

By email only Banking.reform@hm-treasury.gov.uk

15 September 2008

To the Banking Reform Team

Dear Madam,

HMT/FSA/Bank of England Financial stability and depositor protection: further consultation and the special resolution regime papers

This response relates to the two July consultation papers continuing the theme: financial stability and depositor protection. Responses are made against the questions in the first of those papers "further consultation". The responses to the SRR paper can be found in the answers at 4.3.

The Investment Management Association (IMA) represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes.

They are responsible for the management of £3.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies).

Thank you for the opportunity to comment. We have made a few policy comments but as we trust is well known, the IMA are very supportive of the efforts of the Government to address a wide-range of issues, both at macro policy level and in technical detail, better to underpin financial stability and confidence in UK banking and so in the wider financial services industry. We have participated in the two workshops on the SRR and special insolvency regime. We mention in short-hand our comments and proposals for the sake of the record. We found those meetings useful not just for their comment but for the clear commitment from officials to get the detail right whilst remaining on the correct policy track.

One policy proposal to note is our suggestion to set up a **Financial Stability Legislative Committee** chaired by the Bank of England and drawn from practitioners and lawyers in order to keep the technical aspects of the secondary legislation under review akin to EU Level 3 committees' advisory roles.

65 Kingsway London WC2B 6TD
Tel:+44(0)20 7831 0898 Fax:+44(0)20 7831 9975

www.investmentuk.org

1. Reducing the likelihood of a bank failing (D.2 to D.13)

IMA were supportive of most of these proposals as first described in the 30 January consultation. Underlying our approach to the stabilising powers is a firm view that banks should be allowed to fail. This is essential if market disciplines are to apply properly. In the recent past this approach may have needed to have been sacrificed too readily to financial stability concerns, in part because there has been a lack of appropriate tools to ensure that depositor interests are properly protected during the process of winding-up. The proposed stabilising powers ought to go a long way to address this. This is critical as it impacts not only the efficient application of capital but also imposes a background that may constrain the worst excesses of behaviour by senior management.

We have consistently called for the legislation not to be delayed and we note, as D.7 records, that Government has had to pass some of this legislation already. We did propose that registration of Emergency Liquidity Assistance as a charge should continue, but with greater delay; however we note that at D.10 Government states its intention to exempt this. In the scheme of things, and with a range of new financial stability tools, this is the sort of issue that could always be altered over time if it felt there was a need, for example, to narrow the exemption.

We shall respond separately to the FSA consultation (CP08/13) concerning when notification to the market might be delayed legitimately; it seems a sensible clarification.

As regards the new questions in this section:

- In relation to the effect on contracts

3.1) The Authorities are seeking views from respondents on the extent that contractual provisions, such as those set out [in D.12 and relating to negative pledges and trigger clauses] may prevent the Authorities from taking appropriate action; and the merits of the two approaches set out above.

This is an important issue. This will potentially affect funding, and has analogies with the effect of administration on some security rights. Alternatively, banks might be prohibited, or discouraged, from entering into such contracts, which may or may not be seen as more problematic. Banks themselves will be well placed to respond but in our view legislative intervention within contracts is not the priority and could have significant unintended consequences. Care must be taken not to tip the balance too far in favour of the debtor (the bank) against the creditors (those providing funding and imposing negative pledges). Already it is proposed that ELA will not be registrable, so public notice will not exist; the FSA are proposing to at least soften the disclosure boundary; in light of these, legislation that then prevents certain contractual protections could affect the balance of power significantly. Whilst we are against a general prohibition that attempts to interfere with default clauses, we would concede that there might be some caveats to this:

1. First, consistent with the absence of public notice: we see a strong argument for introducing a legislative provision restricting contractual terms that require disclosure by a bank to a funder or counterparty of the receipt of ELA. The

terms will need to be carefully considered; for example, there will be a greater policy need for such disclosure to be made non-publicly to a clearing system than to a mere counterparty. In this regard we would address the issue as if the fact of the receipt of ELA were inside information (as it must be);

2. Secondly, in principle provisions akin to shorter-term stays on execution and enforcement of certain rights that are associated with administrations may have their place so as to not prevent appropriate action; and
 3. Thirdly, the presence or absence of funding covenants or contractual triggers ought to be matters in relation to which FSA as supervisor should have regard. Just as the post-BCCI directive requires supervisors to have regard to the complexity of a group, then alongside more explicit references to liquidity that we have previously called for in the threshold conditions, the FSA ought to be able to regard the nature of the funding covenants within the threshold condition assessment.
- In relation to the oversight of payment systems

3.2) Are the criteria as set out [in 3.22 et seq of the consultation], the right criteria and will they provide sufficient flexibility as payment systems evolve overtime?

