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Banking Bill

Bill 147 of 2007-08

This Bill represents part of the Government's legislative response to the ongoing and worsening financial crisis affecting the UK. It continues powers provided temporarily in the aftermath of the Northern Rock nationalisation; provides a framework for new rescue initiatives of failing banks; alters the existing regulatory structure surrounding banks and makes changes to the compensation scheme which protects depositors' deposits.

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Summary of main points

Recent events have posed significant challenges for financial markets and regulatory responses across the world. Powers granted to the UK Authorities (the Bank of England, HM Treasury and the Financial Services Authority (FSA) to deal with a previous crisis cease in February 2009. This Bill extends these powers and provides new ones.

The *Banking Bill* was introduced into the House of Commons on 7 October 2008 with second reading on 14 October 2008. The overriding aim being to improve the resilience of the financial system and support financial stability by strengthening depositor protection and dealing with banks in difficulties. The Bill contains provisions to:

- enable the Bank of England to lend in a more effective manner (including by allowing short-term disclosure of liquidity assistance by the Bank of England);
- enable the Financial Services Authority (FSA) to collect information from banks in difficulty, and remove any impediments to them sharing it with the Financial Services Compensation Scheme (FSCS) to assist it carrying out its functions and the Bank of England or HM Treasury, where relevant to maintain financial stability;
- introduce a special resolution regime (SRR) which would allow the Authorities to intervene when a bank gets into severe difficulties and bring about a more orderly resolution of a failing bank - this includes the introduction of a specific insolvency regime for banks;
- Formalise the Bank of England's role in the oversight of banking payment systems
- improve the FSCS to facilitate faster pay outs; and
- provide the Bank of England with a financial stability objective and amending the size and composition of the Bank's court.

A Special Resolution Regime (SRR) provides the Authorities with a new set of tools to deal with a failing bank. The SRR tools include:

- a private sector purchaser tool;
- a bridge bank tool;
- partial transfers, including a new special bank administration procedure;
- a temporary public ownership tool; and
- A new bank insolvency procedure.

At the same time, the Bank of England would be provided with additional statutory responsibilities and policy tools, to ensure that it can fully deliver its financial stability role. The changes to the operation of the UK's deposit compensation scheme, are intended to ensure that consumers are swiftly and adequately compensated should a bank fail.

Throughout this note, whenever the term 'Authorities' is used, it should be taken to mean the Tripartite Authorities (TPA) comprising the Bank of England, HM Treasury and the FSA.

As well as dealing with the financial crisis, the Bill also contains provisions with respect to the issuance of Scottish and Northern Ireland banknotes.

CONTENTS

I The Bill

The Bill was introduced on 7 October 2008 and is scheduled for second reading on the 14th October. It is 240 clauses long. The text of the Bill can be found here.[1] The Explanatory Notes to the Bill can be found here.[2]

This Paper draws heavily on three consultation documents. The first, "*Financial Stability and depositor protection: strengthening the framework*", was published on 30 January 2008.[3] A second document, *Financial Stability and depositor protection: further consultation*, was published on 1 July 2008.[4] The third consultation document, *Financial Stability and depositor protection: special resolution regime*, was published on 22 July 2008.[5]

II World financial crisis

That all was not well in the financial world was brought to wider attention in the UK on 9 August 2007 with what Bank Governor Mervyn King described to the Treasury Committee as "market disturbance".[6] Characterized by a sudden contraction in inter-bank lending, market liquidity; a shortage of capital and declining share values it can fairly be described as ongoing.

The consequences have been felt across the developed world. Every new crisis offers hope that the worst is now past; but such hopes last only until the next crisis. Policy makers across the world have appeared variously, resolute, determined, united, divided, bewildered and helpless. Rescue packages and measures have got progressively bigger in financial terms and more extensive and intrusive in scope. And yet, even with the benefit of over a year's experience there remains a debate over what the crisis actually is.[7] Is it a liquidity crisis? Is it a capital crisis?

The boxer Mike Tyson is reported to have once said that every boxer, when he steps in the ring, has a plan: until he gets hit. Up till August 2007 the UK had one of the world's best and most powerful financial centres and a regulatory regime admired abroad and trumpeted by the Government that introduced it. Along with others it got hit. The next section looks at the search for a new plan.

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1 http://www.publications.parliament.uk/pa/cm200708/cmbills/147/08147.i-v.html
2 http://www.publications.parliament.uk/pa/cm200708/cmbills/147/en/index_147.htm
3 TPA, Cm 7308, 30 January 2008. Available at: http://www.hm-treasury.gov.uk/media/3/5/banking_stability_pu477.pdf
4 TPA, Cm 7436, 1, July 2008 available at: http://www.bankofengland.co.uk/publications/other/financialstability/financialstabilitydepositorprotection080701.pdf
5 TPA, CM 7459, 22 July 2008 available at: http://www.official-documents.gov.uk/document/cm74/7459/7459.pdf
6 Treasury Select Committee, *The run on the Rock*, HC56-II 2007-08, Q32
7 See *Officials struggle to get to heart of lenders' ailment*, *Financial Times*, 2 October 2008,

It is important, in order to set the context of the Bill, and to temper expectations of its possible effect, to appreciate the difference between short term policy responses and the longer term ones. In the former governments can change specific rules that have national application and can respond in some way to institution-specific problems. The longer term issues are invariably those that cross borders and markets. There has been discussion for example, about the role that the Payments Directive has played in some aspects of recent events. Clearly, this is not something that a single government can do much about on its own, or governments can do anything about quickly. Thus, the new Bill should be seen as just one element in a wider strategy to confront crisis. It could be argued that this Bill deals far more with the consequences of failure than establishing a way to prevent it worsening. It cannot be regarded as the sole or final word. Similarly, over the last year the Government has set in train initiatives and legislative action that have addressed aspects of the problems which have surfaced.

a. UK government and the Tripartite Authorities (TPA)

The initial wave of action was prompted by the collapse of the Northern Rock Bank (NRB) which began, in stages, from September 2007 when it first required Bank of England resources to function. The response was not just NRB specific. In the speech made by the Chancellor in the aftermath of the collapse, he outlined the immediate areas in which he thought action was required. Part of the speech is shown below:

> We need to make more reforms to prevent problems from happening internationally and in Britain. First, when the Financial Stability Forum reports to Finance Ministers at the G7 in Washington next week, I will urge faster rapid implementation of international agreements on solvency, accelerated work on international standards for regulating liquidity, more transparent information on credit ratings and action to improve the transparency of off-balance sheet vehicles. Secondly, I will propose an International Monetary Fund and Financial Stability Forum early warning system to strengthen financial sector surveillance and to identify risks to stability and co-ordinated regulatory responses to them. Thirdly, I can report a European agreement this week to strengthen arrangements for ensuring financial stability in Europe and increase cross-border management.
>
> It is important that regulators focus on liquidity as well solvency. Here at home, the FSA will shortly set out proposals for a review of the UK liquidity regime. As the Governor has said, all central banks face problems in providing support to banks in difficulty in a world where markets rightly expect high levels of disclosure and transparency. I can therefore confirm that if it proves necessary to clarify in Europe the legal and practical issues surrounding the way in which such support is provided and disclosed to protect financial stability, we will work with other European countries to provide that certainty. We will now review whether rules about swift takeovers of banks need to be changed.[8]

Alongside the long term global response the UK government also had to micro manage the destiny of NRB. This is described in considerable detail in a Library Standard Note available on the intranet.[9] The eventual outcome was nationalisation when the Government's preferred option, the purchase of the bank by another, failed. The result

8 HC Deb 11 October 2007 c 463
9 Northern Rock and financial supervision; SNBT/4478

of this was the passing of the *Banking (Special Provisions) Act 2008*[10] in two days in February 2008. The Act was not NRB specific (thus avoiding parliamentary complications associated with private legislation). However, Alistair Darling told the House of Commons at the first reading of the Bill on 18 February that: “The Government have no intention at present to use the Bill to bring any institution other than Northern Rock into temporary public ownership”.[11]

The Act defines the circumstances in which the Treasury can take a financial institution into public ownership. This can only occur if either of the following two conditions is met:

> (a) maintaining the stability of the UK financial system in circumstances where the Treasury consider that there would be a serious threat to its stability if the order were not made;
>
> (b) protecting the public interest in circumstances where financial assistance has been provided by the Treasury to the deposit-taker for the purpose of maintaining the stability of the UK financial system.

Having dealt with NRB and having put in place other market measures aimed at improving market liquidity such as the Bank of England’s special liquidity scheme, the Government turned to the reform of the regulatory structure found wanting in 2007.

In January 2008, a TPA Consultation Paper was published: *Financial Stability and Depositor Protection: strengthening the framework*.[12] This document, the forerunner to the current Bill, presented the initial thoughts, in a long list, of the TPA on what needed to be done post NRB. The reforms reflect weaknesses of the regulatory system discovered during the NRB saga and wider ‘credit crunch issues’. Reforms arising from the NRB experience, were:

> to ensure that there is no statutory impediment to the FSA obtaining and sharing information that the Bank of England and HM Treasury require for purposes related to financial stability;
>
> to provide for a new and flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework;
>
> to introduce a special resolution regime for banks;
>
> to allow the Authorities to direct and accelerate transfers of banking business to a third party;
>
> to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a 'bridge bank';

10 Banking (Special Provisions) Act 2008, Cap 2
11 HC Deb 18 February 2008 c22
12 TPA, January 2008, Cm 7308

should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank is appropriate, to introduce a modified insolvency process for banks – a 'bank insolvency procedure' to facilitate fast and orderly payment of depositors' claims under the FSCS;

to formalise the Bank of England's role in the area of financial stability and to give its Court a formal role in overseeing its performance in this area; and

to amend the provisions governing the size and composition of the Bank of England's Court.[13]

Several of these issues feature in the new Bill. The consultation document also gave a very lengthy list of 'operational changes which the authorities intended to be introduced during 2008. Many of these are aimed at the larger question of financial system robustness.[14]

- the FSA will intensify its work with banks to improve stress-testing[15] in light of recent events;
- the Authorities will work with international partners to encourage a stronger consensus on the importance of stress testing, in particular at group level and by multinational banks;
- the Authorities will work to consider whether the stress-testing standards under Basel II (the international capital requirements regime) are sufficiently robust;
- the Authorities will work with international partners to ensure that liquidity regulation standards are consistently high across banking groups, and encourage more consistent approaches to liquidity regulation;
- the Authorities will work with their international counterparts to ensure that firms' valuation approaches are consistent with the relevant accounting standards and the EU's Capital Requirements Directive/Basel II prudent valuation guidance;
- the Authorities will work with their international counterparts to ensure accounting standards require adequate disclosure about the uncertainties around valuations, their significance for the entity and how these risks are being managed;
- the Authorities will encourage markets to find ways to increase transparency of valuation methodologies and, to the extent appropriate, move towards greater standardisation of methodologies for valuation;
- the Authorities will work with international counterparts in the FSF and the EU to look at the role of CRAs (credit ratings agencies) in structured finance. The Authorities will

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13 Ibid p141-2
14 Ibid chapter 2
15 Seeing how the bank would survive if it came under pressure – for example large falls in house or other asset prices, increased borrowing costs etc.

also support the work of the International Organisation of Securities Commission taskforce on CRAs, which has recently been reviewing the applicability of its Code of Conduct for CRAs to structured finance business;

- the Authorities will keep the development of investor practice in relation to structured products under review to determine if further measures are needed to assist markets to achieve an appropriate outcome;
- the Authorities will consider the implications for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large;
- the Authorities will work with their international partners in the FSF and the EU to identify whether there remain incentives under the CRD/Basel II framework for banks to minimise their regulatory capital requirements by holding assets in SIVs (special investment vehicles) and other funding vehicles, and if so whether this might reduce the total amount of regulatory capital in the financial system below the level that the Authorities consider desirable;
- the Authorities recommend that the IASB consider in particular whether reputational risks are properly taken into account in decisions about consolidation;
- the FSA intends to work with banks to ensure that indirect members of payment systems, ‘agency banks’, have contingency plans in place in the event that their sponsor banks fails;
- the Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements;
- the FSA and the Bank of England will consider the scope for greater combined initiatives to develop common understanding, building on, for example, existing cooperation through the Bank of England’s Financial Stability Board; the Authorities propose to clarify responsibilities within the Memorandum of Understanding for decisions around providing support to firms – in particular emergency liquidity assistance;
- the Authorities will work with international counterparts to pursue changes to improve the effectiveness of the FSF;
- the Authorities propose that the IMF considers how to improve further the focus of its financial sector surveillance; and
- the Authorities will continue to work with international counterparts to improve international crisis management arrangements and ensure the UK authorities are well prepared to respond to international financial crises, building on ongoing initiatives in the EU and FSF, and working bilaterally with key partners who share exposures to specific risks.

The Chancellor also commissioned a report into mortgage finance. This was published in July 2008. The report by Sir James Crosby - *Mortgage Finance – interim analysis* examined "what market–led initiatives might be necessary to improve the functioning of secondary and primary markets in UK mortgage backed securities".[16] Extracts from his letter to the Chancellor published within the interim analysis of mortgage market funding markets are shown below:

> In July 2007, when credit markets faced a sudden and significant re-pricing of risk, new issuance in these markets came to an abrupt halt. One year later, trading in the secondary markets continues to be on much wider interest rate spreads than was hitherto the case. In time these markets will stage some sort of recovery but I am firmly of the opinion that in the foreseeable future, there will be very little new issuance of UK mortgage-backed securities.
>
> Such a major source of funding for UK mortgages will not be replaced quickly, certainly not in current market conditions. The combination of new capital adequacy rules (Basel II) and the 'mark-to-market' disciplines introduced in recent years under new International Accounting Standards will force banks to operate with less leverage in their balance sheets.
>
> Recent months have seen major capital raising exercises but significant 'mark-to-market' adjustments and increasing credit losses mean that the adjustment to lower leverage will take years rather than months. In my opinion, such a shortage of mortgage finance will persist throughout 2008, 2009 and 2010, and I suspect that current forecasts for net new mortgage lending during this period will prove optimistic, perhaps significantly so.
>
> It is impossible to separate the effects of a shortage of mortgage finance from a correction in the housing market. Nor can anyone identify its effect on consumer spending with any precision. However, my discussions have identified a broad consensus that such a significant and prolonged shortage of mortgage finance must take its toll of both.[17]

b. Government Rescue package

In September 2008 the Government dealt with the difficulties experienced by the troubled Bradford and Bingley bank, by transferring its deposit book to Abbey/Santander Bank and had brokered a deal to allow HBOS to be taken over by Lloyd's TSB. Worse was to follow.

Following two days (6 & 7 October 2008) when the share prices of some banks fell by as much as 40% in a day the Treasury announced a significant rescue package. Key elements of this package were set out in a Treasury press notice:

> In these extraordinary market conditions, the Bank of England will take all actions necessary to ensure that the banking system has access to sufficient liquidity. […]At least £200 billion will be made available to banks under the Special Liquidity Scheme. Until markets stabilise, the Bank will continue to conduct auctions to lend sterling for three months, and also US dollars for one week, against extended collateral. […] The Bank next week will bring forward its plans for a permanent regime underpinning banking system liquidity, including a Discount Window

[16] James Crosby, *Mortgage Finance: interim analysis*, July 2008, available on the Treasury website at: http://62.164.176.164/fin_mort_crosby.htm

[17] Introductory letter to the Chancellor, ibid

facility. In addition the Government is establishing a facility, which will make available Tier 1 capital in appropriate form (expected to be preference shares or PIBS[18]) to "eligible institutions". Eligible institutions are UK incorporated banks (including UK subsidiaries of foreign institutions) which have a substantial business in the UK and building societies. […]

Following discussions convened by HM Treasury, the following major UK banks and the largest building society have confirmed their participation in a Government-supported recapitalisation scheme. These institutions comprise:

Abbey, Barclays, HBOS, HSBC Bank plc, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland and Standard Chartered

These institutions have committed to the Government that they will increase their total Tier 1 capital by £25bn. This is an aggregate increase and individual increases will vary from institution to institution. In order to facilitate this process the Government is making available £25bn to be drawn on by these institutions if desired to assist in this process as preference share capital or PIBS and is also willing to assist in the raising of ordinary equity if requested to do so. The above institutions have committed to the Government that this will be concluded by the end of the year.

