Financial stability and depositor protection:

strengthening the framework

January 2008

BANK OF ENGLAND HM TREASURY FSA Cm 7308

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Presented to Parliament by
the Chancellor of the Exchequer
by Command of Her Majesty

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Executive Summary

All modern economies benefit from financial markets which are efficient, fair and – above all – stable. Recent months have seen a period of sustained turbulence and instability in global financial markets, with financial firms across the world affected.

The Government, the Financial Services Authority (FSA) and the Bank of England – as well as financial firms and authorities across the world – must respond to these episodes. The Chancellor of the Exchequer announced on 11 October 2007 that he would review the existing supervisory regime, including complex areas such as the legal framework for dealing with banks facing difficulties. The FSA and Bank of England have made similar commitments to review their actions and areas of responsibility. Internationally, the UK is working with other G7 and EU countries to identify areas where international lessons can be learnt and changes made.

This consultation document sets out the views of the Government, the FSA, and the Bank of England on these issues, building on responses to a discussion paper, '*Banking reform – protecting depositors*' published in October 2007. The House of Commons Treasury Select Committee published its report, *'The run on the Rock'* on 26 January. This consultation document takes account of the Committee's report, which makes a positive and useful contribution. The Government proposes to bring forward legislation after consultation, alongside actions by the FSA and the Bank of England, to address five key objectives, as detailed below.

Strengthening the financial system – given the interconnectedness and complexity of the financial system, actions are required in the UK and internationally, to strengthen its stability and resilience, including:

- strengthened risk management by banks – such as better stress testing and liquidity management; and
- improved functioning of securitisation markets – including improvements in valuation and credit rating agencies.

Reducing the likelihood of banks failing – the high costs for the wider economy and society if a bank gets into difficulty require that further steps be taken to reduce the likelihood of this happening. It remains a clear principle that those in charge of individual firms are primarily responsible for managing risk. It is proposed to:

- strengthen the regulatory and supervisory framework – including requirements to provide information to the FSA at short notice, and more formal oversight of payment systems; and
- make changes to the framework for provision and disclosure of liquidity assistance.

Reducing the impact of failing banks – despite the actions described above, it is neither possible, nor desirable, to ensure that no bank will ever fail in any circumstance. For that reason, important new arrangements are proposed that will enable failing banks to be dealt with in a way that minimises the potential impact on financial stability. These include:

- the introduction of a 'special resolution regime' within which there would be a range of tools to resolve a failing bank in a more orderly manner, including an accelerated method to transfer its business to a healthy bank, a 'bridge bank', deployment of a restructuring officer and a bespoke 'bank insolvency procedure'; and

- proposals to ensure that banks have in place practical arrangements to lessen the impact of their failure, should it occur.

These proposals – especially the special resolution regime – would mark an important step change in the institutional, legal and insolvency arrangements in the UK. It is therefore important to consult thoroughly before proceeding to legislation.

Effective compensation arrangements in which consumers have confidence – consumers need to have full confidence in, and understanding of, the compensation arrangements in the event of a bank failing. As part of this, it is proposed to:

- consult on a potential increase to the compensation limit for deposits, and the coverage of certain balances above the limit;
- make changes to enable the Financial Services Compensation Scheme to make payments within one week of a bank failing; and
- increase consumer awareness of the scope and operation of the compensation scheme.

Strengthening the Bank of England and improving coordination between authorities – it is essential that authorities cooperate if their roles in preventing and managing financial difficulties are to be effective. The Government, the FSA and the Bank of England believe that the tripartite arrangements are appropriate for the UK, as endorsed by the Treasury Select Committee.

However, they believe that important changes are required to the way that the arrangements work in practice, including:

- a statutory basis for the Bank of England's financial stability role and better governance arrangements within the Bank of England to support the new statutory obligation; and
- strengthening the Memorandum of Understanding, applying lessons from the operation of COBR during 'crisis' conditions, and improving external communications.

Moreover, it is increasingly vital that cooperation across borders works effectively. Current market events have demonstrated both the benefits and the difficulties of achieving this. It is therefore proposed to work with international partners to:

- improve the coordination of approaches to international financial stability issues; and
- introduce an early warning system on global financial risks and improve cross-border crisis management.

Future work

The proposals and recommendations in this document are provided for consultation. They build on examples of best practice from around the world and represent a real opportunity for modernising the UK regime to respond to the challenges presented by rapidly changing financial markets. The Government, the FSA and the Bank of England will consult actively on these proposals, seeking discussions with financial institutions, consumer representatives and counterparts from across the world, to ensure that the final arrangements are effective and deliver the five objectives set out above. In doing so, they aim to establish a world-leading regime, that builds on the lessons of recent months.

