APRIL 2008

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 133 – BANKING REFORM – DEPOSITOR PROTECTION

FMLC Response to the Tripartite Consultation Paper on Banking Reform – Depositor Protection

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1. Introduction and Executive Summary

Introduction

1.1 The role of the Financial Markets Law Committee ("FMLC or Committee") is to identify issues of present and future legal uncertainty, or misunderstanding, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

1.2 The FMLC has reviewed the Tripartite banking reform proposals with great interest. In considering the Financial Stability and Depositor Protection Consultation Paper (the "CP") it has become apparent to the FMLC that the proposals raise a number of complex issues, which are likely to have widespread repercussions for financial services business carried out within the United Kingdom, for the relative competitiveness of the UK's financial services institutions and for legal certainty within the financial markets. It is beyond the remit of the FMLC to offer opinions on issues of policy and, accordingly, this response will not seek to address all of the questions set out in the CP: the comments that are put forward in this response are restricted to the areas within the CP proposals where the Committee has identified the potential for legal uncertainty to arise.

1.3 The Committee supports and endorses many of the objectives set out in the CP and welcomes the opportunity to explore ways to strengthen the financial system, to improve the framework for dealing with banks in distress, and to develop effective depositor compensation arrangements with a view to instilling consumer confidence.

1.4 Chapters 3, 6 and 7 of the CP address proposals to increase the FSA's supervisory powers, to strengthen and formalise the Bank of England's role in the area of financial stability and to promote effective coordination between the Tripartite Authorities. *Prima facie* these proposals do not concern the FMLC as they do not immediately relate to the existing private law framework within which the financial markets operate. However, the proposals detailed in Chapters 4 and 5 of the CP are more complex and, in the Committee's view, will have a direct impact upon private financial markets law, not least as regards creditor and shareholder rights. Given the remit of the FMLC, this response seeks only to address the more complex proposals set out in Chapters 4 and 5, where the FMLC considers that legal uncertainties could arise.

Executive Summary

1.5 The issues raised by the FMLC in this paper are wide-ranging and, in part, quite complex, making it difficult to summarise all of the concerns effectively. In brief:

(a) The principal concern relates to the proposed timetable for both the consultation process and implementation of legislation, which the FMLC believes is inadequate for stakeholders to submit sufficiently detailed responses or for the Authorities to digest those responses received, given the extent of the changes being proposed.

(b) The FMLC is not convinced that all the possible negative repercussions of the proposed SRR have been considered and believes that a more extensive analysis and impact assessment is required. The Committee is concerned that a number of the tools available under the proposed SRR could substantially interfere with the fundamental rights of stakeholders and believes that appropriate safeguards need to be devised. It is also convinced that a clearer account must be given of how and when these SRR tools may be used.

(c) With regard to banking insolvency procedure, the FMLC suggests that minor amendments adapting the existing, tried and tested insolvency regime would arguably offer more clarity than the proposed new 'stand alone' regime. The Committee is concerned that the proposed reform could complicate UK insolvency law and bring additional burdens to market participants leading to unpredictable results and damaging confidence in the UK markets.

(d) The proposals regarding compensation payments raise issues of compatibility with existing European legislation and existing compensation schemes and it is not clear from the CP how the scheme will be applied to European and "Third Country", ie non-European, banks. The Committee is also concerned that the move towards gross payments could have an inadvertent negative impact upon netting and set-off provisions on insolvency.

2. General Concerns

2.1 **Detail.** The FMLC has concerns that the CP does not set out in sufficient detail and with enough clarity the government's plans as regards Chapters 4 and 5. While the lack of detail preserves a degree of flexibility for the Authorities to determine the best way to implement the desired reforms, it also makes it difficult to form a view as to whether the proposals are acceptable. The Committee believes that in certain areas its ability to provide a thorough response was hindered by the lack of specific information substantiating the proposals in the CP. It is hoped that the consultation process will be ongoing and that there will be further opportunities for the FMLC to contribute to the detailed development of the reform legislation.

2.2 **Timetable.** The FMLC's primary concern is the brevity of the consultation and implementation timetable. Indubitably, there is an acknowledged need for the Authorities to address the problems that surfaced during the recent market turmoil and to regain consumer confidence. However, the FMLC strongly believes that the time allocated for this consultation and thereafter for implementing the proposals is insufficient in a number of areas given the extent of the changes to the current regime that are envisaged and the way in which the reforms will affect the conduct of wholesale business in London. The schedule underestimates the time required for detailed consideration of the complex issues likely to arise from such extensive reform. There is a real risk that the expedited timetable will present new problems and uncertainties and will have unexpected consequences if legislation is implemented without sufficient time to consider all the ramifications.

The Committee is particularly concerned that the limited time between the consultation deadline and the proposed date for implementing legislation allows very little time to digest and respond to consultation responses. The FMLC is of the view that certain aspects of the proposals in the CP may need to be reconsidered and the current proposed timetable does not allow for this. In order to ensure that all the implications of the proposals in the consultation are taken into account, the FMLC has concluded that a reconsideration of the timetable is necessary to allow for a more restricted reform to take place in 2008 and an extended consultation period to look at the more complex issues detailed in this paper below.

The Banking (Special Provisions) Act 2008 (the 'Act') provides the Treasury with a number of powers including, among others, the power to acquire the shares in, or other securities issued by a financial institution or to compel the transfer of those shares or securities to another body corporate and the power to compel the transfer of all or part of the property, rights and liabilities of a financial institution to another body corporate. These powers bestowed by the Act essentially give the Treasury rights comparable to those that would become available under the proposed SRR. The Act is valid for a twelve month period and accordingly removes the need for immediate implementation of permanent legislation. The FMLC believes that the Authorities should maximise use of the time available for a more complete consultation on the complexities of the proposed SRR to avoid future uncertainties.

2.3 **Risk of exacerbating existing problems.** The FMLC is concerned that a short, reactive, timetable could lead to the implementation of ill-thought out changes that may have the effect of exacerbating the very problems which the CP is setting out to address. Uncertainties about various aspects of the proposal such as the triggers for the SRR process or the treatment of unprotected creditors and commercial counterparties once the SRR is in operation or during the new bank insolvency procedure, are not simply matters of concern for academic lawyers. If financial institutions are unsure of their position in these respects, their willingness to continue to deal with a bank which has, or is rumoured to have, potential financial difficulties will clearly be adversely affected. The result could easily be that the proposed changes to the law which are intended to improve the position in a Northern Rock-type situation could in future contribute to the creation or escalation of such a situation by intensifying the concerns of third parties dealing with a bank, who may feel that lack of clarity as to their rights as creditors requires them to withdraw credit at an earlier stage than they would otherwise have done so.

