



Financial stability and depositor protection:

- ***Further consultation***
- ***Special resolution regime***

Consultations by Bank of England, HM Treasury, and the Financial Services Authority

Response by the Building Societies Association

Introduction

1. The Building Societies Association (BSA) represents all 59 building societies in the United Kingdom. Building societies have total assets of over £360 billion and, together with their subsidiaries, hold residential mortgages of £250 billion, more than 20% of the total outstanding in the UK. Societies hold about £230 billion of retail deposits, accounting for more than 20% of all such deposits in the UK. Building societies also account for about 38% of all cash ISA balances. Building societies employ over 51,500 full and part-time staff and operate through more than 2,000 branches.

2. This paper provides the BSA's response to the two, closely related, joint consultations published by the Bank of England, HM Treasury, and the Financial Services Authority (the Authorities) in July 2008; namely –

- *Financial stability and depositor protection: further consultation (CP1), and*
- *Financial stability and depositor protection: special resolution regime (CP 2)*

which together contain further proposals for strengthening the current framework for financial stability and depositor protection. There is an executive summary in paragraph 6 below.

3. We are also considering FSA CP 08/13 *Disclosure of liquidity support*, and await the forthcoming FSA consultations on –

- the Financial Services Compensation Scheme (FSCS)
- stress testing, and
- additional information required from banks

which form further elements of the latest round of consultations relating to financial stability. The BSA will respond separately to these FSA consultations. The Association is in regular contact with HM Treasury, the Bank of England and the FSA on all relevant matters.

4. The Association provided a detailed response to the earlier consultation, *Financial stability and depositor protection: strengthening the framework* (the January consultation) www.bsa.org.uk/docs/general/financial_stabilityresponse.pdf. Rather than repeating detailed text, much of this paper briefly cross-refers to or summarises important aspects of, our earlier response where relevant. We have answered most of the specific questions in the appropriate sections of our response, except where the BSA or our sector has no particular expertise (eg question 4.1 concerning investment banks).

Background

5. CP1 summarises events since the January consultation and re-iterates the Authorities' five key objectives (paragraph 1.22) concerning stability of the UK financial system, addressing the risks of banks getting into financial difficulties, effective compensation arrangements, and the operation of the Authorities. The Association supports the objectives in principle but, in our response to the January consultation, we –

- Cautioned against hurried changes, especially those of an extensive nature or dealing with complicated matters, and risking unintended consequences.
- Suggested that it was very important that the FSA did not mechanistically impose particular 'solutions', advising that an appropriate degree of individual firm discretion should be maintained during this period of uncertainty.
- Noted that, however many procedures were put in place, there was unlikely to be a serious regulatory bulwark against financial instability unless the Authorities were fully committed in practice to carrying out their *existing* functions effectively.
- Supported most of the CP's proposals, but viewed it as important that any changes did not have a disproportionate effect on smaller institutions; for example, if smaller firms had to bear the costs of changes without benefiting from them.
- Saw no substantial case currently made for certain radical changes, notably the introduction of a special resolution regime or pre-funding of the FSCS.

Summary of BSA Response to the latest Consultations

6. By far the most important aspect of the CPs is the section entitled 'reducing the risk of bank failure', which is predicated upon the two things – the need for sound business plans and effective regulation – nearly everything else being consulted upon, while no doubt important, is essentially to do with damage limitation: prevention is far more effective, as the Northern Rock collapse demonstrated. The BSA strongly opposes pre-funding of the FSCS (see paragraph 89 below). A general, but important point, is that firms that (because of their small size) are unlikely ever to need recourse to the new 'rescue' mechanisms being established, should not be required to put in place stringent, and disproportionate, record keeping systems. The key points in this response are as follows; the BSA –

- Sees the benefit, in principle, of the range of prudent initiatives being undertaken by the UK and international authorities in relation to the stability and resilience of the financial system (see paragraphs 7 – 11 below).
- Considers prevention to be much more effective than cure – the keys to preventing further serious problems are (i) sound business plans and (ii) effective regulation (the two elements absent from the Northern Rock crisis) – nearly everything else is damage limitation (paragraphs 12 – 21).
- Welcomes the main elements of FSA’s supervisory enhancement programme, but cannot understand why more staff are needed (paragraph 19).
- Broadly welcomes the new arrangements to facilitate liquidity support and liquidity disclosure (paragraphs 22 – 26).
- Agrees with the decision that the Bank of England should exercise increased oversight through a more formal role in relation to UK payment systems (paragraphs 27 – 35).
- Believes it to be imperative that the special resolution regime is proportionate, targeted and used as a last resort. Unfortunately there are several outstanding uncertainties (paragraphs 36 – 39).
- Generally supports the proposed arrangements for the special resolution regime, but opposes the use of a code of practice because this could create uncertainty in an area where there is no room for doubt and is concerned that UK arrangements should not be so excessively rigorous, when compared to other countries, that UK competitiveness is affected (paragraphs 40 – 63).
- Supports the proposal that SRR arrangements for a failed bank should apply to a failed building society, subject only to necessary differences to take account of the distinct corporate arrangements of a plc bank and a mutual building society and that the new arrangements should not prejudice existing tools eg section 42B Building Societies Act 1986 (paragraphs 64 – 76).
- Acknowledges that the Authorities are moving towards a £50,000 Financial Services Compensation Scheme limit regarding deposit-taking and provides some additional comments on this matter (paragraphs 77 – 79)
- Urges the Authorities to give full consideration to the information that consumers should, on a consistent basis across the industry, be given about the Financial Services Compensation Scheme (paragraphs 80 – 81)
- Supports all proportionate, practicable endeavours to reduce the current period for payments from the Financial Services Compensation Scheme (paragraphs 83 – 88).