In addition to this, the Government stands ready to provide an incremental minimum of £25bn of further support for all eligible institutions, in the form of preference shares, PIBS or, at the request of an eligible institution, as assistance to an ordinary equity fund-raising.

The amount to be issued per institution will be finalised following detailed discussions. If the Government is to provide the capital, the issue will carry terms and conditions that appropriately reflect the financial commitment being made by the taxpayer. In reaching agreement on capital investment the Government will need to take into account dividend policies and executive compensation practices and will require a full commitment to support lending to small businesses and home buyers.

The Government will take decisive action to reopen the market for medium term funding for eligible institutions that raise appropriate amounts of Tier 1 capital.

Specifically the Government will make available to eligible institutions for an interim period as agreed and on appropriate commercial terms, a Government guarantee of new short and medium term debt issuance to assist in refinancing maturing, wholesale funding obligations as they fall due. Subject to further discussion with eligible institutions, the proposal envisages the issue of senior unsecured debt instruments of varying terms of up to 36 months, in any of sterling, US dollars or Euros. The current expectation is that the guarantee would be issued out of a specifically designated Government-backed English incorporated company. The Government expects the take-up of the guarantee to be of the order of £250bn, and will keep this under review alongside ongoing monitoring of capital positions and lending volumes.[19]

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18 permanent interest bonds

19 HM Treasury press release 8 October 2008 available at: http://www.hm-treasury.gov.uk/press_100_08.htm

In effect, the UK banking system is being offered the opportunity of part-nationalisation with up to £50 billion of taxpayers' money being advanced through a bank recapitalisation fund.

c. FSA changes

The FSA carried out a full investigation into the failure of the NRB and its part in it. On 26 March 2008 it published a summary of this review carried out by its internal audit division.[20] An FSA press notice of the day noted that:

> The Internal Audit review identifies the following four key failings specifically in the case of Northern Rock:
>
> - A lack of sufficient supervisory engagement with the firm, in particular the failure of the supervisory team to follow up rigorously with the management of the firm on the business model vulnerability arising from changing market conditions.
> - A lack of adequate oversight and review by FSA line management of the quality, intensity and rigour of the firm's supervision.
> - Inadequate specific resource directly supervising the firm.
> - A lack of intensity by the FSA in ensuring that all available risk information was properly utilised to inform its supervisory actions.

In addition to reviewing past mistakes the FSA published a consultation paper concerning disclosure, by a bank, of support funds from the Bank of England;[21] a Discussion Paper on a *Review of the Liquidity Requirements for Banks and Building Societies*;[22] as well as specific, immediate, rule changes such as changes to the deposit protection scheme and the ban on 'short selling'.

The level at which depositors' funds should be guaranteed was discussed in the first consultation paper issued by the tripartite authorities.[23] The increase in the guarantee for depositors' funds to £35,000 in October 2007 and to £50,000 in October 2008 was effected by the FSA without the formal consultation procedures. However, the FSA did publish a feedback paper in June 2008[24] and after the second increase a further consultation document - *Financial Services Compensation Scheme: Review of the scheme limits consultation paper*.[25] More detail on the deposit scheme can be found in a Library Standard Note (SN/BT/4466).

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[20] 26 March 2008, available at FSA website at http://www.fsa.gov.uk/pubs/other/exec_summary.pdf

[21] See FSA Consultation Paper 08/13 at http://www.fsa.gov.uk/pubs/cp/cp08_13_newsletter.pdf

[22] See FSA Discussion Paper FS08/3 at http://www.fsa.gov.uk/pubs/discussion/fs08_03.pdf

[23] See *Financial Stability and Depositor Protection: strengthening the framework* CM 7308, p63

[24] Feedback on TPA consultation document: Operation of the Financial Services Compensation Scheme (FSCS) for deposit protection, June 2008, on FSA website at: http://www.fsa.gov.uk/pubs/other/Tripartite_feedback.pdf

[25] FSA Consultation doc 08/15

The FSA also announced, without prior notice, a ban on the practice of 'short selling'.[26] The ban only applied to certain banks and other financial sector firms. This was in response to the perception that 'speculation', rather than fundamental market valuations, was threatening certain banks with collapse. It came to head around the time that the HBOS share price declined rapidly ahead of a proposed takeover by Lloyd's TSB. The FSA maintains a list of those companies that are protected from short selling. The list changes from day to day as firms apply to be put on it, and, occasionally, to be removed from it. The current list can be found here.[27]

d. EU response

Work on integrating a European co-ordinated response to financial difficulties was taken forward by the publication, in June 2008, by the European Commission, of *Memorandum of understanding on Co-operation between the Financial Supervisory Authorities, Central Banks & Finance Ministries of the EU on cross border financial stability.*[28] This document is rather short on legal commitments but does set out broad principles and obligations on all parties:

> The *Parties* commit themselves to open, full, constructive and timely cooperation; and to prepare and search for jointly acceptable solutions. Cooperation between the *Parties* both in normal times and financial crises will involve:
>
> 1. setting up an appropriate framework for cooperation with the aim to prepare common solutions and actions to manage potentially detrimental effects of a crisis;
>
> 2. exchanging information relevant for the preparation, management and resolution of a cross border systemic financial crisis, including assessments of the situation in order to allow the *Relevant Parties* to promptly assess the systemic nature and cross-border implications of the crisis, making use of the common framework for systemic assessments on the basis of the agreed template (summarised in Annex 2);
>
> 3. coordinating public communication; and,
>
> 4. establishing contingency plans, including stress testing and simulation exercises.[29]

The European Commission has also set out a programme of work at EU level to review changes to the Capital Requirements Directive. The latest commentary on this is set out in the following press release:

> The European Commission has put forward a revision of EU rules on capital requirements for banks that is designed to reinforce the stability of the financial system, reduce risk exposure and improve supervision of banks that operate in more than one EU country. Under the new rules, banks will be restricted in lending beyond a certain limit to any one party, while national supervisory authorities will have a better overview of the activities of cross-border banking groups. The

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[26] See FSA Press Notice 18 September 2008 at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml
[27] http://www.fsa.gov.uk/pubs/other/Shortselling_list.pdf available at 3 October 2008
[28] http://www.hm-treasury.gov.uk/media/D/8/mou2008_160608.pdf
[29] Ibid p4

> proposal, which amends the existing Capital Requirements Directives, reflects extensive consultation with international partners, Member States and industry. It now passes to the European Parliament and the Council of Ministers for consideration.
>
> Proposed amendments to the Capital Requirements Directives
>
> The purpose of the Capital Requirements Directives (2006/48/EC and 2006/49/EC) is to ensure the financial soundness of banks and investment firms. Together they stipulate how much of their own financial resources banks and investment firms must have in order to cover their risks and protect their depositors. This legal framework needs to be regularly updated and refined to respond to the needs of the financial system as a whole. The main changes proposed are as follows:
>
> Improving the management of large exposures: banks will be restricted in lending beyond a certain limit to any one party. As a result, in the inter-bank market, banks will not be able to lend or place money with other banks beyond a certain amount, while borrowing banks will effectively be restricted in how much and from whom they can borrow.
>
> Improving supervision of cross-border banking groups: 'colleges of supervisors' will be established for banking groups that operate in multiple EU countries. The rights and responsibilities of the respective national supervisory authorities will be made clearer and their cooperation will become more effective.
>
> Improving the quality of banks' capital: there will be clear EU-wide criteria for assessing whether 'hybrid' capital, i.e. including both equity and debt, is eligible to be counted as part of a bank's overall capital – the amount of which determines how much the bank can lend.
>
> Improving liquidity risk management: for banking groups that operate in multiple EU countries, their liquidity risk management – i.e. how they fund their operations on a day-to-day basis – will also be discussed and coordinated within 'colleges of supervisors'. These provisions reflect the on-going work at the Basel Committee on Banking Supervision and the Committee of European Banking Supervisors.
>
> Improving risk management for securitised products: rules on securitised debt – the repayment of which depends on the performance of a dedicated pool of loans – will be tightened. Firms (known as 'originators') that re-package loans into tradable securities will be required to retain some risk exposure to these securities, while firms that invest in the securities will be allowed to make their decisions only after conducting comprehensive due diligence. If they fail to do so, they will be subject to heavy capital penalties.[30]

More detail of these changes can be found in a summary impact assessment document available here.

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[30] European commission press release 1 October 2008, available at: http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/1433&format=HTML&aged=0&language=EN&guiLanguage=fr

e. International and multinational initiatives

The Report alluded to by the Chancellor in the speech above (see page 10) by the Financial Stability Forum was published in April 2008.[31] The executive summary listed the specific actions which it recommended the world's financial regulators ought to pursue.

Capital requirements:

Specific proposals will be issued in 2008 to:

• Raise Basel II capital requirements for certain complex structured credit products;
• Introduce additional capital charges for default and event risk in the trading books of banks and securities firms;
• Strengthen the capital treatment of liquidity facilities to off-balance sheet conduits.

Changes will be implemented over time to avoid exacerbating short-term stress.

Liquidity:

Supervisory guidance will be issued by July 2008 for the supervision and management of liquidity risks.

Oversight of risk management:

Guidance for supervisory reviews under Basel II will be developed that will:

• Strengthen oversight of banks' identification and management of firm-wide risks;
• Strengthen oversight of banks' stress testing practices for risk management and capital planning purposes;
• Require banks to soundly manage and report off-balance sheet exposures;

Supervisors will use Basel II to ensure banks' risk management, capital buffers and estimates of potential credit losses are appropriately forward looking.

Over-the-counter derivatives:

Authorities will encourage market participants to act promptly to ensure that the settlement, legal and operational infrastructure for over-the-counter derivatives is sound.

Enhancing transparency and valuation

Robust risk disclosures:

• The FSF strongly encourages financial institutions to make robust risk disclosures using the leading disclosure practices summarised in Recommendation III.1 of this report, at the time of their mid-year 2008 reports.

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[31] *Enhancing Market and* Institutional Resilience, FSF (available at: http://www.fsforum.org/publications/r_0804.pdf)

• Further guidance to strengthen disclosure requirements under Pillar 3 of Basel II will be issued by 2009.

Standards for off-balance sheet vehicles and valuations:

Standard setters will take urgent action to:

• Improve and converge financial reporting standards for off-balance sheet vehicles;
• Develop guidance on valuations when markets are no longer active, establishing an expert advisory panel in 2008.

Transparency in structured products:

Market participants and securities regulators will expand the information provided about securitised products and their underlying assets.

Changes in the role and uses of credit ratings

Credit rating agencies should:

• Implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process;

• Differentiate ratings on structured credit products from those on bonds and expand the information they provide.

Regulators will review the roles given to ratings in regulations and prudential frameworks.

Strengthening the authorities' responsiveness to risks

• A college of supervisors will be put in place by end-2008 for each of the largest global financial institutions.

Robust arrangements for dealing with stress in the financial system

• Central banks will enhance their operational frameworks and authorities will strengthen their cooperation for dealing with stress.

Another useful analysis of the issues can be found in a March 2008 Report - *Observations on Risk Management Practices during the Recent Market Turbulence.* This was written by the Senior Supervisors Group and is a good guide to the individual components of the 'crunch'.[32]

Other aspects are progressing through various international fora.

[32] Senior Supervisors Group Report available at: http://www.fsa.gov.uk/pubs/other/SSG_risk_management.pdf

III The UK regulatory system

The new Labour Government introduced a system of financial regulation, repealing the generally more self-regulatory system of the *Financial Services Act 1986* previously in force. Under the *Financial Services and Markets Act 2000* (FSMA 2000) the Financial Services Authority (FSA) became the single, independent, regulator for UK financial services with powers to regulate a wide range of markets and financial institutions. The regulatory system is described as 'a model of principles-based regulation by a single regulator, with the aim of effective regulation without burdening firms with regulatory duplication'. Section 2 of FSMA establishes statutory duties and general principles:

> (2) The regulatory objectives are—
>
> (a) market confidence;
>
> (b) public awareness;
>
> (c) the protection of consumers; and
>
> (d) the reduction of financial crime.
>
> (3) In discharging its general functions the Authority must have regard to—
>
> (a) the need to use its resources in the most efficient and economic way;
>
> (b) the responsibilities of those who manage the affairs of authorised persons;
>
> (c) the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
>
> (d) the desirability of facilitating innovation in connection with regulated activities;
>
> (e) the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
>
> (f) the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions;
>
> (g) the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.

The FSA has the power to make rules governing the conduct of licensed individuals and companies without recourse to Parliament. It has a statutory duty to consult the industry ahead of rule changes, a duty which it can avoid in exceptional circumstances. Over time, the FSA has gained responsibility for a wider range of products and sectors than envisaged in 2000. For example, it now regulates general insurance sales as well as the investment side of insurance.

The Act required that the FSA would review its progress after two full years in operation. The review is dealt with in detail in a Library Standard Note (SN/BT/3787). One issue that stands out from that review and the feedback received by the FSA was the over burdensome nature of its rulebook and regulations. The FSA was forced time and again to defend itself against charges of over-regulation. From this has evolved a doctrine of principles-based regulation. This approach was reviewed in 2006/7. A document published in April 2007 sets out the FSA's approach to regulation.

> We take a risk-based and proportionate approach to regulation, founded on the assessment of risks to our statutory objectives, taking into account the principles of good regulation. FSMA also requires us to be efficient and economic in using our resources, which means we need to prioritise our efforts and focus on the most significant risks.
>
> Underlying this prioritisation is an explicit recognition that, given the risks inherent in financial markets, a zero-failure regime is neither achievable in practice nor desirable in theory. In January 2000 we published *A New Regulator for the New Millennium* which articulated this approach and the operation of a risk-based regime across all our areas of responsibility. Since then we have further developed this risk-based approach, including through the development of an updated risk-assessment system in 2006.
>
> When deciding on new policy initiatives, we take an evidence-based approach. We consider carefully whether there is a market failure which needs to be addressed and, if so, whether regulation is the best way to deal with the concern. In deciding whether to make rules, we examine the potential costs and benefits of such regulatory intervention.
>
> We keep our regulatory approach under continuous review to ensure that the regime enables us not only to meet our statutory obligations in an increasingly innovative and competitive marketplace, but also to remain up to date with international regulatory developments.[33]

Within the sphere of banking, the FSA is not the sole authority. Government has created a Tripartite Standing Committee of the Treasury, FSA and the Bank of England with responsibility for overseeing financial stability. These are the Tripartite Authorities (TPA). The relationship between the bodies is governed by a Memorandum of Understanding (MoU) which can be found on the Treasury website amongst other places.[34] Each of the bodies has unique functions. The Bank of England has the following core responsibilities:

i. ensuring the stability of the monetary system as part of its monetary policy functions. It acts in the markets to deal with fluctuations in liquidity;

ii. overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad. As the bankers' bank, the Bank stands at the heart of the payments system. It falls to the Bank to advise the Chancellor, and answer for its advice, on any major problem arising in these systems. The Bank is also

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33 *Principles-based regulation Focusing on the outcomes that matter,* FSA April 2007, available at http://www.fsa.gov.uk/pubs/other/principles.pdf

34 Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority, available at: http://www.hm-treasury.gov.uk/documents/financial_services/regulating_financial_services/fin_rfs_mou.cfm (last viewed 5 October 2008)

closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk;

iii. maintaining a broad overview of the system as a whole. The Bank is uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor (financial stability)). Through its involvement in markets and payments systems it may be the first to spot potential problems. The Bank advises on the implications for UK financial stability of developments in the domestic and international markets and payments systems and assesses the impact on monetary conditions of events in the financial sector;

iv. undertaking, in exceptional circumstances, official financial operations, in accordance with the arrangements in paragraphs 13 and 14 of this Memorandum, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

The role of the FSA is:

i. the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies;

ii. the supervision of financial markets, securities listings and of clearing and settlement systems;

iii. the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where:
    i. the nature of the operations has been agreed according to the provisions of paragraphs 13 and 14 of this Memorandum; and
    ii. the operations do not fall within the ambit of the Bank defined in paragraph 2 above. (Such operations by the FSA may include, but would not be restricted to, the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties.)

iv. regulatory policy in these areas, including that intended to promote the resilience to operational disruption of authorised firms and Recognised Bodies. The FSA advises on the regulatory implications for authorised firms and Recognised Bodies of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The role of the Treasury is:

i. the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EC directives;

ii. informing, and accounting to Parliament for the management of serious problems in the financial system and any measures used to resolve them, including any Treasury decision concerning exceptional official operations as set out in paragraphs 13 and 14; and

iii. accounting for financial sector resilience to operational disruption within government.