1 INTRODUCTION AND OVERVIEW

1.1 Recent months have seen a period of sustained turbulence in global financial markets, with financial firms across the world affected. The Government, the Financial Services Authority and the Bank of England – as well as financial firms around the world – have responded to these events by considering what changes to the regulation of banks are needed, including with respect to the question of how to deal with banks in difficulty.

1.2 This chapter:

1. presents the context – the nature of modern financial markets and the framework for financial regulation;
2. sets out the work under way to learn lessons – internationally and in the UK; and
3. summarises proposals for reform, aimed at five objectives:
   - strengthening the stability and resilience of the financial system – in the UK and internationally;
   - reducing the likelihood of individual banks facing difficulties – including regulatory interventions and liquidity assistance;
   - reducing the impact if, nevertheless, a bank gets into difficulties – including a new 'special resolution regime';
   - providing effective compensation arrangements in which consumers have confidence; and
   - strengthening the Bank of England, and ensuring effective coordinated actions by authorities, both in the UK – including through reforms to the tripartite arrangements – and internationally.

CONTEXT

Modern financial markets

Role **1.3** All modern economies benefit from efficient, stable and fair financial markets. The financial services sector makes a vital contribution to the rest of the economy, by:

- matching the resources of savers to the needs of borrowers, allowing businesses and households to finance investment and savers to manage their finances over their lifetime;
- providing firms and individuals with the means to make and receive payments; and
- providing channels for the distribution and diversification of risk to those most willing and able to hold that risk.

1.4 In a highly competitive international industry, the financial sector plays an increasingly important role in the UK economy. The contribution of financial services has increased from 6.2 per cent of UK GDP in 1997 to 9.4 per cent in 2006.[1]

Financial instability

1.5 Financial instability, to the extent that it disrupts these functions, has a damaging effect on the wider economy. In particular, the failure of a bank[2], building society or other deposit-taking firm (for simplicity, unless more precision is needed, referred to as 'banks') would leave customers – individuals or businesses – unable to access savings, to raise finance or to meet obligations. A single bank failure, though rare and often isolated, has the potential to spread to other parts of the financial system through the effect on consumer confidence, through the inter-bank lending market, or through other channels. This, in turn, can have knock-on effects for the wider economy. In short, the failure of a bank can involve greater and more widespread costs to the economy than that of a non-financial firm of similar size.

1.6 Financial markets have become increasingly fast moving and international in scope. This has brought considerable benefits, by allowing increased access to finance, more efficient allocation of capital within and between countries, and greater diversification of risk. However, the increasing complexity and interconnectedness of financial markets have meant that developments in one market can be quickly transmitted to other markets. These present new and constantly evolving challenges for authorities in mitigating financial stability risks and protecting consumers.

1.7 The primary responsibility for managing a bank's risk lies with its own management and directors. They are responsible in law to shareholders (or, in the case of mutuals, to members). However, given the importance of the role that banks play in the wider economy, almost all countries regulate their banking systems. Regulation aims to ensure both that consumers have appropriate protections, given the difficulty they face in assessing the soundness of individual banks, and that banks manage risks well, in the interests of the soundness of the financial system as a whole.

1.8 Authorities also seek to minimise the risk of distress at a single bank damaging the broader financial system. This is partly achieved by the arrangements for deposit protection and by the provision of liquidity support, where the risks to the stability of the financial system justify such intervention. For these reasons, consideration should also be given to special measures allowing for the orderly resolution of the difficulties faced by a failing bank.

1.9 As financial markets have become increasingly international in nature, so regulation and crisis management need to work effectively across borders. Increased financial integration necessitates greater international coordination and cooperation to mitigate the risks to global financial stability and to manage crises should they arise.

UK framework for financial regulation

1.10 In 1997, the Government introduced a new system of financial regulation in the UK. The Financial Services and Markets Act 2000 (FSMA) created a single financial regulator in the UK – the Financial Services Authority (FSA) – with powers to regulate a wide range of markets and financial institutions independently, while requiring it to act

[1] Office for National Statistics, *National Accounts Yearbook*

[2] It should be noted that the proposals outlined in this document refer to UK incorporated banks. They are not necessarily applicable to UK branches of EEA or third country banks, or to entities within a UK banking group other than a UK incorporated bank.

in a risk-based and proportionate manner. In parallel, a Memorandum of Understanding between HM Treasury, the Bank of England and the FSA (the 'Authorities') has provided the framework for tackling disruptions to financial stability. These arrangements have been complemented by the Financial Ombudsman Service and the Financial Services Compensation Scheme (FSCS), providing customers of financial services firms with formal rights to redress and compensation respectively.