2.4 **Separate legislative reform.** The FMLC appreciates the need of the Authorities to take positive steps to ensure that appropriate mechanisms are put into place to deal with future troubled banks in response to recent events. However, in the Committee's view, there is no need for the proposed reforms to be implemented together and at once. The FMLC suggests that the Authorities should give careful consideration towards severing the proposals and fast-tracking those reforms which have marginal impact upon existing private law framework, set out in Chapters 3, 6 and 7 of the CP, whilst extending the timetable available for the proposals in Chapters 4 and 5 to allow for more a more thorough analysis of those proposals which directly impact upon private financial markets law.

3. Special Resolution Regime ("SRR")

3.1 The need for a SRR

The recent market turmoil exposed a number of weaknesses in the financial markets and the tools currently in place for dealing with troubled banks. The FMLC recognises the need to address the apparent shortfalls in the current regime and is supportive, in principle, of the need for a clear legislative framework to instil depositor confidence that critical banking functions can be maintained when banks encounter problems. Whilst it is easy to conclude that some form of SRR is required to cope with banking failure, it is more difficult to anticipate how such a regime might be adopted in a way that would not simply replace the current problems and uncertainties with new ones.

3.2 Identifying the most effective SRR

If it is accepted that some form of special regime is required for failing banks then the focus must be on obtaining the most effective SRR possible for the UK. An ill-considered legislative response to the recent financial tumult has the potential to escalate uncertainty and damage the UK markets.

The US corporate sector was damaged when US legislators responded with too much haste to the Enron collapse and introduced the Sarbanes-Oxley legislation. Care should be taken to ensure that the UK does not make the same mistake by hurrying legislative reform. A new regime such as this, which fundamentally changes banking law, should not be implemented without a full and detailed exploration of all possible alternatives. The overall merits of the regime must be incontrovertible. A precipitous change to the UK legislative framework risks bringing additional uncertainty, rather than the clarity and depositor confidence that it is seeking to achieve. The FMLC is particularly concerned that rushed solutions could create unintended legal uncertainties and a situation where more problems are created than cured.

(a) **Lack of experience of bank failure.** It is rare, in the UK for a bank to fail. This means that there is little practical institutional, public or social experience to build upon in determining how troubled banks should be managed and what the optimum resolution regime would be in such circumstances. This infrequency of bank failures also means that it is unlikely that the effectiveness of any regime will ever be fully tested. Given, then, a real question exists about whether the SRR will ever confer real practical benefits, it is essential that it does not cause significant detriment in the meantime by generating costly uncertainties for banks and their trading counterparties.

(b) **Develop upon experience of other jurisdictions.** Much has been made of the fact that the UK is the only G7 nation not to have a SRR in place to deal with failing banks and there is undoubtedly a need to explore and learn from the different insolvency regimes that exist in other jurisdictions. However, insolvency regimes vary greatly from country to country in response to the specific features of the local legal and commercial landscape and there is no single optimal model for the UK to draw upon. The United States regime, which has been a template for the CP SRR proposals, presents a useful and important example from which to learn. However, the UK market and legal systems are very different to the US market in a number of ways and whilst lessons should be learnt from other jurisdictions it must be recognised that a wholesale transposition of another country's regime would involve a radical change that would create uncertainty and would be unlikely to work effectively when superimposed on the UK legal framework and market culture. The FMLC believes that a more detailed exploration of what can be learnt from a number of different regimes is required to develop the 'best fit' for the UK.

(c) **Sensitivity to the UK market.** The introduction of an SRR in the UK would be a significant step with far-reaching implications, beyond the intended objectives. A SRR will affect established UK insolvency law and have an impact upon the fundamental rights of shareholders and commercial counterparties. To avoid more uncertainty than is necessary such changes must be implemented with sympathy to the current UK regime, as well as the EU legislation that directly affects the UK market, and should not be undertaken without thorough consideration of the possible repercussions. It is suggested that a number of the tools available under current UK insolvency legislation and the law on administration could feasibly be adapted to create substantially the same effect as some of the proposed SRR tools, with less risk of legal uncertainty.

(d) **Timetable.** The FMLC strongly believes that the timetable discussed for implementing legislation regarding a SRR is inadequate.

3.3 Specific areas of concern

The proposed SRR would give the Authorities access to a wide range of tools to assist in the orderly resolution of a failing bank. The FMLC is of the view that, whilst some of the proposed tools are unproblematic, others involve very significant changes and have the potential to bring extensive legal uncertainty to the financial markets. The FMLC has identified a number of specific points, which it believes are not fully addressed in the CP and, therefore, require further exploration and clarification. There is a real risk of legal uncertainties arising if these issues are not given careful thought prior to the implementation of legislation.

(a) **Triggers.** The FMLC is of the view that the CP is insufficiently clear in relation to the circumstances that would trigger the decision to subject a bank to the SRR tools. Although it is appreciated that triggers are likely to be largely subjective, dependant on the unique circumstances of the institution involved, the Committee believes that some thresholds, quantitative and qualitative, will need to be defined for the benefit of the Authorities, the banks themselves and their market counterparties. The CP indicates that the decision as to when and how the SRR tools will be applied may be left entirely to the discretion of the Authorities, primarily the FSA, and there is no suggestion that there will be any specific criteria or thresholds set down to act as a prescribed trigger. It is also not apparent what would happen if the Authorities were in disagreement as to whether the SRR should be applied or not. A discretionary approach clearly has the advantage of flexibility, but, in the view of the FMLC, may lead to market uncertainty in the event of a bank reaching crisis point. The FMLC recognises the need for a degree of flexibility but believes that this requires further thought and that more detailed guidance is required.

(b) **All or Part?** The CP provides that under the proposed regime it would be possible to transfer '*all or part*' of a troubled bank's business (assets and liabilities) to a private bank (paragraph 4.21), to a bridge bank (paragraph 4.26) or even into public ownership (paragraph 4.54).

There is a significant risk of uncertainty regarding the proposed '*part*' transfers. If a part transfer is to be permitted, there can be no uncertainty as to which of the bank's assets and liabilities should be included. There must be clear and certain criteria in place to ensure that market participants and stakeholders are able to predict the outcome of any such transfer at the time they are considering whether and on what terms to deal with a bank (even in the absence of threatened financial problems). Bank creditors with security interests or equivalent arrangements (for example under a credit support annex or GMRA) posted at the bank and other commercial counterparties will want transparency so that they can be certain of the value and viability of their claims. Assets separated from a failing bank will be in a safer position, whereas those that remain suffer the risk of being abridged or swallowed up by the troubled bank. The possibility that certain creditors of or counterparties to the bank could be placed at a significant disadvantage to others at the discretion of a Government-appointed officer heightens the need for complete clarity regarding the criteria that will determine the 'partial transfer' decision.

