolios of assets and liabilities to a healthy bank; to create a Bridge Bank to keep a failed bank operational while resolution options are evaluated and implemented; and/or to transfer any residual estate for insolvency administration/liquidation or nationalisation, as appropriate.

P&A transfers would shift operations for eligible assets and liabilities to a healthy intermediary (e.g., the book of eligible current accounts and savings accounts at a bank, the portfolio of assets in a nominee and associated client money account

at a broker) without the need for depositor/investor prior notification or consent, and with minimal administrative burden. A Bridge Bank would keep open the doors of the failed bank with limited operations to promote depositor access to funds while other resolution options are evaluated.

Intermediary internal systems and UK payment and settlement systems should be reviewed and, if necessary, reconfigured to promote ease of transfer of designated SRR-eligible assets and liabilities to receiving healthy firms to minimise disruption and consequent illiquidity.

Where rapid P&A resolution is impractical, it may be necessary to establish a Bridge Bank – a special purpose bank to assume the operations of the failed bank pending investigation of assets and liabilities and determination on resolution options. The term of Bridge Bank status should be limited, subject to extension with the approval of the Tripartite Authorities.

Set-off of loans, mortgages and other debts of depositors against deposit insurance recoveries or SRR transfers of deposits should be statutorily waived – up to a limit – as inconsistent with the public interest in preserving depositor liquidity and confidence. A limit on the funds available free of set-off may be appropriate to prevent unfairly advantaging depositors with debts relative to other ineligible creditors.

Audits should regularly assess the adequacy of internal arrangements at SRR-eligible firms to ensure compliance with SRR requirements. The audits may be done by the SRR or delegated to the FSA as part of regular reviews of regulated firms. There may be advantages to combining SRR audits with contingency planning reviews as the objective of ensuring business continuity is common to both.

The SRR Administrator should have powers to investigate, possibly in cooperation with the Serious Fraud Office, the actions of management in the period running up to the failure of an intermediary. Very often this period will be characterised by pressures to conceal performance and/or defraud creditors and/or defraud stakeholders by misappropriation. The SRR Administrator should have the authority to audit management compensation, dividends, suspect financial transactions, and other potentially preferential transactions transacted over the year preceding the failure of an SRR-eligible firm.

> “The supply of corruption increases in a pro-cyclical way much like the supply of credit. Soon after a recession appears likely, the loans to firms that were fueling their growth with credit decline as the lenders become more cautious about the indebtedness of individual borrowers and their total credit exposure. In the absence of more credit, the frauds sprout from the woodwork like mushrooms in a soggy forest.”
>
> - Charles Kindleberger, Manias, Panics and Crashes: A History of Financial Crises

The residual estate of the failed firm subject to SRR administration after transfers of SRR assets and liabilities should either be nationalised or turned over to an insolvency practitioner as receiver or liquidator.

1.3.5 Timeliness

SRR-eligible assets and liabilities should be transferred through P&A and Bridge Bank mechanisms as quickly as possible, preferably overnight on the day the SRR Administrator assumes authority over a failed firm, but in any event within the first few weeks of SRR administration.

Rapid intervention will require that SRR-eligible intermediaries capture and preserve structured data about eligible assets and liabilities in a format that will facilitate Purchase and Assumption transfers or Bridge Bank resolution, and that the SRR Administrator maintain an up to date list of firms deemed able and willing to undertake either P&A or Bridge Bank resolutions at short notice. Coordination between the SRR Administrator and the FSA will be required to ensure that eligible firms maintain data and operations consistent with SRR requirements. SRR preparation may be defined as an element of contingency planning for business continuity.

1.3.6 Moral Hazard

Several kinds of moral hazard need to be considered and resolved, striking a public policy balance between the public interest and the interests of other stakeholders, including depositors, shareholders, directors, employees and creditors.

The Special Resolution Regime should aim to minimise moral hazard among bank executives and shareholders that their institution is “too big to fail”, or will otherwise be salvaged from public funds or mutual interest, or that they can otherwise recover compensation for loss of equity or employment or benefits arising from SRR administration and/or nationalisation and/or insolvency. **Business line severability of systemically important assets and liabilities pursuant to SRR administration with residual resolution in insolvency will go far to reducing currently high moral hazard perceptions in the UK.** An ongoing obligation to maintain systems and data to enable SRR resolution, enforced by continuous oversight, will provide a consistent reminder that dissolution is both practical and a likely outcome of failure.

More than that, it is important for prudential supervisors to re-evaluate the common wisdom of the Greenspan era that supervisors can rely on the self-interest of financial firms to protect shareholder equity as sufficient to ensure prudent management and business operations. Free market doctrines and deregulation have led to financial excess – once again – and are not a sound basis for governance of the financial sector which respects the public interest and indirect public liability for failure.

Moral hazard among depositors is affected by the level of deposit insurance and its coverage. The existing level of deposit insurance in the UK is very high relative to the European norm and non-US peers, but includes a 10 percent co-insurance element for amounts above £3,000 and the practice of set-off of loans or other debts against deposit insurance recovery.

Set-off should be statutorily waived as inconsistent with the deposit insurance public policy objective of ensuring access to sufficient immediate liquidity and confidence among depositors, at least within some defined limit.

Co-insurance encourages depositor consideration of the strength of the bank, and so some responsibility for exposures, but is inconsistent with the objective of preventing runs on banks as most depositors would rather secure 100 percent immediately from waiting in line than 90 percent some time later from FSCS. On balance, the co-insurance should probably be eliminated, but without raising the amount of total deposit insurance eligibility.

Moral hazard among counterparties and peer banks should be reduced by improved certainty as to SRR eligibility, practicality, legal basis and operations, as severability of systemically important business lines will reinforce the principle of counterparty risk for other assets and liabilities negotiated with commercial and financial counterparties.

1.3.7 Costs

It is important to distinguish between operating costs of the SRR and the costs associated with the resolution of any failed intermediary subject to the SRR. The SRR should be required to account independently for these, as operating costs may be subject to different funding than recovery of resolution costs.

The SRR should have minimal ongoing operating costs, as it may be years or even decades between the collapse of firms eligible for SRR resolution if prudential supervision and regulation are otherwise effective. Operating costs of the SRR may be a further category of the FSCS levy assessed on SRR-eligible intermediaries.

Recovery of SRR resolution costs should generally be assessed against the assets of the failed intermediary's estate in SRR administration as part of its

insolvency resolution. Where the assets of the failed intermediary's estate are insufficient to cover resolution costs, the SRR should have powers to raise funds as described below. It should be an explicit objective of the SRR to reduce the costs associated with long, drawn out liquidations by insolvency practitioners and compensation by FSCS in favour of rapid, business line resolution by the SRR Administrator, bearing in mind the interests of other stakeholders and creditors and subject to reporting and review.

1.3.8 Funding

We are unlikely to have a fully agreed resolution of funding issues for SRR and FSCS in the timeframe necessary to legislate and enable SRR, so the enabling legislation should provide all powers necessary with the flexibility to define the funding scheme through regulation.

In general, funding mechanisms should be designed to encourage mutuality among SRR-eligible firms to reinforce the objectives of preventing costly failures through peer review and market discipline to prevent losses actually being incurred. However, the concentration of the sector in the UK means that the failure of one of the top banks has the potential to wipe out the capital of the others if they were forced to suddenly reimburse all deposit insurance liabilities. As a result, the SRR should be aimed at minimising draws on deposit insurance through P&A and Bridge Bank options and possibly capping individual bank liabilities. The SRR should be empowered to spread any large liability over a longer timeframe, possibly requiring public backstop funding or private finance and/or insurance or a combination of these.

It is important to establish in the first instance whether SRR will be combined with deposit insurance, currently administered by the FSCS, in addressing funding issues. In respect of deposit insurers generally, the major funding issues are whether funding is ex-ante (maintained fund to cover failures) or ex-post (assessments only in the event of a failure), or a combined approach, and whether any premiums are standard or differential (related to the perceived riskiness of participants). It is normal in countries with a highly concentrated banking sector to cap the liabilities of participant banks to prevent contagion or capital impairment, backstopping liabilities of deposit protection from public funds.