1.11 This model of financial regulation and supervision has helped steer the UK's financial markets through periods of potential instability, including the fallout from the collapse of the Long-Term Capital Management hedge fund and the Russian debt crisis of 1998, the collapse of the 'dot-com bubble' in 2000, and the aftermath of the events of 11 September 2001. Market participants cite the quality of the regulatory environment in the UK as a key contributor to the industry's stability and growth.

1.12 In parallel, the scope and depth of international cooperation in financial regulation have also grown as financial markets have become more integrated globally. The European Union (EU) has introduced wide-ranging new frameworks for financial regulation, while international standard-setting bodies, such as the Basel Committee on Banking Supervision (the Basel Committee), are increasingly laying the basis for regulation of financial institutions across the world. The Financial Stability Forum (FSF)[3], with the International Monetary Fund (IMF), has a key role in assisting these developments and in monitoring market developments.

THE NEED FOR CHANGE

1.13 Disruption in global financial markets, starting in the second half of 2007, has presented direct challenges to banks and authorities throughout the world. These events are discussed in Chapter 2. It is important that action is taken, both in the UK and internationally, to ensure that regulation and risk management continues to respond to rapidly changing events.

International issues

1.14 In addition to reform in the UK, it is important that the international community responds in a coordinated way to recent events. The G7 has asked the FSF to analyse the underlying causes of recent market turbulence and propose appropriate recommendations, with a focus on events in the markets for structured products. Similar work is under way in the EU; the Economic and Financial Affairs Council (Ecofin) has endorsed a programme of work on recent market turbulence, focusing on broadly the same issues as the FSF.

1.15 There is considerable international consensus on the key issues raised by recent events. Broadly speaking, work by the FSF and the EU is focusing on:

4. effective prudential risk management within banks and other financial institutions, including liquidity, market and credit risk management practices;

5. issues relating to the securitisation markets, including:

[3] The FSF brings together senior representatives of national financial authorities (e.g. central banks, supervisory authorities and treasury departments), international financial institutions, international regulatory and supervisory groupings, committees of central bank experts and the European Central Bank.

- accounting and valuation procedures for complex structured products;
- the role of credit rating agencies in structured finance; and
- prudential regulation of financial institutions, particularly in relation to their exposure to off-balance sheet vehicles.

UK regime

Areas for reform

1.16 The Authorities' discussion paper on banking reform and depositor protection, published in October 2007, asked in particular about the nature and level of protection for depositors and ways to ensure banks experiencing difficulties can be dealt with in a more orderly way. Responses to this paper (summarised at Annex B) and recent events have highlighted a number of areas for further improvement. In particular:

- consumers do not have sufficient awareness of, or confidence in, the current compensation arrangements;
- the powers available to the Authorities to reduce the likelihood or impact of a bank failing need to be updated and expanded;
- the existing regime for resolving failing banks through the application of general corporate insolvency law is inadequate; and
- changes to the UK regime need to take place in the context of changing international markets and the need for greater international coordination.

Proposals for reform

Objectives

1.17 The UK Authorities therefore propose action, both in the UK and internationally, targeted at achieving five objectives:

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

1.18 This document sets out the emerging conclusions from the Authorities and proposes a series of reforms. A brief summary of these proposals follows.

STABILITY AND RESILIENCE OF THE FINANCIAL SYSTEM

1.19 The Authorities support an international approach to identifying the lessons from the turbulence in the global financial markets and proposing actions that strengthen the resilience of the global financial system. A key principle guiding the response is that the primary responsibility for managing risk must remain with individual financial firms and investors. Two key issues for further consideration are prudential risk management (in particular the areas of stress testing and liquidity risk management) and the way in which securitisation markets function. Further details on all of the proposals discussed below are given in Chapter 2.

Risk management by banks

Stress testing **1.20** Market turbulence has highlighted the need for better prudential risk management and stress testing practices in banks and other financial firms. In the UK, the FSA has already stepped up its efforts to ensure that banks improve their stress testing. The Authorities will work with the FSF and the EU to ensure a stronger international consensus on the importance of stress testing and to assess whether the stress-testing standards under Basel II[4] are sufficiently robust.

Liquidity **1.21** A key lesson is that, in times of stress, liquidity in financial markets (even those that have historically been very liquid) can dry up very suddenly. This may leave banks with little or no access to the money markets. The FSA has published a discussion paper[5] on liquidity requirements, which reviews some of the lessons from recent market turbulence and sets out preliminary ideas for reform. The Authorities will work with international partners to ensure that standards are consistently high across banking groups and more consistent approaches to liquidity regulation internationally.