The proposed regime should also clearly provide that a financial market master agreement may itself only be transferred in whole. In other words, the power to transfer part of the assets and liabilities of a troubled bank should not be used to disrupt close-out netting under a financial market master agreement by "cherry-picking" transactions (or even selected rights and obligations under individual transactions) under the master agreement. To provide for this possibility in the legislation would create considerable uncertainty, even if the Authority granting the power to make such transfers would never exercise it on this basis. Such uncertainty could have an immediate and adverse effect on banks' cost of doing business and raising finance at a time when such issues are of vital importance to banks. It would also make it very difficult, perhaps impossible, for a law firm to give a "clean" netting opinion as to the enforceability of close-out netting against an English bank, with adverse regulatory capital consequences for the English bank and any of its counterparties subject to supervisory capital requirements.

Such a provision in the regime would also be inconsistent with Article 7 of the Financial Collateral Arrangements Directive, which requires close-out netting to be recognised and given effect in relation to a financial collateral arrangement. We understand that a significant proportion of master agreements relating to OTC derivatives include as part of their terms a financial collateral arrangement. In addition, master agreements relating to securities lending and securities repurchase (repo) transactions will normally constitute financial collateral arrangements, protected by Article 7. We understand that the US bank resolution regime requires that a financial market master agreement must be transferred, if at all, only as a whole.

(c) **Substantial Prejudice**. An inevitable outcome of the proposed move away from general insolvency procedure towards a SRR would be that the role afforded to stakeholders generally will become more restricted as more power is placed in the hands of the supervisory authorities.

The increased powers of intervention do have obvious benefits in assisting with the speedy resolution of the bank. However, throughout the SRR process a number of the available tools could substantially interfere with the fundamental rights of stakeholders such as shareholders, employees and commercial counterparties, particularly those with security interests held with the bank.

The FMLC recognises that the primary objective of any resolution regime for banks will be retail depositor protection and that in certain circumstances it will be justified for the Authorities to be given the power to step in and take control of the bank in order to fulfil this objective. However, it strongly believes that the Authorities should not use their discretion to exercise the powers available to them to alter commercial agreements into which the bank has previously entered. There are concerns that the rights of wholesale creditors and other counterparties will become uncertain and that they will be detrimentally affected by the SRR tools. Rather, the SRR should be subject to an overriding principle to the effect that the exercise of the powers should, as far as possible, not cause substantial prejudice to any creditor.

The CP recognises that the SRR tools would, in some circumstances, have a negative impact on certain stakeholder rights, but does not, in the view of the FMLC, develop adequate safeguards to address this concern. A troubled bank's shareholders and creditors, for example, would clearly be affected by the bank entering into an SRR but would not be consulted or have any standing throughout the proceedings. The CP suggests that appropriate mechanisms as well as possible compensation schemes would be put in place to protect these stakeholders but lacks detail as to how this suggestion might be implemented. This uncertainty could pose real problems in the financial markets and the lack of protection could create a general reluctance towards shareholder and institutional investment in the banking sector, as well as a greater reluctance of wholesale market counterparties to deal with English banks. It is suggested that further exploration of appropriate appeal mechanisms and compensation schemes is necessary to create certainty and to protect the interests of the relevant stakeholder interests.

(d) **Bridge Bank.** Whilst the FMLC appreciates the purported benefits that a bridge bank could provide, through separating the 'good' from the 'bad' assets of a troubled bank, it maintains some reservations as to how the bridge bank would operate in practice. Further, it is not immediately apparent from the CP what the bridge bank would specifically be able to achieve that could not be achieved through minor adaptation to the current administration regime.

The FMLC is not convinced from the CP that a bridge bank is actually required and believes that the objectives of speedy payouts and continuity for retail deposits could perhaps be achieved more simply if the Authorities were given the power to apply for some form of 'regulatory administration' enabling them to appoint an administrator at the failed bank with additional powers to suspend certain parts of the bank's business in order to ensure efficient and effective management and the ability to continue to deal with the bank as a going concern. The FMLC recognises that there could be some drawbacks to relying on a regulatory administration scheme, in particular the stigma attached to intervention from the Authorities could bring about a degree of consumer panic. However, it nonetheless considers that an expansion of existing powers might be preferable to the general corporate restructuring and transfer of assets and liabilities envisaged by the introduction of a bridge bank. Furthermore, the adaptation of existing powers would have the benefit of increased certainty and familiarity for market participants. Although the introduction of the bridge bank is intended to foster consumer confidence, as a restructuring device it is untested and there is no real way of knowing how it would be received by depositors or how it would work in practice in the UK. Furthermore, the FMLC is not convinced that the use of a bridge bank would be appropriate for banks above a certain size, for which only temporary public ownership is likely to suffice in mitigating the immediate risks of contagion.

(e) **Compatibility with European Directives.** It is not entirely clear from the CP how the US-modelled resolution framework would fit with European Collateral and Winding-Up Directives (see paragraph 3.3 (b) above). These Directives build upon the framework of EU banking law to provide principles of unity and mutual recognition in relation to bank reorganisation and winding up provisions and the treatment of collateral on insolvency. An overhaul of UK banking law to provide for a SRR must take account of the provisions in these directives. One area that needs further consideration is whether the proposed SRR is a "reorganisation measure" for the purposes of The Financial Collateral Arrangements (No.2) Regulations 2003. It would be anomalous for other insolvency measures to be within the terms of these Regulations but the SRR to be outside them.

Further considerations relating to the Directive on the Winding Up of Credit Institutions (2001/24/EC) are set out in the Banking Insolvency Procedure section below (paragraph 4.4(b)) but are equally applicable to the SRR process.

(f) **Event of Default.** The SRR is intended to provide a mechanism for pre-insolvency intervention. The FMLC agrees that such intervention is desirable in principle to achieve a more orderly resolution of a bank. However, it considers that the introduction of intervention prior to formal insolvency could in fact expedite the onset of insolvency and create significant uncertainties.

It may be that the new regime would result in standardised financial market documentation being adapted to provide that pre-insolvency intervention amounts to an event of default. In the event of troubled bank entering an SRR its counterparties and creditors would, accordingly, call an event of default, resulting in the termination of the majority of the bank's credit lines. If this were to happen it would only escalate the bank's problems and ultimately precipitate its insolvency.

Paragraph 4.23 of the CP suggests that the Authorities might be given the power temporarily to suspend the ability of counterparties to treat the Authorities' action as an event of default. However, the CP does not make it clear how and when this might be done. Uncertainty exists in a pre-insolvency situation where the Authorities are able to step in and alter the terms of fairly negotiated contracts to put one of the contracting parties at a disadvantage. The existence of a situation where the onset of an SRR acts as an trigger for a default clause, which in turn triggers cross-defaults and ultimately a petition for the bank's insolvency is also problematic. Clarification is required to ensure that the appropriate safeguards are in place, to provide certainty and to reduce the risks of the bank's credit lines disappearing. Clearly it would be preferable to find a way to achieve the policy goal without providing the Authorities with the power to prejudice validly-concluded wholesale market contracts.

