
FINANCIAL STABILITY &
DEPOSITOR PROTECTION:
SPECIAL RESOLUTION
REGIME

RESPONSE FROM
LLOYDS TSB GROUP PLC

SEPTEMBER 2008

FINANCIAL STABILITY AND DEPOSITOR PROTECTION: SPECIAL RESOLUTION REGIME RESPONSE FROM LLOYDS TSB GROUP PLC

The following pages set out Lloyds TSB's response to the Tripartite Authorities' proposals for a Special Resolution Regime where a bank is judged to be in difficulty. Responses to specific questions follow an executive summary of our key messages on consultation themes.

EXECUTIVE SUMMARY

We welcome the government's commitment to improving financial stability and developing appropriate protection for depositors. However the tools set out in this consultation, in particular the sweeping powers to suspend creditor's rights, have very damaging implications for UK banks and the UK market. It is therefore crucial that the Authorities consult further on the balance to be struck between protection of depositors and the erosion of the rights of stakeholders.

At this stage, in the absence of the Code of Practice and secondary legislation, we have set out our main concerns arising from the SRR consultation. We understand that the aim is to consult further on these during the passage of the Bill through Parliament. As they will set out how SRR tools will be used and articulate the safeguards to be put in place, it is imperative that the Authorities consult fully in advance of laying draft legislation before parliament.

Because the Authorities have yet to consult the industry or other stakeholder groups on important and problematic elements of the proposed regime, we consider that the timetable proposed for the SRR consultation is too ambitious. We strongly encourage the Banking Reform team to extend the period for consultation, by extending the duration of the Banking (Special Provisions) Act 2008 in order to consult properly and ensure that the proposed changes do not detrimentally impact the UK as Sarbanes-Oxley did in the US.

Impact of these proposals on the UK banks and the UK market

We are gravely concerned that the effect of SRR proposals will be to create a legal uncertainty which will damage investor confidence and markets in the UK. This would, in turn, undermine financial stability and undermine the international competitiveness of the UK. If banks believe that their legal position could be compromised and there would be limited or no ability to re-negotiate pricing, they will pull in their credit lines and stop lending to a bank in financial difficulty which could lead to financial instability.

Furthermore, if there were no legal certainty regarding the safeguards for qualifying financial contracts (QFCs) and net off and setting arrangements, banks would change the way in which they negotiate new contracts and would also renegotiate existing contracts. More draconian conditions would be required for collateral arrangements, to mitigate netting positions for capital which would probably be reviewed on a daily basis. This would be a serious drain on liquidity again triggering financial instability.

The legal uncertainty about how the SRR will operate and the lack of safeguards could lead to a loss of investor confidence and force other banks to invest elsewhere. Credit ratings for transactions could be impacted which would push up the price and the cost of funds for UK banks.

We are therefore concerned that as the proposals stand, there is a real danger the competitiveness of UK markets will be detrimentally impacted as players and investors withdraw from the wholesale markets in the UK, raising capital becomes more difficult and liquidity ultimately becomes unavailable or more costly.

International context

The Authorities also need to examine the consequences of these proposals in the international context, particularly because of the “universal” nature of the UK banks. Whilst they have modelled their proposals on other countries’ regimes, we do not believe they are analogous to the UK market which is far more concentrated and comprised of financially complex institutions. For example, we do not consider that the Federal Deposit Insurance Act (FDIA) is a good precedent for the UK given that it was created for small, local deposit-taking banks and not the large, global, financially complex institutions there are in the UK. Furthermore, it is untested in the US on a bank similar in make-up and size to UK banks.

Furthermore, the FDIC regime has specific protections for close-out netting and financial collateral arrangements that are lacking from these SRR proposals.

Objectives

We agree with the Tripartite Authorities’ objectives of protecting and enhancing the stability of the financial systems of the UK and of protecting and enhancing consumer confidence and public funds. However, we are concerned that the inclusion of an objective focused on protecting depositors, without a balancing objective of protecting the interests of other stakeholders, is inappropriate. In essence this objective gives depositors a preferential creditor status to the detriment of other creditor stakeholders and ignores the need to protect the market and investor confidence.