IV The reforms in the Bill

As was stated above the debate over legislative reform has progressed largely through the publication of a series of consultation papers from the TPA. The ideas and content of these papers has evolved significantly over time both in response to formal responses and because of the rapid pace with which events in the 'real' world have advanced. What were once seen as full solutions[35] looked less comprehensive as the size of the problems increased and their impact widened.

The first, "*Financial Stability and depositor protection: strengthening the framework*", was published on 30 January 2008.[36] Commenting on it the Chancellor, Alistair Darling, said:

> Recent months have seen a period of sustained turbulence and instability in global financial markets, with financial firms across the world affected. A response to these episodes requires action, not only from the UK Authorities, but also from international firms and institutions.
>
> The Government is determined that its response is proportionate and appropriate and will therefore consult actively on these proposals, seeking discussions with financial institutions, consumer representatives and counterparts from across the world, to ensure that the final arrangements are effective and deliver the five objectives set out here.[37]

The five objectives were:

> strengthening the stability of the financial system, both in the UK and globally;
>
> reducing the likelihood of banks facing difficulties;
>
> reducing the impact if, nevertheless, a bank gets into difficulties;
>
> providing effective compensation arrangements in which consumers have confidence; and
>
> strengthening the Bank of England, and ensuring effective coordinated actions by authorities, both in the UK and internationally,

A second consultation document, *Financial Stability and depositor protection: further consultation*, was published on 1 July 2008.[38] This document outlined the objectives,

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[35] for example the Banking (special Provisions) Act was not meant to be used for any other purpose than to deal with the Northern rock situation

[36] TPA, Cm 7308, 30 January 2008, available at: http://www.hm-treasury.gov.uk/media/3/5/banking_stability_pu477.pdf

[37] HM Treasury press notice 07/08, 30 January 2008

[38] TPA, Cm 7436, 1, July 2008 available at:

roles and governance arrangements for a Special Resolution Regime (SRR) for banks. This section might be viewed as the key, operational, legislative reform; the legislative guidance on the 'tactics' which the TPA might employ in cases when a financial institution was in, or was near to, a critical phase of its survival – or otherwise.

As well as dealing with the national problems of a failing financial system the second consultation paper included a section on a largely unrelated matter, but one which was now important enough to be put into the Bill. This was the law surrounding the production and issuance of Scottish and Northern Ireland banknotes.

The TPA published a third consultation document, *Financial Stability and depositor protection: special resolution regime*, on 22 July 2008.[39] This document set out the technical detail of how the SRR would work in practice in support of the SRR objectives. Launching this document, the Chancellor of the Exchequer, Alistair Darling, said:

> No system of regulation can or should prevent the failure of each and every firm, but we must do everything possible to reduce the impact of problems which would pose a wider threat to stability.
>
> The challenge is to ensure that the Authorities can act quickly and decisively to take appropriate steps to resolve failing banks. These proposals for a special resolution regime give the Authorities the full range of powers they need.[40]

A. The special resolution regime (SRR)

1. Approach and objective

The failure, or imminent failure, of a bank can seldom be dealt with or be avoided through the normal functioning of the market, for example, through the takeover by another firm, without the intervention of the Authorities. The collective problems of the secondary banks in the 1970's were resolved by a joint 'lifeboat' organised by the Bank of England. Problems at the Johnson Matthey bank in the 1980s resulted in nationalisation. Abroad, crisis in the Swedish banking system in the early 1990s required substantial state intervention. The recent examples of NRB, HBOS and Bradford and Bingley suggest that the 'invisible hand' needs considerable support at the very least. The SRR proposals, as a bloc, are designed to provide the framework for this support.

It is proposed that the SRR would have the following high-level statutory objectives:

1. to protect and enhance the stability and resilience of the financial systems of the UK;
2. to protect and enhance public confidence in the stability of the banking systems of the UK (i.e. by reducing the likelihood of individual banks

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http://www.bankofengland.co.uk/publications/other/financialstability/financialstabilitydepositorprotection080701.pdf

39 TPA, CM 7459, 22 July 2008 available at:: http://www.official-documents.gov.uk/document/cm74/7459/7459.pdf

40 HM Treasury press notice 81/08, '*Treasury launches a consultation on banking 'special resolution regime*'', 22 July 2008

facing difficulties and reducing the impact if, nevertheless, a bank does get into difficulties);

3. to protect depositors (i.e. by providing effective compensation arrangements in which consumers have confidence);
4. to protect public funds; and
5. to avoid interfering with property rights in contravention of a Convention right, within the meaning of the Human Rights Act 1998.[41]

The USA and many other countries (including most of the G10 countries) already have special arrangements in place for dealing with a failing bank, rather than relying on normal corporate insolvency laws, although the exact form of each regime differs from one country to another. In contrast, the UK has no special regime for dealing with banks and as a consequence the TPA's powers are limited:

> Even if a bank is unlikely to be able to survive as an independent going concern the Authorities should, in most cases, be able to reach a resolution (for example a takeover by another institution) through discussion with the firms concerned and the use of the normal regulatory powers. However, there may be a small number of cases in which these tools prove insufficient, and a resolution is only possible on the basis of additional intervention by the Authorities. To deal with such situations, the Authorities have proposed the introduction of a special resolution regime (SRR).[42]

In effect, the SRR would enable the Authorities to take decisive action to resolve a failing bank in a more orderly manner than currently possible, allowing people to have continued access to bank functions or rapid and orderly depositor payments. In so doing, customers would be protected and the impact on the economy overall would be minimised. However, the Authorities recognise that action taken in implementing any SRR tool must be proportionate:

> A wide range of stakeholders can potentially be affected by the exercise of different SRR tools, including the failing bank itself, and its creditors, shareholders and subordinated debtholders. In implementing any SRR tool the Authorities recognise that the action taken in any individual case must be proportionate to the aims pursued. Moreover the regime should seek to maintain the priority ranking and equitable treatment of classes of creditors under existing insolvency law. In recognition therefore of the Authorities' duties under the European Convention on Human Rights and the Human Rights Act 1998, it is proposed that, in pursuit of the objectives, a further statutory objective should govern how action taken within the SRR would be undertaken. This objective would be: to avoid interfering with property rights in contravention of a Convention right (within the meaning of the Human Rights Act 1998.[43]

In short, if the authorities brokered a deal splitting the failing institution into a profitable portion and the rest, the rights of creditors (established when the institution was whole) have to be protected. This subject is deeply controversial in the industry (see below).

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[41] TPA, *Financial stability and depositor protection: special resolution regime*, Cm 7459, pp2.2
[42] TPA, *Financial Stability and depositor protection: further consultation*, Cm 7436 , pp1.41
[43] TPA, *Financial stability and depositor protection: special resolution regime*, Cm 7459, pp2.4

The SRR provisions are set out in Part 1 of the Bill. Clause 4 sets out the objectives and clause 5 the requirement for a code of practice to be published alongside the Bill.

2. Governance

All members of the Tripartite Authorities will participate in the SRR process.

- The FSA: responsible for deciding a bank has failed to meet its threshold conditions.
- The Bank of England (the Bank) will decide which of the SRR tools to use i.e., how to move forward once a bank has been declared 'failed'.
- The Treasury would be responsible for any decisions involving public money.

The Financial Services Compensation Scheme (FSCS) which delivers the payment of compensation will also be involved in the assessment of the readiness of a bank for payout of its depositors.

Ultimate responsibility, however, for the operation of the SRR and the resolution tools would rest with the Bank. In practice, this would mean that that the Bank would, in consultation with the Treasury and the FSA, be responsible for the decision on which SRR tool to use and also for the subsequent implementation of the tool.[44]

The operation of the SRR will be governed by:

- the statutory objectives of the regime as set out in primary legislation;
- supporting secondary legislation; and
- a statutory code of practice setting out the roles and actions of the Authorities within the SRR. The Authorities would be required to have regard to the code in exercising their functions under the SRR.[45]

The code of practice is to be drawn up by the Treasury after consultation with the other Authorities and the FSCS (clause 5). This is to enable proper consideration of the content of the code and of the balance between what should appear in primary legislation and what can properly be contained within the code of practice.

The British Bankers' Association (BBA) is unhappy with the interrelationship between these three elements. In its response to the third consultation document, it says:

> One specific timing issue concerns the interrelationship between the primary and secondary legislation. It is understood that the authorities' wide ranging powers to intervene vis-à-vis creditors' rights will be covered in the primary legislation whilst at least some of the associated safeguards will be in the secondary legislation. The significance of this could depend on the elapsed time between the two. Even

[44] Excluding temporary public sector ownership of the failing bank
[45] Ibid 2.25

> if the implementation of the relevant part of the primary legislation was deferred until the secondary legislation was in place, a material elapsed time period could have an important legal impact. In giving a legal opinion during this interval a law firm would have to pay regard to the (known) pending powers of intervention but could not offer any comfort to a client in respect of any safeguards yet to be finalised. Similarly, banks raising capital during this period would need to include risk warnings associated with the powers of the Authorities, which may be expected to damage their ability to raise capital relative to other financial institutions. Any guidance that the authorities are able to provide on the expected timing of the secondary legislation would be welcome
>
> Turning to the proposed code of practice, whilst this could have a useful role to play we have major reservations on key elements of the proposed regime being consigned to a code – as appears to be the intention. As we understand the position, the status of the code would be non binding guidance. If this is correct, the code could not mitigate any legal uncertainty created by the legislation and a law firm could not place reliance upon it when drawing up a legal opinion. We have particular concerns about policy intentions regarding safeguards, especially safeguards for creditors' rights, being articulated in code – including provisions setting out the circumstances in which the partial transfers route could be used. The principles governing creditors' rights should be enshrined in the legislation itself.[46]

3. A bank's entry into SRR – how is it triggered?

It is recognised by the TPA that to use any SRR tool in the case of a specific bank[47] is a very significant step. The regulatory triggers that would place a bank into this regime are:

- that a bank is failing, or is likely to fail, to meet its threshold conditions;[48] and
- that having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.[49]

The procedures for moving towards a SRR situation are set out in clauses 7-10 of the Bill. It is for the FSA, as the bank's supervisor, to decide whether or not the bank meets its threshold conditions. However, it is important to note that threshold conditions differ from the standards for corporate insolvency. In particular, the threshold condition for capital is the bank's capital requirement. This means that the resolution regime for banks could be initiated when the bank still has positive net worth.

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[46] BBA Response to Tripartite Authorities consultation document Cm 7459, p3-4 available at: http://www.bba.org.uk/content/1/c6/01/45/17/SRR_response_-_15th_September.pdf

[47] 'banks' here refers to building societies too, although their different commercial structure will entail practical differences in treatment

[48] In considering whether a bank meets its Threshold conditions, the FSA would leave out of the account financial assistance provided by the Bank of England (except for ordinary market assistance) or the Treasury

[49] threshold conditions are set out in the FSA Handbook, and in detailed rules and guidance throughout the Handbook, particularly in relation to capital and liquidity requirements

4. SRR tools

a. Introduction

The proposed regime would have two distinct elements, the first providing for three 'stabilisation options' while the bank subject to the SRR was a 'going concern' – albeit after considerable aid. The second consisting of a distinct bank insolvency procedure. This is described in section IV. B of this Paper below.

The three pre-insolvency stabilisation tools (or options) of the SRR would be:

- the private sector purchaser tool (i.e. a transfer of part or all of the failing bank to a private sector third party); (clause 10)
- the bridge bank tool (i.e. a transfer of part or all of the failing bank to a bridge bank);(clause 11)
- the temporary public ownership tool (i.e. the power to take a bank in to temporary public sector ownership) (clause 12)

In addition, partial transfers would necessarily involve a new bank administration procedure. Each of these tools could be used in conjunction with the provision, to a failing bank, through funding or the provision of financial guarantees. It is recognised that since the SRR tools will involve disruption to property rights, legislation will need to provide for the possibility of compensation.

The pre-insolvency SRR tools or options are described in more detail below.

b. Transfer to a private sector purchaser

According to the Authorities, under existing legislation, the transfer of a bank to a private sector purchaser is too uncertain and too lengthy to be achieved during a crisis. Part 7 of the *Financial Services & Markets Act 2000*, already includes powers to transfer businesses if they are either banks or insurance companies.[50] Such a transfer requires complex commercial negotiations, an application to court and the chance of affected parties to be heard in court. One limitation of the Part 7 powers is that although it permits the transfer of the assets and liabilities of a bank, it does not allow for the transfer of shares, and hence ownership. The *Banking (Special Provisions) Act 2008* introduced powers for shares to be transferred quickly and the new Bill follows this approach. This option is set out in clause 10 of the Bill.

The majority of respondents to the January 2008 consultation document agreed that the short period of time in which SRR action would be required warranted granting the Authorities the power to direct a sale of a bank. Certainly, the Authorities would argue that sale of a bank to a private sector purchaser would be the resolution outcome that best meets the SRR statutory objectives, and was clearly the preferred political solution:

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[50] See *FSMA 2000* s112

> Such an outcome has the potential to maintain financial stability, provide continuity of banking services to depositors, achieve desirable outcomes for creditors and counterparties, and protect public funds.[51]

Once the failing bank's business had been transferred, the 'shell' would contain little or no property and could be wound up in the normal way.

c. Transfer to a bridge bank

This is set out in clause 11 of the Bill. A bridge bank is a company, newly set up by and run by, the Bank of England. It will be a temporary public sector company, which can be established to take control of all or part of a failing bank's business. It is a procedure possible in the United States and Canada. The January 2008 consultation document outlined the idea:

> A proposal, to keep the bank solvent and ensure that its customers had continued access to banking services, would be to transfer all or part of a bank's business to a bridge bank. This would also ensure that the Authorities had control over the bank to achieve as efficient and timely a resolution as possible, for example, to:
>
> - continue pursuing a private sector sale, especially by allowing time for potential acquirers to carry out due diligence on the business; or
> - carry out a restructuring of the business.
>
> The 'transfer of undertakings' mechanism involves a bridge bank acquiring some or all of the failed bank's assets and assuming some or all of its liabilities. The Government would arrange for the establishment of the company, appointment of suitable persons as its directors, and for its financial support so that it could obtain authorisation from the FSA with appropriate permissions to enable it to take over all or part of the business of the failing bank.
>
> The Authorities would have the option of transferring some or all of the failing bank's assets and liabilities into a bridge bank. The residual company could then carry on its remaining business (if any) or be wound up in an orderly manner. The Treasury Select Committee report also recommends that a bridge bank mechanism be available to Authorities to deal with failing banks.
>
> The bridge bank would be permitted to carry on business for a limited period of time (indicatively up to twelve months, though this could be extended by order). New senior management and non-executive directors would usually need to be appointed. The restructuring officer (see below) is likely to have knowledge of the business, and so would be an appropriate person to be a director of the bridge bank.[52]

The later consultation document, of 22 July 2008, points out that to be a 'bank' requires (under *FSMA 2000*) the organisation to be a body corporate and to be approved by the FSA. It was proposed that the Bank would run a bridge bank and own all its shares. Thus, it would appoint a Board to run it and be responsible for setting a business plan for the company. The Authorities preference is that the life of a bridge bank ought to be

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[51] TPA, *Financial stability and depositor protection: special resolution regime*, Cm 7459 pp3.15

[52] TPA, *Financial stability and depositor protection: strengthening the framework*, Cm 7308 pp4.26-4.29

time-limited, perhaps to 12 months, subject to extension through an appropriate statutory power, mainly because the status of a bridge bank is that it should be a transitional stage ending with a private sector solution. Although there is no time limit set in the Bill, under clause 70 the Bank would have to prepare an annual report for the Chancellor on the activities of any existing bridge bank.