4. Banking Insolvency Procedure

4.1 Lack of appropriate detail in the CP

The FMLC is of the view that the proposal to introduce a new bank insolvency procedure in the CP lacks substance and provides little justification as to why a 'stand alone' regime is required. The CP states that the new regime will be 'based on existing insolvency provisions and practices' but it does not provide detail as to the extent that it will be different or an explanation as to why changes need to be in the form of a new 'stand alone' regime rather than more simple amendment to the existing regime. The FMLC is of the view that it is difficult for an informed response to be provided when so much detail is lacking from the CP.

4.2 Is there really a need for change?

(a) Strength of existing insolvency legislation

English law is one of the most important systems of law in the world. It has a dominant role in international, financial and commercial transactions. It is renowned for its stability and its respect for contract and property rights. This is a major factor in the role of London, and protects the status of the UK's banking institutions internationally.

The existing corporate insolvency procedures in England and Wales (namely administration, company voluntary arrangements, schemes of arrangement under the companies legislation and liquidation for terminal cases) provide for one of the most versatile and effective insolvency regimes in the world. They are often used as a model for jurisdictions reforming or developing their laws. In the recent Schefenacker restructuring (involving a major supplier in the motor industry), the assets and liabilities of the German parent company were migrated into an English company in order to make use of the English company voluntary arrangement as there was no equivalent procedure in Germany that would have achieved the desired objectives of the creditors. Various other reorganisation procedures (including US Chapter 11) were considered and dismissed for the purposes of this transaction.

Key features of the existing procedures which make them so effective include the following:

- They can be commenced quickly in urgent cases. This is particularly true of administration following the changes that were made by the Enterprise Act 2002. An administrator can now be appointed simply by filing the prescribed documents with the court or, if a court order is required, this can be obtained ex parte and on very short notice if necessary. This is important if the business is deteriorating rapidly.

- The emphasis of the procedures is on rescue where possible (particularly through the use of administration, voluntary arrangements and schemes of arrangement).

- In each case, an experienced insolvency practitioner is appointed i.e. someone who is used to dealing with the competing demands of creditors and other stakeholders and getting to grips, in an very short timeframe, with the underlying business and the reasons for the financial crisis. This can often involve liaising with the relevant regulator in the case of a regulated business.

- The insolvency officeholder has the ability to seek directions from the court where necessary without the process becoming overly court-driven (and therefore slow and expensive). Ultimately the insolvency officeholder is expected to make commercial judgments regarding the insolvency process and has the experience to make such judgments. As the duties and responsibilities of the insolvency officeholder are clear under the existing (tried and tested) procedures, this reduces the need for court applications to clarify the scope of those duties.

- Cases such as BCCI, Barings, Maxwell and more recently TXU and Marconi show that the existing insolvency procedures are able to deal with complex businesses with many different stakeholders (often with very different interests and objectives) in a transparent and predictable manner. The fact that these procedures are tried and tested means that the market knows what to expect from the procedures. These existing procedures should be perfectly adequate for dealing with the special issues that arise when a bank becomes insolvent.

- Finally (and crucially) many of the existing procedures are given automatic recognition in Europe as a consequence of European legislation, and have a track record of being recognised outside Europe (for example in any jurisdiction, such as the US, that has adopted the UNCITRAL Model Law). It is not clear whether any special bank insolvency procedure or the SRR would benefit from such international recognition.

b) **Is change necessary?**

The FMLC has some reservations as to whether change to the banking insolvency procedure, to the extent envisaged by the CP, is required at all.

As already stated, the Committee believes that the CP lacks sufficient detail as to how the new insolvency procedure will operate. Accordingly, the following view is put forward on the basis that the process is intended to be a variant on the special insolvency procedures that already exist, (eg under the Railways Act 1993 and the GLAA PPP Administration scheme). These 'special' insolvency procedures essentially involve modification of the current administration process with additional purposes. In both the examples cited, the additional purpose is to enable the business to continue until transferred, even when that would not be the economically logical thing, recognising that the businesses in question provide essential infrastructure for public transport which cannot be shut down even for a very short time. These examples present, however, very different situations from that of a bank insolvency.

The FMLC's understanding is that the tools under the SRR would be used, as required, where there is a banking business to save. Therefore, if the SRR is introduced as proposed and is effective, there should be no need for substantial changes to be made to the existing insolvency regime. For those banks that are beyond saving and are already considered insolvent, the aim, as set out in the CP, would simply be to facilitate the paying out of compensation by the FSCS within the stated timetable. Assuming that depositor preference will not be introduced this would simply involve administrative arrangements which could largely be carried out under the existing insolvency regime. The FMLC considers that there is, therefore, no need for a special insolvency regime in the true sense. It suggests instead that the desired result could be achieved, with less disruption to the market, by making amendments to the current law on administration contained in the Insolvency Act. The amended provisions would become effective in circumstances where the company in administration is a 'bank'.[1] The FMLC is of the view that a simple adaptation of the existing regime would provide more clarity to market participants.[2] Such clarity would not only reduce the scope for legal uncertainty within the UK, but would also maintain the positive external perception of the UK markets as having 'creditor-friendly' insolvency arrangements.

4.3 **Comparison with the US regime**

In the United States the insolvency resolution of commercial banks and other financial firms is entirely distinct from the insolvency resolution of companies, and involves an administrative procedure governed by the Federal Deposit Insurance Act and overseen by the FDIC. As stated in the paragraph 3.2 above, the FMLC recognises that lessons can be learnt from other jurisdictions and notes that this applies as much to banking insolvency procedure as to the other SRR mechanisms.

The US insolvency procedure is considered by the FMLC to be a good starting point for developing a UK banking insolvency model but the limitations of its applicability in the UK must be stressed.

Between 2000 and 2006 the US insolvency regime was put to the test by 24 separate bank insolvencies[3] and proved on the whole to be largely effective. Taken at face value, this positive empirical evidence could lead one to conclude that the UK should follow the example set by the US, however this simple account is misleading and should not give rise to the inference that the same results would follow in the UK. The US banking industry is fundamentally different to that in the UK. It consists of a significant number of small and mid-sized banks and financial organisations, whereas the UK markets are largely dominated by fewer, much larger financial institutions.

[1] The use of the word bank throughout the CP is in the view of the FMLC misleading and could lead to potential uncertainty as to the scope of the reforms. The FMLC believe that some clarification of the terminology is required to ensure certainty. FSCS applies to a range of financial market participants, other than banks (the old English definition of "bank" was a deposit taking institution, however, the modern EU definition now in use in the UK is a "credit institution" - a body that both takes deposits or other repayable funds and grants credits for its own account). It should be made clear that where the CP refers to measures which apply to "banks" it intends for such measures to apply to virtually all "credit institutions" or (to mirror the actual scope of the FSCS to the full extent that UK insolvency processes can be applied) applies to any body of which the FSA is the lead regulator which holds deposits and has customers eligible for compensation under the FSCS.