- Strongly opposes pre-funding of the Financial Services Compensation Scheme (paragraph 89).
- Broadly welcomes measures to improve coordination among the Authorities (paragraphs 93 - 94).

Stability and Resilience of the Financial System

7. CP1 asks no questions under this heading. It outlines the Government's, and the international, policy response to recent events, and considers associated matters such as capital requirements, liquidity management, compensation structures, risk management, valuation, credit ratings etc.

8. The Association supports in principle the range of prudent measures being undertaken by the UK and international authorities, such as –

- The Financial Stability Forum's recommendations regarding firms' transparency of risk exposures, write-downs, and fair value; steps to improve accounting and disclosure standards; improved transparency in various areas; risk management practices, the practices of credit rating agencies; strengthening of prudential oversight, better international co-operation etc (summarised in paragraph 2.26 of CP1).
- The FSA's forthcoming examination of liquidity management (as noted above, we are currently considering FSA CP 08/13 *Disclosure of liquidity support*).

9. It is to be hoped that these initiatives lead to targeted, proportionate solutions that do not cause unintended adverse consequences in the market. International cooperation is welcome because it reduces the risk of the UK adopting a super-equivalent position that, unless carefully calibrated to specific, different domestic circumstances, could undermine the UK's competitive position.

10. Paragraph 2.53 highlights the problem of lack of transparency regarding who carries the risk in off-balance sheet vehicles on assets based securities. While we acknowledge this particular risk, there was no lack of transparency about Northern Rock's flawed business plan that allowed it to be so highly exposed to the wholesale markets – the Board knew and should not have let it happen – the FSA should have known and should have taken prompt and effective action.

11. While all relevant matters need to be examined, we should not get bogged down in too many technical details and miss the wood for the trees – ie the fundamental causes of Northern Rock's difficulties, which were fundamentally quite straightforward (see below).

Reducing the Likelihood of Bank Failure

12. This chapter considers ways of reducing the likelihood of a bank failing and focuses on improving current regulatory arrangements, liquidity assistance, and oversight of payment systems.

(a) **The importance of regulation**

13. Paragraph 3.1 of chapter 3 of CP1 states –

“The primary responsibility for the conduct, success or failure of any deposit-taker (for simplicity “banks”) rests with the management of the firm. This responsibility is undertaken within a framework of regulation and supervision, designed to address market failures, protect consumers, and prevent problems that pose systemic risks to the wider economy. **Effective principles- and risk- based regulation is therefore fundamental,** and is the primary means the Authorities have to reduce the likelihood of failure.”

14. The Association agrees with the above statement. The passages in bold (our emphasis) in particular underline the existence of two things (‘the key facts’), the absence of which is likely to lead to a major financial problem, as was the case with Northern Rock–

- (i) a sound business plan on the part of a firm of significant size, that does not expose that firm to unreasonable risk (although we understand that even soundly run firms can be affected, for example, by much wider losses of confidence)
- (ii) efficient and effective supervision and regulation of the firm¹.

It is important to credit these key facts with their due, indeed fundamental, importance and not lose sight of them in the continuing plethora of discussions, consultation, legislation and practical work. Everything else under discussion is peripheral or ancillary.

15. Other relevant matters should, of course, be considered and sensible changes should be made. It is absolutely right to re-examine the arrangements for dealing with the aftermath of a business collapse more effectively, including how the Authorities themselves can act more efficiently, decisively and with greater coordination than was displayed in relation to Northern Rock.

16. *However*, it is worth asking - when considering each option or proposal –

“Would this have made any difference – ie would it help *prevent* an equivalent problem happening again?”

Prevention is better – and usually much easier and more effective – than cure. None of the foregoing disregards the strong possibility that, if a further problem emerges, it is likely to be different from Northern Rock.

17. Similarly, we believe that the Government and the Authorities must be very careful not to introduce new measures, which are no more than ancillary to the key facts but that, while they might be potentially useful in certain – damage limitation - respects, risk unintended and detrimental consequences that could outweigh their utility. Accordingly, we welcome CP2, which goes into more detail on the special rescue regime (SRR) – see below.

18. We also welcome the FSA’s supervisory enhancement programme, the main features set out in paragraph 3.5, especially the increased direct involvement of FSA senior management in

the supervisory process, the supervisory focus on high-impact firms, improvement of staff quality and retention, and extra emphasis on assessing the competence of firms' senior management.