The majority of respondents to the January 2008 consultation document believed that a private sector solution would be preferable to a bridge bank. However, they also appreciated that there may be circumstances prohibiting an immediate sale to the private sector. By way of example, the BBA accepted the need for a bridge bank tool, "but only in circumstances where the directed transfer is not possible due to an absence of willing transferees of the banking business". They also had comments on the technical treatment of different tiers of the failed bank's debt instruments which would remain with the residual company. Tier 2 instruments, they say, should not be treated in this way.

> Such an outcome would potentially have a significant impact on the ability of UK banks to raise capital. This increased cost, in turn, could have negative implications for UK banks' credit ratings. The result would be further damage to UK banks' competitive position.[53]

The BBA also questioned the accountability of the Bank of England which will, in effect, be running a bank. They questioned whether the Bank has full legal immunity for possible poor commercial performance.

d. Partial transfer

The combination of the transfer powers under the Bill for the previous solutions also enables a third. They would enable the Bank to split the failing bank's business between a 'newco' and the 'residual company'. The type of scenario envisaged is when a willing buyer could be found only for part of the failing business. Another option would be to transfer the majority of the bank's business to a bridge bank, leaving those parts least attractive to a private sector purchaser in the residual company.

Many respondents to the January 2008 consultation document expressed serious concerns about the partial transfer tool under the SRR. The greatest concern was about legal certainty:

> Respondents had expressed the view that, without strong safeguards, counterparties would not be able to know in advance whether contractual relationships would be subject to the transfer, and might therefore reflect such issues in their pricing and risk management arrangements. Stakeholders believed these uncertainties would make a counterparty's risk profile difficult to assess in the context of a bank resolution.[54]

[53] BBA Response to Tripartite Authorities consultation document Cm 7459, p5
[54] House of Commons Treasury Committee, *Banking Reform Report*, HC 1008, 16 September 2008, p113

They also argued variously that any partial transfer would disturb property rights; creditor rankings and collateral, set-off and netting arrangements. Again, by way of example, the BBA said:

> In the event of a partial transfer it is important to ensure that the division is on a coherent basis and that the arrangements work in such a way that all the creditors of the original institution benefit from the value protected as a result of the partial transfer into the bridge bank and not just the parties to the elements transferred. This is essential if the arrangements are to respect the existing creditor ranking. In the case of a group of companies in most instances it would be less disruptive to adopt an entity-by-entity view.[55]

The BBA document goes into considerably more detail about its "major reservations on the proposals for partial transfers".[56]

The document recognises that creditors in the residual company are likely to be worse off after a partial transfer than if the whole bank had become insolvent. If one considers that the best assets of the whole company will have been transferred over to a private purchaser, probably, given the circumstances of a rescue, at less than full value then the likelihood becomes all the greater. The consultation document freely acknowledges this:

> The Authorities believe that it is appropriate to address this issue. Rather than providing compensation fixed by reference to value attributed to the business transferred at the time of the transfer, the Authorities propose to provide the residual company with a contingent economic interest in the net proceeds of the resolution (for example, the proceeds of the sale of the bridge bank to a purchaser in due course, less any costs of the resolution). The Authorities propose a mechanism called the bank resolution fund to achieve this, which is considered at the end of this chapter. The Authorities consider that this provides a fair way of providing compensation to the residual company (and therefore its creditors) for the business that has been transferred to the bridge bank: creditors would receive real and significant compensation linked to the ultimate outcome of the resolution.
>
> It is possible that in some circumstances the bank resolution fund might be insufficient in size to compensate appropriately those creditors left in the residual company for the amount they have been made 'worse off' by the Authorities choosing a partial transfer. However, the Authorities believe that these circumstances will be limited, for example to situations influenced by external market conditions, because in most cases, as has been demonstrated by international experience, the intervention of the Authorities would be likely to increase the value of the part of the bank's business transferred (as it is likely to have been realised on a going concern value, rather than just a break-up value). As such, the bank resolution fund stands to be a relatively generous means of compensation, especially given the Authorities are not proposing to impose a 'ceiling'.[57]

The Bill addresses this issue in clause 55, which makes provision for compensation for creditors in the residual bank for the amount they are made "worse off" because of the partial transfer.

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[55] Ibid pp113
[56] BBA Response to Tripartite Authorities consultation document Cm 7459, p6
[57] TPA, *Financial Stability & Depositor protection*, CM 7459, pp3.64-65

The June consultation document proposed that the situations where a partial transfer is used "be set out in the statutory code of practice as a set of 'comply or explain' guidelines on the scope of each particular set of circumstances".[58] In the Bill however, restrictions on the use of the partial transfer powers must be made by the Treasury and by secondary legislation subject to the affirmative procedure.

In comments that predate the rescue of the Bradford and Bingley bank, the Authorities feel that the most likely scenario for a partial transfer would be where the deposit book is transferred to a private sector buyer (Bradford & Bingley's book was transferred to Abbey/Santander Bank). They do, however, recognise "significant practical obstacles" to the effective implementation of a partial transfer. First, the Bank would have to select the 'toxic' liabilities in order to make the transfer of remaining assets attractive to a purchaser. Second, both assets and liabilities would need to be transferred to 'newco' in order to provide the new bank with a capital base. Clearly, this selection of assets and subsequent transfer could take longer than the hoped-for timetable of the SRR procedure, especially if foreign assets are involved.

The other practical point is that although now divided, both parts of the failed bank will rely on shared computer systems to operate and ways have to be found for the services to be continued post transfer, at least in the short run.

e. Transfer to temporary public ownership

As a last resort, where none of the other SRR stabilisation tools were either appropriate or feasible, the TPA might be forced into taking the failing bank into public ownership. This is set out in clause 12 of the Bill. Commenting on this tool, the BBA said that (temporary) public ownership would only be a reasonable course of action if one of the very largest banks were at risk.[59] It is unclear what temporary means in this context except as a statement of intent.

5. The banks' response

The British Bankers' Association (BBA) has produced detailed responses, especially about the SRR tools, to all the consultation papers and some of these comments have been shown above. Their overall summary is shown below:

> The BBA fully recognises the need for an SRR framework to be put in place and agrees that legislation establishing this should be progressed as a high priority.
>
> • However we believe that it is of critical importance for this to be fully thought through and consulted on, and we share the widely held unease in financial markets and in the legal community that the proposed fast track timetable for legislation carries real risks.

58 Ibid, pp3.45
59 Treasury Committee, *Banking Reform Report*, HC 1008, pp115

• Our main concerns centre on the proposed sweeping powers that the authorities would have to vary or suspend creditors' rights, in particular in the context of partial transfers of the business of an ailing bank. In the absence of clear safeguards these could lead to damaging uncertainty, with serious implications for the funding costs of UK banks and their regulatory capital and large exposures requirements. The statutory objectives under the regime do not mitigate these concerns. It remains to be seen if these concerns will be allayed by the content of the secondary legislation. Also awaited is the proposed code of practice, though we do not believe that this would be a suitable vehicle for the provision of fundamental safeguards.

• We believe also that the possibility of interference in creditors' rights could seriously undermine the reputation and competitiveness of London as an international financial centre and UK financial markets generally.

• An area of acute concern is that the proposals would allow the Bank of England to cherry pick among certain types of contracts in master netting agreements and collateral arrangements, so compromising close out netting and collateral arrangements – the potential impact of this is underlined by the fact that in 2007 London accounted for 43% of global OTC derivatives business (with average daily turnover in excess of $1 trillion).

• The proposed allocation of SRR responsibilities among the tripartite authorities is endorsed, subject to suitable accountability.

• Also endorsed are the high level conditions for triggering the SRR, with reference to the threshold conditions. It is agreed that the test should not be purely 'mechanical' in nature and that the FSA would have to exercise its judgement in the light of all the circumstances.

• We accept that a range of resolution tools should be available to the authorities as the circumstances of an ailing bank could vary widely. We agree that the tools identified in the consultative document should be at the authorities' disposal. However this endorsement does not extend to the use of partial transfers where it is feared that formidable difficulties could arise. A clear exposition of the proposed binding safeguards for counterparties and other creditors, and costbenefit analysis based on those safeguards, will be needed before a final view may be expressed.

• If there was to be a partial transfer of a bank's business to a bridge bank, it is recognised that a special bank administration procedure could be needed to deal with the affairs of the residual company. But more detail is required as to the safeguards for creditors of the residual company.

• For the most part the distinctive features of the proposed bank insolvency procedure are dictated by the context in which it would be used. But there remains ambiguity as to the proposed 'precedence' of the liquidator's duty to support the FSCS – and so uncertainty on the impact this could have on the position of creditors. Further clarification is needed.

• We do not believe that a convincing case has been made for the FSCS to be obliged to contribute to the costs of resolution under the SRR. These costs should be met by the acquirer of the banking business or, in insolvency, from the assets

> of the firm. In no circumstances should the FSCS be required to fund the payment of compensation to the shareholders of a failed bank.[60]

The BBA has particular reservations about partial transfers and creditor rights. Later in the same document it states:

> Our strong preference would be for the SRR element of the legislation (or at least the part dealing with partial transfers) to be deferred pending a much more detailed analysis of the cost and risk factors arising – and the availability of draft secondary legislation setting out, inter alia, the key safeguards to be built into the regime. In this regard, it is noted that in his oral evidence to the Treasury Select Committee in July the Governor of the Bank of England emphasised that it would be far more important to get the SRR legislation right rather than to rush it to a fixed timetable, and left as an open question whether the authorities' proposed timescale for the legislation would prove to be feasible.[61]

B. Bank administration procedure

Part 3 of the Bill establishes a new bank administration procedure for use where there has been a partial transfer of business from a failing bank. A bank administrator may be appointed by the court to administer the affairs of an insolvent residual bank created where part of the bank has been transferred to a private sector purchaser or to a publicly controlled bridge bank under the SRR.

This new bank administration procedure is largely based on the existing administration provisions of the *Insolvency Act 1986* (IA 1986) as amended by the *Enterprise Act 2002* (EA 2002), but with modifications where required.

1. Background

a. Existing 'ordinary administration'

An administration procedure already exists in UK insolvency law (in the Bill, referred to as 'ordinary administration proceedings').[62] Further, under its existing powers, the FSA can force a bank in financial difficulties to enter administration proceedings. The primary aim of this existing procedure is to rescue a failing company as a going concern; that is, with as much of its business as possible. An administrator can be appointed by either a group of creditors or a court. The procedure is designed to enable reconstruction of a company, with the administrator taking over the management functions. Importantly, in administration the company is protected from actions by creditors while negotiations with creditors are ongoing.

However, if the company cannot reasonably be saved the administrator can perform his functions with the objective of achieving a better return for creditors than would be

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60 BBA Response to Tripartite Authorities consultation document Cm 7459, available at: http://www.bba.org.uk/content/1/c6/01/45/17/SRR_response_-_15th_September.pdf

61 Ibid p3

achieved in an immediate winding-up. For example, a better return for creditors may come from trading on for a period whilst seeking to sell off the business and/or assets.

Despite the existence of this administration procedure already in UK insolvency law, the Authorities wish to introduce a special bank administration procedure. This procedure would be specifically designed both to:

- operate and manage the residual company after a partial transfer of a bank's business to a bridge bank or private sector purchaser; and

- to fully to wind up its affairs once the residual company was no longer required in connection with the resolution.

According to the Authorities, 'ordinary' administration would be unsuitable to deal with the management and winding up of the residual company, given the potential need to maintain certain inter-relationships between the residual company and the bridge bank or private sector purchaser. That said, bank administration is modelled on ordinary administration procedures but with some significant modifications.

b. Why is a separate bank administration procedure necessary?

A pre-insolvency stabilisation tool of the SRR is the partial transfer of a failing bank's business, assets or liabilities, to either a publicly-controlled bridge bank (established and controlled by the Bank of England) or a private sector purchaser. According to the Authorities, partial transfer would protect depositors because their claims would be wholly transferred to a stable new company whilst creditors in the residual company would benefit from the net proceeds from the resolution.

Once the partial transfer has been made, it is likely that the residual part of the bank would be rendered insolvent. However, it may not be possible to wind up parts of the residual bank's business if they are needed to provide services essential to the operation of a bridge bank or private sector purchaser. This might be necessary where, for instance, certain essential systems, contracts or services cannot immediately be transferred to, or integrated with, the new company's infrastructure or contractual arrangements due to legal or practical obstacles.[63]

In such circumstances, an application may be made to the court by the Bank of England for a bank administration order. The bank administration procedure enables the residual bank to continue to operate to the extent necessary to support the bridge bank or private sector purchaser in circumstances where it would otherwise be placed into an insolvency procedure. Once this primary objective has been achieved, the procedure would continue in a similar way to an ordinary administration although some of the existing powers of a liquidator have been built in to the procedure.

In their most recent consultation document, of 22 July 2008, the Authorities explained the approach taken in drawing up a new bank administration procedure:

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[62] *Insolvency Act 1986* and *Enterprise Act 2002*

[63] Bank of England, HM Treasury, FSA, '*Financial Stability and depositor protection: special resolution regime'*, CM 7459, 22 July 2008

> […] the Authorities consider that a special form of insolvency procedure (based on existing administration provisions) will often be necessary, at least in the initial stages, to deal with the affairs of the residual company. This procedure would be designed both to operate and manage the residual company and fully to wind up its affairs once the residual company was no longer necessary to achieve the SRR objectives, although for flexibility other outcomes should also be provided for.
>
> Ordinary insolvency procedures and the proposed bank insolvency procedure would be unsuitable to deal with the management and winding up of the residual company, given the potential need to maintain certain inter-relationships between the residual company and the bridge bank. For example, ordinary insolvency procedures would inevitably lead to tensions between the residual company and the bridge bank, particularly in respect of the ownership and control of assets. Moreover, ordinary administration or liquidation proceedings, which would be focussed on achieving the best outcome for creditors generally, would not necessarily provide a means for addressing potential short-term tensions between the bridge bank and the interests of creditors remaining in the residual company in a manner conducive to satisfying the SRR objectives. The new bank insolvency procedure is designed to facilitate rapid FSCS payments to eligible claimants and so would not be capable of achieving what is required in the context of the residual company and partial transfers to a bridge bank. Indeed, the aim of the bank insolvency procedure would not be applicable to the residual company since depositors eligible for compensation under the FSCS would most probably have been transferred to the bridge bank. [64]

It is important to note that bank administration will not only apply to banks. Clauses 145 and 146 of the Bill give the Treasury a power to apply the bank administration procedure to building societies and credit unions (with any necessary modifications) by secondary legislation subject to the affirmative procedure.

It should also be emphasised that not all partial transfers would lead to a bank administration procedure. The residual company could potentially be allowed to enter ordinary insolvency proceedings (such as liquidation or administration) where no assets, systems or contracts etc. remaining in the residual company were considered essential to the functioning of the new company and there was no other reason why the bank administration procedure was needed for the successful resolution of the bridge bank or private sector purchaser.[65]

2. Bank administration

a. Overview of the administration procedure

This new bank administration procedure has two statutory objectives:

Objective 1 - is to ensure the continuation of the insolvent residual company, to facilitate and support the operations of the bridge bank or private sector purchaser until such time as this support is no longer required.

