

## **Insolvency Lawyers' Association**

### **Financial stability and depositor protection: special resolution regime**

#### **1. GENERAL**

The Insolvency Lawyers' Association ("ILA") is pleased to have the opportunity to comment on the consultation paper entitled "Financial stability and depositor protection: special resolution regime" dated July 2008.

The ILA was formed in 1989 as a special interest group to promote the role of lawyers in the insolvency profession generally and to advance the theory and practice of insolvency administration. The ILA provides a forum for lawyers practising insolvency law to co-operate on matters of professional interest and to represent the ILA's view to Government and to other professional bodies having an interest in insolvency practice.

We understand that the Treasury intends that the primary legislation should come into effect in February 2009, thereby taking the place of the Banking (Special Provisions) Act 2008 which ceases at that time.

We are concerned at the haste of the approach and in particular that seeking views on the present proposals as set out in the latest consultation give an incomplete picture. In some key aspects of the intended legislation it makes it very difficult to respond in a constructive manner. In particular, it would be helpful to have sight of the Code of Practice and the supporting secondary legislation as soon as possible so the full implications of new powers can be assessed. This is key especially in circumstances where fundamental and well-established proprietary rights may be effected by transfers imposed by the Authorities.

Although we note that the powers set out in draft legislation are only to be used in rare circumstances those powers will have a significant impact on the UK as a centre and forum for the financial services industry. In particular, counterparties doing business with these institutions now will be considering how they may be affected in the event of a failure where the SRR is used and this may be a factor in a counterparty's decision to invest or otherwise contract with a UK deposit taking institution. Therefore the uncertainty which presently exists needs to be minimised by clear drafting and a complete draft of the intended legislation provided to those who have been invited to contribute in the consultation process.

#### **SRR objectives, roles and governance**

2.1) Do you agree with the SRR objectives, as set out in draft clause 4?

We agree although we question whether Clause s4(9) is too uncertain - for example, how are conflicts between objectives to be resolved? (i.e. stability vs protection of public funds). One might want to provide for one or more objectives to have primacy in the event of irreconcilable conflict.

2.2) Do you agree with the role of the FSA in determining the conditions for entering the SRR?

Agree

2.3) Do you agree with the conditions for entering then SRR as set out in draft clause 7?

Agree, although we find Clause s7(6) difficult to follow. Although objectives will clearly be independently assessed, they are still relevant to the exercise of power under Clause 7(1).

2.4) Do you agree with the role of the Bank of England in operating the SRR in the public interest as set out in draft clause 8?

Agree

2.5) Do you agree with the roles of the Treasury as set out in draft clauses 8(4), 8(5), 9 and 10?

Agree although we find clause 8(5) difficult to follow albeit we think we follow its purpose in that if the Treasury has financed an activity, it should have input.

Clause 9(3) gives the Treasury practical veto over most situations, though not in circumstances where there is a complete transfer.

Clause 10 - it is understandable that the Treasury should have final say in relation to the temporary public ownership route. That said, and as stated elsewhere previously, we are not sure we really understand the practical/commercial difference between this option and the Bridge Bank where the Bridge Bank must be controlled by the Bank of England (clause 12(1)) by way of holding all the shares or at least a controlling interest in the sense that both options create a temporary public ownership.

2.6) Do you agree that the SRR objectives should be supplemented by a code of practice?

Agree

2.7) Do you agree with the proposed areas to be covered in a code of practice?

Agree

### **SRR tools: stabilisation powers and compensation**

3.1) What are your views on the breadth of the property transfer powers in clauses 14 to 23? Are there particular powers that are lacking?

These appear pretty comprehensive but

- We query how effective Clauses 16(c) - (d) are going to be inasmuch as they relate to foreign property (in this regard, see Clause 20(3))
- We query if clause 17(1)/(4) are designed to deal with TUPE issues? It certainly looks that way in which case, there is no need for further powers
- The clause 20 concept might be widened to include any property which has not - for whatever reason - been transferred
- Clause 20(4) might cause some difficulty. An unconditional requirement on the part of the transferor to hold the foreign property for the benefit of the

transferee might give rise to a tension between the obligations of the transferor under this provision and the transferor's obligations as a matter of foreign law. It would be prudent to include some language to make clear that the transferor's obligation is subject to his obligations as a matter of foreign law.