Improving the operation of securitisation markets

1.22 Securitisation (the process of originating or purchasing loans and other assets, then packaging and reselling them to investors and other banks) has brought considerable benefits. However, recent market turbulence has particularly affected many markets for asset-backed securities (ABS), and has highlighted issues, including:

- difficulties in valuing some ABS;
- the role of credit rating agencies (CRAs) and some investors' apparent over-reliance on ratings; and
- lack of transparency about who is ultimately carrying risk, particularly in relation to banks' exposures to off-balance sheet financing vehicles.

Valuation **1.23** ABS can be difficult to value as they are often complex and frequently trade in illiquid markets, if traded at all. Initiatives are under way, internationally and in the UK, to help ensure that banks' financial statements give a true and fair view, based on full disclosure of losses.

1.24 Going forward, it is important not to take regulatory action before it is clear how markets themselves have adjusted to the lessons from recent events, and the impact of accounting standards on the valuation of structured products is fully understood. The Authorities recommend that international work should focus on ensuring that:

- firms' valuation approaches are consistent with relevant accounting standards and prudent valuation guidance; and

[4] The revised Basel Committee agreement on international capital standards.

[5] *DP 07/7 'Review of the liquidity requirements for banks and building societies*, FSA, December 2007.

- accounting standards require adequate disclosure about the uncertainties around valuations, their significance for the firm and how these risks are being managed.

Credit rating agencies

1.25 Certain structured credit products have created significant challenges. This has undermined confidence in ratings of structured products since the second half of 2007 and highlighted concerns about:

- conflicts of interest for credit rating agencies;
- the information content of ratings; and
- over-reliance on ratings by investors.

1.26 The Authorities believe that, where possible, market-led solutions should be encouraged and will work with the market to ensure that the concerns above are properly addressed. However, if the markets do not adequately address these issues, alternative measures will need to be considered. It is also essential that investors learn lessons from recent events – in particular, to develop a more sophisticated use of ratings.

Off-balance sheet vehicles

1.27 Both prudential regulatory and accountancy issues arise from the exposure of banks to structured investment vehicles (SIVs) and conduits. Basel II marks a significant improvement in the prudential regulation of off-balance sheet exposures, but the Authorities will work with their international counterparts to assess whether further improvements should be made. It is too early to judge the impact of new accounting standards and the new disclosure requirements under the Basel II and Capital Requirements Directive (CRD)[6] on disclosures by banks of their off-balance sheet exposures. The Authorities will continue to work with the Basel Committee and the International Organisation of Securities Commissions (IOSCO) to ensure that the existing framework is maintained and appropriately applied and that proper analysis of recent events is carried out. Authorities will also need to reflect on the implications of increased emphasis on 'marking-to-market' for the cyclical volatility of banks' balance sheets and capital.

REDUCING THE LIKELIHOOD OF BANKS FAILING

1.28 Recent events have highlighted the potential impact that an individual bank failure can have on consumers and financial stability. A key objective of reform must therefore be to reduce the likelihood of individual banks facing serious difficulty, while recognising that no system can, or should, prevent any bank ever failing. The Authorities are clear that, for financial markets to work efficiently, firms (including banks) must be allowed to fail, in order for competition to take place and improve efficiency. Further details on all of the proposals detailed below are provided in Chapter 3.

Regulatory interventions

Supervisory information

1.29 It is important that the FSA is in a position to make, with confidence and at an early stage, a judgment that a bank is at significant risk of failure. To ensure this, **the FSA intends to consult on new rules to require banks to be in a position to provide**

[6] The CRD implements in the European Union the revised Basel Committee agreement on international capital standards, or Basel II. Pillar 3 of Basel II includes disclosure requirements on banks.

additional evidence to the FSA at short notice that they are meeting threshold conditions on an ongoing and forward-looking basis.

1.30 The Bank of England and HM Treasury also have important roles in working towards the common objective of financial stability. It is therefore important that the FSA is able to collect information that the Bank of England and HM Treasury need, as required. **The Government proposes legislation to ensure that there is no statutory impediment to the FSA obtaining and sharing information that the Bank of England and HM Treasury require for purposes related to financial stability.**

FSA powers to intervene

1.31 Should the FSA judge that a bank may breach threshold conditions, or that it is desirable for other reasons to act to protect the interests of consumers, it has a wide range of regulatory powers and sanctions to require a bank to address the situation. It is important that the range and escalation of current powers are clearly understood by all stakeholders. This consultation document sets out these powers and the circumstances in which they would be used. These include the power to require the board to appoint an expert to help a bank in difficulty.