Furthermore, depositor protection could be achieved by reforming the Financial Services Compensation Scheme (FSCS) without the need to introduce a new insolvency regime for banks. Depositors already have the benefit of the FSCS and the focus should be on ensuring the FSCS is fit for purpose and facilitates a reasonably fast payout to depositors.

Ironically, the creation of the SRR tools, particularly partial transfer, may itself have adverse consequences for the UK financial system because creditors will anticipate a weakened position upon counterparty default, and will therefore seek to reduce and re-price exposure to UK financial institutions. This may reduce competition and increase systemic risk because concerns will be focused on smaller, higher-risk institutions that will find it harder to hedge their positions and raise funding in wholesale markets. These potential outcomes are in direct conflict with the objective of protecting and enhancing the stability of the financial systems.

Code of Practice

We believe that, given the ramifications of the infringement of creditors’ legal rights and the credit risk issues, particularly in the partial transfer scenario, proposed safeguards should be enshrined in statute rather than a code of practice to provide the comfort of legal certainty.

Partial transfer

We understand the need for a range of tools, however we have considerable concern about the partial transfer proposals because they cut across insolvency, contractual and proprietary rights. The ability of the bank of England to cherry-pick assets and, in effect, create depositor preference creates further legal uncertainty for other creditors.

The partial transfer tool is inherently inequitable for creditors when it is invoked. We believe that the ongoing damage and cost to the industry outweigh any possible benefits and would urge the Authorities to reconsider the option of the partial transfer tool as it will erode investor confidence in the UK.

Qualifying financial contracts

We consider that there is currently insufficient detail in the SRR Consultation Paper and therefore a great deal of legal and therefore pricing uncertainty surrounding qualifying financial contracts (QFCs). A great deal of time and resource and been spent worldwide to ensure for example that derivatives, stock loans and repurchases in many jurisdictions should have the benefit of set-off and netting arrangements.

Pricing for many transactions is contingent upon the efficacy of the netting arrangements and the capital adequacy requirements of the relevant regulator. As of June 2007, mark-to-market credit exposure of all outstanding OTC derivatives was reduced by 76 per cent after applying close-out netting. Unintended potential adverse consequences of the SRR need to be examined.

Banks currently seek ordinarily to manage credit risk on a net basis in reliance on the legal enforceability of set-off and close-out netting arrangements and market integrity is driven to a degree by legal certainty. A difference does exist between set-off and netting and this must be recognised clearly in all situations.

We believe that statutory safeguards (by way of primary legislation) for set-off and netting are essential and should not be in anyway be impacted adversely. The ability to set-off and net financial arrangements is of enormous importance in managing credit risk. Furthermore, we believe that there would be a high likelihood that limiting the scope of netting so as to put the scope of any currently enforceable netting arrangement in doubt would have adverse consequences for the UK financial markets, by potentially driving business offshore, increasing the cost of funding for UK financial institutions and potentially creating another liquidity crisis in the market.

Funding

We feel strongly that the FSCS should not be used to meet any of the costs of resolving the failing bank, as the FSCS was established to compensate depositors.

We disagree with the Authorities' argument that the cost will be less than the costs of paying out depositors under the FSCS once the bank is in insolvency, as the consultation fails to recognise that the industry could ultimately pay twice. If the SRR tools are unsuccessful and the failing institution goes into insolvency, the levy payers would have to fund the FSCS and the costs of the SRR.

At the same time, particularly in a partial transfer scenario, banks contributing to the levy could be creditors to the failed bank and would likely see compensation greatly reduced through the preference for depositors.

We do not believe that it should be for well run banks to fund the costs of failure of a badly run bank, particularly as we believe the SRR tools could actually trigger financial instability. Nor should the shareholders of the failed bank be eligible for compensation. We believe there should be no question of the industry being expected to subsidise the owners of failed competitors.

Stabilisation powers and merger control

Finally, the stabilisation options include the possibility of a transfer to a private sector purchaser. However, the provisions of the Consultation Paper do not address the relationship between this provision and the merger control rules.

So far as the merger control rules are concerned, there must be a case arising from the proposals for a new public interest consideration under section 58 of the Enterprise Act, expressed in terms of prudential supervision or confidence in the financial system. This would enable decisions to be made by the Secretary of State on the basis of a fuller consideration of relevant issues, including those set out in the special resolution objectives.