The current FSCS deposit insurance scheme relies on a combined approach of levying expected losses through an ex-ante levy on industry sectors, with a pooled liability to cover large losses among all regulated sectors. This revised funding model is effective from 1 April 2008, capping industry liabilities at £4.03 billion per year. A single large bank failure might exceed this cap, driving resolution toward P&A and Bridge Bank with nationalisation as a last resort.

There are a variety of funding mechanisms for bank resolution and deposit insurance in use internationally which provide attractive models worthy of careful

study. As the SRR needs to be enacted quickly, however, a default funding model must be chosen in the enabling legislation, but the legislation should allow for a market-led funding model to operate either in parallel via opt-out or in substitution if the SRR-eligible firms can devise a better market-led solution over time.

Issues relevant to the SRR/deposit insurance funding model specific to the UK include:

- High concentration of the financial sector and relative size of participants;
- Infrequency of intermediary failures;
- Infrequency of draws on deposit insurance;
- Long history of mutual, self-regulatory compensation arrangements;
- Liquid bond markets for both government issued and privately issued debt;
- Local expertise in specialist credit assessment, credit insurance, re-insurance markets, and catastrophe insurance.

The ongoing operations costs of the SRR can be funded as a parallel or additional levy with the FSCS levy, applying to SRR eligible firms. The levy for ongoing SRR administrative costs should be proportional to participants' base of deposits and/or fiduciary investments. There seems little advantage to attempting to differentiate risk-based profiles for a *de minimus* levy when the "bright line" benefit of coverage is relatively evenly shared among participants. While smaller participants may have a slightly greater benefit from enhanced depositor confidence, the public interest is also served by the promotion of competition given the high concentration in the UK financial sector.

While ex-ante funding for deposit insurance is viewed by the IADI as providing many advantages, it will likely prove impractical and inappropriate in the UK for several reasons. First, there is not time to build up a large fund with an international liquidity crisis now pending, so an ex-ante funding scheme will not have the resources to assuage depositor and investor concerns in a short timeframe unless it draws heavily on SRR-eligible intermediaries immediately, further constraining scarce capital and finance among these firms and reinforcing pro-cyclical trends. Second, the UK banking and financial sector is concentrated in a handful of very large, diversified, complex, international banks which are best resolved through P&A and Bridge Bank options rather than deposit insurance, so a standing pool to fund their deposit insurance liabilities would be costly without being realistic as a resolution option. Third, ex-ante funding that incorporates risk-profiling would likely further inhibit competition in the financial sector as advantaging the few large, (relatively) well capitalised banks over time. Fourth, the financial sector will likely resent a large pool of funds being maintained during times of stability, leading to political pressure to reduce the standing pool or cap it which would raise similar issues as pension contribution freezes during the tops of market cycles. Finally, as the global financial capital we have access in the

City to a depth of resource and expertise which can fund an ex-post system quite efficiently if the industry is given the opportunity to realise a market-led solution.

For these reasons an ex-post system of funding is required in the near term. Ex-post systems have their own challenges. They can demand contributions from banks for covering the costs of a peer's failure just when they themselves are financially stressed by capital constraints and market instability, increasing pro-cyclical pressures. Ex-post systems also require backstop funding from a debt issuance or public funds to cover immediate draws on the SRR and/or deposit insurer pending reimbursement from the industry. The UK is likely to require some form of backstop funding for the SRR and deposit insurer from the Bank of England or HM Treasury to instill public confidence and cover immediate requirements in the event of a large institution's failure.

The SRR could be framed as having the following funding options:

- Ex-ante levy for SRR operating costs consistent with FSCS funding pre-April 2008 reforms;
- Ex-post discretionary levy for SRR resolution costs to fund small resolutions with moderate resolution levies perhaps staged over several quarters;
- P&A proceeds of sale and transfer of severable lines of business (e.g., the book of deposit accounts or the book of brokerage accounts);
- Realisation (sale) of unimpaired assets of the failed firm;
- Letters of credit from SRR-eligible firms which can be set-off against subsequent levies or repaid from realisation proceeds;
- Issuance of bonds (possibly with a Treasury guarantee) to cover costs of a large-scale resolution incorporating a lien on resolution/liquidation proceeds and longer term levies over a fixed number of years;
- Insurance and re-insurance of SRR liabilities;
- Standing credit facility with the Bank of England reimbursable from other resources and funding options;
- Backstop public funding of liabilities above a cap on per-failure or annual liabilities of participants set as a proportion of insured deposits or investments;
- Opt-out for private insurance, re-insurance or mutual scheme which adequately meets all objectives and criteria for SRR funding and depositor protection.

Many deposit insurance systems that assess ex-ante contributions incorporate differential premiums based on the perceived risk of failure of participants, an example being the CAMEL ratings used by the FDIC. The aim is to encourage firms to prevent loss by achieving higher ratings, although the evidence supporting success in this regard is relatively unclear and there are competitive implications. Such ex-ante funding and differential premiums are likely to prove inappropriate and difficult to administer in the UK for a number of reasons, but there is an alternative which might prove superior. **If the success of SRR**

resolution depends on the severability of lines of business implicating the public interest and FSCS liability, then it makes sense to reward firms with good data capture, good IT systems and good line of business severability with a reduced premium or reduced share of liability rather than focus on capital adequacy. To the extent that any premium differential is proposed for SRR or FSCS funding, it will be worth exploring whether the premiums can be referenced to demonstrating the severability of relevant assets and liabilities. This could do more to promote the aims of SRR of reducing loss and draws on deposit insurance as an incentive to practical, operational reforms than CAMEL-style ratings.

1.3.9 Mutuality

The legislation enabling the SRR and/or FSCS reforms should explicitly encourage the City to investigate market-led arrangements to meet all or some of the statutory objectives and/or funding requirements.

Mutuality of opportunity and obligation have historically played an important role in ensuring the prudent governance of financial enterprise, generally rewarding strongly mutual associations with greater credibility and financial resiliency. Examples are families (Rothschilds), mutual exchanges (London Stock Exchange pre-big bang), insurance societies (Lloyds), and friendly societies. Free market reforms of the recent past have largely undermined the role of mutuality in restraining excessive risk taking and promoting prudent investment and credit decisions. It is worth considering whether reforms now being considered, including changes to the operation of the FSCS and the introduction of the Special Resolution Regime, might benefit from reintroduction of some principles of mutuality to encourage UK financial firms to cooperate with one another and supervisors in constraining the excesses of their peers.

The FSCS, FSA and Bank of England should periodically emphasise to the financial services industry that losses associated with SRR and FSCS will be minimised by effective internal management controls and self-regulation of counterparties and competitors. Firms should be encouraged, on a confidential basis, to share concerns about counterparties or competitors arising from poor controls, poor operations or poor risk management in periodic operational reviews between regulated firms and their FSA supervisors.

1.3.10 Reporting

The SRR should report at least annually to the Tripartite Authorities on its operations, costs and preparedness, whether or not there have been any SRR administrations during the period covered.

The SRR Administrator should report to the Chancellor, the Governor of the Bank of England, and Chairman of the FSA following each SRR administration. The report should address the following elements:

- Actions taken by the SRR Administrator to transfer assets and liabilities of a failed firm for the protection of depositors/investors and to prevent systemic disruption or illiquidity;
- Questionable transactions within one year of SRR administration which may have been influenced by management conflicts of interest, self-interest or otherwise prejudiced the fiduciary interests of depositors/investors;
- Recommendation to the Chancellor on nationalisation or insolvency resolution of the residual estate of the failed firm;
- Observations on legal, accounting and prudential supervision factors which influenced the scale and/or cost of SRR resolution or the likely scale and/or costs of insolvency resolution and/or FSCS compensation.