3.3) Is there a preferred method for recognising payment systems?

3.4 Do you agree that the indicative list in paragraph 3.47 includes all the relevant payment systems which are of systemic or system-wide importance?

3.5) Are the powers, as set out above, necessary and appropriately graduated?

Previously IMA has supported some measure of statutory recognition and oversight of critical payment systems, particularly to secure greater clarity of accountability and responsibility amongst the Tripartite Authorities. Accordingly the proposals are welcome.

Reducing the impact of a failing bank (D.14 to D.24)

IMA were supportive of most of these proposals, and again cautioned against delay. The model now chosen by Government for the SRR provides a greater role to the Bank than we proposed, but we can see advantages in this – see comments about clause 8 below.

The new questions in this section are:

4.1) The Authorities would welcome views on the most appropriate ways to deal with other relevant entities in investment banking groups with the aim of helping to maintain financial stability.

We think this will be very group specific and will need to be looked at on a case-by-case basis.

4.2) Do you agree with the roles for the Authorities for the triggering and operation of the Special Resolution Regime?

4.3) Respondents views are sought on the practical considerations involved in developing a SRR.

We agree with Part 1 of the draft Banking Act with the objections, reservations or comments set out below and which thereby answer relevant questions in sections 1-3 of the second consultation (some of which accordingly we have no comment upon). As regards the questions in section 4 on insolvency, we made or supported

comments in the workshops on the insolvency regime. Our comments and further reflections are at Appendix 2. As regards section 5 questions, concerning building societies, we support equivalent powers being made available as for banks.

Clause 4 – the objectives

There needs to be another Objective designed to allay fears that a transfer may occur at any cost so as to protect depositors, when with some more thought (and perhaps a small measure of time) an option could be considered that might achieve the same as regards depositors and public funds but leave residual creditors, and even shareholders, in a better position. We understood ABI's comments to be promoting this approach and we support that approach. However whether maximising enterprise value is an appropriate legislative formulation (in policy terms) is open, as we can see there will be limiting conditions to this new objective. As an example, assume there are 2 potential purchasers of the depositor book of a failing bank. Assets will be moved with the depositors' accounts. Assume one purchaser is willing to pay 2.5% of the nominal value of the deposits; the other 0% (or even impose a haircut). As formulated it is hard to see which of the current proposed objectives assists in deciding which purchaser to choose. *Prima facie* it ought to be the one which leaves more value in the failing bank. This is why a sixth objective is needed. On the other hand, it is also possible that as between the two potential purchasers, the one (offering 0%) is far stronger financially and is more likely to secure the first four existing objectives. In such a case, it is right that relevant authorities might determine to transfer to the stronger ahead of a maximising value argument.

Clause 6 – the Code

We, like many others, await sight of the draft code, and encourage you to make that available from the time of the publication of the Bill. It will be necessary to refer to EU law constraints in our view to ensure the Code addresses what is within the authorities' powers and what not. We mention some below.

Clause 8 – the Bank of England's role

Balancing the public law powers between the FSA and the BoE is not easy, but an appropriate balance needs to be struck. The role now given to the BoE will have 3 advantages:

1. the interdependence of consultation by FSA of the BoE in clause 7(5) and vice versa in clause 8(3) ought to secure early and iterative engagement between these parties as issues escalate;
2. importantly, the proposal ensures the BoE exercises the stabilising power and the FSA supervises the bank – segregation of these functions ought to provide a more robust conflict management solution than were FSA in both roles immediately before and after a bank failure; and
3. the BoE will need to ensure it has sufficient and competent resource effectively to exercise these new powers at short notice, and so consequently this ought to have advantages more widely in terms of the BoE's ability to assist, consider and question the FSA's judgement as supervisor of banks prior to the crisis moments.