Payment system oversight

1.32 Payment systems play a crucial role in the banking system and the economy as a whole. Their effective operation is essential to the functioning of financial markets and to maintaining consumer access to banking and other financial services. **The Government proposes legislation to provide for a new and flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework**.

Liquidity assistance

Delayed disclosure

1.33 In addition to its general liquidity operations, the Bank of England is able to provide ELA to assist banks in extraordinary liquidity difficulties. The Government recognises that maintaining transparency in financial markets is important and that ELA should therefore be disclosed to the markets at an appropriate stage. However, recent events have suggested that there may be special circumstances where, if possible, a period of non-disclosure of ELA is desirable. Otherwise, the provision of ELA may have an immediate adverse impact on consumer confidence, resulting in insufficient time for liquidity assistance to serve its intended purpose of helping the bank resolve its difficulties.

1.34 While providing ELA on a temporarily undisclosed basis may in practice be difficult, it is considered worthwhile to make changes which will provide for additional flexibility where such action may be necessary. To achieve this:

- **the FSA will come forward with a proposal to make a limited clarification in the guidance to the Disclosure and Transparency Rules;**
- **the Government is seeking views on whether the requirement for a company to put charges over its assets on to a register of its own and to register them at Companies House should be dis-applied for banks in receipt of liquidity assistance; and**
- **the Government proposes legislation to remove the requirement for the Bank of England to release weekly returns and will consider the removal of other statutory reporting requirements related to the Bank of England that have the effect of disclosing operations.**

Facilitating assistance

1.35 To provide the Bank of England with the protection needed to carry out operations in line with its financial stability objectives:

- **the Government proposes legislation granting the Bank of England statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and central bank functions;** and
- **the Government proposes legislation to ensure that realisation of any collateral provided to the Bank of England, in connection with carrying out its responsibilities in relation to financial stability and central bank functions, is fully effective whenever carried out.**

1.36 To ensure that building societies have similar access to liquidity assistance as banks:

- **the Government proposes legislation so that funds provided by the Bank of England are excluded from the calculation of the proportion of building societies' funding which arises from wholesale funding;** and
- **the Government also proposes legislation to allow building societies to grant floating charges to the Bank of England as security.**

REDUCING THE IMPACT OF A FAILING BANK

1.37 As described above, a bank facing a significant risk of failure may represent a serious public concern given the possible costs to its depositors and to the rest of the economy. To minimise these costs, banks themselves need to take more responsibility for reducing the impact of a failure. The Authorities also need to have a broader range of tools available to them, in special circumstances, to achieve a more orderly resolution. Further details on all of the following proposals are given in Chapter 4.

Special resolution regime

1.38 Should regulatory interventions in respect of a failing bank not remedy the situation, the Authorities propose that there should be a range of tools (beyond the regulatory powers used in normal conditions) for achieving a more orderly resolution of a failing bank – a 'special resolution regime' (SRR). To maximise the chances of a successful resolution, these tools would need to be available for use prior to insolvency, while the bank retains some net worth. Key elements of this proposal build on recommendations from the Treasury Select Committee's recent report.[7]

Triggers

1.39 It is proposed that the trigger for a bank becoming subject to this special resolution regime would be based on a judgment, reached by the FSA after consultation with the other Authorities, that regulatory powers available to the FSA in normal circumstance were insufficient and that more radical options were needed to protect the stability of the financial system or the interests of depositors. **The Government is seeking views on the criteria and process for triggering a special resolution regime.**

Tools

1.40 A range of tools, some of which already exist, could be included in the SRR to ensure a more orderly resolution, including:

[7] Treasury Select Committee, *The Run on the Rock*, January 2007

- **powers to allow the Authorities to direct and accelerate transfers of banking business to a third party;**
- **powers to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a 'bridge bank'** as is possible, for example, in the United States and Canada;
- **powers to allow the Authorities to appoint a suitable person, or 'restructuring officer', to oversee the bank to carry out the resolution;**
- existing tools for the provision of financial support to a failing bank through a public sector liability guarantee or public sector capital injection; and
- should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank is appropriate, **a modified insolvency process for banks – a 'bank insolvency procedure' – to facilitate fast and orderly payment of depositors' claims under the FSCS.**

Governance and operation

1.41 Decisions on which of the available tools in the SRR to use in any specific case would be taken by the Authorities in line with their shared objective of protecting financial stability. For practical reasons, it is expected that the Authorities will have taken preparatory measures so that the chosen option can be swiftly implemented once the SRR has been triggered. The Authorities are consulting on whether the SRR should be overseen by HM Treasury, the Bank of England the FSA, or the FSCS. They would be assisted by market professionals, as appropriate, such as experienced bankers and turnaround professionals. **The Government is seeking views on the governance arrangements that would be most suited to the SRR for failing banks.**