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[64] Bank of England, HM Treasury, FSA, “Financial stability and depositor protection: special resolution regime”, 22 July 2008, Cm 7459

[65] In addition, in situations where a solvent demerger is possible, the residual bank may not need to enter an insolvency procedure (i.e. if it was not insolvent).

Objective 2 - when such support from the residual company is no longer required, to achieve either of the two principle aims of an ordinary administration; either to rescue the company as a going concern or to achieve a better result for creditors than in an immediate liquidation. The Bill gives priority to the first objective.

Clause 123 of the Bill provides an overview of the new administration procedure. It states:

> 123(1) Part provides for a procedure to be known as bank administration.
>
> (2) The main features of bank administration are that -
>
> (a) it is used where part of the business of a bank is sold to a commercial purchaser in accordance with section or transferred to a bridge bank in accordance with section (and it can also be used in certain cases of multiple transfers under Part 1),
>
> (b) the court appoints a bank administrator on the application of the Bank of England;
>
> (c) the bank administrator is able and required to ensure that the non-sold or non-transferred part of the bank('the residual bank') provides services of facilities required to enable the commercial purchaser ('the private sector purchase') or the transferee ('the bridge bank') to operate effectively, and
>
> (d) in other respects the process is the same as for normal administration under the Insolvency Act 1986, subject to specified modifications.

It is clear from this clause, that bank administration is modelled on existing insolvency procedures – principally administration under Schedule B1 to the *IA 1986* – but with significant modifications. Uniquely, it would only be applied to an insolvent residual company in conjunction with partial transfers to a bridge bank or to a private sector buyer. Safeguards are also introduced with the procedure in order to protect the interests of creditors left in the residual company; to ensure they are not prejudiced by the continuation of the company.

The main procedural features of bank administration are outlined in more detail below.

b. Bank administration order

Entry into the bank administration procedure requires an order of the court; this reflects the way in which insolvency proceedings commence. The court will only make such an order if notice requirements to be satisfied in secondary legislation have been observed.[66]

Under clause 152 of the Bill, only the higher courts may make a bank administration order. The reason given for this provision is the size and complexity of the UK's banks and the nature of the partial transfer tool under the SRR.

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[66] Clause 128

Only the Bank of England, as the authority responsible for administering the SRR, is able to apply directly to the court for a bank administration order.[67] However, the FSA may be allowed to make such an application in respect of a residual bank where appropriate notice has been given to the Bank of England.[68] In such circumstances, the Bank of England would be entitled to appear at any consequent court hearing and make representations.

An application may be made only where a partial transfer of the bank's business has been made and the residual bank is left as an insolvent entity; that is, it is unable, or is likely to become unable, to pay its debts.[69] Notice of the application must be given in accordance with the rules made under section 411 of the IA 1986.

As in an ordinary administration, on the making of the application by the Bank of England, an interim moratorium will take effect.[70] This means that creditors will not be able to enforce their security over the residual company's property and no legal proceedings may be taken against the company – except with the permission of the court.
Ultimately, it would be for the court to decide whether to grant the application, adjourn it or dismiss it.[71] The procedure would begin at the time the court makes an order appointing a special bank administrator.[72]

c. Bank administrator

Appointment

When making an application to the court for a bank administration order, the Bank of England must nominate a person to be appointed as the bank administrator.[73] Only a qualified insolvency practitioner, who is willing to accept the position, may be appointed by the court to act as a bank administrator. The bank administrator will be an officer of the court, and as such, he will be ultimately answerable to the court.[74]

Under the Bill, the bank administrator must agree with the Bank of England a statement of proposals for achieving the two statutory objectives of the bank administration (with the first objective taking priority).[75] Those proposals may subsequently be revised. Copies of the proposals document should be circulated to creditors, members of the company, Companies House and to the FSA.[76]

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[67] Clause 130
[68] Clause 144
[69] Clause 130(3)
[70] Clauses 130, 132
[71] Clause 131
[72] Clause 128
[73] Clause 129
[74] Clause 133
[75] Clause 134(1) to (4)
[76] Clause 143(6)

Once the first objective has been achieved, the bank administrator is able to shift the focus of the bank administration to achieving the second objective. At this point, the bank administrator is required to produce a new statement of proposals.[77]

Powers and duties

The role of the bank administrator is to take over the management and affairs of the insolvent residual company. Clause 124 of the Bill sets-out the bank administrator's two statutory objectives:

- First, to ensure the continuation of the insolvent residual company, to facilitate and support the operations of the bridge bank or private sector purchaser until such time as this support is no longer required.

- Second, when such support is no longer required, to achieve either of the two principle aims of an ordinary administration; either to rescue the company as a going concern or to achieve a better result for creditors than in an immediate liquidation.

Importantly, the bank administrator is given a general power to do anything necessary or expedient for the pursuit of the objectives.[78]

The Bill gives priority to the first objective. However, given that there are some elements of an ordinary administration that may be started immediately without interfering with the first objective, clause 124(2) requires the bank administrator to pursue both objectives in parallel. To ensure that the bank administrator does not sell any assets of the residual bank that may be essential to achieving the first objective, the Bill provides that only assets specified by agreement between the administrator and the Bank of England may be sold.[79]

In order to pursue the first objection, clause 125(2) provides that the bank administrator may be obliged to act as a transferor or transferee in relation to any supplemental property transfers made between the residual company and either the bridge bank or the private sector purchaser.[80] Moreover, in cases where a partial transfer of a failing bank's business has been made to a private sector purchaser, a bank administrator would be required to act in accordance with the terms of any service agreement drawn up between the residual company and the commercial purchaser.[81] In effect, the bank administrator is expected to avoid action that is likely to prejudice performance by the residual bank of its

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[77] Clause 134
[78] Clause 132(1)
[79] Clause 127(3)(a)
[80] It should be noted that the Bill restricts transfers of property, rights and liabilities between a residual bank and a bridge bank or private sector purchaser. These restrictions are as follows: (i) property, rights and liabilities may not be transferred from a bridge bank to a residual company, they may only be transferred from the residual company to the bridge bank (clause 39(3)(a); (ii) no supplemental transfers of property , rights and liabilities may be made between a residual bank and a private sector purchaser (clause 39(5)).
[81] Clause 124(3)

obligations.[82] If necessary, the court would act as the final arbiter in the event of any dispute or uncertainty.

In cases where a partial transfer has been made to a publicly controlled bridge bank, the bank administrator would be obliged to work with the Bank of England to effect appropriate service arrangements at a fair market value.[83] Following on from this, the Bill provides that where the bank administrator requires the prior agreement of the Bank of England to take certain actions, the Bank of England may only block actions which would be adverse to the continuing provision of services or facilities to a bridge bank. [84]

To cater for all eventualities, clause 137 deals with cases where, following a partial transfer to a bridge bank, part or all of the bridge bank's business is subsequently acquired by a private sector purchaser. In this situation, the continued provision of essential services and facilities from the residual company to the commercial purchaser may be vital to ensure a successful resolution. In such circumstances, clause 137 continues to bind a bank administrator to achieving the first objective.

Once the first statutory objective has been achieved, and the continued provision of services and facilities to the bridge bank or private sector purchaser is no longer required, the bank administrator would be expected to direct all his attention to achieving statutory objective 2; either to rescue the residual company as a going concern or to achieve a better result for the bank's creditors than an immediate liquidation by the piecemeal realisation of assets.

The powers of the bank administrator are drawn primarily from ordinary insolvency procedures, principally the powers and duties of an ordinary administrator set out in Schedules B1 and 1 to the IA 1986. However, modifications have been made where necessary to ensure that the two statutory objectives can be achieved. Many of the modifications also reflect the unique supervisory role of the Bank of England in the initial stages of the procedure.[85]

Significantly, some of the powers that only a liquidator currently has under the IA 1986 have been given to the bank administrator. Specifically, under the Bill the bank administrator is given powers to:

- disclaim onerous property (which would only be exercisable to the extent that it was compatible with the need for the residual company to support the operations of the bridge bank or private sector purchaser);[86]
- apply the provisions of the *Company Directors Disqualification Act 1986* (i.e. submit a return on the conduct of the failed bank's directors);[87]
- bring proceedings before the court for fraudulent trading;[88]

[82] Clause 125(3)(6)
[83] Clause 125(4)
[84] Clause 125(5)
[85] Clause 132
[86] Clause 132(6)
[87] Clause 142
[88] See table 2 entries for sections 213 and 214 of the *Insolvency Act 1986*

- bring proceedings before the court for wrongful trading; and
- pay dividends to unsecured creditors without the permission of the court (but only after an Objective 1 Achievement Notice has been issued by the Bank of England).[89]

According to the Bill's Explanatory Notes, the bank administrator has been given these additional powers in order to keep down costs, maximise returns to creditors and provide for a variety of outcomes. The intention is that bank administration will be a flexible, stand-alone procedure.[90]

Sharing of information

It has already been established that bank administration can be triggered by the partial transfer of the bank's business to a publicly controlled bridge bank. Given the unique nature of the first statutory objective, this type of bank administration will by necessity involve a number of parties. The purpose of clause 135 of the Bill is to ensure that information is properly shared between all the parties involved in the procedure.

Under clause 135(2), the Bank of England is specifically required to provide the bank administrator with details of the financial situation of both the residual bank and the bridge bank.[91] This is to ensure that the bank administrator is equipped to produce an appropriate statement of proposals to the central bank.

The bridge bank is also obliged to supply information to the bank administrator. In part, this is to enable the administrator to properly pursue the first objective. However, this supply of information is also important because the resolution of the bridge bank will impact on the timing and amount of any distribution to creditors of the failed bank.[92]

The bank administrator is also expected to play a part in this exchange of information. Specifically, the bank administrator is required to provide information both to the Bank of England and the bridge bank on the financial position of the residual company.[93]

The Bill requires the Treasury to specify by secondary legislation what set of information and class of record will be relevant in a particular case.[94]

d. Role of the Bank of England

Supervisory role

Given the nature of the first statutory objective, the Bank of England is required to play an important supervisory role in the initial stages of a bank administration, exercising a high degree of control over the process. For example, under the Bill the central bank would have the following functions:

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[89] Clause 132
[90] Banking Bill Explanatory Notes, Bill 47-EN
[91] Clause 135(2)
[92] Clause 135(3)
[93] Clause 135(4)
[94] Clause 135(5) and (6) – the new regulations will be subject to the negative procedure

- considering and approving, with or without modification, the bank administrator's proposals for achieving the objectives of the procedure;
- providing information to the bank administrator in relation to the financial position of the residual company and the bridge bank or private sector purchaser;
- approving those assets, or types of asset, that may be realised immediately for the benefit of creditors (that is, "non-essential assets");
- effecting supplemental transfers of assets and liabilities between the residual bank and the bridge bank or private sector purchaser (subject to certain restrictions);
- determining, with the co-operation of the bank administrator, what essential services, assets and contracts etc., the residual bank would be obliged to continue to provide in support of a bridge bank or private sector purchaser;
- determining whether to consent to the taking of certain actions in the procedure where those may prejudice the successful resolution of the bridge bank; and
- agreeing that the procedure may be terminated

In considering the role of the Bank of England, a distinction has to be made between the two statutory objectives. Whilst the first objective is still being pursued, the bank administrator would only be permitted to exercise certain powers or take certain actions with the permission of the Bank of England or the court. Most importantly, the Bank of England would fulfil the functions of a creditors' committee.

However, once the first objective has been achieved, the procedure would continue in a similar way to an ordinary administration. Effectively, the Bank of England would 'step down' from the proceedings, and the administrator would be free to act in pursuit of the second statutory objective and to deal with all assets of the residual bank.[95] The need for the bank administrator to obtain the consent of the Bank of England to take certain actions would lapse at this point. If necessary, the bank administrator could seek directions from the court as to how to proceed.[96]

Creditors' committee

In an ordinary administration, Schedule B1 to the IA 1986 provides for the calling of a creditors' meeting and the functions of that creditors' committee. However, under the clauses of the Bill, these provisions would not apply immediately to a bank administration.

Specifically, a creditors' committee cannot be called until an 'Objective 1 Achievement Notice' has been served on the administrator by the Bank of England. Until such time, the Bank of England would have a supervisory role in place of a creditors' committee. In practice, this could mean that the Bank of England could require the bank administrator to provide information in relation to the exercise of his functions and would generally assist the bank administrator in discharging his functions.

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[95] Clause 127(3)(a)
[96] Clause 126(2)

Once the first statutory objective has been achieved (and the appropriate Achievement Notice served by the Bank of England), the procedure would continue in a similar way to an ordinary administration. A meeting of creditors would be called to consider the bank administrator's proposals for the progression of the administration and at this stage the creditors would be able to form a creditors' committee.

e. Position of creditors

In order to ensure that the first statutory objective can be met, by necessity the Bill curtails some of the rights that creditors would have in an ordinary administration. For instance, until the first statutory objective has been achieved the Bank of England fulfils the functions of the creditors' committee and assets of the residual company cannot be sold without the Bank of England's prior consent. That said the creditors of the residual bank would have an important stake in the success of the bridge bank solution through the bank resolution fund.[97]

To provide consistency with ordinary administration proceedings and to safeguard the interests of creditors, the Bill preserves certain rights from ordinary administration, such as:

- The ability of creditors to requisition a further meeting of creditors;[98]
- the ability of creditors to challenge the bank administrator's conduct (provided that the court is satisfied that it would not prejudice the pursuit of Objective 1);[99] and
- the normal statutory order of priority of creditors remaining in the residual bank for distribution purposes.

f. Termination of the procedure

Once the first statutory objective has been achieved, and the continuation of the residual bank is no longer required to support the operations of a bridge bank or private sector purchaser, the procedure would continue in a similar way to an ordinary administration.

Reflecting the position in ordinary administration proceedings, the Bill provides a variety of ways to bring the procedure to a close. These include provisions for:

- terminating the bank administration and allowing the residual bank to continue to function as a viable going concern;
- dissolving the residual bank (i.e. it would no longer exist as a legal entity) following a voluntary winding up;
- rescuing the residual company by implementing a company voluntary arrangement (CVA);

Specifically, clause 140 of the Bill provides a way to terminate a bank administration where Objective 1 has been achieved and the residual bank has, in the opinion of the administrator, been rescued as a going concern. At the other extreme, clause 141 deals

[97] Clause 53
[98] Paragraph 62 of Schedule B1 to the *Insolvency Act 1986*
[99] Paragraph 74 of Schedule B1 to the *Insolvency Act 1986*

with cases where closure of the residual bank and the realisation of assets is the most appropriate option. This clause allows for the dissolution of the residual bank where the objectives of the bank administration procedure have been achieved and the bank's affairs have been fully wound up.

Alternatively, as in ordinary administration, and where it would be in the best interest of creditors, the bank administrator may make proposals to creditors for a Company Voluntary Arrangement (CVA) under Part 1 of the IA 1986. Briefly, a CVA is a rescue plan for re-organising the debts of a company that is put to its creditors and shareholders.

g. Secondary legislation

Clause 147 amends section 411 of the IA 1986 to allow secondary legislation to be made to enable the bank administration procedure to work in practice.

This is not greatly significant, since under the existing administration legislation is already based on primary legislation (the IA 1986 and the EA 2002) supported by a set of insolvency rules, dealing mainly with matters of procedure.

C. New bank insolvency procedure (BIP)

Part 2 of the Bill creates the other SRR tool - a bank insolvency procedure (BIP). This new procedure is largely based on the existing liquidation provisions of the *Insolvency Act 1986* (IA 1986), with modifications where required. In cases where closure of the failing bank and payout of depositors is the most appropriate option, the aim of the BIP is to provide for the orderly winding up of the failed bank and to facilitate rapid FSCS payments to eligible claimants.