Transfer of property (clauses 14 – 23), including partial transfer

The subject of partial transfer in particular has generated a lot of debate across the City. For our part, we wish to make the following points:

1. The fact that there are real technical challenges should not deflect Government from obtaining the powers it proposes in primary legislation; the

- counterfactual, no action, is unacceptable in the present climate and would severely damage the UK's standing.
2. Early publication of the secondary legislation will assist in narrowing the debates, and a commitment to keep any secondary legislation under review as part of the UK's financial stability strategy will be important. To that end we would propose that a **Financial Stability Legislative Committee** chaired by the Bank of England and drawn from practitioners and lawyers should keep the technical aspects of the secondary legislation under review. It could be seen as analogous to the advisory roles to the European Commission of CESR, CEIOPS and CEBS as regards level 2 measures within the Lamfalussy process as used by the European Union for financial services. The job of the Committee would be to respond to mandates from HMT to advise; for example, to examine whether the list of QFCs remained appropriate, or if the impact of restrictions on notifications of ELA receipt were as expected, and to propose alternative measures.
 3. A more explicit statement (in one place) of the safeguards that we read dispersed within the papers, should be made. These should also be expressed in the Code or through some Ministerial commitment. We understand these to be:
 - a. Creditor compensation
 - b. The preservation of set-off and netting for QFCs (and in this regard early publication of a first list of QFCs will be needed)
 - c. Secured liabilities would not (generally) be separated from the assets – and see below
 - d. Creditors claims moved out from a failing bank would not be sent back
 - e. The existing ranking of creditors will be preserved (whilst effectively providing long-stop precedence to depositors through compensation by the FSCS).
 4. Debates about partial transfer ought to reflect upon experience from the USA; HMT could publish evidence about that market and the fact (if it is) that there is not widespread re-pricing of financial instruments in normal markets due to the mere existence of analogous FDIC powers.
 5. The circumstances in which partial transfers might be used probably have more analogies to hive-downs in existing insolvency rescues and describing how these can bring value might assist in marshalling wider support. At its heart, some of the fears relate possibly to such a hive-down being effected at an undervalue; this links back to the need for a 6th Objective.

Interaction with existing EU law

We have some concerns that the constraints of EU law may not be reflected in some of the policy aspirations set out in the consultation papers. Particularly with regard to transfers, we think draft legislation and the proposed Code must make clear the interaction of the proposed powers with several pieces of existing law (most of which the UK Parliament does not have the formal competence to override). The Financial Collateral Directive is mentioned, but clarity is also needed as regards:

- The Settlement Finality Directive and Part VII of the Companies Act 1989
- At this stage it seems unclear from the paper what will be the position of banks in relation to Stock Exchanges, other recognised exchanges and clearing houses. At present insolvency law is modified in the UK to ensure that the default rules of an exchange or clearing house are not hampered by the insolvency of a member. These provisions, found in Part VII of the Companies Act 1989, presently ensure that the default rules of an exchange can continue to operate to apply margin and settle

bargains “for the purpose of safeguarding the operation of certain financial markets” as section 154 CA 1989 states. If it is the intention of the authorities to propose transfers of assets and liabilities which may be within the grasp of exchange or clearing house rules then this must be considered carefully (not all of the steps that exchanges will need to take will necessarily be within provisions of the Financial Collateral Directive). The priorities of laws which both pursue financial stability, one systemic (concerning the SRR), the other market-based (under Part VII), ought to be made clear.

- Credit Institutions (Reorganisation and Winding up) Regulations 2004

Assuming the UK sees the SRR powers as reorganisation measures and so notifies them, the Directive underlying the above regulations will provide EEA-wide recognition of measures taken under the powers. This would seem essential. However this has some potentially adverse impacts; constraints relating to insolvency are set out later but clauses 26 and 27 may prevent some steps being taken to transfer property. As an example, see clause 26, Third parties' rights in rem:

26. - (1) A relevant reorganisation or a relevant winding up shall not affect the rights in rem of creditors or third parties in respect of tangible or intangible, movable or immovable assets (including both specific assets and collections of indefinite assets as a whole which change from time to time) belonging to the affected credit institution which are situated within the territory of an EEA State at the relevant time.

4.4) What would be the best way to calculate the hypothetical net cost of depositor compensation payments, including the estimation of the recovery rate?

Given that we presume the requirement to pay will affect deposit-taking institutions only, and that the FSCS rules will be drafted on this basis, then properly this answer is firstly for the banks as “taxpayer”. We have considered this issue briefly and inconclusively in Appendix 1.