LLOYDS TSB RESPONSE TO CONSULTATION QUESTIONS

Lloyds TSB welcomes the Tripartite Authorities' consultation on a proposed Special Resolution Regime (SRR) for failing banks. In our response to the Tripartite Authorities' January consultation we questioned the need for a special regime and, in particular whether an SRR would have the undesired consequence of driving ailing banks more swiftly towards failure and of increasing the risk of contagion to other businesses. As we set out in our response to specific questions in this consultation, we continue to have grave concerns. Although we agree the need to put in place measures which will ensure the Authorities have the powers they need to deal effectively with banks in difficulty, we believe that the range of tools proposed currently would have far-reaching implications for the stability of the sector by creating legal uncertainty and thereby encouraging healthy banks to withdraw lines of credit more swiftly and rein back lending. We consider that aspects of the proposed regime require considerable further development to ensure that they are effective and balance the interests of different groups of stakeholder.

SECTION 2: SRR OBJECTIVES, ROLES AND GOVERNANCE

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

We agree with the Tripartite Authorities' objectives of protecting and enhancing the stability of the financial systems of the UK; of enhancing public confidence and of protecting public funds. However, we are concerned that the inclusion of an objective focused on protecting depositors, without a balancing objective of protecting the interests of other stakeholders, is inappropriate. In essence, this objective gives depositors a preferential creditor status, to the detriment of other creditor stakeholders.

Although paragraph 2.4 of the consultation asserts that the "Authorities should pay due regard to the rights of interested stakeholders", their absence from the list of objectives fails to give us reassurance that this will be the case. This lack of balance in the objectives and the outlined operation of some of the proposed SRR tools also give us no confidence that the Authorities will be able to deliver on the commitment, in the same paragraph to "seek to maintain the priority ranking and equitable treatment of classes of creditors under existing insolvency law".

Furthermore, if the aim of the regime is to ensure financial stability and depositor protection, then the SRR tools are potentially in conflict with this objective.

Depositor protection is already achieved through the Financial Services Compensation Scheme (FSCS). The focus should be on ensuring the FSCS is fit for purpose and facilitates a reasonably fast payout to depositors rather than through a new insolvency regime for banks

The legal uncertainty created by some of the proposed tools could have the undesired impact of undermining the objective of financial stability. If banks believe that their legal position could be compromised and where they have limited or no ability to re-negotiate pricing, they will pull in their credit lines and stop lending to a bank in financial difficulty which could lead to financial instability.

Furthermore, if there were no legal certainty regarding the safeguards for qualifying financial contracts and set off and netting arrangements, banks would change the way in which they negotiate new contracts and would also renegotiate existing contracts. More draconian

conditions would be required for collateral arrangements, to mitigate netting positions for capital which would probably be reviewed on a daily basis. This would be a serious drain on liquidity again triggering financial instability.

These proposals therefore threaten to undermine the standing of UK banks and building societies, damaging confidence in the UK banking sector, increasing the cost of capital and liquidity and ultimately undermining the competitiveness of UK financial services.

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

We agree that the decision to trigger the SRR should be a regulatory judgement by the FSA, in consultation with the other Authorities. As we say in our response to the further consultation, the FSA's ability to make an appropriate judgement at the right moment will be dependent on the long term effectiveness of the supervisory relationship it has developed with the bank and the ability of FSA staff accurately to assess information related to the bank in the context of prevailing market conditions. We therefore urge the FSA to press ahead with its supervisory enhancement programme including improvements in staff training and development approaches.

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

It is difficult to take an informed view of the conditions for entering an SRR before we have had sight of the Code of Practice proposed at paragraphs 2.28 – 2.29. What is clear is that a decision to trigger the Special Resolution Regime will need to result from a consideration of both the objective criteria suggested in Condition 1 and the exercise of expert judgement by a supervisory team suggested in Condition 2. This judgement will need to draw in input from senior FSA officials and other Tripartite Authorities, capable of interpreting and predicting a bank's performance in the context of wider conditions. Clearly articulated minimum conditions will need to be applied to justify entry to the SRR together with an informed and expert conviction that no other alternative to deliver the agreed objectives is viable.

Any trigger point will need to be considered extremely carefully with a special reference to "material change clauses" in securitisation and structured product contracts if set-off and counterparties rights are suspended.