2 Response to Part D Questions for Consultation

2.1 Chapter 1 Question Responses

1.1 Reform of the legal basis for addressing financial failures is essential and appropriate, but the Consultation Document is insufficient on its current terms as it is limited to deposit-taking firms. Securitisation of credit markets means that securities intermediaries also present substantial systemic risks of liquidity and credit contagion. Further, globalisation of markets and the eroding competitive position of the UK as other nations modernise their financial sector statutes and regulations implies that failure to adequately address insolvency resolution of financial firms more broadly could undermine the UK's comparative advantage and the financial sector's contribution to the UK economy.

1.2 Prudential supervision, central bank liquidity facilities, insolvency resolution and depositor/investor compensation are all related and complementary elements of addressing public interests in financial stability and investor protection. Reforms to any of these pillars cannot be considered in isolation, but as part of an interlinked framework which requires balanced consideration of functions, objectives and appropriate mechanisms to influence financial sector conduct, incentives and contribution to the UK economy.

1.3 It is insufficient to limit reforms to deposit-taking firms. Other financial intermediaries also raise substantially similar risks of loss and systemic disruption, and a broader framework would be more appropriate to contain the risks and provide flexibility for future financial market innovation.

WHAT IS A RIGHT OF REVINDICATION AND WHY DO U.K. INVESTORS NEED IT?

A right of revindication entitles an investor holding securities through a nominee account with an intermediary to seek return or transfer of those securities in the event of the intermediary's insolvency. It offers a valuable protection to investors against loss of property and income in the event of a lengthy insolvency administration or liquidation and a valuable protection to an economy against the spread of illiquidity and financial instability in the case of a securities intermediary's failure.

Securities held in a nominee account are not the property of the intermediary but the property of investors as clients of the intermediary. Registration in the name of the intermediary as nominee facilitates efficient administration of investor assets, but absent statutory protections, exposes investors to the risk of losing the assets or some of their value in an intermediary insolvency. Logically, as the intermediary has no proprietary ownership of nominee assets, those assets in the nominee should not come into the insolvency estate of the intermediary when the intermediary is put into receivership or liquidation. To avoid systemic contagion of illiquidity to the nominee investors, investors should have a right to return of their assets – the right of revindication.

Most nations with substantial financial services sectors provide statutory protection for nominees. Two quirks of history have led to belief that a right of revindication isn't required in the UK. First, trust law is well established here and offers similar protection for trust assets. Unfortunately, many investment intermediaries prefer to register securities in house name as nominee to facilitate dealing, denying investors the protection of trust law. Second, the London Stock Exchange was for hundreds of years at the heart of self-regulation in the City, and enforced a severe distinction between jobbers and brokers among its members. Jobbers could not transact for clients and brokers could not deal for proprietary account. Additionally, the Stock Exchange acted as receiver of failed members, ensuring securities from a broker were swiftly transferred to a successor broker to ease client liquidity and quietly mutualising any losses from mismanagement or misappropriation for over 200 years.

Today a statutory right of revindication would go far to diminishing the scope for systemic contagion in the event of a securities intermediary's failure.

For a thorough treatment of the rationale and justification for a right of revindication being enacted by statute in the UK and comparative analysis of laws in other leading jurisdictions see:

Financial Markets Law Committee, 'Analysis of the need for and nature of legislation relating to property interests in indirectly held investment securities, with a statement of principles for an investment securities statute' (July 2004).

For an example of a fully modern law on securities entitlements which has been vetted by Allen & Overy and Clifford Chance as fully consistent with best practice principles and the laws of the United Kingdom, see Part 8: Investment Entitlements of the Personal Property Law, Law No. 9 of 2005 from the Dubai International Financial Centre. The laws of the United Kingdom apply by default in the absence of specific legislation in the DIFC, so there can be confidence that this law reconciles with UK requirements and jurisprudence as a model for similar protections in the UK.

2.2 Chapter 2 Question Responses

2.1 There is no harm in improving stress testing, but it will prove an insufficient basis for preventing harmful excessive risk taking and for detecting problems in firms which could lead to failure so long as other measures to improve management accountability, transparency, accounting practice, management incentives and capitalisation/reserve calculation encourage excessive risk. I doubt that the failures observed recently due to credit deleveraging, risk aversion and asset deflation would have been significantly reduced or made less disruptive with better stress testing.

2.2 Stress testing, and risk management modeling generally, have not been demonstrated as contributing significantly to curb the primary causes of financial failure: poor business models, sudden credit illiquidity, rogue traders, poor management controls, ill-transparent instruments and markets, poor price discovery, poor transaction reporting, poor accounting practice, off-balance sheet weakening of capital frameworks, etc. Clever traders and managers can manipulate their models and/or their data and/or their balance sheets to get whatever result meets their objectives.

2.3 It is unclear that liquidity can be accurately measured, much less regulated, and models of liquidity are very poor in depicting the dynamics of liquidity expansion and contraction. In general, liquidity evaporates suddenly when there is a triggering event that reveals that previously widely held assumptions about the performance of counterparties or investments were based on unsound observations. Most models use historic data, but this will rarely accurately reflect liquidity conditions going forward as liquidity is abnormally abundant and volatility is abnormally low at the tops of investment cycles.

2.4 Mark to market valuation models have been disapplied to banks historically because credit deleveraging and asset deflations tend to occur simultaneously. As all banks are in the business of borrowing short (demand deposits) to lend long (mortgages and commercial lending), all banks are subject to similar threats to their solvency and liquidity during economic downturns which erode the profitability and creditworthiness of debtors and banks alike. Capital adequacy rules which lower reserves and capital in good times, and raise reserves and capital in bad times do exactly the opposite of what a good bank management ought to be doing in both periods. **Walter Bagehot observed in Lombard Street that it is essential that banks increase their reserves during the good times, despite the fact that this will be unpopular with shareholders, as banks will tend to take on more risk for less return the longer the good times endure. It seems that modern regulatory practice and Basle II have worked in the direction of overturning this long cherished wisdom, with dangerous consequences now all too apparent.**

Asset deflation as markets fall stresses balance sheets at the same time in the cycle that borrowing becomes more scarce and expensive. As a result, traditional bank capital regulation allowed banks to carry assets, particularly retail and commercial loans and mortgages, at face value subject to write downs when assets became impaired. Banks were required to reserve against all their assets at flat rates (8 percent under the old Basle I rules) in both good times and bad times because supervisors then understood the perils of trying to game liquidity and credit in bad times and good times alike. Strict ratios on capital adequacy and regulatory prohibitions against complex bank holding structures prevented banks from off-balance sheet manipulations and dilution of capital.

Securitisation and universal banking have changed the way banks appear to operate, but have not overturned the fundamental principals of credit markets. Off balance sheet accounting appeared to reduce the risk to banks, and therefore the amount of capital required to support the volume of credit extended, but in ways that are now demonstrably illusory. We are likely to find that the mark to market discipline of Basle II and the implications for bank reserves are powerfully pro-cyclical. Concerns about pro-cyclicality were raised before Basle II was adopted, but somehow policies to counteract the pro-cyclical nature of the new capital rules were never adequately expressed. A grave misjudgement may have been made in adopting the US-led approach of mark to market valuation of assets and ratings-based assessments in preference to the traditional broad

brush reserve requirements based on a fixed percentage of liabilities. Market-led reforms rarely improve prudential outcomes as market-led reforms will almost always ignore the public interest in financial stability. It may be that authorities will have to reopen capital treatment of some bank assets and liabilities if mark to market proves so powerfully pro-cyclical that the capital treatment itself becomes a source of instability on both the upswing of the cycle, as credit, liquidity and asset values all rise together, and on the downswing of the cycle, as credit, liquidity and asset values all rapidly contract together. Globalisation of markets will have compounded the problems, as virtually all markets now expand and contract together.