[2] Due to the lack of detail in the CP regarding the proposed new insolvency regime, the FMLC does not feel it is currently able to detail how the same result might be achieved though adaptation of the existing regime. However, the Committee would be happy to liaise with the Authorities as the bank insolvency procedure is developed, to explore how it could be introduced within the existing insolvency regime.

[3] Bliss and Kaufman – *US Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation* – Federal Reserve Bank of Chicago WP 2006-01

There is no certainty that a regime that works well in the US for small, structurally simple banks, would transfer well to the UK.

The US insolvency procedure has proved effective in providing for the prompt payment of insured depositor claims and reducing liquidity losses. However, a significant reason for this effectiveness is thought to be that the large majority of bank insolvencies in the US have involved small banks with very few non-deposit liabilities. Problems with applying the US procedure have also been identified and these have arisen in situations where the insolvent bank had significant non-deposit creditors, was a subsidiary of another bank or financial holding company, undertook complex on and off balance sheet activities, or was involved in significant international activities. Therefore, the problem areas identified in the US regime are the very things that may be exacerbated in the UK context, where the vast majority of banks are large institutions, undertaking complex cross-border activities.

A further problem with the US procedure is the potential for the FDIC, in overseeing the insolvency procedure, to face conflicts of interest in its roles as trustee in bankruptcy, bankruptcy court and significant creditor. In situations where the insolvent bank has significant non-deposit creditors (more common in large banks), there is a real risk of conflicts arising between those creditors interests and those of the FDIC as a senior creditor. The FDIC has complete control over the non-deposit creditors' losses and no obvious incentive to maximise the value of asset recoveries for these creditors. A situation where such conflict can arise is clearly far from ideal. In the view of the FMLC if the same procedures were introduced in the UK, where the majority of banks are large and have significant non-deposit creditors, it would lead to damaging uncertainty and a lack of confidence in the effectiveness of the regime.

In conclusion, while the FMLC recognises many of the positive qualities of the US regime, it also acknowledges its significant limitations. The FMLC is of the view that two wholly separate regimes do not necessarily create an advantage. The experience of financial markets participants is that non-US counterparties often find the separate regimes in the US, including the slight differences applied to nationally chartered banks compared to the various state chartered banks, confusing and costly in terms of the time and money spent trying to plan for counterparty failures under a variety of procedures. This can, in some cases, act as a deterrent to conducting business in the US and the FMLC believes that care should betaken before adding unnecessary complications to the UK regime.

4.4 **European Law and the Bank Insolvency Procedure**

(a) **ECHR.** The FMLC believes that once a bank reaches the point where insolvency is recognised the procedures available to that bank should be restricted and should simply seek to facilitate compensation payments from the FSCS within the stated timetable. More ambitious purposes, such as the continued trading of some of the bank's business, would, in the view of the FMLC, be inappropriate at this stage and would involve a number of complications which are not adequately addressed in the CP. Anything more ambitious than facilitation of compensation would require extensive funding and would constitute extensive interference with pre-existing creditors' rights, possibly to the point of completely extinguishing their claims and their security. The FMLC considers that such a regime would be unlikely to meet with ECHR requirements and, accordingly, would be very difficult to justify (see also paragraph 5.3 below).

(b) **Directive on the Winding-Up of Credit Institutions and interaction with the administration of the FSCS.** Under the EU law on the winding up of credit institutions (Directive 2001/24/EC), the UK is prohibited from instituting any reorganisation measure or winding up procedure (including administration) of any credit institution for which the FSA or other UK regulator is not the "home Member State" competent authority. Therefore, if the UK is not the lead regulator, and the bank in question originates from an EU country bound by the Directive, UK insolvency procedures (including any special insolvency procedure and, arguably, any special resolution regime) could not be applied. The FMLC notes that this differs to the case of Third Country foreign banks with branches in the UK: for such banks UK insolvency and the FSCS processes may be applied where it has made the FSA its lead regulator within the EU. A UK customer of a Third Country bank, in contrast to a UK customer of an EU based bank, would be eligible for the FSCS compensation. The FMLC considers the lack of clarity surrounding the contrasting application of the UK scheme to these different bank branches to be far from transparent (see also paragraph 5.3 below).

(c) **Deposit Guarantee Schemes Directive.** Pursuant to the Deposit Guarantee Schemes Directive (Directive 94/19/EC, Article 4(2)), where the FSA is not the lead regulator and UK insolvency processes cannot apply, some branches of credit institutions may still contain FSCS-eligible depositors. However, the FMLC believes that a special insolvency procedure for this class of credit institution would not be viable because access to the credit institution's records, or any other step that would facilitate a prompt FSCS-payment to UK branch depositors, could not be achieved. With the aim of facilitating a FSCS payout to eligible UK customers, branch records of the failing bank may be accessed but only if appointed foreign insolvency officers grant the necessary permission. However, even where such measures can be taken, the costs involved would have to be accounted for. In practice, the FMLC believes there may be some difficulty in ensuring equal treatment for these credit institutions' UK depositors.

The FMLC notes that Article 8 of the Deposit Guarantee Directive requires a deposit scheme such as the FSCS to apply limits to compensation. This is based on the aggregate of deposits placed with the same credit institution irrespective of the number of deposits, the currency and their location within the EC. Thus, the FMLC considers that information and co-operation requirements will need to extend to branches of the insolvent bank in the UK and throughout the EC.

Finally, where a bank can provide, at the very least an equivalent security to depositors, Articles 3 and 4 of the Deposit Guarantee Directive recognise that these credit institutions may be exempt from a national scheme. It is possible that some entities could be the subject of UK insolvency processes yet still be exempt from the FSCS payout scheme. This would be the case for branches of credit institutions with their head office in a third country where that Third Country has its own scheme. In this circumstance, the FMLC believes that legislation must provide for the necessary FSCS access to records to be disapplied.

As it currently stands the CP does not explain how each of these various situations will be dealt with and as such the FMLC remains cautious and concerned; we would encourage the Authorities to explore further the means necessary to create procedural certainty and ensure that those classes of customers who qualify for the FSCS are necessarily protected and properly compensated.

(d) **Financial Collateral Directive.** The FMLC is concerned that the adoption of a special banking insolvency procedure should in no way limit the enforcement rights given to holders of financial collateral provided by the insolvent institution. These rights to immediate enforcement are entrenched in Article 4 of Directive 2002/47/EC on Financial Collateral Arrangements (rights to sell or appropriate in the case of financial instruments and rights of set-off and application in the case of cash). Furthermore, Article 7 requires the recognition of close-out netting, which could include contractual set-off (see paragraph 3.3(b) above).