19. However, we do not see why more FSA staff are needed – the fundamental problem with the supervision of Northern Rock, judging eg from its own internal audit report, appears to have been the failures of existing staff to do their jobs properly or, even, at all – not a shortage in their numbers. While we understand why there will be more focus on liquidity, we would caution against placing insufficient emphasis on other risks.

20. Paragraphs 3.9 – 3.14 summarise the additional powers that the Government will give the FSA in respect of information from firms and market abuse. While we have no objections to this in principle, we remind the authorities that the January consultation stated –

"The interventions and powers that are already available to the FSA are wide-ranging. In order to support the reforms outlined in this document the Authorities judge that the FSA requires a small number of additional powers." (Paragraph 3.13)

21. In conclusion on this particular aspect of CP 1, the key regulatory requirement, if a further Northern Rock-type situation is to be averted, is for the FSA to exercise its powers effectively. Having a wide range of powers that are exercised ineffectively is inferior to having a leaner, smarter set of powers that a regulator exercises competently and in good time. Therefore, there should be clarity and transparency about why the FSA needs the new powers and, in due course, about the extent and effectiveness of their use.

(b) Liquidity support arrangements

22. We broadly welcome the proposed new arrangements to facilitate liquidity support and liquidity disclosure. Enhanced liquidity support from the Bank is fundamental to consumer confidence in the financial system.

23. We also welcome the changes in respect of building society arrangements referred to in paragraphs 3.19 -3.20 (removal of barriers to receiving liquidity and changes and the power to grant floating charges to the Bank). We believe that the Authorities should retain sufficient flexibility to help ensure that building societies were not constrained unreasonably in respect of the granting of floating charges because, for example, of requirements regarding the operation of payments or settlements systems.

Question 3.1 – The Authorities are seeking views from respondents on the extent that contractual provisions, such as those set out above may prevent the Authorities from taking appropriate action; and the merits of the two approaches set out above.

24. This is a proposal that could have a very significant impact on third party property rights, the conditions for granting and pricing of liquidity, and the wider UK economy; for example, would the new arrangements make the UK less attractive to investors?

25. Our member building societies are subject to statutory nature limits, which restrict the amount of funds that can be obtained from non-retail sources. Therefore, they would probably

be less affected, proportionately, than banks by the proposal. Nonetheless, for the reasons given above we believe that, if any statutory override or non-statutory mechanism is introduced, the Authorities must be absolutely clear about –

- which types of contractual provision are affected, including those indirectly affected
- precisely how they are affected, eg will they be completely void or continue to be effective in certain circumstances,
- whether contractual provisions will be affected retrospectively, or will only those entered into after the new legislation comes into force be affected, and
- what the impacts will be on the willingness of counterparties to lend, having lost this contractual safeguard.

26. Have the Authorities researched what relevant powers exist in foreign jurisdictions, as they have researched SRR-type arrangements (pages 61 – 2 of CP1)? Of all the proposals in the CPs, the ‘ousting provisions’ proposal seems to be one where the case for EU-wide or internationally agreed arrangements is particularly strong.

(c) Oversight of payment systems

27. The BSA agrees with the decision for the Bank of England to exercise oversight through a more formal role in relation to UK payment systems. The Authorities must, of course, guard against the risk of disruption to the system leading to systemic problems. A key to this is to have one of the Authorities exercising overall control of oversight – to split such a function would cause confusion.

28. We concur with the majority of those responding to the January paper who (see paragraph 3.38) favoured the Bank of England having this responsibility. There are strong reasons for this - it already has an informal oversight function, it averts any splitting of responsibility, and links to the Bank’s statutory objective of financial stability.

29. The BSA supports the key elements of the Bank of England’s proposed role, as described in paragraph 3.41. It is important, in due course, to have a further discussion with the most relevant agencies about precisely which systems are the “payment systems that are systemically or of system-wide importance.” because, once identified, steps might be taken – if possible and practicable - to improve their resilience. Therefore, we welcome the confirmation, in paragraph 3.49, that the matter will be subject to consultation.

30. We agree with the conclusion, set out in paragraph 3.46, that a fundamental criterion is that the process must be of systemic, or system-wide, importance in order to fall into the Bank’s remit.

31. The rest of chapter 3 examines in more detail how the framework might work, including the recognition process and the Bank of England’s principles and powers.

Question 3.2 – Are the criteria as set out, the right criteria and will they provide sufficient flexibility as payment systems evolve over time?

32. We believe that the criteria for recognition need to be proportionate and clear, and that the criteria (set out in paragraph 3.44) are broadly correct, and sufficiently flexible. A couple of points –

- *“the number and value of the transactions that the system presently processes or is likely to process”*

Presumably this will also include the number, and type, of organisations that use the relevant system. It is important, for example, for smaller firms that use systems also used by large firms, to be kept informed of potential implications, if any, for their businesses flowing from the identification of the process as ‘systemic’.

- *“whether the transactions can be handled by other systems”*

No doubt this will encompass a study of how quickly, or - more to the point – how *slowly* the relevant processes could be transferred to other systems, if at all.