2.5 If bank managements cannot value structured products, or even accurately catalogue them as appears to be the case based on disclosures at CSFB, Societe Gen and elsewhere, it is very unlikely that regulators can do better. A superior and more practical approach might be to promote objective cataloguing of structured products by market participants through an independent registry of structured products with a depository or clearing house. The registry could use structured data, FpML, to describe the underlying securities and derivatives of each structured product and cross-index products that are underlying/derivative of others.

A structured products registry would be relatively straight forward and provide several advantages:

- Transparency of the positions of each firm in structured products;
- Transparency of counterparties/investors in structured products and respective exposures;
- Finality under the EU Finality Directive if the registry is administered by a recognised clearing house;
- A more objective basis for comparing valuation and risk management models between firms with similar structured product exposures and portfolios.

I wrote to Pierre Francotte, Chief Executive of Euroclear SA, on 21st February, 2008, to suggest cooperation on designing and implementing a registry for structured products with the aims of improving objective transaction reporting, price discovery, market transparency and accounting harmonisation. I will be pleased to provide a copy of the letter on request.

2.6 Using credit ratings from credit ratings agencies for regulatory purposes has failed as an instrument of public policy because their use implicates **Goodhart's Law**: ***Once a social or economic indicator or other surrogate measure is made a target for the purpose of conducting social or economic policy, then it will lose the information content that would qualify it to play such a role.*** Credit ratings are a commercial commodity which became devalued as a measure of creditworthiness when their value for capital adequacy and other regulatory and securities marketing purposes became factors in setting the ratings for both the rating agencies and their clients.

2.7 Credit ratings were never intended to have a regulatory role, and the more the regulators insist on using credit ratings to achieve regulatory objectives, the less likely it is that credit ratings will serve either their primary commercial function or a useful regulatory function. The flirtation with using credit ratings for regulatory purposes over the past ten years has led to a catastrophic failure of both credit rating discipline and regulatory discipline. There is nothing in the record of recent events to support a view that integrating credit ratings into financial regulation has improved the quality of financial management, regulatory compliance or prudential supervision – and much to support the opposite conclusion.

2.8 As above.

2.9 Where the failure of a financial intermediary has systemic implications, a bright line rule restricting their ability to place business off-balance sheet might be more effective in ensuring the public interest in the integrity of firms. The UK might borrow from the Bank Holding Company Act model in the USA to require that any bank or building society seek FSA explicit approval of creation of or investment in any off-balance sheet vehicle.

Under current rules and practices, banks and non-bank institutions have been able to massively increase the levels of credit and leverage in the economy, particularly in the financial sector, without increasing the capital reserves which protect against loss and disruption.

Excerpt from Chapter VI, Lombard Street, by Walter Bagehot

In consequence, a long-continued low rate of interest is almost always followed by a rapid rise in that rate. Till the available trade is found it lies idle, and can scarcely be lent at all; some of it is not lent. But the moment the available trade is discoveredthe moment that prices have risenthe demand for loanable capital becomes keen. For the most part, men of business must carry on their regular trade; if it cannot be carried on without borrowing io per cent more capital, 10 per cent more capital they must borrow. Very often they have incurred obligations which must be met; and if that is so the rate of interest which they pay is comparatively indifferent. What is necessary to meet their acceptances they will borrow, pay for it what they may; they had better pay any price than permit those acceptances to be dishonoured. And in less extreme eases men of business have a fixed capital, which cannot lie idle except at a great loss; a set of labourers which must be, if possible, kept together; a steady connection of customers, which they would very unwillingly lose. To keep all these, they borrow; and in a period of high prices many merchants are peculiarly anxious to borrow, because the augmentation of the price of the article in which they deal makes them really see, or imagine that they see, peculiar opportunities of profit. An immense new borrowing soon follows upon the new and great trade, and the rate of interest rises at once, and generally rises rapidly.

This is the surer to happen that Lombard Street is, as has been shown before, a very delicate market. A large amount of money is held there by bankers and by bill-brokers at interest: this they must employ, or they will be ruined. It is better for them to reduce the rate they charge, and compensate themselves by reducing the rate they pay, rather than to keep up the rate of charge, if by so doing they cannot employ all their money. It is vital to them to employ all the money on which they pay interest. A little excess therefore forces down the rate of interest very much. But if that low rate of interest should cause, or should aid in causing, a great growth of trade, the rise is sure to be quick, and is apt to be violent. The figures of trade are reckoned by hundreds of millions, where those of loanable capital count only by millions. A great increase in the borrowing demands of English commerce almost always changes an excess of loanable capital above the demand to a greater deficiency below the demand. That deficiency causes adversity, or apparent adversity, in trade, just as, and in the same manner, that the previous excess caused prosperity, or apparent prosperity. It causes a fall of price that runs through society; that fall causes a decline of activity and a diminution of profitsa painful contraction instead of the previous pleasant expansion.

The change is generally quicker because some check to credit happens at an early stage of it. The mercantile community will have been unusually fortunate if during the period of rising prices it has not made great mistakes. Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of a greater prosperity. They altogether over-estimate the demand for the article they deal in, or the work they do. They all in their degreeand the ablest and the cleverest the mostwork much more than they should, and trade far above their means. Every great crisis reveals the excessive speculations of many houses which no one before suspected, and which commonly indeed had not begun or had not carried very far those speculations, till they were tempted by the daily rise of price and the surrounding fever.

The case is worse, because at most periods of great commercial excitement there is some mixture of the older and simpler kind of investing mania. Though the money of saving persons is in the hands of banks, and though, by offering interest, banks retain the command of much of it, yet they do not retain the command of the whole, or anything near the whole; all of it can be used, and much of it is used, by its owners. They speculate with it in bubble companies and in worthless shares, just as they did in the time of the South Sea mania, when there were no banks, and as they would again in England supposing that banks ceased to exist. The mania of 1825 and the mania of 1866 were striking examples of this; in their case to a great extent, as in most similar modern periods to a less extent, the delirium of ancient gambling co-operated with the milder madness of modern overtrading. At the very beginning of adversity, the counters in the gambling mama, the shares in the companies created to feed the mania, are discovered to be worthless; down they all go, and with them much of credit.

The good times too of high price almost always engender much fraud. All people are most credulous when they are most happy; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity. Almost everything will be believed for a little while, and long before discovery the worst and most adroit deceivers are geographically or legally beyond the reach of punishment. But the harm they have done diffuses harm, for it weakens credit still farther.

When we understand that Lombard Street is subject to severe alternations of opposite causes, we should cease to be surprised at its seeming cycles. We should cease too to be surprised at the sudden panics. During the period of reaction and adversity, just even at the last instant of prosperity, the whole structure is delicate. The peculiar essence of our banking system is an unprecedented trust between man and man: and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it.

Now too that we comprehend the inevitable vicissitudes of Lombard Street, we can also thoroughly comprehend the cardinal importance of always retaining a great banking reserve. Whether the times of adversity are well met or ill met depends far more on this than on any other single circumstance. If the reserve be large, its magnitude sustains credit; and if it be small, its diminution stimulates the gravest apprehensions. And the better we comprehend the importance of the banking reserve, the higher we shall estimate the responsibility of those who keep it.

2.3 Chapter 3 Question Responses

3.1 The powers are probably sufficient, but I would prefer to see an emphasis on prevention through prudential supervision rather than intervention after bad judgment or mismanagement has rendered a regulated firm incapable of meeting objective standards. Prudential supervision requires greater skepticism of market-led reforms or deregulation pleas and a recognition that managements and shareholders, both of which increasingly act on short term impulses, are motivated by self-interest to evade constraints and shirk their responsibility to reserve adequately. The pattern of the past fifteen years of prudential supervision is to enable more and more lending to occur systemically with less and less capital behind it at credit institutions. This has been the primary motivation for much of the asset securitization, off-balance sheet accounting and derivatives innovations. Obviously, this trend has led ultimately to a very fragile financial system dependent on ever expanding credit for the long sustained illusion of robust health, with the usual inflationary consequences and widening solvency issues.