Whilst, the FMLC recognises that not all financial collateral given by financial market participants in the course of their UK financial market operations will benefit from the UK's current implementation of the Directive, there is support in the market for extending rather than limiting the scope of implementation. The FMLC, therefore, welcomes the proposal in the CP to introduce additional powers to enable the Government to extend the protection of financial collateral arrangements discussed at paragraphs 4.82 to 4.86. The Committee is generally supportive of such protection, which would enable the UK to implement the full spirit of the Directive.

Despite the positive proposals in paragraphs 4.82 to 4.86 of the CP, the FMLC has concerns that the new bank insolvency regime may not adequately protect collateral holders and does not consider fully the possibility of a downward spiral in the markets caused by such lack of protection. The majority of secured creditors of an insolvent bank or other financial institution will be holders of financial collateral. The FMLC believes that they should all be able to exercise their rights at any time and should not be limited by an insolvency process, except in very limited circumstances where the collateral transaction is not complete at the time the insolvency commences (see Article 8 Financial Collateral Directive). The purpose of such protection is to prevent the domino effect of a single insolvency crippling counterparties in the financial markets. As well as this potential for market uncertainty and instability, a regime that prevents enforcement of collateral holder's rights would appear to put the UK in breach of its EU obligations.

4.5 Netting/set-off issues

The potential disruption of set-off and netting arrangements that is likely to stem from the proposed bank insolvency regime is of particular concern to the FMLC and thought to be something that could have significant repercussions for legal certainty. Currently UK insolvency law provides an automatic right to set-off under common law and further recognises creditors' rights to protect themselves against default through *ex ante* contractual agreements which allow a solvent party to close out contracts and set off obligations. The FMLC believes that the CP lacks sufficient consideration as to how these set-off procedures, which form an integral part of the current insolvency process, will be affected by the new proposals. The FMLC is not convinced that the full legal ramifications have been examined or understood from a commercial or wholesale perspective.

If set-off requirements are overlooked, there is a real possibility that retail depositors who are eligible for 'gross payments' under the FSCS scheme will enjoy an unfair advantage over other creditors, which could be viewed as the creation of a preferred-creditor status for depositors. It is essential that the set-off rights of wholesale and commercial creditors, as well as their ability to realise collateral or enforce security interests, be preserved as far as possible. The FMLC believes that the current proposals could lead to significantly increased credit risks for wholesale and commercial counterparties owing to the uncertainties around their ability to close out contracts against the defaulting bank on a net basis. Furthermore, the FMLC is concerned that the uncertainty surrounding set-off could negatively impact upon other regulated counterparties' capital requirements associated with dealing in derivative and financial collateral arrangements and accordingly increase their costs and the risk of contagion. The FMLC suggests that further consideration of the effect that a move to 'gross payments' would have on current set-off provisions is required and that further safeguards should be explored for non-retail creditors.

5. Depositor Protection and FSCS Payment

5.1 Overview Depositor Protection

The FMLC appreciates the importance of ensuring that the new regime includes effective compensation arrangements which prioritise the protection of consumers and guarantee their deposits or provide compensation for the loss of their deposits, thereby, increasing consumer confidence and reducing the likelihood of 'contagion' to the financial markets. However, whilst these objectives are commendable, the FMLC believes that the CP is not entirely clear on the manner and method in which Depositor Protection reform and the FSCS payment scheme will be carried out. Certain details of the proposed reform need more clarity; in particular more thought must be given to how the scheme will fit with the existing legal and commercial infrastructure, to avoid adding to existing legal uncertainty or creating further operational uncertainty for the financial markets.

From a legal certainty perspective the FMLC has identified two main areas of concern. Firstly there are a number of uncertainties in relation to how the proposed move to gross payment will operate in practice and how it will be made compatible with existing or proposed insolvency and set-off provisions; secondly, the FMLC believes that there is a need for the Authorities further to address how the compensation regime will comply with existing European legislation. The FMLC also recognises that there are serious concerns as to whether existing bank infrastructure has the capacity to bear the additional stress of a seven-day payout scheme, but believes that this is a question of logistics which is largely outside the FMLC remit.[4]

5.2 **Interplay between FSCS Compensation Arrangements and Insolvency Procedures.**

The Committee believes that the CP inadequately addresses the possible interrelationship of the proposed FSCS compensation arrangements and banking insolvency procedures. The CP indicates an intention to apply set-off as part of the bank insolvency process 'in a way which is compatible with a gross payment regime' to ensure that customers, creditors and the FSCS are treated fairly. However, under the CP proposals there is little explanation of how this objective will be achieved. The FMLC has concerns that if the compatibility issue is not considered more seriously the proposed regime could have a detrimental impact on established insolvency set-off provisions and pose a real risk of substantial prejudice to certain stakeholders.

a) **The single view of the customer and gross payments.** The single view of the customer and the question of gross payments are issues which primarily raise questions of policy and/or logistics – both matters outside the FMLC's remit. Moreover, in so far as the FMLC is in a position to consider policy issues, it recognises that a move to a system of gross, rather than net, payments will have the advantage of simplicity and should facilitate speedier payments, while the

[4] On this issue the FMLC would draw attention to the response put forward by the BBA.

single view of the customer, if feasible, is an important safeguard against sweeping overpayments. However, these two issues will undoubtedly have a very significant impact on compensation payments made by the FSCS. Below, the legal relationship between compensation payments and set-off on insolvency is discussed. Lack of clarity about the basis upon which it is proposed that compensation payments will be made, and the consequent ambiguity about which overpayments will be tolerated, exacerbate concerns about this interrelationship. The Committee therefore takes this opportunity to draw attention to the ways in which these aspects of the proposals remain unclear.

The CP does not distinguish between the single view of the customer which one bank holds and the single view which an entire banking group may hold. It may be much more feasible for a single group company to obtain the relevant single view than it is to identify accounts held within different entities, under different brands, within the group. The FMLC believes that clarity on this issue should be given. If the Authorities believe that the FSCS needs to have access to information that, on the insolvency of a group, gives a single view of the customer across the various group entities, consultation should be undertaken on the feasibility of achieving this view within the prescribed timetable for payments. If consultation reveals that a single view across the entire group is not yet feasible – or easily manageable – in every case, some thought should be given to the impact of this conclusion on other CP recommendations.

The CP draws a contrast between net payments, which would reflect a netting of the customer's outstanding debts against his deposits, with gross payments. However, the CP does not distinguish between different types of debts and in particular between typically short-term debts such as overdrafts and typically longer-term debts such as mortgages. The FMLC has been given to understand that the HMT Workshops on the CP recognised that netting in respect of long-term loans such as mortgages is more likely to have a serious effect on consumer confidence than netting against, say, overdrafts. If a compromise position on netting of this sort is being considered, it should be consulted on so that the implications for set-off can be considered in detail.