We are concerned that the existence of the cap will give a target for potential purchasers of the book of depositors to aim at, hoping to be paid for taking on so much business. The legislation will need to delimit the costs to which the FSCS money could be applied. For example, using it to defer the running costs of a bridge bank would be expected, but using it to make payments to transferees of the deposit book would not be.

Effective compensation arrangements for depositors

IMA were the first body to call for the compensation limit for depositors to rise to £50K and for the proposals in D.26 to be given consideration. We have also supported the notion of pre-funding for liquidity purposes given the proposal for near immediate payout to depositors. We refer to our comments about pre-funding that have been made in meetings with the Minister and with officials and see 5.2 below.

The new questions in this section are:

5.1) The Authorities would welcome further views on the best way of introducing gross payout when there are mutual debts.

If payment is to be made on a gross basis, then with payment from FSCS, a **statement of absolute clarity from the failed bank** to depositors that they may be indebted to the bank and required to make payment from the receipt or incur higher interest (or whatever the terms are).

To that end it must be clear that the failed bank would **be entitled to impose higher interest terms** where an account is removed under the SRR, and without that entitlement of itself offending unfair contract terms legislation. This would allow market solutions to incentivise depositors to meet the spirit of any mutual debt arrangement.

Beyond that an issue is whether the failed bank should be entitled to claim over onto the new depositor's account at the new bank without court action as if that account were its own. Calculating what the failed bank could attach to in a running account and deciding which account(s) at the new bank might be affected (as these might pre-exist the failure) is likely to be unworkable. Non-payment will need to be pursued through the courts.

5.2) The Authorities would welcome further views on a possible move to pre-funding and on the proposed legal framework for pre-funding and FSCS borrowing from the National Loans Fund.

It would be wrong for the wider economy to have to fund cashflow payments by the Financial Services Compensation Scheme because of misplaced fears at this time that banks' balance sheets may not be sufficiently strong. Many of the public may consider that their own "balance sheets" are also under strain. The point is not who is in a weaker position presently, but what should be seen axiomatically as a cost of doing business. The purpose of these contributions to the compensation scheme would be to ease the burden on the FSCS of its obligation to pay out within 7 days. IMA considers that this is a cost of doing banking business that should be borne by the banking sector.

FSCS should have the power to borrow from the National Loans Fund. It will smooth the impact upon banks if additional money is needed and provide additional confidence in the event of several banks or building societies failing.

Strengthening the Bank of England and tripartite coordination

The remainder of the paper announces Government policy to change and strengthen the Bank of England's role and inner workings. We have no comments but do not object to any proposals.

Please contact us if you wish to have any point explained or otherwise require our assistance,

Yours faithfully

A handwritten signature in black ink, appearing to read 'Guy Sears', with a large, stylized initial 'G'.

Guy Sears
Director, Wholesale

Appendix 1

A cap might be described as follows:

$$Cap = E(1 - ((A + \kappa B)/(E + L)))$$

Where (all units in GBP except κ) E = eligible depositors; A = the value of all assets realisable within 2 years in the normal course of business; κ = the industry constant for recovery on longer-term assets expressed as a percentage; B = the value of all assets minus A ; and L = the value of all liabilities less E .

We think the hypothetical net cost ("the cap") needs to be considered within only one or two particular FSCS levy accounting periods. In other words in calculating what would have been recovered we would haircut any asset realisation that might occur more than 2 years after the transfer. (Assets include claims arising only in the hands of FSCS or by virtue of the bank failure and the events around it). On this basis the most recent audited previous accounts would be taken. If the loans to customers for Northern Rock were principally repayable more than 2 years hence then they would be discounted by 100%; we shall assume all were, leaving the assets at c.£16bn. The liabilities are taken at face value (£98bn) giving a recovery rate of c.16% in the first 2 years. The FSCS payment out would be set at 84% of the eligible depositor value in the accounts (we appreciate that the statutory accounts will not show this figure but we envisage this will be discoverable under other HMT proposals). Retail funds and deposits were shown as £26bn, and assume 80% were eligible then an 84% shortfall would equal:

$$£26bn \times 80\% \times 84\% = £17.4bn$$

This would be the first component of the *hypothetical net cost of depositor compensation payments*; it would be an estimate of cash flow from FSCS in the first 2 levy periods that would have occurred after a collapse. It is on any basis a vast sum compared with usual FSCS payments.