3.2 No comment.

3.3 All information requirements are backward looking, and so all information requirements are inadequate to prevent misapplication of financial resources to unproductive and insufficiently remunerative investment. While a short term demand for supervisory information may be helpful in preparing for intervention, it does nothing to forestall the necessity.

That said, the focus of any short term accounting of a bank's positions should be aimed at facilitating intervention to mitigate systemic harm to other financial institutions and the real economy from further bad practice or bad management of the bank. Requiring a bank to prepare itself for transfer of business lines, such as retail deposit accounts or nominee assets, would send a powerful message to management and shareholders that the bank was being prepared for dissolution, that it was not "to big to fail", while reassuring the public that deposits and assets would remain liquid and secure.

3.4 A sudden deterioration in a bank's financial soundness is usually the result of a persistent deterioration in a bank's management and credit judgment over many months or years previous. Detecting a "sudden deterioration" seems fairly pointless and unlikely. Sudden deteriorations in financial soundness are almost always perceived and communicated through the short term money markets once some event has triggered a collapse of confidence, at which point the market's judgment is both judge and executioner in making a previously liquid bank an illiquid problem of public and supervisory interest.

> *"Panics do not destroy capital; they merely reveal the extent to which it has been previously destroyed by its betrayal into hopelessly unproductive works." – John Stuart Mill*

3.5 As the public's funds and public interest in the health of the broader real economy are ultimately at risk from the failure of any bank or large financial intermediary, the FSA should always be able to share relevant concerns about banks and other financial intermediaries presenting systemic concerns with the Bank of England and Treasury and any SRR authority.

3.6 A statutory basis for oversight of payment systems may have merit given the importance of payments to all commercial activity in the economy. The responsible authority, however, should be the Bank of England. The Bank of England, as lender of last resort, has the ultimate liability for potential illiquidity and disruptions to payment mechanisms.

The scope of a flexible payments supervisory regime should be aimed at ensuring the integrity of operations and the resiliency of the system in the event of a participant failure. This should include the authority to require the payment system be able to re-route payment instructions from/to a failed institution in favour of a healthy institution designated by the SRR Administrator to assume payments functions for designated accounts. This would greatly reduce the systemic disruption that currently threatens payments operations and retail and commercial liquidity whenever a bank is in difficulty.

3.7 The statutory basis for payment systems supervision should achieve the following:

- allow the supervisor to designate a payment systems as subject to supervisory authority;
- require information and reports for the supervisor detailing operations;
- give a right of audit of systems operations and financial position;
- require compliance with regulations enacted by the authority aimed at mitigating systemic disruption in the event of operational or financial failure of one or several participants.

3.8 The requirement that floating charges be registered at Companies House is designed to prevent fraud against creditors who may be denied knowledge of prior or competing claims to the assets subject to a charge. It is worth recalling that one of the more embarrassing recent cases of fraud in the City involved the failure of banks to adequately perfect charges and secure collateral prior to the collapse of the Maxell newspaper group. Because Robert Maxwell was able to convince multiple banks to provide finance without charges being registered or the collateral being taken into custody, the same assets were secretly leveraged over and over again. While this scenario is not directly implicated by the proposal to withhold public record of the Bank's charge over assets, the principle is still relevant. Managers of troubled firms are highly motivated to raise finance by whatever means possible, and may not be entirely scrupulous in their methods.

Creditors who finance a troubled bank after the Bank has intervened with ELA may justly feel that their interests were prejudiced by their ignorance of the Bank's prior claims and interests in assets of the troubled bank if they are not indemnified. Also, it will be very difficult to wean a bank off the ELA if other banks cannot be granted adequate security and transparent rights and interests.

An ELA preference over bank assets is particularly relevant to the floating charge registration, which is used extensively to secure perfection of collateral portfolios subject to frequent substitution and margin movements under negotiated interbank financial netting agreements.

3.9 If there is an exemption, it should be restricted to ELA. The public interest in intervention to support the troubled bank must be sufficient to outweigh the commercial interest of other creditors of the bank in timely disclosure of charges. Any ELA not disclosed promptly should be subject to ex-post reporting and review to ensure that the facility is appropriately limited to banks threatening broader financial instability.

A possible solution to the conflict inherent in an unregistered ELA lien may be a statutory indemnification of later creditors prejudiced by their ignorance of the ELA. Otherwise there is a risk that the management of a bank drawing on the ELA will be acting in bad faith when it secures funding elsewhere, and that creditors generally will have even more reason to shun a bank suspected of having difficulties making it eligible for ELA.

3.10 Extension of the 21 day period should be considered as an alternative to eliminating the charge registration requirement. This has several advantages. First, more secrecy in the handling of financial intervention by the authorities has the potential to create "crony capitalism" of secret financings to the advantage of the well connected at the cost of others in the markets (a concern raised by the operations of the Term Auction Facility as recently implemented by the Federal Reserve in the USA). Second, delayed disclosure will open the intervention to review by the public and the industry which will act as a valid and necessary check on excessive use of Bank ELA facilities. Finally, if the market is to reintegrate a troubled firm once the liquidity issues are resolved, it must be in possession of relevant information for effective price discovery and negotiation.

3.11 Any change of legislation or operations to diminish current levels of transparency in the operations of the Bank requires careful consideration. In retrospect, it is clear that the moves by the Federal Reserve to halt publication of M3 broad money growth and to substitute the secret Term Auction Facility, where terms and recipients are undisclosed, are exacerbating the problems associated with evaluating Federal Reserve monetary policies and the condition of US financial institutions. More secrecy and ill-transparency can cause instability and uncertainty, regardless of good intentions.

3.12 Yes, with some checks and balances, including ex-post reporting and review. It may be appropriate in parallel with grant of immunity to require the Bank of England to report to the Treasury and/or Parliament on its actions, and perhaps be subject to independent inquiry or audit where such actions are controversial, to ensure that the public interest is protected in the exercise of its powers.

3.13 Agree. However, the interests of other creditors of a troubled bank will need to be considered in crafting this provision. Banks turn to the Bank of England as lender of last resort when access to finance from other institutions is withheld or becomes too costly. As a general matter of policy, the system should create incentives which force banks to pay market rates to obtain peer finance as long as possible and to wean them off the public teat when sufficient health is restored. If the Bank of England's protections allow it to secure finance after the fact which a bank had pledged or held forth as available in securing finance from its peers, the Bank's superior claim may actually undermine the availability of credit in the market by discouraging peer lending or delaying the reintegration of a troubled bank into the commercial market.

3.14 No opinion.

3.15 If building societies are to have access to Bank of England credit on the same terms as banks, they must be able to provide security on the same basis as banks. The floating charge is a very useful

mechanism for taking security while leaving a debtor in possession. As noted above, however, there is a real risk that if the floating charge is not promptly disclosed – as proposed – that other creditors may be defrauded or impaired by taking an interest in the same assets.

2.4 Chapter 4 Question Responses

4.1 Yes, but the Special Resolution Regime should extend beyond deposit-taking firms to embrace other financial intermediaries such as securities brokers whose insolvency or illiquidity would raise similar issues for illiquidity contagion or systemic risk.

4.2 The decision to place a firm under the Special Resolution Regime should be taken by the Tripartite Authorities collectively. The Treasury will have an interest as public confidence and public funds may be at stake when a large institution fails. The Bank will have an interest because it is likely to have substantial credit exposure to a troubled firm through liquidity facilties. The FSA may be responsible for ongoing assessment of compliance with objective triggers, but the ultimate determination that the public interest in a firm's failure sufficiently to invoke SRR should be shared by all Tripartite Authorities.