Question 3.3 – Is there a preferred method for recognising payment systems?

33. We do not have specific expertise on this subject, which is mainly a matter for organisations responsible for payments systems – notably, APACS - but the recognition process described in paragraph 3.42 seems appropriate in terms of responsibility and transparency.

Question 3.4 – Do you agree that the indicative list in paragraph 3.48 includes all the relevant payment systems which are of systemic-wide importance?

34. We agree with the Authorities’ preliminary assessment that systems such as CHAPS, BACS, Cheque and Credit Clearing, the Faster Payments Service, the Link Scheme, Euroclear UK and Ireland, and LCH.Cleartnet Ltd are recognised systems. We note, and think we understand why, cards would not be covered (although this is not fully spelt out in CP 1). While the BSA certainly would not support regulatory overkill, are the Authorities certain that current arrangements are adequate to cover cards and that relevant systems relating to cards – especially, perhaps, debit cards - are sufficiently discrete to justify their omission from recognition?

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

35. On the face of it yes, but we believe that the Bank –

- should make requests for information on matters only where it reasonably believes the information would be material to its wider oversight function, and be transparent about how it was used, and

- should exercise all of its other related functions in a proportionate and focused way eg adoption of Core Principles into its own principles and code of practice (if any); in imposing censure, penalties and disqualification etc.

However, these matters will no doubt be included in the forthcoming consultation.

Reducing the Impact of a Failing Bank

36. At this point, we respond to both CP1 and CP2, since each deals with the proposed ‘special resolution regime’ (SRR) –

- Chapter 4 of **CP1** outlines, at a high level, the authorities’ proposals for the SRR, proposals for applying SRR tools to building societies, and considers certain related matters. Key proposed tools are a –
 - transfer of part or all of a failing bank to a private sector third party, or to a publicly-controlled bridge bank
 - new bank insolvency procedure
 - power to take a bank into temporary public ownership
 - the existing option to support these tools by providing financial support to a failing bank through funding or the provision of guarantees.
- **CP 2** sets out specific proposals for the SRR, including draft legislative clauses.

(a) CP 1 (Further consultation)

37. The Association agrees with the Authorities that the wide range of tools and powers available to them should usually be sufficient to resolve a serious problem, even if a bank was unlikely to survive. The proposed SRR regime is intended to be applicable to the small number of cases where those existing mechanisms prove insufficient or are inadequately applied.

38. We further acknowledge that current insolvency procedures are not designed to deal with the kind of bank failure experienced in relation to a Northern Rock-type episode. We also recognise that the existence of the SRR at the time of the Northern Rock crisis might have accelerated the process of reaching a resolution. But, with better coordination, an earlier resolution might have been achieved anyway.

39. Now that the Government has decided to legislate to introduce the SRR it is, in our view, imperative that –

- a proportionate, targeted approach is taken towards effective SRR arrangements
- a concerted effort is made to minimise unintended consequences and counter-productive effects (especially regarding existing property rights)

- the SRR should not be triggered if other, existing, mechanisms can be invoked – it should be the final option (but we do, of course, recognise that time might be of the essence, so the process of examining the options might have to be carried out very quickly) and there are a number of specific concerns in this respect, for example –
 - the proposed powers under SRR give rise to uncertainty as they are so wide-ranging - the proposed powers would allow relevant UK authorities to override contractual obligations and security rights, and we need clarity on how these fundamental changes will operate
 - there is uncertainty in relation to transactions where the originating bank/building society maintains a servicing or other role in respect of the securitised assets where legal title remains with the bank/building society - this uncertainty also applies in relation to enforcement concerns for UK covered bond transactions, which involve a transfer of the covered pool assets from the originating bank/building society to a special purpose vehicle
 - the proposed powers under the SRR will allow the relevant UK authorities to vary the rights of third parties in certain circumstances (eg UK deposit-takers may be involved in structured finance transactions in a number of service provider capacities - swap counterparties, liquidity facility provider etc)
 - how would creditors be recompensed in relation to partial transfers?
 - there is ambiguity as to whether non-English courts will recognise the validity of actions taken under the proposed powers.

40. CP1 proposes the following division of responsibilities among the Authorities –

- **the FSA** for supervisory decisions and regulatory actions, including the supervision of a firm while it continues to operate the SRR
- **the Bank of England** for liquidity support and operation of the SRR
- **the Treasury** for public finances and the overall public interest.

Question 4.2 – Do you agree with the roles for the authorities for triggering and operation of the SRR?

41. Broadly, yes. We recognise that the ‘trigger’ should be the FSA because it should be closest to the firm and its likelihood of failure. Logically, the FSA must consult, in a timely and appropriate fashion, with the other Authorities. Ideally, there should be some objective measure that the firm has failed, or is likely to fail (eg relevant threshold conditions), but some degree of flexibility might well be appropriate at this initial stage. In any case, there must be transparency for firms, so we favour relevant SRR guidance being included in the FSA Handbook of Rules and Guidance, as well as in the statutory provisions.