Naturally there would be some recoveries for FSCS which as assignee of the depositors' claims as creditors would be recovered through a liquidation. Necessarily this figure needs to be approximated at the beginning of the resolution. In this regard we consider that any asset discounted in the cashflow calculation above for being more than 2 years ahead, should have a haircut applied at a single level. This would be the same for all banks in any year and would be in a sense "rough and ready". For example it might be 80%. On that basis for NR, the total assets would have been (£16bn + (80% x £85bn)) = £84bn. If the liabilities were £98bn, then there is an approximate recovery rate of 86%; and so FSCS would have to fund 14% of the eligible amounts (£26bn x 80%) or around £2.9bn. This would be the cap; it is still very substantial. It shows that any cap calculation is very sensitive to the recovery rate where businesses have long-term receipts rather than liquid assets.

We think there might be 2 data sources for what the recovery rate should be. One source could be real data from existing liquidations (and not just for banks) on overall recovery rates against future assets on audited accounts. We imagine the spread will be very wide, but some upper level of the spread might be appropriate. We expect after costs this will not be above 80%.

The second data source could be market-based, such as using market-implied expectations of ultimate loss rates on mortgages and real assets, through derivative indices, such as the ABX, though we recognise that there are real arguments that those were out of line with credit fundamentals earlier this year.

Appendix 2

Clause 36(7) – we think this is an unnecessary draughtsman’s flourish. The phrase “just and equitable” is a term of art and replacing it by “fair” and then having to explain what that means and also import construction practice is indulgent in such an important statute (let alone adding over 40 words unnecessarily).

Clause 38 - were a direct (non-court) appointment also to be proposed then a provision equivalent to Regulation 6 of the Credit Institutions (Reorganisation and Winding up) Regulations 2004 will need to be included. We assume the UK will consider the SRR provisions are reorganisation measures within the 2004 regulations. Regulation 6 permits an office-holder appointed out of court to seek a Court confirmation of appointment so that for European law purposes the re-organisation regime is recognised by all other EEA jurisdictions. Such co-operation may be vital given the cross-border activities of many banks. It does have an impact in relation to the transfer power however that has not been drawn out in the consultation papers and which we mentioned above.

More generally in relation to the above regulations you will wish to have regard to:

- Reg 8 and the current notice and delay requirement;
- Reg 14 which requires contact "as soon as reasonably practicable" with all known creditors [and which in the Directive is expressed as "without delay"] which may require some step to be taken even during the Objective 1 phase; and
- the professional secrecy requirements deriving from Art 33 of the Directive which the requirement to provide information in section 43(5) will need to have regard to.
- No doubt this procedure will be notified alongside the other reorganisation provisions of the 2004 regulations to ensure recognition across the EEA.

Clause 42(3) and(4) - Objective 1 needs to reflect that transfer is to be preferred but payment may be the fallback. A test of prejudicing creditors is wrongly directed and may not allow the first objective ever to be achieved.

“(3) For the purposes of Objective 1 the appropriate treatment always to be preferred if practicable is for an eligible depositor is to have the relevant account transferred to another financial institution.

(4) Appropriate treatment for an eligible depositor may also include (or consist wholly of) the receipt of a payment from (or on behalf of) the FSCS.”

Clause 43(4) – it is important to explain what is meant by participate in proceedings, especially if it is envisaged that notification should ever be made to the FSCS

Clause 43(5) – a bank liquidator should be under a positive obligation to provide information to the FSCS/Authorities (we think Articles 30(5) and (6) of 2000/12/EC are wide enough to include the SRR funding role)

Clause 45(3) – should apply only to the clause 44(2) liquidation committee

Clause 45(8) – introduce by “where there is no liquidation committee”

Clause 62(7) – the 14-day notice period can be abridged if within the time the Authorities file notice (to join the 62(6) notice) that Condition 3 is met.

Clause 47(3) [which is a useful model of drafting] s.239 should be included but the modification to s.239 "preferences" is unnecessary

Clause 52 - Creditors should be able to apply for the removal of the bank liquidator after a full payment resolution

Clause 66 – a bank liquidator should be able to seek directions of court not to use the ISA either generally or for specific assets (such as currency held overseas).