1.42 To the extent that these powers did not give the Authorities sufficient control over the bank, the Authorities might determine that, as a last resort, it would be in the public interest to take all or part of a bank into temporary public sector ownership. **The Government is considering legislation to allow it to take temporary ownership of all or part of a bank as a last resort.**

1.43 The introduction of these tools would be significant, and would alter participants' property rights. Given this, stakeholder views will form an important part of the policy development process. The Government therefore intends to seek views on how best to address the implications for the rights of shareholders and counterparties of the failing bank, and the impact on providers of debt and equity capital to healthy banks, of initiating special resolution at a pre-insolvency threshold.

Requirements on banks

1.44 Bank shareholders should generally share in the costs arising from their failure. One way in which they do so is through the payment of levies to the FSCS. Another way for banks to share in this cost is through contingency preparations for minimising the impact and cost of a potential bank failure. The FSA will continue, as part of its risk assessment framework, to scrutinise banks' contingency plans for communicating with customers and managing distribution channels in the event of rapid retail withdrawals. Where potential vulnerabilities are identified, risk mitigation programmes will be agreed with the individual firm in question.

Funding of the SRR

1.45 **The Authorities are seeking views on whether the industry should contribute to the costs of a resolving a failing bank by funding the SRR**. In such a case, the contribution would be limited to the cost that the FSCS – and therefore the levy payers – would have incurred, had there been a pay-off of protected deposits. Accordingly, the Government is considering whether the FSCS, or indeed any other mechanism, could be used as means of the Government sharing the costs of resolving a bank failure – at an earlier stage than is currently the case – with the industry, and therefore whether to amend FSMA to enable the FSCS to contribute to the funding of the SRR.

Contingency planning and agency banks

1.46 In addition, to ensure that their payments services are not unduly affected by the failure of another bank, **the FSA intends to work with banks to ensure that indirect members of payment systems ('agency banks') have contingency plans in place in the event that their sponsor bank fails,** so that the failure of one settlement bank does not automatically undermine the ability of other banks to make payments.

CONSUMER CONFIDENCE AND COMPENSATION ARRANGEMENTS

1.47 Effective compensation arrangements are an essential part of the system for protecting consumers. This protection also gives consumers confidence, thereby reducing the likelihood of a run on a bank and supports confidence in the financial system as a whole. Further details are provided in Chapter 5.

Compensation limit and coverage

1.48 On 1 October 2007, the FSA changed the FSCS compensation limit applying to deposits so that 100 per cent of an eligible depositor's losses up to £35,000 are covered. The FSA proposes that this limit will continue to be applied per person per bank, and without any co-insurance below the limit. **The FSA intends to consult on a review of the FSCS limits in all sectors and other changes to the compensation scheme.** The Authorities will also work with the financial sector to explore alternative ways for individuals to cover amounts above the threshold, as the Treasury Select Committee has recommended.

Faster compensation payment

Facilitating faster payments

1.49 To provide the necessary consumer protection, the Authorities believe that compensation should be paid within one week of a bank being closed. Changes to legislation and FSA rules will speed up the process for FSCS payments. The changes being considered include measures to:

- **require banks to have readily available information on the account balances of FSCS-eligible depositors;**
- **enable the FSA to collect and immediately share with the FSCS the information the FSCS require, as soon as the first signs of difficulties emerge;**
- **simplify the eligibility criteria for FSCS payments;**
- **automatically assign the relevant rights of claimants to the FSCS;**

- **pay compensation based on the amount of the eligible deposit, without setting off any loans that the depositor may have from the failed bank;**
- **remove the need for a formal claim by consumers;** and
- **ensure that the FSCS has access to immediate liquidity through borrowing from the Government or the Bank of England and, potentially, through the introduction of an element of pre-funding.**

1.50 To preserve continuity of banking services for consumers, **the Authorities will also work with banks to ensure that consumers can open up a new account quickly enough to facilitate fast payment by the FSCS.**

Other compensation and consumer protection issues

1.51 The Authorities are also considering a number of other changes in relation to consumer protection, including:

- to improve awareness of available protections, **the FSA intends to consult on how consumers can be better informed about the compensation scheme;**
- to ensure that customers of a failed bank still have access to their benefits and tax credit payments, **the Government will ensure that DWP and HMRC have contingency plans in place to continue payments;**
- in line with its priority to ensure that holders of banknotes have appropriate protection as creditors, **the Government proposes legislation to strengthen the arrangements underpinning issuance in Scotland and Northern Ireland by commercial banks;**
- **the Government proposes legislation to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the United Kingdom;**
- **the Government proposes legislation to ensure that the FSCS has the management flexibility it needs to manage a wide range of claim volumes;** and
- **the FSA is seeking views on the advantages and disadvantages of introducing risk-based levies or other ways of bringing behavioural factors into levy calculations.**