The Bill also contains powers to extend this new insolvency procedure to building societies and credit unions.

1. Why is a bank insolvency procedure necessary?

Currently, financial firms in the UK are subject to normal corporate insolvency procedures, which have a narrow focus on the failing firm and the interests of creditors. There is no special insolvency regime for banks that is designed to facilitate speedy and efficient resolution of a bank, nor the preservation of critical banking functions. According to the Authorities, it is this fear of a disorderly wind-up of the bank, which can substantially contribute to a loss of depositor confidence in the bank concerned before it reaches a critical point.

In the two consultation documents of July 2008, the Authorities explained that the current insolvency procedures are not specifically tailored for dealing with a bank failure for a number of reasons, including:

- depositors might be deprived of access to their accounts at very short notice;
- no objectives exist around fast payout for depositors;
- likely destruction of any residual franchise value, which significantly reduces any chance of a rescue or turnaround of the firm; and

- the risk of contagion to other banks (i.e. domino effect as one bank falls, so do others).

The new BIP seeks to remedy these short-comings. The first objective of this procedure is to facilitate appropriate treatment of depositors:

> The new bank insolvency procedure will ensure that, in cases where closure of the failing bank and payout of depositors is seen as the most appropriate option, there is a specifically tailored insolvency vehicle for achieving this aim. The Government proposes that the decision to use the new insolvency procedure within the SRR would be taken by the Bank of England, and implemented through an application to the Court. As the body responsible for paying compensation to customers of the bank once it has been placed into the new insolvency procedure, the FSCS will also need to be involved in providing an assessment of the readiness of the failing bank's systems to support prompt payments to protected depositors.[100]

It is hoped that a new BIP will instil confidence in bank customers by ensuring that eligible claimants under the FSCS receive appropriate treatment in terms of quick access to their insured deposits. This point was made in the Bill's Explanatory Notes:

> The Government's principal reason for seeking to introduce a new insolvency procedure for banks (as an alternative to existing insolvency processes) is to ensure that, where a bank fails, depositors who are eligible claimants under the terms of the Financial Services Compensation Scheme are paid out promptly.
>
> The equitable treatment of creditors as a whole is a key feature of the UK's insolvency regime, and the bank's insolvency procedure has therefore been designed to enable rapid compensation payments to depositors without creating a regime in which those depositors receive preference over other creditors.[101]

It is worth pointing out that the majority of respondents to the January 2008 consultation document felt that wholesale changes to current insolvency provisions were not required to ensure rapid payments to eligible FSCS claimants. There were suggestions from several parties that any new procedure should be closer to liquidation than administration proceedings; and that the existing duties and powers of a liquidator, with some minor modifications, ought to be sufficient to achieve the objectives of the Authorities.

Subsequently, the Authorities have explained the approach taken in drawing up the new BIP:

> In preparing draft clauses on the bank insolvency procedure, the Government has therefore sought to avoid wholesale changes to existing winding up provisions.
>
> Consistent with this approach, a significant number of existing insolvency provisions will be applied to the bank insolvency procedure in full, or with only minor modifications. This reflects the Authorities' intention to adhere, where possible, to existing insolvency law and practice, so that the formal insolvency of a bank will be dealt with along similar lines to an ordinary liquidation. The table at

[100] TPA, 'Financial Stability and depositor protection: further consultation', Cm 7436, pp1.48
[101] Banking Bill Explanatory Notes, Clause 77

> draft clause 47 sets out the application of provisions from existing insolvency law to the bank insolvency procedure.
>
> Other aspects of the bank insolvency procedure also closely follow existing insolvency law and practice and will be familiar to companies and their professional advisers. However, a number of additional new provisions are considered essential to enable the new procedure to achieve its objective of ensuring that eligible claimants under the FSCS receive appropriate treatment in terms of timely access to their insured deposits.[102]

2. Bank failure – insolvency approach taken in other countries

A bank is considered to have failed when the competent authorities order it to cease operations and activities. The effect of a bank failure can be significant due, in large part, to the fact that banks play a special role as credit providers, deposit takers and payment intermediaries. There is also a risk of contagion with a loss of public confidence.[103]

It is generally accepted that the main aims in bank insolvency proceedings should be to ensure the safety and soundness of the financial system at large; the integrity of the payment system (i.e. the clearing of cheques etc); and prompt repayments to eligible depositors. However, without any international insolvency regime, different insolvency arrangements have been adopted by countries to deal with a failed bank.[104]

In some jurisdictions a failed bank is subject to the general corporate insolvency law. In other words, the bank is treated like any other large corporation. This is currently the case in the UK where general insolvency principles are applied to banks (with some modifications for financial contracts) under court administered proceedings. Alternatively, a failed bank might enter ordinary administration proceedings.[105]

In other jurisdictions, banks are subject to a special insolvency regime administered by the bank supervisor or the depositor protection agency. This is the case in Italy and the United States. Norway is another country with pre-specified distress resolution procedures for banks. Whilst in Canada, bank resolution arrangements are in place that draw-on aspects of general insolvency law, supplemented by the provision of extensive powers for the bank supervisor and deposit insurance fund.[106]

The Unites States provides a good case study of a bespoke insolvency regime for banks. In the United States the insolvency resolution of most corporations is governed by the federal bankruptcy code and is administered by special bankruptcy courts. In practice, many large corporations are resolved under Chapter 11 restructuring proceedings. In contrast, bank insolvencies are resolved under a statutory insolvency regime governed by the *Federal Deposit Insurance Act 1991* and are administered by the Federal Deposit Insurance Corporation. Under this regime, special resolution measures may be taken in

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[102] TPA, “Financial stability and depositor protection: special resolution regime”, Cm 7459, pp4.5
[103] TPA, Cm 7436 p61
[104] Ibid
[105] Insolvency Act 1986 and the Enterprise Act 2002
[106] *Cross border insolvency*, Rose Maria Lastra, European Bank, October 2007, & *Deposit insurance and bank insolvency in a changing world: synergies and challenges*, Michael H Krimminger, IMF conference, 28 May 2004

relation to banks whose failure could have systemic consequences and threaten financial stability. Wide powers are given to the special administrator who is appointed to carry out the resolution of the bank and is answerable to the banking regulator and financial or legislative authorities, rather than the bankruptcy courts. The two separate resolution processes – corporate bankruptcy and bank receiverships – exist side by side.[107]

Some, but not all, European countries have made special insolvency arrangements for dealing with banks in financial difficulties under administrative or legal rules. Whilst these arrangements do not go as far as the US model, some countries have made provisions for financial authorities to appoint special or provisional administrators with some discretion over the initiation of measures, including the ability to apply them to banks before they are technically insolvent. However, there are other European countries with no formal distress resolution procedures for banks; instead, general insolvency laws apply.

3. Bank insolvency

a. Overview of the new BIP

Clause 77 of the Bill provides an overview of the new procedure. It states:

> 77(1) This Part provides for a procedure to be known as bank insolvency.
>
> (2) The main features of bank insolvency are that:
>
> (a) a bank enters the process by court order,
>
> (b) the order appoints a bank liquidator,
>
> (c) the bank liquidator aims to arrange for the bank's eligible depositors to have their accounts transferred or to receive their compensation from the FSCS,
>
> (d) the bank liquidator then winds up the bank, and
>
> (e) for those purposes, the bank liquidator has powers and duties of liquidators, as applied and modified by the provisions of this Part.

It is clear from this clause, that whilst some of the provisions are new, a large number of existing insolvency provisions under the IA 1986 will be applied to the BIP in full, or with only minor modifications.

The main features of bank insolvency are outlined in more detail below.

b. Bank insolvency order

For the purposes of the Bill 'banks' are taken to mean UK institutions with permission under the FSMA 2000 to carry out the regulated activity of accepting deposits.[108] The BIP procedure may be extended by secondary legislation to building societies and credit

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[107] *US corporate and bank insolvency regimes: a comparison and evaluation*, Robert Bliss and George Kaufman, 23 October 2006 Virginia Law and Business Review
[108] Clause 78

unions.[109] Whilst the Treasury may, by order, add to the exclusions from this definition of bank.

The decision to use the BIP under the SRR would be taken by the Bank of England and implemented through an application to the court; the procedure would be subject to the general supervision of the court.[110] The FSCS, as the body responsible for paying compensation to the bank's depositors once it has been placed into the new insolvency procedure, would also be involved, not least in providing an assessment of the readiness of the failing bank's systems to support prompt payments to protected depositors.

Under clause 82 of the Bill, an application for a bank insolvency order may be made to the court by:

- the Bank of England; or
- the FSA (with the Bank of England's consent); or
- the Secretary of State

The application must nominate a qualified insolvency practitioner to be appointed as the bank liquidator. Importantly, the directors of the failing bank must be given notice of the application prior to the court hearing for a bank insolvency order.[111] This is to ensure compatibility with Human Rights legislation.

Clause 83 of the Bill sets out the three grounds on which an application for a bank insolvency order could be made:

1. Insolvency - that is, a bank is unable, or likely to become unable, to pay its debts;
2. the winding up of a bank would be in the public interest; and
3. the winding up of a bank would be fair.

In addition to these grounds, as the BIP has been designed to ensure rapid compensation payments to depositors under the terms of the FSCS, an application for a bank insolvency order may be made only where a bank has eligible depositors.[112]

In effect, to make a bank insolvency order, the court must be satisfied that:

- the bank in question has eligible depositors, and
- where the application has been brought by the Bank of England or the FSA, the court must be satisfied that the bank is either insolvent or that the winding up of the bank would be fair; or
- where an application is made by the Secretary of State, the court must be satisfied that the winding up of the bank would be in the public interest and fair.[113]

[109] Clauses 117 and 118 – subject to the affirmative procedure
[110] Clause 79
[111] Service requirements will be specified in secondary legislation facilitated by clause 1112 of the Bill
[112] Clause 84

Only the higher courts would be able to consider an application for a bank insolvency order.[114] This restriction is thought necessary because of the size and complexity of many UK banks and the public interest likely to be generated at the time of a bank's failure. As with existing insolvency provisions, on the hearing of an application for a bank insolvency order the court may make such an order, adjourn the application or dismiss it.[115] If a bank insolvency order is made, it will be treated as commencing at the time the application was made.[116]

Under clause 107 of the Bill, ordinary insolvency proceedings can only begin where appropriate notice has been given to the FSA. Specifically, insolvency applications covered by the clause cannot be determined until a period of 14 days has elapsed or the FSA and the Bank of England have informed the notifier that they do not intend to apply for bank insolvency. A 14-day notice period is thought necessary in order to give the FSA, in the unlikely event that it was unaware that a bank was in difficulties, an opportunity to step in and trigger the SRR and make use of an appropriate resolution tool, which may be more appropriate than normal insolvency. Commenting on this point, the Authorities have said:

> Given the high degree of regulatory involvement with banks by the FSA, it is unlikely that the Authorities would be unaware that a bank was in financial difficulties prior to notification of a proposed insolvency event from a third party. However, were a bank to collapse suddenly (for example due to large-scale fraudulent activity), the 14-day notice provision would ensure that the Authorities were notified and could either allow the proposed insolvency proceedings to go ahead or quickly initiate, if required, an alternative SRR tool. These alternatives would, of course, include the bank insolvency procedure, via substitution of the original application or petition by an application for the bank insolvency procedure.[117]

It is possible that there may be an occasion where the SRR is triggered without any notice being received by the FSA of a third party application for insolvency, with the Bank wishing to implement the bank insolvency procedure. In which case, clause 104 of the Bill allows the court to make a bank insolvency order on the hearing of a third party's winding up petition or an application for an administration order where representations are made by either the Bank of England or the FSA. In such a case, the proceedings would (as with any ordinary liquidation) be deemed to have commenced from the time the application was made.[118]

On the same theme, clause 105 of the Bill provides that a resolution for the voluntary winding up of a bank under section 84 of the IA 1986 shall have no effect without the prior approval of the court.[119] Once the BIP has started no other insolvency procedures can be initiated.[120]

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113 Clause 84. This reflects the Secretary of State's existing powers under section 124A of the IA 1986 to present a winding up petition against a company where there id considered to be public interest.
114 Clause 79
115 Clause 84
116 Clause 85
117 TPA, Cm 7459, pp4.13
118 Clause 85
119 Clause 105
120 Paragraph 42 of Schedule B1 of the *Insolvency Act 1986* – moratorium on insolvency proceedings – is applied with necessary modifications

c. Role of the bank liquidator

Appointment

At the same time as the court makes a bank insolvency order, a qualified insolvency practitioner (nominated by the body making the insolvency application) is appointed as the bank liquidator.[121] As an officer of the court, the bank liquidator would be subject to the general supervision of the court and be expected to adhere to all professional and ethical standards.[122]

In keeping with existing corporate insolvency procedures, joint bank liquidators may be appointed in bank insolvency.[123] This would ensure the necessary expertise for a high profile insolvency. However, the appointment would need to specify which functions could be exercised by some or all of the officeholders solely and which could be executed jointly.

Tenure

Clauses 93 to 99 of the Bill are concerned with the tenure of the bank liquidator. They deal with matters such as the death, replacement, resignation or removal of the bank liquidator, what happens where the bank liquidator ceases to be qualified to act as an insolvency practitioner, and the effect of his release from office. Although these clauses reflect existing provisions of the IA, 1986 modifications have been made to ensure that the first statutory objective of the BIP can be achieved. For example, a meeting of creditors may resolve to remove or replace a bank liquidator only after a full payment resolution has been passed.

Powers and responsibilities

Under clauses 90 and 91, a bank liquidator has the same general powers as a liquidator under Schedule 4 to the IA 1986 (powers of a liquidator in a winding up). The bank liquidator also has some additional specific powers (usually reserved for an administrator or administrative receiver) drawn from Schedule 1 of the IA 1986. However, modifications have been made in order to support the first objective of the BIP, and to reflect the roles of the Authorities and the FSCS in the initial stages of the BIP up to the point that a full payment resolution has been passed.

By way of example, an ordinary liquidator is able to bring an action before the court to recover money lost to creditors as a consequence of a transaction at undervalue (i.e. a transfer at less than the full value) or preference (i.e. a payment by the debtor to one creditor to the disadvantage of another) given in specified periods prior to commencement of the winding-up proceedings.[124] Under the Bill, a bank liquidator is not

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[121] Clause 81
[122] Clause 92
[123] Clause 86 and clause 90
[124] Under sections 339 to 342 IA 1986 a transaction at undervalue or a preference can be set aside by the court

allowed to bring such actions before the court where those transactions relate to the prior exercise of any of the pre-insolvency stabilisation tools.

Bank insolvency would fall within the provisions of the *Company Directors Disqualification Act 1986* (CDDA 1986).[125] This means that the bank liquidator would also be required to submit a return on the conduct of the failed bank's directors and, where action was considered to be in the public interest, the Secretary of State would be able to seek a disqualification order from the court in relation to any directors whose conduct was considered to be unfit. As an alternative to a disqualification order, a disqualification undertaking could be mutually agreed between the parties. The effect of a disqualification order or undertaking is to bar a person from acting as a company director and from holding certain offices for a fixed period of time (between two and fifteen years).

As in any ordinary liquidation, the bank liquidator is obliged to pay funds from the realisation of assets into an Insolvency Services Account (ISA).[126] For consistency of approach, this will also be a requirement for the bank liquidator of a Scottish bank. The reason given by the Authorities is that since the ISA is held with the Bank of England the central bank is able to offer security in the event of a general crisis in the banking industry. In effect, the Authorities want to avoid a situation where funds from the realisation of assets of one failed bank were held in another commercial bank which itself got into difficulty.

d. Process of bank liquidation

Under clause 86 of the Bill, the bank liquidator has two statutory objectives:

- First, to work with the FSCS to ensure that as quickly as possible either depositors' accounts are transferred to another financial institution or payments are made to eligible depositors from (or on behalf) of the FSCS. (As with current provisions, the FSCS would take the place of eligible claimants within the insolvency and would rank as an ordinary unsecured creditor in the proceedings alongside the claims of other creditors.)