42. From a formal point of view, the bank's Board should be given the opportunity, if at all practicable, to authorise the SRR. Also, in a plc, shareholders might be willing, given the opportunity, to provide additional capital. However, we recognise that, ultimately, the final decision must be with the Authorities in what will be, by definition, an extreme and probably fast-moving situation.

43. We acknowledge the point (paragraph 4.23) that the FSA, because of the need to avert conflict with its various statutory objectives etc, should not be directly responsible for the operation of the SRR.

44. Regarding building societies (paragraphs 4.34 – 4.35), the BSA's firm view is that banks and building societies should be subject to the same legislative arrangements (any necessary changes being made eg to reflect their different corporate forms). This would include the SRR.

45. At this point, however, it is worth noting that we would expect existing arrangements to pick up failures among firms that are too small to have a 'systemic' effect and it is conceivable that some larger firms might also be dealt with in these, more traditional, ways.

46. We have serious reservations, in principle, with the decision to legislate to provide for the FSCS to be called upon to contribute to the costs arising out of an SRR. Our provisional view is that a purchasing organisation could reasonably be expected to cover these costs. Otherwise, the costs should be borne by the shareholders and creditors, with the State paying what remained. We await details of this proposal before making any further detailed comment.

(b) CP 2 (Special resolution regime)

(i) General

47. The key individual concerns about the SRR, set out in our response to the January consultation, were the effects of the SRR in relation to the following–

- existing property rights
- business contracts
- systems
- building society membership rights
- transfer of consumer data (fraud prevention in relation to data security)
- cheques issued by the FSCS (the assumption that they would clear immediately – further consideration would need to be given to matters such as indemnity if normal clearing times were to be waived)
- oversight of the use of discretionary powers under SRRs – credible governance would be of the utmost importance

- unplanned cost burdens inherent in new, complicated arrangements etc.

(ii) SRR objectives, roles and governance

48. CP 2 sets out four SRR objectives; namely to –

- protect and enhance the stability of the financial systems of the UK
- protect and enhance public confidence in the stability of UK banking systems
- protect depositors
- protect public funds; and
- avoid interfering with property rights in contravention of a Convention right.

Question 2.1 (CP 2) – Do you agree with the SRR objectives, as set out in draft clause 4?

49. The BSA is by no means certain that four, such broad, objectives – while individually entirely laudable, are appropriate. For example, are they really all compatible with one another? It would be important that the Authorities, in making decisions about the SRR, were not out into a position of conflict of interest akin to the potential conflict that could affect the FSA individually, in the context of its statutory responsibilities (see paragraph 4.23 in CP 1). Previously, the first and third objectives were considered to be the main ones (paragraph 4.6 of the January consultation).

50. We presume that the final objective would not override the normal circumstances where Article 1 of the First Protocol to the European Convention on Human Rights² applies, such as the public or general interest.

Question 2.2 (CP 2) - Do you agree with the role of the FSA in determining the conditions for entering the SRR?

51. Yes, for the reasons set out above.

Question 2.3 (CP 2) – Do you agree with the conditions for entering the SRR?

52. The proposed criteria – relating to the threshold conditions – for triggering the SRR seem appropriate.

Question 2.4 (CP 2) – Do you agree with the role of the Bank of England in operating the SRR in the public interest?

53. As noted above, we are not certain that the objectives are all compatible with one another.

Question 2.5 (CP 2) – Do you agree with the roles of the Treasury?

54. We agree that the proposed roles – relating largely to protection of the public finances and compliance with international obligations – are entirely appropriate for HM Treasury.

55. CP 2 goes on to deal with governance of the SRR, by –

- statutory objectives
- supporting secondary legislation
- a code of practice.

Question 2.6 (CP 2) – Do you agree that the SRR objectives should be supplemented by a code of practice?

56. We do not believe that CP 2 makes a convincing case for use of such a vehicle. Why can the relevant matters not be included in the secondary legislation? The SRR is not a matter on which there should be any uncertainty. Therefore, we oppose the suggestion of a code of practice.

Question 2.7 (CP 2) – Do you agree with the proposed areas to be covered in a code of practice?

57. See answer to above question.

(iii) SRR tools: stabilisation powers and compensation

58. This chapter sets out the SRR tools; namely, the private sector purchaser, the bridge bank, partial transfers, and temporary public ownership.

59. In its response to the January consultation, the BSA suggested that the existing insolvency legislation, suitably modified, might be preferable to introducing the unknown quantity of the SRR, fraught with the risk of unintended consequences. Therefore, we welcome the Authorities' examination of a special insolvency regime for banks and note the reasons why this will not be the proposed model – ie that an insolvency could reduce confidence in the firm and that, combined with the new governance framework, would reduce the likelihood of a private sector solution.

Question 3.1 (CP 2) - What are your views on the breadth of the property transfer powers? Are there particular powers that are lacking?

60. We have no particular comments – the arrangements appear workable. Our reservations are as to principle and similar to those set out above in relation to question 3.1 above and relate to the wider, and long-term consequences for the UK, of deprivation of third party property rights. If broadly similar provisions apply within our principal EU and international competitors, then it is less of a concern.