With reference to the proposed conditions:

Condition 1: The threshold conditions should be clearly articulated and agreed between the individual bank and its supervisory team such as continuing breach of minimum regulatory standards leading to unavoidable failure. In setting these minimum standards, the regulators should ensure that they do not adopt a risk aversion strategy and set minimum requirements for capital or liquidity that are too high.

Condition 2: We note that a code of practice is proposed to set out how the Authorities will reach a view on whether or not it is reasonable to envisage that a bank may return to compliance with threshold conditions. We cannot comment fully on the proposed conditions for entry to SRR without sight of this code.

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

We support the formalisation of the Bank of England's role. We believe that defining this role in statute will provide greater clarity in respect of the Bank of England's participation in the Tripartite and help support active cooperation between the three entities.

Clause 8.2 states that the exercise of the power is necessary having regard to the public interest in the stability of financial systems, maintenance of public confidence in the stability of banking systems and the protection of depositors. This repeats the imbalance in the overall objectives for the SRR as we set out above. We propose either that Clause 8.2(c) be deleted or that an addition be made as Clause 8.2 (d) to reflect the need to protect other creditors of the bank.

In addition, because the SRR includes tools for the whole or partial transfer, the legislation will need to address the relationship between this provision and the merger control rules. There must be a case arising from the proposals for a new public interest consideration under section 58 of the Enterprise Act, expressed in terms of prudential supervision or confidence in the financial system. This would enable decisions to be made by the Secretary of State on the basis of a fuller consideration of relevant issues, including those set out in the special resolution objectives.

We appreciate that there might be a gap for transactions governed by the European Merger Control Regulations, which has no exemption for rescues and no explicit scope for balancing wider interests. In the context of broader concerns about financial stability that may be perceived to be a gap about which the Authorities can do nothing. It does not however seem to us to be a reason not to make sensible provision under applicable UK rules.

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

We agree the role proposed for H M Treasury in Clauses 8(4), 8(5), 9 and 10. However, we note that Clause 8.5 (a) allows a considerable degree of latitude and interpretation in defining and assessing "public interest" which creates legal uncertainty, particularly against the backdrop of overarching SRR objectives which give clear preference to one group of creditors over another. The "public interest test" should be clearly articulated and as far as it is possible to do so with objective criteria.

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

No. As proposed, the code of practice will set out in more detail how the Authorities propose to use the SRR tools. It would appear that the code is non-binding guidance. If this is the case, there is no certainty that the principles set out in the code would be followed.

We agree that more detail is needed to articulate the operation of the SRR tools. We note that the intention is to provide a Statutory Code under Primary Legislation to which the Authorities would be obliged to have regard. This is important as a non-binding code would create legal uncertainties which, in our view, would have a destabilising effect and, potentially, constrain liquidity as safeguards, especially those relating to creditor rights, would be uncertain. We believe that the principles governing creditor rights should be part of the overarching legislation and carried forward into a binding Statutory Code.

Furthermore, clauses 6(3) and 6(4) appear to give HM Treasury the powers to revise the code in consultation with the Authorities but without the need to consult externally. Any amendments to and updating of the code should also be subject to consultation. Under the Financial Services and Markets Act (FSMA) the FSA has a duty to consult on changes and we would expect the same duty to consult on the SRR.

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

Yes, subject to our comments in 2.6.

SECTION 3: SRR TOOLS: STABILISATION POWERS AND COMPENSATION

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

The property transfer powers cause us serious concern. The proposals give the Authorities sweeping powers that can vary or suspend creditor or counterparty rights, in particular if a partial transfer is invoked. In the absence of any information on the statutory protections for stakeholders, which are due to be incorporated in the code, our concern is compounded.

In particular, clause 19 of the draft legislation empowers the Authorities to override termination or close-out rights under instruments which are transferred. This would mean that a bank, instead of crystallising its exposure at the point of default, would be left with lingering exposure. This exposure would attract a larger regulatory capital charge reflecting the counterparty's poorer credit quality but there would be limited or no ability to re-negotiate pricing.

The property transfer powers also create problems in a partial transfer scenario. Where a financial institution's exposure to a failed bank is split between the bridge bank and the residual bank, the net effect could be to place that innocent bank in breach of its own regulatory exposure limits.