3.2) What are your views on the nature of these powers?

They seem necessary if a quick transfer is required subject to adequate safeguards being put in place for Human rights and expropriation etc which seem to have been addressed

3.3) Do you consider that a company limited by shares, with the Bank of England as the sole or controlling shareholder, would be the most appropriate governance structure?

Agree although see our comments above regarding Bridge Bank v. Temporary Public Ownership

3.4) Do you agree that the lifespan of a bridge bank should be limited? What do you think is an appropriate length of time?

Agree - no fixed views about time length but possibly 6 months should be sufficient. Also have to factor in State Aid considerations to timing for Rescue and State Aid.

3.5) Do you think that the extension of a bridge bank's lifetime should be subject to certain conditions? If so, what?

There must be some flexibility to extend but conditions must relate to necessity, proximity of solution and Rescue and State Aid considerations

3.6) Do you think that partial transfers increase the chances of the successful operation and sale of a bridge bank and the chances of a private sector purchase?

Yes but also potentially:

- Opens up the possibility of unfairness to those creditors left in the residual company in terms of relative valuation of entitlements; and
- Creates uncertainty for counterparties dealing with financial institutions (albeit it is noted that some attempt to address this has been made in the areas of netting, collateral and security)

3.7) Do you agree that guidelines, setting out when partial transfers might be used, should be provided in the code of practice?

Absolutely agree

3.8) Would these guidelines provide reassurances about how the Authorities might use partial transfers?

If they clearly describe the circumstances when partial transfer can be used, yes. It depends on what they actually say

- 3.9) Do you agree with the situations in which it is proposed that the partial transfer powers could be exercised?

Yes although see concerns above/below as well as recognition in paragraph 3.48 of consultation that practical obstacles will limit use of partial transfer.

- 3.10) What is the appropriate level of flexibility for the situations in which these powers can be used?

Flexibility leads to unpredictability so the guidelines need to be very clear and to carry some statutory force if possible

- 3.11) Do you think the Bank of England should have the flexibility to make subsequent transfers between a bridge bank and a residual company?

Yes - but see 3.13 below

- 3.12) Do you think the Bank of England should have the power to make subsequent transfers using the stabilisation powers?

Yes - but see 3.13 below

- 3.13) Do you agree with the restrictions the Authorities propose for subsequent transfers (that they should only occur between a bridge bank and a residual company and not involve moving liabilities from the bridge bank to the residual company)? Should there be additional restrictions?

Yes - the ability to "sanitise" a balance sheet by separating out parts which have deteriorated could, in theory at least, create uncertainty not only for counterparties in general but also an officeholder appointed to the residual company if new transfers back from the Bridge Bank can occur. For example, an officeholder may be ready to make a distribution, or may have already made a distribution, when the transfer of new liabilities/assets skews the level of distribution which ought to have been paid so that the officeholder has paid too much too soon.

- 3.14) Do you think that the bank resolution fund is an appropriate means for compensating creditors left in the residual company?

The basis of valuation is key here. Creditors of the residual company should be compensated on the going concern value of the part of the bank transferred. Failing this the basis of compensation needs to be clearer.

- 3.15) Do you agree that an explicit safeguard to protect set-off and netting arrangements is required?

Agreed

- 3.16) Do you agree with the risks of adopting a complete master netting arrangement safeguard?

Agreed although potentially unlikely

- 3.17) Should the qualifying financial contracts approach be adopted, what do you think should be defined as qualifying financial contracts?

No fixed views but presumably swaps, repos, forwards etc. We agree that they should be specifically listed in Secondary Legislation.

- 3.18) Can you suggest any alternative options for how the safeguard might be framed in a sufficiently wide but workable way?

No fixed views

- 3.19) Do you agree that an explicit safeguard to protect structured finance arrangements is required?

Agreed

- 3.20) Do you have any workable suggestions for how the safeguard might be framed in a sufficiently wide but workable way?