4.3 As a practical matter the affairs of illiquid or insolvent banks are likely to be rather too confused for objective application of guidance criteria, especially where management has been active in hiding the true state of affairs for some time. Also, where a collapse of confidence has triggered a run on the bank or broker, the need for a rapid intervention to prevent creditors pursuing insolvency proceedings, depositors closing accounts, etc., make objective criteria largely irrelevant.

Despite that reality, international best practice is to embody transparent, objective triggers for intervention in regulation so that regulated firms can be held accountable to the objective standards and so that regulators have a clear legal basis for taking action.

4.4 Yes, with the caveat that more development is required and the SRR enabling legislation should provide some flexibility for adjusting the scheme as future conditions may require. It is also worth noting that the SRR will only be successful at transferring lines of business (such as retail deposit accounts or nominees) to healthy firms where transferability is promoted by prudential supervision and regulation which enforces appropriate accounting, client money segregation, nominee administration, etc.

4.5 Agree.

4.6 The SRR Administrator should only be appointed by on determination that the failure of the firm presents a danger of illiquidity contagion or systemic disruption. The SRR Administrator should be required to provide an ex-post report on his actions to avert loss or disruption and to recommend either nationalisation, receivership or insolvency liquidation as recommended in Part 1 of these comments.

4.7 Yes. Suspension of private law contractual rights, such as notification of an event of default, requires more careful consideration and consultation with industry experts to ensure that the UK's primacy as a centre for contracting negotiated derivatives and other financial contracts is not unduly prejudiced by the reforms.

4.8 Judicial review of the exercise of SRR authority seems to raise the possibility that the SRR Administrator may be prevented from timely action to transfer business or otherwise prevent loss or disruption. It may be preferable to reserve to stakeholders a right to challenge the adequacy of recovery in the ultimate disposition of the failed firm's assets and/or require an ex-post review of SRR actions rather than enable stakeholders to frustrate the process before losses can be reckoned

with any degree of certainty.

4.9 No opinion.

4.10 Yes.

4.11 Yes.

4.12 As in 4.8, concern that judicial review may impair speedy action to prevent loss or systemic disruption.

4.13 No opinion.

4.14 Yes.

4.15 Yes. The SRR procedures should be aimed at severability of lines of business or categories of assets and/or liabilities for transfer or sale to healthy firms through P&A transfers and/or operation of a Bridge Bank under limited authority for a limited period. As recently experienced with Northern Rock, it may be impossible as a practical matter to determine the scale of the challenge in administering a failing institution at the time that it first encounters difficulties necessitating Bank of England liquidity facilities or other supervisory intervention. As a result, I prefer a flexible regime that appoints an SRR Administrator to take rapid and necessary actions to minimise systemic threats, and then makes an official ex-post report and recommendation to the Bank, FSA and Treasury on further disposition of the residual assets and liabilities of the failed firm.

4.16 The emphasis on FSCS payout seems misplaced. Surely the objective of intervention should be to prevent loss and illiquidity, and the objective of transferring the assets and/or liabilities of a firm subject to SRR administration should be to keep FSCS liability for depositor and investor losses non-existent or low.

4.17 Yes. My preference is for the SRR Administrator to be appointed by an independent SRR or the Bank of England, with reporting to the Treasury, FSA and Bank on all actions taken and recommending a course for resolving the residual estate through nationalisation or insolvency.

4.18 No. The public interest in limiting the systemic harm of a financial firm is quite limited, and the SRR Administrator should only take actions to transfer lines of business or categories of assets and/or liabilities as consistent with this limited public interest. Once this has been accomplished, the remainder of the failed firm's estate can be relegated to insolvency practitioners to recover any residual value for unsecured creditors and/or shareholders or nationalised if the unwinding is feared to cause massive wholesale market dislocation (as may be the case with a major, global bank).

4.19 No. Costs of the SRR and any bank insolvency resolution should be covered from the assets available in the insolvent firm's bankruptcy estate as defined by current insolvency practice.

4.20 No. The public interest in preventing loss and illiquidity contagion to depositors is expressed already in the limits on FSCS compensation and in the protections and procedures to intervene with problem banks. Above these limits, depositors should rank as unsecured creditors. This will force a useful commercial discipline on the managements of banks in attracting and retaining wealthy depositors.

4.21 A notice period to supervisors in advance of bank insolvency proceedings is useful, but this should not impair the commercial rights of contractual counterparties to enforce default provisions and rights in collateral, margin and other assets. Impairing enforcement of security interests or margin

collateral might spread illiquidity from one problem institution to others in unpredictable ways.

4.22 Independence of the SRR will provide a healthier balance in the regulatory system. Also, the Bank of England and Treasury will likely have a direct financial interest in the resolution of a failed firm whereas the FSA's interest in prudential supervision and regulation will be historic by that point, although there may be lessons learned.

4.23 Agree. The SRR restructuring officer, or SRR Administrator, performs the useful function of determining actions to be taken in the public interest to limit loss or disruption.

4.24 As far a possible, the actions of the SRR restructuring officer should be limited to preventing systemic disruption and illiquidity contagion, with any residual assets and liabilities of a failed bank or other SRR-eligible firm then passed to an insolvency practitioner for receivership or liquidation in line with existing practice.

4.25 Yes, although if recommendations for the SRR regime as outlined are adopted, this should not be necessary except in truly exceptional circumstances.

4.26 The enabling legislation for the SRR should encompass sufficient flexibility for the scope of the SRR to be determined by Regulations.

4.27 Yes.

4.28 Yes.

4.29 Yes.

4.30 No. This requires careful consideration which balances the interests of the members in mutuality against their claims as creditors. If there is not particular benefit to be derived from mutuality then all building societies might as well be required to become banks. If there is a benefit, then the mutuality of obligation should be offset by a responsibility to oversee the management of the building society in the interests of the creditors as well as the members.

4.31 Costs of the SRR should be funded out of the assets available to the SRR Administrator as part of the resolution of the estate of a failed firm. Any non-recoverable costs should be funded as defined in the funding model adopted for SRR resolutions to mutualise the costs among SRR-eligible firms.

4.32 The objective of SRR is to avoid loss to depositors and investors, minimising the call on the FSCS. If the SRR Administrator has sufficient power to transfer accounts and assets as lines of business, then very likely the call on the FSCS will be less than is currently incurred with a lengthy, costly and inefficient insolvency practitioner liquidation.

4.33 As suggested in Part 1, payment systems and bank operations should be required to configure accounts and data so that payments can be rerouted from accounts at a failed institution to an institution accepting transfer of those accounts. This will minimise consequent illiquidity disruption to commercial businesses and retail depositors alike.

4.34 Modern payment systems incorporate structured data for payor and beneficiary and all intermediary banks in the transaction chain, and should be capable of amendment to remap processing between intermediaries where accounts are transferred between a failed firm and a healthy firm. The SRR will need to work with experts in transaction processing and structured data to identify current operational possibilities and define requirements promoting the objectives of the SRR.

4.35 Yes.

4.36 Any revisions to financial collateral arrangements should be consistent with international best practice recommendations.

2.5 Chapter 5 Question Responses

5.1 I do not believe that the compensation limit is particularly relevant to the motivation for bank runs. Bank runs are generally motivated by a concern that depositors will be left illiquid by a bank failure, rather than they will ultimately bear a financial loss, although concern about the co-insurance liability may be a factor. Depositors with more than the limit can split their deposits between banks easily.

5.2 The limit on compensation defines the public interest in preventing depositor loss on the failure of a deposit-taking bank or building society. Above this limit it is appropriate for depositors to scrutinise the management and operations of firms they entrust with their funds, and the public interest in securing these excess funds or compensating their loss is limited. As only the relatively wealthy are likely to have deposits above the current limit, raising the limit does little to improve confidence or financial stability.

5.3 A higher compensation limit may distort market discipline.

5.4 Spreading balances between accounts at different institutions should be the primary mechanism for limiting depositor exposure to bank failure.