- Second, to wind up the affairs of the failed bank in the interests of creditors as a whole. No changes are proposed to the current statutory order of priority of creditors for distribution purposes.

Under clause 90(1), the bank liquidator is empowered to do anything necessary or expedient for the pursuit of the two objectives.

The bank liquidator is expected to give precedence to the first objective but is also obliged to begin working towards both objectives immediately on his appointment. In effect, the bank liquidator is expected to take all the immediate steps that he would in an ordinary liquidation to protect the interests of creditors generally, for example, identifying and collecting in the assets of the failed bank.

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[125] Clause 108 - this clause applies the Company Directors Disqualification Act 1986 with necessary modifications

[126] Clause 114

Once the first objective has been achieved, or has been substantially completed, the bank insolvency process is expected to continue in much the same way as any ordinary winding up. In other words, the bank liquidator would call a meeting of creditors, the assets of the failed bank would be realised and the proceeds distributed to creditors.

e. Liquidation committee

Two-stage committee process

In ordinary winding up proceedings under the IA 1986, creditors may resolve at a meeting to form a liquidation committee. That committee can require the liquidator to report to the committee on matters relating generally to the winding up of a company and the liquidator may take certain actions only with the committee's approval. Under the new BIP, the committee process has been significantly modified.

The first objective of the banking insolvency is to ensure the appropriate treatment of depositors. To facilitate a bulk transfer of accounts or prompt FSCS payments to eligible depositors, the BIP provides for a two-stage committee process.

In the first stage of the BIP, representatives from the Bank of England, FSA and the FSCS are obliged to form a liquidation committee until such time as the first objective is achieved.[127] In addition to giving consent (or otherwise) to certain proposed actions by the bank liquidator, the committee is required to make a 'full payment resolution' – that is, it resolves that, as far as practicable, it considers that the first objective had been achieved.[128]

Once this resolution has been made by the initial liquidation committee, the bank liquidator is obliged to call a meeting of creditors. At that meeting, among other matters, the creditors could resolve to elect new members to the liquidation committee. At this stage, representatives from the Bank of England and the FSA would be obliged to stand down from the committee, although the FSCS representative (as the largest of the failed bank's creditors) would have the option of remaining on the committee. However, it should be noted that the representatives of the Bank of England and the FSA would still be entitled to attend future meetings; as is already the case for the FSA in ordinary liquidation proceedings.[129]

Under clause 88(2) of the Bill, a meeting of the initial liquidation committee is able to conduct its business only when all of the members are present. Importantly for creditors and other stakeholders, the actions of this initial liquidation committee may be challenged in court under clause 88(3). It should also be noted that the bank liquidator is able to apply to the court for an order to deem that the committee has passed a full payment resolution or for directions where he believes that the first objective has been achieved but the liquidation committee is failing to act accordingly.[130]

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[127] Under clause 88(6) the Bank of England, the FSA or the FSCS may replace their representative on the initial liquidation committee at any time

[128] Clause 87

[129] Clause 88(7)

[130] Clause 88(4) and (5)

Committee to decide on how to pursue the first objective

The initial liquidation committee is required, under clause 89, to advise the bank liquidator as to whether to pursue a bulk transfer of accounts to another institution or to work with the FSCS to enable prompt payments to eligible depositors. The committee may also recommend that certain accounts be transferred while others paid out. In reaching that decision, the liquidation committee is required to "balance the need for quick action to achieve objective 1 with the general interests of creditors of the bank as a whole".[131]

There are certain safeguards: if the liquidation committee thinks the bank liquidator is failing to comply with their recommendations it can apply to the court for directions. The bank liquidator may also apply to the court for directions if the liquidation committee fails to make a recommendation as to how he should proceed to achieve the first objective.[132]

Where, in pursuit of the first statutory objective, the bank liquidator (acting on advice from the initial liquidation committee) arranges for the transfer of eligible depositors' accounts from the bank to another financial institution, clause 111 allows such contractual arrangement to override other contractual provisions or legislation. The purpose of this clause is to allow transfer arrangements (where feasible) to be put into place quickly for the benefit of all eligible depositors. In practice, this would mean that there would be no need for the bank liquidator to seek consent from all relevant customers agreeing to such a transfer. Again, there are safeguards: in making the contractual arrangement the bank liquidator must ensure (by agreement with the institution accepting the accounts) that eligible depositors will be able to remove money from transferred accounts as soon as is reasonably practicable after transfer.

f. Unique role of the FSCS

In order to pursue the first objective of the BIP, the bank liquidator is obliged to work with, and to provide information to, the FSCS.[133] Although it is clear from clause 110(6) that the FSCS can delegate functions to the bank liquidator.[134] The FSCS is also able to participate in court proceedings relating to a bank insolvency order.[135]

In order to facilitate rapid compensation payments to eligible depositors under the FSCS, clause 110(1) of the Bill is important. It specifies that compensation payments may be made or arranged by the FSCS rather than being funded from the assets of the failed bank. Alternatively, where a transfer of accounts to another financial institution is possible, and the costs of such a transfer would be lower than making the compensation payments, the provision enables the FSCS to make monies available to fund that transfer.

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[131] Banking Bill Explanatory Notes, Bill 147 - EN
[132] Clause 89(3)
[133] Clause 110(5)
[134] Under its power in section 221A of the *Financial Services and Markets Act 2000*
[135] Clause 110(4)

g. Termination of the bank insolvency process

Alternative exit routes from the BIP

On the completion of ordinary liquidation proceedings, the company is normally dissolved (i.e. it will cease to have legal existence). In exceptional circumstances, it may be possible under the IA 1986 to rescue a company in liquidation through administration or a company voluntary arrangement (CVA) where that would be in the best interests of its creditors as a whole. Very briefly, under an administration order a company which is in financial difficulty is put into the hands of an administrator. The administrator seeks either to rescue the company as a going concern or to achieve a better result for creditors from the realisation of assets than in an immediate liquidation. A CVA is a plan for re-organising the debts of a company that is put to its creditors and shareholders.

In certain circumstances, a failed bank may also be rescued under the Bill instead of being dissolved on completion of the bank insolvency, Clause 101 of the Bill provides for an alternative exit route from bank insolvency to an ordinary administration (under Schedule B1 to the IA 1986). There is also a provision to move the failed bank from the bank insolvency procedure to a CVA (under Part 1 of the IA 1986), provided that such a proposal is feasible and is acceptable to the requisite majority of the failed bank's creditors.[136]

A bank liquidator may therefore submit proposals to creditors for a CVA or apply to the court for the making of an administration order but both these steps are made subject to certain conditions; a key provision being that either all eligible depositors have received their compensation or that arrangements have been made with the FSCS with regard to any outstanding payments. In effect, alternative insolvency procedures may only be pursued once the first objective of the BIP has been achieved.

The Authorities readily acknowledge that in practice the most likely outcome for a failed bank on completion of the BIP is to be formally dissolved. Clauses 100 and 101 are included in the Bill just in case they could be used on rare occasions to serve the best interests of the creditors.

Dissolution of the company

Clauses 102 and 103 of the Bill allow for the dissolution of the company where the BIP has been completed and set out the conditions that must be met prior to dissolution.

h. Secondary legislation

The current insolvency regime under the IA 1986 is supplemented by the Insolvency Rules 1986. Whilst the same rules will be applied where possible to the new BIP (with any necessary modifications), the Authorities recognise that some new rules will also be required. Consequently, clause 112 amends section 411 of the IA 1986 to allow for this secondary legislation.

[136] Clause 100

D. Inter-bank payment systems

Part 5 of the Bill includes provisions affecting the inter-bank payment system. It should be stressed that, to date, there has been no evidence that existing systems have failed or are threats to future stability. The Authorities have, however, been working since early 2007 on developing a clearer and more robust framework for the oversight of payment systems, and one that takes into account the potential for systems' characteristics and importance to change over time, and for wholly new systems to be developed.

Given the link to both financial stability and consumer protection, the decision was taken to include these provisions as part of the package of proposals within the financial stability and depositor protection consultation paper.

Clause 170 gives the Treasury the power to designate an inter-bank system as a recognised system. Once recognised, the Bank’s formal powers of oversight would apply. Clause 171 sets out the criteria the Treasury must adopt before making a recognition order, namely they must judge if the system is so important to the financial markets that a breakdown would ’threaten the stability of, or confidence in, the UK financial system, or have serious consequences for business or other interests in the UK’.

Clauses 174 to 177 give the Bank powers to publish principles and codes of conduct; make directions to operators and require operators to make rules for the operation of systems. The Bank will have under the Bill escalating enforcement powers from penalties on the operators to forced closure of its system. Firms do have a right of appeal to the Financial Services and Markets Tribunal against sanctions imposed on them (clause 188).

E. Financial Services Compensation Scheme

1. Introduction

The Financial Services Compensation Scheme (FSCS) was created by Part XV of *FSMA* and has been operating since December 2001. It replaced five previous compensation schemes, including the Deposit Guarantee Scheme (which covered bank deposits); a similar scheme for building societies; the Policyholders Protection Board (which protected insurance policyholders) ; and the Investors Compensation Scheme (which protected customers of investment businesses authorised under the *Financial Services Act 1986*).

The underlying principle of the FSCS and of its predecessor schemes is that while financial institutions should generally be responsible for meeting their own liabilities, it is desirable to create a fund of last resort which can be called on to protect investors and depositors when an institution can no longer meets those liabilities.

As the first consultation document on establishing the FSCS noted, such a fund has benefits beyond investor protection and helps contribute to confidence in the financial services sector and to systemic stability:

> The provision of compensation to consumers where firms fail to meet their liabilities is integral to the protection of investors, depositors and policy-holders, and plays an important part in promoting confidence in financial institutions as well as in the financial system as a whole. The justification for establishing compensation schemes is that individual investors, depositors and policyholders are not generally in a position to make an informed assessment of the risk that the firm to which his or her funds are entrusted may fail. As well as providing protection in the last resort for consumers, the existence of compensation schemes also helps to reduce the systemic risk that a single failure of a financial firm may trigger a wider loss of confidence in the rest of the financial sector concerned (e.g. through a run on deposit-taking institutions).[137]

The most high profile changes to the scheme during the banking crisis has been the increases in maximum value of compensation. First from £31,700 to a £32,000 maximum compensation level, then to £35,000 and, currently, £50,000. The changes to the rules were done by way of changes to the Rule Book and hence are outside the Bill.[138] As allowed under *FSMA*, in times of emergency the FSA can make rule changes without the standard consultation process normally required under the Act. The new rules can be found in the Compensation section of the Redress part of the full FSA Handbook.[139] Changes proposed by the Bill reflect concerns about several aspects of the current scheme.

2. The scale of the scheme

The Bill is not concerned with the level of compensation per se. What it attempts is to make the scheme more fit for purpose at a time when the calls upon it are, potentially, far in excess of what was considered likely when the rules were established.

Figures for compensation claims paid in 2007/8 show that claims made on the 'accepting deposits' fund were £1.25 million arising from defaults of credit unions. On 7 October 2008 the parent of Icelandic banks operating in the UK, IceSave, and Heritable bank, was declared insolvent. Early estimates suggest that claims on these banks will be in the region of £3 billion. Clearly, the whole scale of the scheme has to be recalibrated for exceptional times. According to the January 2008 consultation document the FSCS "currently call upon a commercial loan facility of around £50 million".[140] This does not sound like a large sum in the context of some of the potential threats facing the UK's banking sector.

Income streams for the FSCS come from levies on the industry and recoveries from insolvent firms, if one needs therefore to provide for the possibility of increased payments then provision has to be made for increased contributions too. Put simply, industry groups contribute to their own scheme, so the banks pay into the bank deposit scheme. Separate schemes exist for the securities market and for the insurance industry.

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137 Financial Services Authority, *Consumer compensation*, CP5, December 1997
138 Library Standard note SN/BT/4466 has full details on the FSCS.
139 Specifically Comp 10.2 http://fsahandbook.info/FSA/html/handbook/COMP/10/2
140 TPA, Cm 7308 pp5.51

3. Timeliness of payment

The consultation document also addressed the issue of the timeliness of payment and set out an aspiration that payments should be made "within one week of a bank closing".[141] As has been said already, the FSCS was established at a time when the thought of a major depositor becoming insolvent was very much not on the 'radar'. As the document says:

> The FSCS normally processes deposit claims in relation to relatively small deposit taking firms within one month...more time would be needed in a complex failure involving a high volume of claims and depositors could be left without access to their funds for several months.[142]

After receiving responses the TPA amended their aspiration for full payment in seven days to "access to at least a proportion of their funds, and the balance within the following few days, consistent with the aim of minimising disruption for depositors".[143] Measures to achieve this 'demanding' deadline include:

- Enabling the FSA to collect the data the FSCS needs before default
- Ensuring that there are no barriers to the Bank of England, once resolution is invoked, being able to collect and share with the FSCS relevant information on the bank in question.
- Giving the FSA the power to make new rules to specify the circumstances in which consumers need to make a formal claim to the FSCS before receiving a compensation payment and to allow for the automatic conferral of rights on the FSCS to make recoveries in place of claimants.

These matters are set out in clauses 160 and 163 of the Bill. Clause 160 sets out new streamlined procedures; clause 163 even permits genuine errors in payments to be written off against future levies buy the FSCS, thus encouraging the speedy settlement of claims.