These proposals therefore threaten to undermine the standing of UK banks and building societies, damaging confidence in the UK banking sector, increasing the cost of capital and liquidity and ultimately undermining the competitiveness of UK financial services.

Finally, the stabilisation options include the possibility of a transfer to a private sector purchaser. However, the provisions of the Consultation Paper do not address the relationship between this provision and the merger control rules.

So far as the merger control rules are concerned, there must be a case arising from the proposals for a new public interest consideration under section 58 of the Enterprise Act, expressed in terms of prudential supervision or confidence in the financial system. This would enable decisions to be made by the Secretary of State on the basis of a fuller consideration of relevant issues, including those set out in the special resolution objectives.

We appreciate that there might be a gap for transactions governed by the European Merger Control Regulations, which has no exemption for rescues and no explicit scope for balancing wider interests. In the context of broader concerns about financial stability that may be perceived to be a gap about which HMG can do nothing. It does not however seem to us to be a reason not to make sensible provision under applicable UK rules.

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

Our comments on property transfers capture our concerns relating to powers to transfer shares. See 3.1

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

We agree that a company limited by shares is the most appropriate legal form for a bridge bank. What is not clear from the consultation is how the bridge bank would be capitalised

and whether it would be bound by the same regulatory capital requirements applicable to banks. Clarification on these points is required.

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?

It would not be appropriate to have a bridge bank with an unlimited lifespan. However, an arbitrary twelve months may constrain the optimum price and could even force a “fire-sale” if a potential buyer knows the bridge bank is up against the twelve month limit.

Our expectation would be that, during the lifespan of the bridge bank, either a private purchase would be achieved swiftly or that the bank would be wound up. Despite reassurances from the Authorities about the security of the FSCS, human nature and experience here and overseas show that once the market and consumers become aware that a bank is in difficulty and has been placed in SRR, depositors – and other creditors - will instinctively withdraw their money. At the same time potential lenders will withdraw from interactions with banks beyond the failing institution resulting in a drying up of liquidity. Both behaviours will accelerate the bank’s demise.

The authorities need to ensure, however, that a bank in a bridge bank position which could be perceived to be state-backed does not create competition issues.

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

Any extension of a bridge bank’s lifetime could exacerbate competition policy issues, particularly if the failing bank is also in receipt of public financial support. This would be unacceptable and distort the market. It could also add to the cost to the industry over and above their contributions to the FSCS.

As the extension of a bridge bank will affect the compensation rights of creditors of the original bank, they should have the right to be heard by the court so their rights are not further disadvantaged.

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?

We can see that the power to transfer part of a failing bank’s business may be attractive, as it minimises the likely impact of a whole bank failure. However, as the residual company is likely to include the ‘unhealthy’ elements of a failing bank it would, in our view, be unlikely to find a willing purchaser and would move inexorably towards insolvency. Inevitably, some creditors would be left with claims on the residual company. The recovery value of claims against the residual company would be damaged by the transfer of the ‘healthy’ elements of the failing bank away from the reach of insolvency calculations.

Therefore, partial transfer is the SRR tool that gives us the greatest concern. It cuts across insolvency, contractual and proprietary rights. While the Authorities agreed not to give depositors preferential status, the proposals outlined would in essence provide them with statutory preference. This would leave other creditors in a worse position because the funds available to them would be reduced and the assets available to them would be of lesser quality or creditors would be left without any security if assets have been de-linked from the liabilities they were intended to secure. These creditors would therefore potentially face

greater losses than they would under normal insolvency procedure where there is equitable treatment of classes of creditors.

The partial transfer tool is inherently inequitable for creditors when it is invoked. However, the creation of the tool may itself have adverse consequences for the UK financial system because creditors will anticipate a weakened position upon counterparty default, and will therefore seek to reduce and re-price exposure to UK financial institutions. This may reduce competition and increase systemic risk because concerns will be focused on smaller, higher-risk institutions that will find it harder to hedge their positions and raise funding in wholesale markets.

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

We agree that the Authorities should ensure maximum clarity on the use of partial transfers. However, as we said in our response to Question 2.6, we emphasise the importance of ensuring that the Code has the force of law to avoid the uncertainties of a non-binding code.