Finally, at paragraph 5.42, the CP states that

> "The Government will consider including compatible provisions on set-off... to ensure that making gross payments to eligible depositors will give a fair result for different customers and the FSCS."

And at paragraph 5.46 that

> "The Government is therefore proposing to include provision... to ensure that set-off is applied in a bank insolvency process in a way which is compatible with gross payments being made by the FSCS. This will ensure that customers, other creditors of the failed bank and the FSCS are treated fairly if gross payments are made."

No further information on the interrelationship of compensation payments and set-off is given and no explanation of what is meant by a "fair result" or "treated fairly". Thus, the CP does not address the question of how the financial burden of overpayments made by the FSCS to depositors – either because a gross payments system is used, or because a single customer view is not attainable in respect of different group entities in an insolvent group – will be distributed in cases where the overpayments cannot be recouped from the depositors themselves. In Chapter 4, the CP suggests that the FSCS and any uncompensated depositors will rank alongside the claims of other creditors but it does not explain whether overpayments can be claimed by the FSCS under the normal insolvency procedures, with the attendant reduction in the satisfaction of their claims that other creditors can expect, or whether they must be borne by the FSCS and, ultimately, by the contributors to the Fund. Policy questions of priority as between creditors, levied Fund contributors and customers are not for the FMLC but the way in which these questions are settled will affect the way in which the proposed legislation is received. The FMLC regrets, therefore, the lack of detail provided by the CP on this very important question. Further analysis is provided below.

b) **Set-off.** The FMLC believes that the CP lacks detailed information on how set-off may be managed under the proposed "stand alone" insolvency regime once the FSCS has moved to make payouts to depositors.

General insolvency law currently provides for full set-off when a bank fails, with the consequence that every customer's mutual credits and debits must be resolved into a single lump sum on a net basis. The CP highlights the intention to move away from this approach but is unclear as to exactly how the new regime will deal with customers various different credit and debit obligations. The lack of any detailed consideration as to the various sorts of netting that might occur is mentioned above. More generally, however, the FMLC is concerned that the CP recommends, in effect, preserving insolvency set-off whilst allowing gross repayments to depositors. Preserving set-off for creditors whilst abandoning netting across different accounts for compensation purposes implies an awkward disjunction either: between the amount of compensation which can be claimed by depositors and the amount which can be recouped by the FSCS from the assets of the insolvent bank; or between the position of the FSCS (and depositors) and the position of other creditors. It is not clear how this awkward legal disjunction will be resolved.

c) **Overpayments.** Over payments will exist in any situation where a protected depositor receives more through FSCS compensation payment than they would have received if full set-off had been applied – meaning the depositor continues to have an outstanding debt to the bank.

Overpayment creates a number of questions, not answered in the CP, as to when and how the excess money owed to the failed bank may be recouped from the bank's former customers and through what means. The FMLC accepts that overpayments are necessary to provide depositors with the necessary liquidity. However, there is a risk that the longer any sum is outstanding and the larger the amount overpaid, the greater the risk of uncertainty and the risk that other parties will be detrimentally affected. Furthermore there is a significant risk of a material shortfall in the eventual recovery of these debts, for example if former customers of the failed bank subsequently default on their mortgage obligations. As stated above, it is not clear from the CP who would absorb this shortfall. It is possible that FSCS levy payers, other customers and unprotected creditors of the failed bank could all be prejudiced if funds that could be made available are tied up in overpayments.

To address some of these worrying uncertainties stakeholders at the Authorities' initial workshops on the CP recommended that short term debt facilities such as overdrafts should be netted prior to FSCS payouts and that clear guidelines should be put into place to determine how and when longer term loans will be repaid and who will be responsible for their collection. The

FMLC invites the Authorities to clarify whether any customer debits will be taken into account for the purpose of arriving at a net compensation figure and to consult on its proposals on that basis.

5.3 **Application of UK Compensation Arrangements to EU and Foreign Banks**

The FMLC has some apprehension about the lack of clarity in the CP as to how the proposals are intended to apply to European and Third Country banks, with branches in the UK, as well as to UK banks with overseas branches. The FMLC is of the view that the compensation regime will have to be applied quite differently depending upon whether the UK is a home or host state and whether or to what extent the failed bank has contributed through the payment of levies to the FSCS scheme. In certain circumstances involving overseas branches, deposit holders may have recourse to several different compensation schemes and it must, therefore, be clear how the FSCS scheme will operate alongside the other available schemes to ensure that there is no duplication in the event of an insolvency.

The CP is particularly unclear as to how the FSCS compensation regime will be applied to FSA-registered foreign banks with branches in the UK. UK Customers of such banks could be entitled to FSCS payouts, thus enjoying the benefits of the UK scheme, whilst the bank itself might be subject to an insolvency regimes dictated by its country of incorporation, over which UK Authorities will have no control. Legal uncertainty could easily arise in a situation where the UK Authorities are unable to oversee the whole insolvency process and sufficient safeguards will need to be considered to prevent any abuse of the UK compensation regime in such circumstances.

The FMLC suggests that further detailed consideration of the relevant European law (see paragraph 5.4 below) and other Members States and Third Country's current compensation schemes is required to ensure that there is sufficient certainty for all UK depositors in the event of a bank collapse, even those for whom the FSCS scheme may not apply.

5.4 **Application of European law**

The CP, is unclear as to how the proposed reforms will comply with certain relevant EU Directives. The paragraphs below detail specific concerns on the equal treatment of EU depositors; the host/home Member State distinction; and the treatment of non-European banks.

(a) **Equal treatment of all EU depositors:** the CP at 5.21 proposes a nine-day timeline for payments under the new deposit protection scheme. The FMLC considers this to be a very ambitious timescale for the scheme, especially in light of the fact that the EC Treaty, Directives 94/19/EC and 2001/24/EC have the combined effect of creating an obligation for Member States to give equal treatment to all EU depositors, whatever Member State they reside in.

Article 4 of Directive 94/19/EC provides that a deposit protection scheme created in a Member State "shall cover the depositors at branches set up by credit institutions in other Member States". Directive 2001/24/EC. Article 7, sets out an obligation for creditors of a credit institution which is the object of reorganisation measures to be notified of such measures on an equal footing with creditors in the home Member State of the credit institution. The result of these provisions is to place a burden on the FSCS to individually inform EU depositors outside the UK individually in the same way as those within the UK; however, this would take longer than allowed for in the proposed timescale.