STRENGTHENING THE BANK OF ENGLAND

1.52 The Bank of England has responsibility for monetary policy and in relation to financial stability. To ensure that its role with respect to financial stability is strengthened, a number of changes to its statutory objectives and governance are presented in Chapter 6. The changes include:

- **the Government proposes legislation to formalise the Bank of England's role in the area of financial stability and to give its Court a**

formal role in overseeing the Bank of England's performance in this area; and

- **to support the Bank of England's enhanced statutory role in financial stability, the Government proposes legislation to amend the provisions governing the size and composition of the Bank of England's Court. The Bank of England also intends to modernise the arrangements for meetings of the Court.**

COORDINATED ACTION

1.53 Coordination between authorities – in the UK and internationally – is essential if they are to carry out their responsibilities effectively. Further details are given in Chapter 7.

Coordination in the UK

1.54 In the UK, the coordination of the work of the Authorities is set out in a tripartite Memorandum of Understanding (MoU) originally agreed in 1997 and modified in 2006.

1.55 As supported by the Treasury Select Committee, the Authorities believe that the tripartite structure continues to be the right approach for the UK. However, the Authorities propose to make a series of changes to make these tripartite arrangements more effective in future, so:

- **the Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements;**
- **the FSA and the Bank of England will consider the scope for greater combined initiatives to develop common understanding;**
- **the Authorities propose to clarify responsibilities within the MoU for decisions around providing support to firms – in particular ELA;**

International coordination

1.56 Financial markets are increasingly global in nature. Risks, including those of contagion, also increasingly apply across borders. It is therefore vital that the appropriate structures are in place to provide early warning of these risks and to act where possible to mitigate them. The Authorities will work to improve international coordination in the following way:

- **working with international counterparts to pursue changes to improve the effectiveness of the FSF;**
- **proposing that the IMF considers how to improve further the focus of its financial sector surveillance;**
- **proposing that the FSF and IMF enhance their cooperation to bring together the intelligence gathered from IMF surveillance and from FSF members; and**
- **working with international counterparts to improve international crisis management arrangements and ensure the UK authorities are well prepared to respond to international financial crises,**

building on ongoing initiatives in the EU and FSF, and working bilaterally with key partners who share exposures to specific risks.

SUMMARY

1.57 Recent events have posed significant challenges for financial markets and regulatory responses across the world. It is important to learn from these events, and the proposals set out would:

- strengthen the stability and resilience of the financial system, both in the UK and internationally;
- reduce the likelihood of individual banks facing difficulties;
- reduce the impact if, nevertheless, a bank gets into difficulties;
- provide effective compensation arrangements in which consumers have confidence; and
- strengthen the Bank of England, and ensure effective coordinated actions by authorities, both in the UK and internationally.

1.58 Tackling these issues will require action on the part of financial firms. For the Authorities, it will require primary and secondary legislation, consultation on and changes to FSA rules, operational changes, and discussion and agreement in international fora.

1.59 Subject to the outcome of this consultation, these changes will start to be taken forward over the course of 2008. As announced in the Queen's Speech in 2007, the intention is to introduce a Bill into Parliament following the consultation period. The Government will consult with the devolved authorities to the extent that any proposals in the document impact on their responsibilities. The FSA will consult on the FSCS compensation limits following the consultation, and consult on other changes to FSA rules over the course of 2008. The range of operational changes, both for the Authorities and for banks, will be taken forward as soon as possible. The Authorities will consider whether interim measures are appropriate before full operational changes are possible. Finally, the Authorities will continue to lead work in international fora to ensure appropriate international responses to the turbulence in global financial markets of recent months.

2 STABILITY AND RESILIENCE OF THE FINANCIAL SYSTEM

2.1 HM Treasury, the FSA and the Bank of England (the Authorities) are working together, and with their counterparts across the world, to understand the causes of the ongoing market disruption and to strengthen the stability and resilience of financial markets. This chapter:

1. explains the recent events and, in particular, how problems starting in the US sub-prime mortgage market spread across the globe;
2. summarises the international work to develop an appropriate response; and
3. sets out the Authorities' emerging views on the lessons to be learned and the actions to be taken in order to improve the stability and resilience of the financial system, by:
   - strengthening risk management by banks; and
   - improving the functioning of securitisation markets.