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

See 3.7

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

We agree that the situations outlined in the consultation document capture the range of situations in which a partial transfer might become an option. However, the acknowledgement that they could be used to 'sanitise' a failing bank's balance sheet very much underlines our view that they would disadvantage some creditors and seems to us to go against the desire in paragraph 2.4 of the consultation to 'maintain the priority ranking and equitable treatment of classes of creditors under existing insolvency law'. See our response to 3.6

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

While we understand that ensuring financial stability requires flexibility of policy response, from a counterparty perspective this does need to be balanced against the need for maximum legal certainty. See our response to 3.6. The only appropriate measure is for the authorities to adhere to a legally binding code.

3.11 Do you think the BoE should have the flexibility to make subsequent transfers between a bridge bank and a residual company?

No. This would add to uncertainty in dealing with either entity and could cause creditors' positions to be progressively eroded.

3.12 Do you think the BoE should have the power to make subsequent transfers using the stabilisation powers?

No. As set out in our response to 3.11, it would add to uncertainty in dealing with either entity and could cause creditors' positions to be progressively eroded. It would also lead to further delay in the winding up of the residual company, as this could not proceed until all subsequent transfers occurred. This would also add to further uncertainty for the creditors of the residual company.

3.13 Do you agree with the restrictions the Authorities proposed 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?

No. We would not want to see these transfers taking place. If they do occur, there should be independent oversight e.g. via a creditors' committee.

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

Clearly there needs to be a mechanism and the bank resolution fund will channel any net proceeds back to creditors. However, the proposal fails to address the need for the Bank of England to have some accountability for its running of the bridge bank and maximising the value of the residual fund.

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

We consider that there is currently insufficient detail in the SRR Consultation Paper and therefore a great deal of legal and therefore pricing uncertainty surrounding qualifying financial contracts (QFCs). A great deal of time and resource has been spent worldwide to ensure for example that derivatives, stock loans and repurchases in many jurisdictions should have the benefit of set-off and netting arrangements. We would caution against interrupting these arrangements.

Pricing for many transactions is contingent upon the efficacy of the netting arrangements and the capital adequacy requirements of the relevant regulator. As of June 2007, mark-to-market credit exposure of all outstanding OTC derivatives was reduced by 76 per cent after applying close-out netting. Unintended potential adverse consequences of the SRR need to be examined otherwise there is the potential for another liquidity crisis in the market.

Banks currently seek ordinarily to manage credit risk on a net basis in reliance on the legal enforceability of set-off and close-out netting arrangements and market integrity is driven to a degree by legal certainty. A difference does exist between set-off and netting and this must be recognised clearly in all situations.

We believe that statutory safeguards (by way of primary legislation) for set-off and netting are essential and should not be in anyway be impacted adversely. The ability to set-off and net financial arrangements is of enormous importance in managing credit risk. Furthermore, we believe that there would be a high likelihood that limiting the scope of netting so as to put the scope of any currently enforceable netting arrangement in doubt would have adverse

consequences for the UK financial markets, by potentially driving business offshore and increasing the cost of funding for UK financial institutions.

More generally, the availability of set-off post-insolvency under English law is a fundamental and long-standing principle and underpins commercial dealings. It is important because the fact that set-off is not stayed under English insolvency law means that market players see this as an advantage when dealing with English incorporated entities.

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

See 3.15

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

The scope of any constraint must be considered in conjunction with all the relevant trade bodies (including ISDA, ICMA, SLRC etc) as well as addressing any bespoke single agreement type netting contracts. It is quintessential that we permit QFC's to anticipate transactions developed in the future.

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

The use of qualifying contracts seems appropriate as a way of framing safeguards, but there should be flexibility to expand where appropriate to reflect product innovation (e.g. Islamic finance). There is a real danger that the definition of a QFC will never keep pace with market developments and so this may inhibit innovation.

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

Yes. It would seriously weaken the structured finance market if connected contracts making up a single deal were to be divided between different counterparties, and it would in most instances increase the aggregate risk exposure.

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

The safeguards protecting netting agreements and early termination and close out netting of transactions entered into under those agreements, as well as related financial collateral arrangements should be enshrined in primary legislation.