5.5 Under very limited circumstances, such as cases where a large sum is temporarily held in a bank pending transaction settlement such as a property or investment purchase, it may be desirable to carve out a category of hypothecated accounts or transactions in the course of settlement which would be subject to preferential treatment in the Special Resolution Regime.

5.6 No opinion.

5.7 The one week target for FSCS payment to depositors of a failed bank seems highly unrealistic, but also distorts the objectives and motivations involved. The best outcome for both depositors and creditors of a bank taken into SRR administration will be to maintain the bank as on ongoing operation while its operations and business are transferred or sold to healthy firms. What depositors truly fear when a bank becomes threatened is being left illiquid, without access to their funds, so that they cannot make payment on their own obligations as they come due or finance their domestic routine. If the SRR achieves its objective of keeping the operations of a bank ticking over through P&A transfer or Bridge Bank operations so that depositors are not denied access to their funds, depositors will have no reason to make a run on the bank under SRR administration, and no reason to complain of slow compensation. Indeed, compensation may not be required if the SRR is administered in the best interest of the public, the depositors and the creditors to realise the value of the firm as an ongoing business or severable lines of business that can transferred to healthy firms.

5.8 In my experience of British banks, they are incapable of providing instant access to any funds deposited by cheque. Even Bank of England drafts, which add instantly to reserves, take at least a week to clear. When I opened an account at Barclays Bank using a Bank of England cheque, it took three weeks to get access to the funds. I have no reason to believe the process would be easier or faster now given that money laundering and know your customer rules are much more

stringent.

5.9 When the SRR Administrator takes over a bank, it should continue to operate all standing orders, direct debits and access to customer accounts as normal until the SRR Administrator forms a view as to the appropriateness of transferring business lines to other firms or other action. During any period of Bridge Bank administration, depositors should be limited to withdrawing in total the limit of their FSCS entitlement from the failed bank, and any such withdrawal should diminish their FSCS entitlement. Incoming credits to depositor accounts (e.g., payroll, DWP, HMRC payments) will increase entitlement. By this means, depositors will be kept liquid and non-defaulting on their own payment obligations while arrangements for resolution of the bank are finalised.

5.10 Interim payments that require invoking the full panoply of FSCS claims determination are probably impractical. Keeping the doors open and the accounts operating is more likely to achieve the public policy objectives and keep depositors confident while the SRR Administration gets to grips with the situation inside a problem bank.

5.11 No opinion.

5.12 Account data must be held and represented in a manner consistent with re-routing payments in the payment system to facilitate transfer of depositor accounts and related assets and liabilities.

5.13 No opinion.

5.14 No opinion.

5.15 No opinion.

5.16 Waiving set-off is consistent with the public policy objective of ensuring depositor liquidity. Waiver of set-off for FSCS entitlement should not imply that the depositor is relieved of his obligation to repay any outstanding debts held with the failed bank. Waiving set-off should greatly speed the FSCS claims determination process as it will reduce the resources required for investigation of claims.

5.17 The objective should be to avoid making FSCS payments altogether by avoiding depositor losses on insolvency of a bank. Transferring accounts through P&A or keeping the doors open through a Bridge Bank keeps the depositors liquid while the assets and liabilities of the failed bank are resolved in the SRR administration. Either mechanism will go far to minimising loss and illiquidity and so FSCS liabilities.

5.18 If set-off is waived, it could be subject to a limit which is either the same or somewhat less than the deposit insurance cap. Set-off would only be an issue above the limit. This would be consistent with a primary public policy focus of enabling depositor liquidity to prevent harmful illiquidity contagion to depositors and businesses reliant on the failed banks' payment intermediation with retail clients while respecting the insolvency principle of treating like claimants equitably.

5.19 The FSCS should be a backstop for losses which the Special Resolution Regime should be operated to avoid in the first instance. When a bank exits the SRR to the alternatives of nationalisation, insolvency practice liquidation, or sale to competitor, the SRR should make a final accounting of any depositor losses to be compensated by the FSCS. With luck and skillful administration of the SRR, it may be rare for depositors to incur losses requiring FSCS compensation.

5.20 An expedited process that relies on the records of the failed bank rather than requiring claims from depositors will be easier all around to administer. However, the claims determination should set-

off debts of depositors to the failed bank if it is to remain equitable to other creditors of the bank and not endow a windfall to depositors who were also debtors.

5.21 Pre-funding FSCS payments from Bank of England liquidity facilities will overcome fears of inadequate funding which may contribute to runs on banks when public confidence is low.

5.22 Again, the objective of the SRR should be to minimise losses in the first instance and to recover as much as possible to offset losses from disposal of assets or business lines in the second instance. If this is done well, FSCS losses, if any, should be less than would occur under the existing regime.

5.23 Large failures may necessitate interim finance from the Bank or Treasury to ensure immediate access to sufficient resources to enable successful SRR intervention or FSCS pay outs. Alternatives might include: Bridge Bank or P&A finance by the Bank against a lien on unimpaired assets; issuance of SRR bonds (possibly guaranteed by the Treasury) against unimpaired assets and/or sale of operations in the insolvency; and/or subsequent levies on FSCS participants.

5.24 Rather than opening new accounts, existing depositor and/or investor accounts with the failed intermediary should be transferable to a receiving intermediary under a P&A transfer without the need for depositor action. These accounts can then be subject to a streamlined process of novation or transfer should the depositor choose to open an account somewhere else.

5.25 No opinion.

5.26 As recommended above, the SRR procedures should envision transferring eligible accounts to a healthy institution or bridge bank in an expedited process, preferably overnight on the day a bank enters SRR administration. The receiving bank would then process all incoming and outgoing payments to and from these accounts without interruption and with minimal disruption or inconvenience to depositors.

5.27 No opinion.

5.28 Notification of compensation limits should be posted in plain sight in banks. Unfortunately, the limits only become relevant once confidence is deteriorating, and then depositors' concerns about their own liquidity and access to funds become more important for most depositors (who generally have less than the limit in deposits) than putative compensation levels.

5.29 No opinion.

5.30 Transfer of accounts without disruption to a healthy bank or bridge bank obviates the need for alternative mechanisms for DWP and HMRC payments.

5.31 Yes. The SRR should be funded by the industry for its operating costs, as with FSCS, but actual resolution costs should be recovered from the unimpaired assets of the failed firm in SRR administration.

The idea of giving more discretion about compensation and costs to insolvency practitioners makes me very uneasy. **It is not in the self-interest of insolvency practitioners to make insolvency resolution fast, simple, inexpensive or to the benefit of depositors or investors covered by the compensation scheme.** The complexity of the policy objectives and competing claims implicated by these proposals requires much more thorough consideration than it receives here and will be greatly influenced by the nature and scope of the SRR and FSCS.

5.32 The best way to process a large number of claims is not to have them in the first place. The priority of policies around the SRR and FSCS should be to minimise the circumstances under which a formal claim for compensation will be required by ensuring retail deposit accounts and

nominees can be transferred quickly and with minimal administration to be operated by healthy firms.

5.33 Risk based levies have potential for harmful distortion of markets. Neither the FSA nor the banks themselves have proved very adept in recent years at assessing risks among the banks and other financial actors in the UK economy, becoming over-reliant on ratings and models which have proved easy to distort. To embed an imperfect measure into the levy assessment process could create unfairness and lead to allegations of competitive impacts or regulatory preference which would be difficult for anyone to objectively resolve. Sometimes bright line rules, however imperfect, are best because they are clearest.

WHY NOT FDIC-STYLE INSURANCE ASSESSMENTS?

The Federal Deposit Insurance Corporation (FDIC) was established in 1933 following a national crisis of confidence in American banks as hundred of banks failed across the country during the credit deflation following the 1929 market collapse. The United States had then, and still has, thousands of small, local banks which serve only their local communities and depend for liquidity primarily on local depositors and access to larger state, regional or national banks through discounting of commercial paper or loans. Many banks had only one branch, a result of strict regulation and restrictions on interstate banking which were maintained until the 1980s overturned the McFadden Act.