61. Broadly speaking, the Association recognises that the separate tools described in this section of CP2 could each be of use in different circumstances, and that being able to deploy a variety of potential solutions makes sense – as we are all very aware by now, it is unlikely that any two financial crises will ever be identical, and it is right to aim to ‘future-proof’ if at all possible. Specifically –

- **existing (voluntary or compulsory) mechanisms**, eg mergers within the same business sector, are likely to address the vast majority of problems
- a **private sector purchaser**, as described in paragraphs 3.14 – 3.18 will frequently be the next most favoured option
- the **bridge bank** would potentially be a prudent short-term arrangement, while long-term options were being considered and/or negotiated – we agree with the proposals (ie that the Bank of England should be the sole shareholder, the organisation should be time-limited, and the various proposals for corporate governance set out in paragraph 18)
- **partial transfers** would add an element of flexibility – eg transfer of deposit book only - but, as many respondents to the January consultation pointed out, would bring with them certain additional complications (in the time available, we have not been able to give detailed thought to these matters but a key question is how creditors would be recompensed)
- the **bank insolvency procedure**, a modified form of insolvency, should help speed up payments from the FSCS (but we are unclear whether, in practice, it is likely to add much to a combination of current insolvency procedures and the FSCS), and
- **temporary public ownership** could be used, as a last resort, eg where substantial sums of public money have been injected into the bank or where wholesale and long-term restructuring is required to return it to the private sector.

However, we are concerned that the UK arrangements should not be excessively rigorous when compared to other countries. There is a risk that this would be another factor persuading businesses that are in a position to do so, to move relevant operations abroad. Outstanding questions, eg relating to partial transfers, need to be answered before the arrangements are put on place.

62. As noted above, we disagree in principle with the decision to legislate to provide for the FSCS to be called upon to contribute to the costs arising out of an SRR.

(iv) **SRR tools: bank insolvency procedure**

63. This part of CP 2 considers the ‘bank insolvency procedure’, designed to help facilitate speedy payments from the FSCS. The Association welcomes the fact that Authorities have decided against wholesale changes to insolvency law in preparing the detail of the bank insolvency procedure, with only minor modifications to existing law. However, we find it difficult to see what, in practice, this new mechanism would add to existing arrangements.

(v) Building societies and other issues of scope

64. This section considers the application of SRR tools to building societies and other mutuals. We agree that an SRR for a building society, like that for a bank, should be triggered only where the Authorities had concluded that the conditions for the SRR had been satisfied. Indeed, as noted earlier, we believe that existing arrangements are likely to pick up most cases. It is important that the new arrangements should not prejudice existing tools eg section 42B Building Societies Act 1986

65. As with banks, we believe that, for constitutional reasons, there should be a board resolution in respect of the SRR, if at all practicable. Also, if possible, members should have the opportunity to transfer their savings and mortgages, in an orderly fashion, to another building society, rather than simply have them rolled up into a plc.

Question 5.1 (CP 2) – Do you agree that the objectives, roles of the Authorities and governance of the SRR should be not differ for building societies and banks?

66. As noted above, the BSA strongly agrees that a failing building society should be able to be placed into the SRR in essentially the same way as a failing bank (and that other features, such as the role of the Authorities and the governance of the SRR should be the same). Some features inevitably differ because of the constitutional differences between the two corporate forms eg the feature of SRRs known as the share transfer power (described in paragraphs 3.12 – 3.13 of CP 2) is potentially applicable to banks, but not readily to building societies (paragraph 5.11).

67. Paragraph 5.7 – 5.8 outline the existing statutory arrangements for voluntary or compulsory transfer of business. As CP 2 acknowledges, these provisions are normally utilised for commercial purposes. In the current context of rescues, we strongly support the decision to keep these in place without amendment.

68. We acknowledge that it is an unfortunate, but necessary, consequence of deployment of some of the tools (eg transfer to a bridge bank), that demutualisation would occur (paragraph 5.14). We would hope that, in practice, a merger with another building society would take place as has happened on occasions in the past.

Question 5.2 (CP 2) – Do you agree that the Authorities should have powers to disapply statutory requirements including the principal purpose and lending and funding limits, for the residual element of a building society following a partial transfer?

69. In light of the fact that a residual society might not be able to comply with its statutory requirements (eg principal purpose and nature limits), during its winding down, it is a logical consequence that such powers of disapplication should be granted.

Question 5.3 (CP 2) – Do you agree that there should be a special building society administration procedure for building societies in the event that part of a building society's business is transferred to a bridge bank?

70. Yes, the position would be the same as for banks (as explained in chapter 3 of CP 2 – paragraph 3.80 onwards).

Question 5.4 (CP 2) – Would temporary public ownership be a useful tool for resolving a failing building society in some circumstances?

71. For the reason given in paragraph 5.21 (ie that temporary public ownership is effected using share transfer powers), this would be an unlikely occurrence for a building society. However, in order to give maximum flexibility and to ensure consistency between both sectors, we welcome the exploration by the Authorities of whether a similar arrangement could apply to building societies and the BSA is happy to assist this exercise.