The Model Netting Act published by ISDA provides a working template, but further analysis (and hence time) is required to ensure we build out the definitions therein should be broad enough and clear enough to cover all existing transactions documented under all forms of netting agreement including hybrid and exotic variations on such transactions, and flexible enough to accommodate future innovation in the financial markets

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

As we explained in our response to 3.6, partial transfer is the SRR tool that gives us the greatest concern because it cuts across insolvency, contractual and proprietary rights. Therefore, we would not want to see any reduction in the protection of security interests and we consider all security interests should be protected.

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

As we have explained in our response to 3.21 we do not believe that there are any security interests which should not be covered. If security interests have been agreed between parties, they should be respected by any insolvency regime to ensure creditor confidence in transacting with UK financial institutions.

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?

It is accepted that a special bank administration procedure is probably needed to ensure the running of the residual bank post partial transfer as someone needs to be accountable for protecting the interests of creditors relegated to the residual bank which would probably be, or would rapidly progress to become, insolvent. However, as the primary role of the residual bank would be to support the bridge bank there may be a conflict of interest.

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?

We believe that there should be a holistic regime which would apply across bridge bank and residual company with the aim of protecting creditor rights, irrespective of where they are.

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

We agree that the special bank administrator should have specific objectives to ensure that the interests of creditors to the residual company are protected.

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?

As we are opposed to the concept of partial transfers, we do not agree with the proposed objective of maintaining the residual bank only for the benefit of the bridge bank until such time it is no longer required. The entire partial transfer process conflicts with the proposed secondary objective of winding up the residual bank in the best interests of its creditors.

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?

No comment

3.28 Should any other grounds be included in the legislation?

No comment

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 BoE?

We believe that the special bank administration procedure should be commenced by an order of the court in order to give creditors an opportunity to make representations or to bring disputes before the court.

This is important because the special bank administrator would only be appointed in respect of a residual bank under a partial transfer regime. As we have already outlined, we have grave concerns about the partial transfer process as it cuts across insolvency, contractual and proprietary rights. Since these creditors are likely to be in a worse position, it is important they have some ability to say how the residual bank should be managed.

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 BoE, with the court ruling on any disputes arising in the resolution?

We believe the special bank administrator should be an officer of the court to allow creditors an opportunity to make representations or bring disputes before 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?

We are content for the moratorium provisions to mirror the current Insolvency Act 1986.

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

Since the powers of the administrator are only restricted to those actions allowable by the Bank of England, we are concerned that this may conflict with the administrators role of maximising value for creditors.

3.33 Should the special bank administrator be give 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?

Please see 3.32

3.34 Do you agree that the BoE 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. As the Authority which operates the SRR, the Bank of England must have accountability for the arrangements it puts in place for the operation of the bridge bank and maximising the value of the residual fund in the interests of creditors.

While we understand the Bank of England has statutory immunity, we believe it should be accountable for the loss of stakeholder rights, should the Bank's mismanagement of a bridge bank arrangement result in a diminution of the value of the failed bank's and a reduction in the net proceeds from the resolution fund.

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

We believe it is important that creditors have a voice and that there should be a meeting of creditors to agree the special bank administrator's proposals.

3.36 Should the BoE rather than creditors fulfil the functions of a creditors' committee?

In the absence of knowing what safeguards there would be for creditors, it is difficult to make a judgement about whether the BoE should fulfil the function of a creditors' committee. However, without safeguards, the removal of the creditors' committee is a further erosion of their rights. Therefore, we would consider a creditors' committee more appropriate to protect creditors' rights, and to act as a counterbalance to the BoE.

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?

We do not believe the rights of creditors to challenge the conduct of the procedure should be subject to restriction. Creditors' rights must be protected and there must be an open opportunity to challenge the operation of the SRR.

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

As we have already stated, we do not want to see any substantial change to the priority of creditors. However, through the SRR's objectives and the objectives of the administrator, prioritization of creditors will be altered with depositors given preferential status particularly where there are partial transfers.

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

We believe that provisions should be introduced which expressly preserve right of set-off and this should be enshrined in statute in the SRR.

3.40 Do you agree that the procedure should only be terminated where the BoE provides consent?

Since the BoE will be ultimately accountable, termination of the procedure would sensibly be where it provides consent.

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

We understand the need for flexibility in bringing a procedure to a close and support the proposal that this mirrors ordinary administration proceedings.

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

Yes, as financial stability and the systemic impact on the market needs to be weighed against any possible competition issues to ensure temporary public ownership is really in the public interest. Furthermore, nationalisation in effect involves expropriation of shareholder rights and a clear case will need to be made that this is in the public interest.