No fixed views

- 3.21) Do you agree that a safeguard to protect all security interests could make a partial transfer practically difficult?

Yes

- 3.22) Which security interests should not be covered by this safeguard?

Floating charge over all assets albeit as stated in paper, this type of security is unlikely to be granted by a credit institution

- 3.23) Do you consider that where part of a failing bank's business is transferred to a bridge bank, a special bank administration procedure may be required to deal with the residual company?

We think it might be unnecessary and confusing given that there is also intended to be a separate insolvency procedure for banks in addition to all other procedures available. If modifications are required to existing processes, that may be a better way to proceed.

- 3.24) Do you think that this special bank administration procedure should be confined to the residual company where a partial transfer is effected to a bridge bank or should it also apply, with any necessary modifications, where a partial transfer is effected to a private sector institution?

It should be extended, although continuity of services should be on commercial terms to benefit the administration .

- 3.25) Do you agree that the special bank administration procedure should have specific objectives?

Agreed

- 3.26) Do you agree with the objectives and their priorities as proposed above? In particular, do you agree that the objective of supporting the bridge bank should take priority?

Agreed

- 3.27) Should the grounds for commencing or applying for special bank administration be linked to the partial transfer of assets and liabilities to a bridge bank?

Yes subject to response to 3.24

- 3.28) Should any other grounds be included in the legislation?

Not sure what these would be

- 3.29) Should the special bank administration procedure be commenced by an order of the court or initiated automatically by the direct appointment of a special bank administrator by the Bank of England?

Direct appointment by the Bank of England is likely to be the most efficient commencement route but court oversight of the process is essential

- 3.30) Should the special bank administrator be an officer of the court, or in the interest of promoting the objectives of the SRR should he or she be subject to overall direction by the Bank of England, with the court ruling on any disputes arising in the resolution?

Officer of the Court

- 3.31) Are the moratorium provisions outlined above sufficient for the purposes of a special bank administration procedure? If not, what additional measures would be required?

The moratorium provisions are sufficient. We do not identify any additional measures that are required. The only issue is whether one ought to make clear that the ordinary administration procedure is substituted and not ancillary to the special bank administration procedure

- 3.32) Do you think that the existing powers of an administrator would be sufficient for the purposes of special bank administration?

Yes

- 3.33) Should the special bank administrator be given any additional powers, including some or all of the powers of a liquidator outlined above? If so, what extra powers do you consider would be appropriate?

Yes - It would be appropriate for the special bank administrator to have all of the powers of a liquidator.

NB: administrator should also be granted immunity from suit for carrying out his statutory functions given his limited powers and role. Query also whether Treasury should be given express powers to provide finance/indemnity cover

3.34) Do you agree that the Bank of England should have a key role to play in the special bank administration procedure to facilitate the successful resolution of a bridge bank and to assist in the winding up of the residual company in the interests of its creditors generally?

Yes

3.35) Should the Bank of England rather than an initial meeting of creditors be responsible for considering and agreeing to, with or without modification, the special bank administrator's proposals?

Yes (in common with the function of the regulator in other special administration regimes) but query also whether Treasury needs to be involved also

3.36) Should the Bank of England rather than creditors fulfil the functions of a creditors' committee?

Yes (in common with the function of the regulator in other special administration regimes)

3.37) Should the rights of creditors to challenge the conduct of the procedure be subject to restrictions to ensure that the principal objectives are not jeopardised?

No

3.38) Do you agree that there should not be any substantial change to the ordinary statutory order of priority of creditors in this special bank administration procedure?

Yes

3.39) Should any special provisions relating to statutory set-off be introduced within a special bank administration procedure?

Yes

3.40) Do you agree that the procedure should only be terminated where the Bank of England provides consent?

Yes but the court ought to retain an overarching power to terminate the procedure even if the Bank of England is inclined not to consent to termination.

3.41) Do you think the provisions should be made for a variety of ways to bring the procedure to a close, including conversion to ordinary insolvency procedures?

Yes

3.42) Do you agree that temporary public ownership should be subject to similar public interest tests as the Banking (Special Provisions) Act 2008?