Question 5.5 (CP 2) – How would this tool best be implemented in the case of a building society, given the lack of applicability of share transfer powers?

72. Section 3 of the Banking (Special Provisions) Act 2008 gives the Treasury power to order that the shares in a deposit-taker be transferred to a third party. As the CP 2 recognises, such a power is inapplicable to building societies. However, it should be possible for the a statutory provision to empower the Treasury to order a transfer of the ‘engagements’ of a building society, similar to the current FSA power.

73. The next three questions concern the compensation arrangements for shareholders of a bank taken into the SRR (paragraphs 3.128 onwards in CP 2) and whether equivalent arrangements might be devised for building society members.

Question 5.6 (CP 2) – Should a set of principles be established to determine how compensation is distributed between members of building societies? If so, what would be the most appropriate and fair equitable principles?

74. The Building Societies Act 1986 applies most provisions of the Insolvency Act 1986 to building societies. If there is a surplus on the conclusion of a winding up, it will be distributed in accordance with the society’s rules (section 154 Insolvency Act as applied by paragraph 25 of Schedule 15 to the 1986 Act). The Association’s Model Rule, used by many building societies, states that any surplus remaining for shareholders (together with any interest due) –

“shall be applied either in accordance with the instrument of dissolution (if any) or otherwise divided among qualifying Members in proportion to the values of their Shareholdings at the date of commencement of the dissolution or winding-up.”

The formula of payment proportionate to the value of shareholdings seems as fair and equitable as any other.

Question 5.7 (CP 2) – What are the risks in creating a pre-determined set of principles for distributing compensation?

75. The risks would be in the possible unforeseen consequences arising from creating a new mechanism.

Question 5.8 (CP 2) – Should the former members have a say in how compensation is distributed?

76. We think that it would over-complicate matters considerably for former members to have a say in how compensation was distributed and we cannot see why, in principle, they should have a say if they have ceased their association with a society.

Effective Compensation Arrangements for Depositors

(a) Compensation limit and coverage

77. Chapter 5 of CP1 deals with the Financial Services Compensation Scheme (FSCS). We have already provided a range of comments in response to the January consultation. As noted above, we await the FSA's Autumn 2008 consultation on the FSCS compensation (including limits), to which we will respond. Therefore, we have little to add at this stage, except for a few comments on certain points made in chapter 5.

78. In our response to the January consultation, we adopted a neutral position on the question of whether the compensation limit in relation to depositors should be increased and, pending the formal consultation, maintain that position. However, we set out a number of relevant considerations concerning consumer confidence, consumer benefit, market consequences, and moral hazard. It is clear from CP1 that the Authorities are moving towards a policy position that the limit should be increased from £35,000 to £50,000. CP1 states that about 97% of accounts are already protected by the existing limit ; for building societies we believe that an increase in the figure would increase the coverage from 95% to 97%.

80. Consumers are entitled to transparency about prospective compensation payments in the event of a firm's collapse, so we welcome the forthcoming discussion about brands. Indeed, CP1 states that –

“It has also become clear that the precise way in which the FSCS's existing arrangements operate is not well understood.”

We agree. In our response to the January consultation, we urged the Authorities to give full consideration to the information that consumers should be given about the FSCS. We firmly believe that the information should be consistent (except for relevant sectoral differences).

81. A compromise must be reached between transparency on the one hand, and averting unnecessary public concern on the other - this is another key nettle that the Authorities must grasp as a matter of urgency. The BSA has raised this matter separately with the FSA and offered to help with any relevant exercise in developing consistent informational requirements.

82. Regarding payments above the compensation limit, in principle, we can see justification for this in very limited cases only; primarily, that of a consumer who had a temporarily large balance eg because he or she had received the proceeds of a sale of a property, an inheritance, an insurance payment etc. Unfortunately, there could be systems difficulties in distinguishing such circumstances from customers who hold high balances for other reasons.

(b) Faster compensation payment

83. We fully support all proportionate endeavours to reduce the current period for payments from the FCSCS, but recognise the numerous practical barriers to providing payments within one week (5 working days).

Question 5.1 – The Authorities would welcome views on the best way of introducing gross payout where there are mutual debts.

84. This question is closely linked to the issue of a ‘single customer view’. We can see no case for customers being paid on a ‘per account’ basis because knowledgeable customers would simply split their funds into a number of accounts with one institution, each balance being the same as the FSCS deposit limit.

85. CP1 also considers the possibility of customers being paid ‘per brand’. It could be argued that this would reduce the risk mentioned above, and would deal with the problems about transparency ie customers not being aware that X was a subsidiary of Y, so they receive only one payment in the event of Y folding and taking X with it. On the other hand, it might encourage an even greater proliferation of brands and, in this way, lead to confusion. However, it certainly makes sense to investigate the possibility of ‘grandfathering’ products, following a merger, so that transferred customers - at the very least those with fixed term accounts - do not lose pre-existing protection.