Drawing on thousands of small banks for modest premiums made sense for a system where each small bank failure would present only a modest draw on FDIC funds. When Marriner Eccles, the architect of the FDIC and first Chairman of the Board of Governors of the Federal Reserve System, first innovated the FDIC concept, he understood that the small levy assessed on each bank would be more than compensated by the confidence that each bank would enjoy in its local community from FDIC insurance of deposits. FDIC compensation to depositors should be modest enough, under normal circumstances, if only a handful of small banks were likely to fail. Eccles also foresaw that losses would be diminished and prevented by the improvements to bank regulation and prudential supervision introduced with the Banking Reform Act of 1934, which severely restricted the risks which commercial banks could underwrite and limited their exposure to fluctuations in investment markets. In short, the FDIC was never designed to compensate the failure of very large banks and never contemplated underwriting the risks taken in modern markets by universal banks.

Deregulation of banks, and the growth of regional, super-regional and national banks in the US has steadily increased the systemic problem of moral hazard in the US bank regulatory system as big banks are “too big to fail”. According to many assessments, the FDIC is vastly undercapitalised for the modern US banking system, and may require imminent reforms should bank failures in the US escalate rapidly in frequency and cost. It is also quite likely that the deregulation of US banks has consequently increased the risk profile of US banks in ways which the FDIC was never designed to accommodate.

The United Kingdom in the twenty-first century presents a very different context from the United States in the early 1930s. The UK has many fewer, and much larger, banks and building societies. Modern UK financial institutions are much more diversified, presenting risks from complex treasury and securities operations. Insurance at sufficient levels to cover the failure of one of the larger UK banks would be a significant cost burden to the rest of the sector, and would likely pressure competitiveness of UK banks globally. “Too big to fail” is a reality for most of the major banks and many of the minor banks from an economic and political perspective because of the high concentration of banking in the UK. Also, bank failures in the UK are relatively infrequent, occurring almost exclusively during recessions when banks may already be suffering pressures on capital and income.

A straight forward comparative analysis of history and characteristics of the US and UK banking sectors indicates that the US model of the FDIC will likely prove ill-suited to meeting the policy objectives of UK deposit protection. It would be preferable to develop mechanisms in the UK which explicitly address the context of a more concentrated banking sector, the pro-cyclical nature of bank failure, and the challenge of moral hazard explicitly, rather than import a model developed for a very different context, only imperfectly implemented, and never adapted to modern, complex banking operations.

Chapter 6 Question Responses

6.1 Financial stability is not something that is amenable to explicit regulation or authority. The speed with which innovations and globalisation are changing the nature and scope of interactions among participants in the financial sector presents a continuing challenge. If the Bank of England could not anticipate the implications of massive monetary laxity in Japan fostering huge credit growth globally through the carry trade, or the massive laxity of monetary policy in the US fostering excessive leveraging of real estate and serial asset bubbles via securitisation, it seems unlikely that any formal statutory responsibility will improve matters. Studying events and trends with an open mind and due respect for the public interest is about the best that can be hoped for under rapidly evolving circumstances. The current crisis is still unfolding, and it may be best to wait for more settled circumstances to re-evaluate whether any official responsibility for financial stability makes sense.

6.2 The beginning of a systemic financial meltdown seems an odd time to be rejigging the Court of the Bank of England, one of the few institutions to retain confidence in the UK system. Given the widespread self-serving of corporate boards in promoting recent excesses, they hardly appeal as a model of governance to impose on the Bank.

Chapter 7 Question Responses

7.1 MOUs are consistent with best practice for coordinating large financial failures.

7.2 The past two decades have witnessed huge advances in regulatory cooperation and information sharing led by the BIS and IOSCO, but it is difficult to judge if this has strengthened or weakened the systems for preventing financial crises. Globalisation of US-led deregulation and free market doctrines may well have contributed to weaker, more unstable financial markets by promoting excessively risky practices and weaker capitalization of intermediaries at the same time globalisation promoted interdependence and scope for contagion. **In short, not all harmonisation works in the direction of improving outcomes.**

It might be better to apply more objective, less politicised, evaluation techniques to judging the consequences throughout the business cycle. Any attempt to evaluate a system without reference to how it performs across the business cycle will provide a misleading signal.

7.3 I am skeptical of any early warning system being truly effective. Anyone suggesting three years ago that deregulation, innovation and monetary laxity were promoting unsustainable leverage and excessive risk taking by financial firms was labeled a conspiracy theorist or financial Luddite. In the same way, challenges to the zero interest rate policy in Japan or the one percent interest rate policy of the Greenspan Fed would have been hugely unpopular with those hedge funds and banks scooping up the liquidity to pump it into global real estate, securities and commodities bubbles. Very often it is hardest to see with foresight what is obvious in hindsight.

7.4 If the same people who promoted irresponsible practices are given the task of investigating and resolving the consequences, I am not very hopeful of improved outcomes.

EXCHANGE MUTUALISED WINDING UP OF JOBBERS AND BROKERS PRE-1986

An example of unintended consequences from recent history of UK regulatory reforms arises from the removal of regulatory and special resolution powers from the Stock Exchange with the Big Bang and Financial Services Act in 1986. Unconsidered at the time was the mechanism for working out broker-dealer failures for member firms.

In the era when jobbers and brokers were kept strictly separate in function, a jobber dealt for his own account putting his own capital at risk. A broker could only deal for a client's account using client funds and holding stocks as nominee. A jobber (market maker) could never cause loss to clients as all losses were on the firm's own capital. A broker could never sustain a loss on his own capital except by a client's failure to make payment on an order, in which case the limit of risk was market risk on the liquidation price of the asset involved and generally secured by stocks in the broker's nominee. When a jobber failed, all shares owned by the firm were available to meet the claims of creditors. When a broker failed, all shares in a broker nominee could be returned to investors as free from any claims of creditors (right of revindication).

The bifurcation of functions provided a very rigid, practical segregation for creditors and investors, and therefore a very real and efficient check on liquidity contagion and systemic risk. On the rare occasions when a broker did fail, the Stock Exchange acted as receiver to wind up the broker's affairs, transferring accounts and nominee holdings fluidly to a healthy broker to minimise disruption and illiquidity to investors. If any stock or cash were found missing, whether by mismanagement or misappropriation, the Stock Exchange quietly funded cash or bought in sufficient stock in the market to make good the deficiency, mutualising the losses among the membership, to maintain confidence in the market. This quiet, mutual resolution of Exchange member failures helped establish and maintain the reputation of the London Stock Exchange for integrity, investor protection and self-regulatory rigour: *dictum meum pactum*.

Post Big Bang, a broker-dealer failure now results in appointment of a receiver or liquidator to supervise the winding up of the affairs of a broker-dealer. This is generally a very long process of discovering assets and liabilities and assessing net investor and creditor claims against the firm. The substantial impacts on investor liquidity, income and recovery of assets are not a primary concern of insolvency practitioners, and so the process generally yields an inferior result in terms of speed, reputational effects, confidence in intermediaries, loss to investors and systemic illquidity.

The clearest case of this is the failure of British & Commonwealth Bank in 1990. Although B&C had perfect client records and surplus regulatory capital at the time of its closure, the liquidator took several years to assess and satisfy claims. Worse yet, investors holding through the nominee did not have their assets transferred to a healthy firm, which would have prevented illiquidity and loss of continued income streams in one stroke, but saw their nominee assets liquidated in the market against their will. They suffered poor realised prices, lost their income streams, paid capital gains taxes on the proceeds of sale, and were denied access to the proceeds until their claims were ultimately resolved some years later. **The costs to the rest of the financial community through assessments via the Investors Compensation Scheme, including the high fees charged by the liquidators for their very lengthy and slow process, were undoubtedly a multiple of the costs that would have accrued under a mutually supervised transfer of accounts and winding up by the Exchange.**