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, as it provides a mechanism to pay compensation

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?

No comment.

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)?

We agree that the bank resolution fund should only comprise net proceeds.

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

We support the appointment of an independent valuer appointed and accountable to the court. Clearly any mechanism for compensation is complex and gives rise to many practical and legal difficulties in terms of quantifying the loss of shareholder value.

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?

We agree with the specific powers with the exception of (6 a/b) which allows HM Treasury to ask the independent valuer to reconsider decisions and gives the Treasury the power to appeal to a court against the valuer's decision. We do not believe these powers exist in normal insolvency proceedings, and see no reason why, in these circumstances, the Treasury should have the right to intervene in an independent process.

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

Yes, we agree.

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?

No. As we have stated in 3.47 above, we do not believe these powers exist in normal insolvency proceedings, and see no reason why, in these circumstances, the Treasury should have the right to intervene in an independent process.

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

Further detail is required before we can come to a view.

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

The FSCS was established to compensate depositors of failed institutions. We feel strongly that the FSCS should not be used to meet any of the costs of resolving the failing bank.

The Authorities argue that the industry should contribute to the costs of resolution through the FSCS on the grounds that it will protect financial stability and that the costs will be less than the costs of paying out depositors under the FSCS once the bank is in insolvency. However, the consultation fails to recognise that the industry could ultimately pay twice. If the SRR tools are unsuccessful and the failing institution goes into insolvency, the levy payers would have to fund the FSCS and the costs of the SRR.

At the same time, particularly in a partial transfer scenario, banks contributing to the levy could be creditors to the failed bank and would likely see compensation greatly reduced through the preference for depositors.

We do not believe that it should be for well run banks to fund the costs of failure of a badly run bank, particularly since we believe the SRR tools could actually trigger financial instability. Nor should the shareholders of the failed bank be eligible for compensation. We believe there should be no question of the industry being expected to subsidise the owners of failed competitors.

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

No, we do not believe there are additional costs of resolution that should be borne by the FSCS. If the Authorities widened the scope of the type of costs that could be borne by the FSCS, such as those cited in the proposals for compensation claims and market guarantees, this would require the FSCS to bear significant extra responsibilities and costs beyond its role to compensate depositors. It would also make improbable the Tripartite's view, that levy payers would pay no more or less than they would if the bank had been liquidated and depositors paid out.

SECTION 4: SRR TOOLS: BANK INSOLVENCY PROCEDURE

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

Yes, we agree.

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?

Objective 1 states that the liquidator is to work with the FSCS to ensure that as soon as possible eligible depositors receive appropriate treatment. This takes precedence over objective 2 which is to wind up the affairs of the bank so as to achieve the best result for the bank's creditors as a whole. . Since we already have concerns about depositors, in essence, being given preferred creditor status, these objectives reinforce the fact that there is prioritisation of one creditor over another. In the context of the legal uncertainty facing counter-party creditors under the SRR tools this needs to be clarified because a liquidator will be unable to reconcile objectives.

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

No comment

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

No. The provisions only allow for nominees from the Bank of England, the FSA and the FSCS to sit on the liquidation committee until each eligible depositor receives appropriate treatment. We can see no reason why creditors should not be appointed to the liquidation committee from day one. They will want to understand the steps the liquidator is taking as this will impact the outcome of objective 2 which is to wind up the affairs of the bank so as to achieve the best result for the bank's creditors as a whole

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

No comment.

SECTION 5: 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, we believe the same objectives, roles and governance structures should apply to building societies.

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?

No comment

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?

Yes, it should mirror the arrangements put in place for a bank.

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

Yes, but only if there were systemic risks to the financial system and the primary objective of maintaining financial stability was at risk.

5.5 How would this tool best be implemented in the case of a building society, give the lack of applicability of share transfer powers?

No comment

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 comment

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

No comment

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

No comment

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 those powers?

Cross border issues, including those arising where a bank is part of an international group are not discussed in any detail in this consultation paper. We would therefore require further information before coming to a view. However, our over-riding concern about any legislation that enables the Treasury to create, alter or nullify contracts between group companies is that it could increase the nervousness of non-UK institutions and potentially damage investor confidence in the UK markets.