86. In principle, gross payments make sense because they would be simpler, quicker to pay and fairer (because depositors who also had long-standing mortgage loans would not suffer a loss of liquidity). However, this is a very complicated matter and we do not have a final position. Indeed, we note that the FSA plans to consult and will respond in due course. It is important to assess potential systems, and other, implications and we note, from paragraph 5.30, that the FSA will be engaging external consultants to examine these matters.

(c) Consumer awareness

87. For reasons noted above, we strongly welcome the forthcoming review of how customers can be better informed about the current arrangements and have already provided some suggestions to the FSA.

(d) FSCS funding and liquidity

88. This part of chapter 3 notes that the Government intends to ensure that the FSCS has access to liquidity through borrowing from the public sector. It then considers pre-funding, risk-based levies, and National Loan Fund borrowing.

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

89. We strongly oppose pre-funding of the FSCS for the reasons that we set out in response to the January consultation; primarily because –

- it would deprive firms of, possibly significant, funds (this would be particularly unwelcome given the likely downturn in the economy)
- estimating an appropriate level of pre-funding would be impossible; until losses had crystallised, the likelihood would be that far too much or far too little would have been pre-paid – this could amount to a very costly, but wasted, exercise
- any fund would be insufficient to cover deposits in the largest institutions. The high level of concentration in the UK market means that the majority of deposits would not be adequately covered by a fund.

We note that powers are being introduced to permit pre-funding, but there are no current plans to implement them. We sincerely hope that this particular measure, ensure will stay on ice – the detrimental consequences would outweigh any supposed benefits.

90. As we noted in our response to the January consultation, although we can see an argument in principle, we very much doubt that risk-based charging is practicable – the risk-ratings would need to be kept strictly confidential and risk-based charging is only really relevant to pre-funding, which we strongly oppose.

91. We support the decision to allow the National Loans Fund to lend to the FSCS. This would be a far more proportionate and effective measure than pre-funding. The funds built up in respect of possible loans for future FSCS payments would need to be strictly ring-fenced.

(e) Banknotes and cheques in Scotland and Northern Ireland

92. The Association supports the plans to require stronger arrangements regarding backing assets for the issue of Scottish and Northern Irish banknotes. It is appropriate that holders of such notes should have a similar level of protection to holders of Bank of England notes. Equally, we support the proposal to bring the law relating to Scottish cheques in line with those of the rest of the UK, by abolishing the ‘funds attached’ rule, thus reducing delays for the drawers of cheques.

Strengthening the Bank of England and Tripartite Coordination

93. As the events of a year ago made clear - prompt, co-ordinated action by the Authorities in a financial emergency can be very important and we welcome measures to improve tripartite authority co-ordination. We note that CP1 asks no specific questions in this chapter and, having made certain comments on the topic, in our response to the January consultation, we have little further to add at this stage.

94. We have one question. Paragraph 6.7 states –

“The FSC will bring valuable external expertise to bear on the Bank of England’s

decision-making in the area of financial stability and will ensure that the Bank of

England commands authority and credibility in discharging its new financial stability objectives as it does on monetary policy. It is anticipated that the FSC will play an important role in overseeing the functions of the Bank of England in relation to financial stability. The Bank of England's executive will be accountable to the committee for its decisions and actions in financial stability, including, for example, market-wide operations and institution specific actions.”

In view of this objective, can it be appropriate that the committee be chaired by the Governor of the Bank of England? An independent chairman might be more appropriate for a committee to which the Bank's executive will be accountable.

Conclusion

95. The crucial element of the financial stability consultations is the need to minimise the risk of bank failure in the first place – above all, there must be sound business plans and effective regulation. Nearly all the other elements of the consultations (the SRR, the FSCS etc), while some are undoubtedly important, essentially concern damage limitation. The key for firms is to take every practicable step to ensure that they have sound business plans. The key for the FSA is to get on with the day-to-day job of regulation and to do so efficiently. A plethora of new initiatives and mechanisms will not alter these key facts, but might well cloud and confuse them. As the Northern Rock made clear, *prevention* is better than cure.

FOOTNOTES

1 “The directors of Northern Rock were the principal authors of the difficulties that the company faced since August 2007 The FSA acknowledged that there were clear warning signals about risks associated with Northern Rock's business model, both from its rapid growth as a company and from the falls in its share price from February 2007 onwards. However, insofar as the FSA undertook greater “regulatory engagement” with Northern Rock, this failed to tackle the fundamental weakness in its funding model and did nothing to prevent the problems that came to the fore from August 2007 onwards. We regard this as a substantial failure of regulation.”

(House of Commons Treasury Committee – Eleventh Special Report of Session 2007 – 08)

"We cannot provide assurance that the prevailing framework for assessing risk was appropriately applied in relation to Northern Rock, so that the supervisory strategy was in line with the firm's risk profile."

(FSA Internal Audit Report, paragraph 27)

2 The First Protocol to the European Convention on Human Rights - “Every natural person or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law” (in short, ‘the right to property’).

The Building Societies Association
16 September 2008