Two other (non legislative) proposals were made. First, the payment of claims on a gross basis. Currently claims are paid on a net basis, i.e., after any loans held with the failed bank have been accounted for. Clearly this slows the payment of claims.[144] Second, the TPA will work with the industry and the Payments Council to establish how large numbers of new accounts in other banks can be opened quickly.[145]

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[141] Ibid pp5.19
[142] Ibid pp5.18
[143] TPA Cm 7436 pp5.18
[144] Ibid pp5.35
[145] Ibid pp5.41

4. Funding

The FSCS is chiefly funded on a 'pay as you go' basis. The fund, as currently set up is simply inadequate to meet possible claims following the failure of a large bank. Clause 156 allows the FSCS to establish contingency funds drawn from levies on the industry. Clause 157 extends the responsibility of the scheme to meeting the expenses of the SRR in cases where but for the SRR a bank would have failed and hence burdened the FSCS. Both clauses give the Treasury wide ranging powers to make regulations giving effect to these intentions. The Bill also allows (clause 159) the National Loans Fund to lend to the FSCS. These loans will have to be repaid, with interest charged at appropriate market rates, out of future levies on the industry, as well as from the share of recoveries from the estate of the failed bank that accrue to the FSCS. There was 'widespread support' for this proposal. Acceptance of National Loans Fund finance introduces considerations common to most public money decisions:

> From the perspective of public financial management, it is necessary, before the National Loans Fund can lend, to provide a suitable assurance that the borrowing will be repaid in full and to ensure that these financial arrangements would not involve any subsidy to the levy payers. Pre-funding would also raise the possibility of a significant gap between the collection of the levies and the costs being incurred.
>
> The Government therefore proposes to use the forthcoming legislation to ensure that borrowing from the National Loans Fund will be repaid and to enable the Treasury to make regulations, if necessary, regarding FSCS pre-funding, including powers to regulate the building up and investment of funds (which it is intended would be deposited with the National Loans Fund), when funds would be used and the levy payers who would contribute. The regulations would be subject to Parliamentary approval under the affirmative resolution procedure.[146]

A more contentious issue was whether the FSCS should substantially increase its pre-funded element. This was not popular with the industry for obvious reasons. It would represent a permanent loss of income earning assets and banks are currently not looking for ways to reduce their capital: this is the rainy day and they see no reason to start saving for the next one now. The Government, however, sees advantages in such a system:

> The Authorities continue to believe that there could be benefits from introducing pre-funding in a proportionate way. While borrowing from the National Loans Fund will allow the cash flow impact of payout on FSCS levy payers to be spread over a longer period of time following a failure, pre-funding would allow part of the impact to be spread over the period before any failure as well. This could reduce the pro-cyclicality of levy payments in the current arrangements – that is the imposition of levies on banks after another bank has failed, when confidence may be low and other banks may also be under financial stress. Pre-funding could also reduce the risk of contagion – the risk that levy demands could weaken the position of some

[146] Ibid pp5.62

> other banks to such an extent that the probability of their failing was materially increased.[147]

When the proposal was first launched there was a range of views. Comments made during a Treasury Committee hearing were reported in a Financial Times article:

> Banks should pay up front to build a multi-billion pound fund that would help compensate depositors quickly when an institution failed, Mervyn King told MPs yesterday.
>
> The Bank of England governor's comments come as many banks struggle to rebuild their balance sheets, making ministers wary of forcing the industry to pay into a pre-funded pool of assets that would help meet the costs of dealing with future banking failures and guaranteeing savers' deposits.
>
> Kitty Ussher, economic secretary to the Treasury, said legislation would include power to pre-fund compensation payments, but would only be used if there were a "market consensus".
>
> But Mr King wants the government to toughen this position before it finalises plans for banking reform. He said banks should contribute on a scale that would build a fund of "many billions" over 10 years, paying more if they had riskier business models.
>
> Although no one was suggesting seeking large sums now, or expecting to rely on pre-funding, he said that "if you wait until there is a problem, that's a pretty bad time to ask banks to put up a large amount of money".
>
> Angela Knight, chief executive of the British Bankers Association, questioned Mr King's proposal for "risky" banks to pay more into the fund. "How is riskiness assessed? Are big institutions classed as risky because they have a large number of customers even though they are well capitalised? Or are smaller banks regarded as riskier even though they have fewer customers."[148]

On the basis of these conflicting views the Government decided to adopt something of a halfway house. The legislation allows the Government "to introduce pre-funding of the FSCS if it was considered appropriate to do so in the future".[149]

F. Strengthening the role of the Bank of England

It has been commented on at length, in the Treasury Committee Report for example, that the Bank of England (the Bank) should have a greater role at the heart of the regulation of the financial system. As the sole issuer of sterling, the Bank cannot be anything but at the centre of the management of liquidity in the markets. But, the Treasury Committee commented, "the Bank appeared to have responsibilities but without power" in relation to the financial crisis of 2007.[150]

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[147] Ibid pp5.54
[148] *Banks should pay upfront into emergency failure fund,* Financial Times, 23 July 2008
[149] Ibid pp5.57
[150] *Banking Reform*, Treasury Committee 17th Report 2007-08, HC1008,pp173

The Committee made several recommendations. In a letter of 19 June 2008, in response to these, the Chancellor accepted "the two basic propositions" of our Report—"that new powers in relation to financial stability, including the special resolution regime, should be conferred on the Bank of England, and that the governance framework needs adjusting to reflect this change"[151]

Commentary in the Press portrayed a 'tussle' between the Bank and the Treasury over the future direction and role of the Bank for maintaining financial stability. The article below illustrates the course of the debate:

> Mr Darling wants City insiders to sit at the shoulder of Mervyn King, the Bank's governor, as part of an overhaul designed to put financial stability "right at the front" of its operations.
>
> While Mr King is not expected to welcome such oversight, there were signs last night that it could be a quid pro quo for him winning a tussle with the Treasury over the choice of a new deputy governor for monetary policy to replace Rachel Lomax.
>
> Mr King has argued strongly that she should be replaced by Charles Bean, the Bank's chief economist, on the grounds that a deputy with a strong monetary policy background is needed to lead the fight against inflation. Some Treasury officials, mindful of the Bank's weakness on financial stability issues, have been promoting the claim of the head of markets, Paul Tucker.
>
> Although Mr Darling has made it a priority to beef up the Bank's financial stability expertise, Treasury officials said they now expected the chancellor to back Mr Bean for the job. Threadneedle Street appeared content with the direction the appointment seemed to be heading.
>
> In return, the chancellor will demand that the Bank accepts more external advice on City issues and formal oversight of its decisions on financial stability.
>
> This will feed in to both the governor and Sir John Gieve, the deputy governor for financial stability, and reflects a considerable departure from the Treasury's initially limited plans for reform of the Bank's role in financial stability, set out in January.
>
> Mr Darling told the Commons yesterday "we should learn from the example of the monetary policy committee", where outside experts were drawn in to help in making interest rate decisions. He said there should be "a similar approach in relation to financial stability so that we can bring in outside expertise to advise the governor and of course the appropriate deputy governor".
>
> […]
>
> Bank officials said the advisers could take more of a governance role. But it is unclear how the Treasury intends to find panel members who are credible yet have no conflicts of interest.[152]

[151] Ibid pp171
[152] *City panel to oversee Bank,* Financial Times, 6 June 2008

Days later, Sir John Gieve resigned (being given the option of leaving or applying for the new job on a five year term). Charles Bean was appointed Deputy Governor. The debate amongst the TPA about new roles was clearly robust and different views emerged as to what the real impact will be. Writing after the Chancellor's Mansion House speech the Financial Times noted:

> Bank officials privately claim Mr King had succeeded in watering down Mr Darling's plans for a powerful financial stability committee, arguing that it would have little more clout than the obscure "transactions committee" set up at the Bank after the Northern Rock affair.
>
> Some in the Bank feared Mr Darling might create a powerful new external committee of eminent City figures rather than a body drawn from non-executive directors on the Bank's governing Court. The Treasury denies having that intention.
>
> Finally Mr Darling has accepted the need for the Bank to take "a leading role in dealing with failing banks", recognising Mr King's insistence that it - rather than the Financial Services Authority - should be in the box seat in tackling Rock-style meltdowns.
>
> […]

But,

> Mr Darling's supporters dismiss suggestions from Threadneedle Street that Mr King and his colleagues can wield new powers over failing banks, and the statutory role to maintain financial stability, without a significantly increased level of external scrutiny.
>
> Indeed, for the Treasury and the FSA a key part of the reform is the need to rein in Mr King's power to take operational decisions in financial stability matters and to raise the status of other voices, often within the Bank.
>
> They argue that the FSC will be open and transparent, ensuring Mr King has fully to explain the Bank's actions, which will be subject to closer parliamentary scrutiny.
>
> The committee will be bolstered by newly recruited City experts sitting on a streamlined Bank Court; its remit will be set out in a regular exchange of letters between the Bank and the treasury.
>
> The Bank was at pains yesterday to stress that negotiations with the Treasury about the new FSC had been cordial, but placed a different emphasis on the significance of the new body to that presented by Mr Darling's team. Mr King was annoyed by Mr Darling's suggestion that he needed to be told how to do his job by external City experts.
>
> But the chancellor bridles at suggestions the FSC is simply a rebranded version of an existing Bank sub-committee. One supporter said: "Who has even heard of this transactions committee?"
>
> Meanwhile, Mr Darling argues that his plan to give the Bank a bigger role in the "special resolution regime" for failing banks is an evolution of thinking set out in a January consultation paper and not a U-turn.

> However, the Bank's role was barely mentioned in this context by Mr Darling in an FT interview on January 4 when he said: "What I want to do is give the FSA the power it needs."[153]

Another article on the same day expressed doubt over the extent to which the reforms would change practice:

> The new financial stability committee of the Bank's Court will scrutinise its work, but this will replace an existing "transactions sub-committee" that was quietly established after the Northern Rock fiasco to keep an eye on liquidity support operations.
>
> In other words, some of the measures look as if they may serve simply to formalise current practice. What will really matter are the details - many still to be decided - of new powers for the Bank and the Financial Services Authority to improve co-ordination, strengthen the system against future crises and deal with failing banks if problems re-emerge. How is this going to help prevent another Northern Rock fiasco? One lesson of the run on Northern Rock was that no one would trust an institution seen to be seeking emergency support to remain solvent. So the Treasury may now change disclosure rules to allow the Bank to mount rescue operations covertly.[154]

The role of the Bank with respect to the SRR procedures has been outlined above. The June consultation document set out a series of reforms.

1. Statutory responsibility for the maintenance of financial stability within the UK.

This will be a high level objective, ensuring that the Bank has the flexibility it needs in meeting the objective. Reflecting the complexity of the task the Government does not intend to set a specific financial stability target for the Bank. This is set out in clause 216 of the Bill and amends the *1998 Bank of England Act*. Flowing from this duty are additional means for the Bank to meet it.

- Providing the Bank with statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and other central bank functions.
- Providing a formal role for the Bank in the oversight of payment systems. The Treasury will have an initial role in recognizing and approving interbank payment systems (Part 5 of the Bill)

Two measures proposed in the Bill reduce the transparency of Bank support for banks:

- Removal of the requirement (under the *Bank Charter Act 1844*) for the Bank to publish a Weekly Return. This document came to prominence during the support

[153] *King in the box seat as deputy's final act steals Darling's thunder,* Financial Times, 20 June 2008
[154] *Reform may be less radical than Treasury implies,* Financial Times, 20 June 2008

effort for Northern Rock. It allowed journalists amongst others to estimate the scale of Bank support for the bank. This is set out in clause 223.

- Banks that provide charges (security) against support from the Bank will not have to disclose these charges at Companies House. This is set out in clause 230.

Additionally the Government will introduce secondary legislation, to amend the *Settlement Finality Regulations 1999* (SI1990/2979) to ensure that collateral provided to the central bank in connection with its functions may be realised more effectively and, the FSA intends to consult on the application of the Disclosure and Transparency Rules to clarify that an issuer in receipt of liquidity support from a central bank may have a legitimate interest to delay disclosure of that fact.

2. Structural changes

The Bill makes changes to the structure and organisation of the Bank to reflect its new statutory duties. The main change is the establishment (by clause 216) of a new sub-committee of the Bank's court of Directors to be called the Financial Stability Committee. The committee will be chaired by the Governor and consist of two Deputy Governors and four other directors. There will be a Treasury representative on the Committee and it will also be able to co-opt outside experts to help with its work.

Its ongoing work will be to advise, and make recommendations to, the Court regarding the Bank's financial stability strategy. It will also provide advice to the Bank in cases where the Bank has invoked one or other of the SRR procedures. A consequence of the new Committee is that the court of the Bank will be reduced from nineteen to twelve members. These changes are set out in clauses 216 and 217 of the Bill.

As a consequence of the changes affecting the role and structure of the Bank, the Memorandum of Understanding, which provides the working basis for the relationships amongst the Tripartite Authorities will be changed.

G. Bank notes

Part 6 of the Bill sets out proposals to change the asset backing arrangements and regulation of the issuers of Scottish and Northern Ireland banknotes.

Although presented as part of a package of reforms designed to deal with a banking crisis it should be pointed out that Treasury plans "to strengthen and modernize" the arrangements for bank note issue predates the current crisis. In July 2005 the Treasury issued a consultation document *Banknote issue arrangements in Scotland and Northern Ireland*.[155] The purpose of which was:

> to strengthen the regulatory framework, including the transfer of administrative responsibilities from the Commissioners for Revenue and Customs to the Bank of England. The Bank has the appropriate expertise, skills and knowledge to be able

[155] *Banknote issue arrangements in Scotland and Northern Ireland*, HM Treasury, July 2005, available at http://www.hm-treasury.gov.uk/d/banknote_issue_arrangements_210705.pdf

> to discharge these responsibilities effectively. The responsibilities would fit well with the Bank's core purpose of ensuring monetary stability, which involves maintaining confidence in the value and integrity of the currency. The transfer would also enable the Commissioners to focus fully on those areas that are core to their own objectives, notably the administration of stamp taxes.
>
> Treasury's proposals to protect note holders by earmarking the note-covering assets required by the 1845 Acts of Parliament so that they are held for the benefit of note holders. This would ensure that, in the unlikely event of an issuing bank becoming insolvent, note holders would be able to receive value for their notes from these assets.[156]

Reaction to the proposals focussed on the net benefit to the Treasury of approximately £80 million with the Scottish banks very critical of the proposals – *Banks push to end threat to Scottish notes* was a Scotland on Sunday headline.[157] The clauses in the current Bill (Part 6 of the Bill) largely resurrect the 2005 proposals which never moved beyond the consultation stage. The proposals re-emerged in the January 2008 consultation document as 'compensation and consumer protection' measures. The benefits of the proposal were summed up in the impact assessment of that document:

> There would be enhanced protection for holders of Scotland and Northern Ireland banknotes, as creditors, in insolvency.
>
> - Requiring banknote issuing banks to hold sufficient and appropriate covering assets at all times would result in additional seigniorage income being realised by the Exchequer rather than by commercial issuing banks (estimated to be £100 million per annum (a sum contested by the Treasury)). This would remove an unintended financial advantage that commercial banknote issuing banks currently gain over non-issuing banks.
> - Regulatory responsibility would be assumed by the Bank of England, in line with its role in maintaining confidence in the value and integrity of currency throughout the United Kingdom and its expertise in banknote issuance.
> - There would be a small resource saving to HM Revenue and Customs, whose historical administrative function in relation to commercial bank banknote issuance is no longer core to its objectives.
> - Abolition of the 'funds attached rule' in Scottish law, insofar as it relates to cheques, would remove an administrative cost for clearing banks in Scotland and would reduce associated expense and inconvenience for the banks' customers.[158]

It should be emphasised that the increased security would be for holders of physical Scottish and Irish notes, *not* the underlying deposits which would be protected in the normal way through the FSCS.

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[156] Ibid pp1.5-1.6
[157] Scotland on Sunday, 8 September 2005
[158] TPA, Cm 7436, 1, July 2008, A.247

The revised proposals in the June 2008 consultation and the clauses in the Bill reflect a compromise. No less than 60% of notes in circulation are to be backed by Bank of England notes and/or current UK coin. The remainder, together with notes with the potential to enter circulation, are to be backed by way of an interest-bearing account at the Bank.

The Bill repeals and replaces the existing legislation (the Bank Notes (Scotland) Act 1845, the Bankers (Ireland) Act 1845 and the Bankers (Northern Ireland) Act 1928). The key points are (clauses 198 and 199) that only existing issuers may continue to issue notes; (clause 205) if an issuing bank ceases to do so the right may not be revived; (clause 203) notes must have 'backing assets'; and (clause 201) requires the Treasury to bring forward in secondary legislation 'banknote regulations' which will cover the detailed rules of issuance. The regulations may (under clause 203) make provisions for the ring fencing of backing assets in the case of the insolvency of an issuing bank.

V Reaction to the Bill

It is a measure of the pace of events that reaction to the Bill's publication has been virtually drowned by other events. With publication of the Bill coinciding with a 40% fall in a bank's share price in one day; mounting evidence of severe 'real economy' problem; the collapse of two banks with depositors in the UK; and speculation about the Government's plan to 'bail out' the financial system (announced the day after publication), the Bill merited not a single mention in any of the serious newspapers.

The fact that most of its contents have been extensively trailed in the consultation documents too has reduced comment. The British Bankers' Association has not officially commented on the final Bill although it did publish a detailed letter in response to the two June consultation documents. This can be found here. As was mentioned above, their main reservations were to do with partial transfers of banks and the rights of creditors. The Chief Executive, Angela Knight, concludes in her letter:

> We therefore see an imperative need for the Government to give further time for consideration of the partial transfer arrangements under the SRR and believe that these provisions should be stripped out of the primary legislation to be introduced into Parliament in October and placed on a different timetable. Failing this, we see no alternative other than the Government obtaining more time to work through these critical issues by seeking an extension to the temporary powers obtained under the Banking (Special Provisions) Act 2008.[159]

[159] BBA Response to consultation documents, July 2008 available at: http://www.bba.org.uk/content/1/c6/01/45/18/15th_Sept_letter_to_Chancellor.pdf