Yes

3.43) Do you agree that the Authorities should have the power to put in place a bank resolution fund for a bridge bank and temporary public sector ownership?

Yes

- 3.44) Do you agree that the bank resolution fund should be mandatory in the case of the bridge bank tool, but optional in the case of temporary public ownership?

Yes

- 3.45) Do you agree that the bank resolution fund should comprise only the net proceeds of resolution (that is, less the costs of resolution)?

Sounds sensible if view Bridge Bank as a "look through" vehicle but see response to 3.14 above. What if it is not possible to sell on?

- 3.46) Do you agree with the mechanisms for compensation and appointing an independent valuer in the circumstances set out above?

Yes

- 3.47) Do you agree with the proposals to confer specific powers on an independent valuer, and the nature of the powers described above and provided for in draft clause 28?

Yes

- 3.48) Do you agree with the principles of valuation set out in draft clause 30?

No real principles are set out here only vague parameters so difficult to comment

- 3.49) Do you agree that the Treasury should have power to provide for the reconsideration of the independent valuer's determination and appeals from the valuer to a court or tribunal?

Yes

- 3.50) Do you agree that alternative compensation arrangements are needed for a private sector purchaser tool, that would not involve an independent valuer?

Agreed but then how would this be managed if there was a private sale following a partial transfer to a Bridge Bank - presumably in the same manner?

- 3.51) Should any of the costs described above not be covered by the FSCS, under the Authorities proposals? Please explain why?

No fixed views

- 3.52) Are there any additional costs of resolution which could be borne by the FSCS?

No fixed views

### **SRR tools: bank insolvency procedure**

Our previous comments on the need for a separate regime refer - we still do not understand why it is necessary to establish a whole new procedure as opposed to

making changes to the FSCS scheme rules. This notwithstanding our comments are as follows:

- 4.1) Do you agree with the provisions for entry into the bank insolvency procedure, as set out in draft clauses 38-41, 60 and 62?

Agree but should it not be a condition that none of the stabilisation provisions apply or are workable?

- 4.2) Do you agree with the provisions for the appointment and objectives of the bank liquidator, as set out in draft clauses 37, 42, 46 and 47?

Clause 37 - fine.

Clause 42 - fine but see overriding objections above regarding actual need for this procedure

Clause 46 - agreed

Clause 47 - ostensibly seems fine but need to have a closer look

- 4.3) Do you agree with the provisions for the powers and responsibilities of the bank liquidator, as set out in draft clauses 47, 48, 61, 63 and 66?

Clause 47 - ostensibly seems fine

Clause 48 - seems fine

Clause 61 - fine

Clause 63 - agreed

Clause 66 - not convinced by this - why is this needed?

- 4.4) Do you agree with the provisions for the liquidation committee, as set out in draft clauses 44 and 45?

Fine but why need a formal committee if this is just to give the FSA, Bank of England and FSCS oversight? If a fuller committee is appointed, do these entities' powers get diluted?

- 4.5) Do you agree with the provisions for the end of the bank insolvency procedure, as set out in draft clauses 50-58?

Yes

### **Building societies and other issues of scope**

- 5.1) Do you agree that the objectives, roles of the Authorities and governance of the SRR should not differ for building societies and banks?

Yes

- 5.2) 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?

Yes

- 5.3) 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?

See comments above

- 5.4) Would temporary public ownership be a useful tool for resolving a failing building society in some circumstances?

Yes but see comments above in relation to Bridge Bank

- 5.5) How would this tool best be improved in the case of a building society, given the lack of applicability of the share transfer power?

Actual control of board mechanisms

- 5.6) 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 fair and equitable principles?

No fixed view

- 5.7) What are the risks in creating a pre-determined set of principles for distributing compensation?

No fixed view but query whether this should not be left to an impartial liquidator?

- 5.8) Should the former members have a say in how compensation is distributed?

No fixed view

- 5.9) Do you agree that the Government should legislate to enable the Treasury to create, alter or nullify contracts between group companies, and introduce duties for group companies (where necessary) to cooperate with the use of these powers?

No fixed view