Further, the proposed system includes opening a new bank-account through an accelerated process, and instant access to the funds received by the depositors under the protection scheme when they deposit the cheque for such funds in this new bank account. Again, the FMLC remains concerned that the practicalities of this process for non-UK residents would not allow for equal treatment. Therefore, unless account opening can be effected remotely from another Member State (including the deposit of cheques and the receipt of debit cards), non-UK residents would be unable to benefit from the streamlined process. Thus, the FMLC believes the proposed system would create disparity between depositors based on their place of residence, which is incompatible with the principle of freedom of movement and establishment under Articles 39 and 43 of the EC Treaty.

It should be noted that the FSA or the FSCS would have to inform any Member States in which the credit institution concerned has branches if the operation of the deposit protection scheme for a UK credit institution were triggered, "if possible before the decision to adopt any reorganisation measures is adopted or otherwise immediately thereafter" (Directive 2001/24/EC, Article 4 – see below for further information on this duty to inform other Member States).

b) **Host/Home Member State distinction under EU law:** Directive 2001/24/EC creates a distinction between the host and home Member States for any given credit institution – that is to say, the 'home' Member State is that which gave authorisation to the credit institution under Directive 2000/12/EC, and any Member States in which it has branches which do not function under separate authorisation are 'host' Member States. In effect and for most credit institutions, this means that the home Member State is the place of incorporation and that other Member States in which the institution have branches are hosts. If the credit institution is incorporated in a country outside the EU, the home Member State will be that in which it obtained authorisation to do business as a credit institution.

Article 3, paragraph 1 of Directive 2001/24/EC gives exclusive right to the home Member State to apply reorganisation measures to a credit institution – this means that only the home Member State has the power to close a bank which is in difficulties and activate any deposit protection scheme which would apply. Therefore, the FSA would have no power to close a bank which was not incorporated in the UK, even if it was in severe difficulties. The UK authorities would only be able to inform the authorities in the home Member State of the situation and apply to them to take action as necessary – and they have the duty to do this under Article 5 of Directive 2001/24/EC. This could delay the implementation of the deposit protection scheme in respect of deposits to UK branches of the credit institution. In a situation not unlike to the failure of BCCI, where a bank is incorporated in one Member State (Luxembourg in that case) but operates for the most part in the UK, this could have wide-ranging consequences as the UK authorities would lack any real power to protect the depositors at UK branches (regardless of their depositors' place of residence).

One of the important issues in such a situation would be in respect of information. Any information needed to implement the deposit protection scheme in the UK would be likely to be situated in the home Member State or, even if situated in the UK, it is doubtful that the FSA and the FSCS could have access to it without the approval of the competent authorities in the credit institution's home Member State. The FMLC is of the opinion that this could compromise the UK proposal's timeline in that any pre-emptive information-gathering would be made difficult and time-consuming, or practically impossible.

Further, the home Member State has a duty under Article 4 of Directive 2001/24/EC to inform all other Member States in which the credit institution has branches of the start of reorganisation measures. In the situation where the UK was a host Member State, the FSA would be informed of the reorganisation measures and would have no power to decide how reorganisation should be effected, beyond an ability to discuss the matter with the home Member State and influence decisions in this way. Again, in a scenario close to the BCCI failure, the UK regulator could find itself without a significant role in proceedings which would affect a very large number of UK depositors. Where, however, a credit institution which has its home regulator in another Member State was a member of the FSCS scheme, which it could be (see Article 4, paragraph 2 of Directive 94/19/EC), the UK would be obliged to operate the UK scheme in an equivalent manner, so as not to create discrimination with regard to rights of establishment for passported banks.

c) **Non-European Union banks:** Where the failing credit institution is incorporated outside the EU, Article 8 of Directive 2001/24/EC places on the Member States hosting branches of this institution the duty to inform one another of a decision to adopt any reorganisation measures, and to "endeavour to coordinate their actions" in respect of this institution. EU law therefore has a limited impact on the application of the deposit protection scheme in these circumstances, though it should be noted that coordination with other Member States could have the effect of slowing down procedures. Further, on a practical note, it may be very difficult, or impossible, to obtain any information regarding the depositors of a credit institution incorporated outside the EU within the timescale set by the proposal, even where the UK is the lead regulator.

d) **Level playing field throughout the EU:** The UK should consider whether it would be compatible with EU law to legislate to require UK branches of non-UK regulated banks participating in the UK scheme to give access to relevant information wherever it is held so that the UK scheme may be applied to the extent the branch's depositors will benefit from it. This would afford depositors, including those residents in other EU States, with comparable benefits from the UK deposit scheme.

While the depositor protection scheme may not be controlled by Articles 39 and 43 of the EC Treaty, the proposed reform certainly does not meet broad EU objectives of equal treatment since it potentially places depositors with banks using their passport rights to do business in the UK at a severe disadvantage to depositors with banks for which the home Member State is the UK. Such distinction between credit institutions, depending on the regime of the country of primary regulation, does not comply with EU law principles. In so far as the solution of this issue is unclear, the UK should press for EU level amendments to one or both of Directives 94/19/EC and 2001/24/EC to deal with this issue and with cooperation where two of more schemes apply, in order to level the playing field between EU Member States as far as practicable. It appears possible from recent EU Commission initiatives that both Directives might be revised, giving an opportunity for this to be done (Communication of 28 November 2006 in respect of Deposit Guarantee Schemes and consultation process in respect of the Winding up of Credit Institutions: summary of responses to the consultation dated December 2007).

6. Building Societies – particular concerns

6.1 Many of the concerns raised throughout this response will apply as much to building societies as to banks but there are a few specific points that the FMLC wishes to raise that apply only to building societies. Building societies are mutual institutions and accordingly all of their customers are also members, with participation rights. In the past the preferred course of action for dealing with a troubled building society has been to transfer its business directly to another building society, preserving the participation of the original members in a mutual society. The FMLC has some concerns that a number of the proposed SRR tools would lead to loss of membership and demutualisation of a troubled building society, which could impact on the ability of the building society to compensate its members for any residual value in the business, placing building society members in a weaker position than that shareholders in a failing bank.

6.2 The FMLC has recently produced a paper relating to building society and incorporated friendly society set-off.[5] The paper intends to address an apparently inadvertent, but potentially serious, lacuna in the law of insolvency set-off as it relates to building societies and incorporated friendly societies. This issue was first brought to the attention of the relevant Authorities by the FMLC in March 2006. The initial view received from HM Treasury was that the lack of rules in this area did not pose

[5] A copy of this paper can be found on the FMLC website *www.fmlc.org*

any immediate practical risk, particularly given the infrequency of building society insolvency. However, given recent market events, it is the view of the FMLC that this lacuna can not now be so easily dismissed and that this area of uncertainty should be addressed as part of the proposed banking law reform to correct this oversight and to introduce a mandatory insolvency set-off rule for building societies to put them in a comparable position to other financial institutions.

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[6] Clive Maxwell abstained from discussions surrounding FMLC Issue 133 and involvement in the preparation of this paper in recognition of his prior official responsibilities.