RECENT EVENTS

Global stability

2.2 As set out in Annex A of the 2007 Pre-Budget Report[8] and further explained in the Bank of England's October 2007 Financial Stability Report[9], the disruption in global financial markets in the second half of 2007 followed a prolonged period of macroeconomic and financial stability and low interest rates in the UK and globally. Historically low interest rates encouraged investors to 'search for yield' by investing in increasingly risky financial products without being fully compensated for the additional risks, leading to a general under-pricing of risk. Benign macroeconomic conditions and the search for yield also encouraged an erosion of credit risk assessment standards in some markets, most notably US sub-prime mortgages.

2.3 Financial markets have also seen a wave of innovation and restructuring in recent years, partly driven by this search for yield. As well as an increase in the interconnectedness of financial markets across borders, there has been a growth in the non-bank financial sector (such as off-balance sheet financing vehicles), and the development of higher-yielding, but riskier and more complex, products capable of delivering returns demanded by investors. A key aspect of recent innovation has been a rapid growth of markets for securitised products and the development of the 'originate and distribute' model of banking, explained further in Box 2.1.

[8] *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007

[9] Bank of England, *Financial Stability Report – Issue No.22*, October 2007

Box 2.1: Securitisation and the 'originate and distribute' model of banking

Securitisation is the process of originating or purchasing loans and other assets, then packaging and reselling them to investors and other banks, so distributing some or all of the associated credit risk. For example, a large proportion of the underlying mortgages in the US sub-prime mortgage market were securitised into residential mortgage-backed securities (RMBS) and sold. In some cases RMBS were re-securitised as more complex and highly leveraged structured products called collateralised debt obligations (CDOs).[10]

The growth of this 'originate and distribute' model of banking has been driven by three main motivations:

- it has allowed banks to distribute off their balance sheets more of the credit they have originated, thereby earning interest income without tying up significant amounts of regulatory capital;
- banks were (until recently) able to obtain a relatively cheap, plentiful supply of wholesale funding by packaging some of their mortgage and other lending into asset-backed securities (ABS); and
- banks have been able to better tailor securities to investors' risk appetite by re-securitising RMBS and other ABS into CDOs and other structured products which 'slice and dice' credit risk into tranches with different risk characteristics.

In many cases banks have sponsored, and provided liquidity lines to, conduits and structured investment vehicles (SIVs), which purchase long-maturity ABS and other assets from their sponsor bank or other banks and fund this by issuing short-maturity asset-backed commercial paper (ABCP) or other securities. ABCP conduits issue only a single class of debt. They are fully backed by bank-provided liquidity lines, available to be drawn should the market for ABCP dry up (as happened recently). SIVs issue a range of short- and medium-term securities and invest the proceeds in assets with a somewhat longer average maturity. In contrast to ABCP conduits, the ABCP issued by SIVs is not fully supported by liquidity facilities.

Sub-prime mortgage market

2.4 In July 2007, renewed concerns about the US sub-prime mortgage market, following earlier periods of stress in February and March, triggered a re-pricing of risk that spilled over with unexpected speed and force into financial markets globally. Difficulties in the US sub-prime mortgage market were caused by loosening of lending criteria, interest rate structures that many borrowers could not ultimately afford, unrealistic expectations about house prices, and in some cases fraud. Defaults have risen far higher than expected when the securities were issued and rated. In some areas house prices have fallen, further aggravating the problem. As a result, many financial firms have suffered losses from holding these instruments, the market value of which has fallen. Although the US sub-prime mortgage market is small in relation to the global financial system, difficulties in valuing many of the residential mortgage-backed securities (RMBS) and uncertainty about where the risks associated with sub-prime mortgages had been distributed led to significant uncertainties about the losses and their impact on banks' balance sheets.

[10] CDOs are securities backed by a portfolio of fixed income assets that are issued in tranches of varying seniority. As default losses accrue to the underlying portfolio they are applied to the securities in reverse order of seniority.

Impacts

2.5 These developments in financial markets have had direct impacts across the world. Investment funds in the US, the UK, France and other countries have faced difficulties. Two banks in Germany have had to be recapitalised or have an emergency takeover arranged. Some of the world's largest banks have announced significant losses, with several choosing to raise new capital as a result.

Securitisation markets

2.6 The sharp contraction of market liquidity, particularly for more complex structured products, has created difficulties in valuing RMBS and other products. The sensitivity of some of these products to changes in assumptions about default rates has been revealed by downgrades by rating agencies of some securities that had been given high investment grade ratings only a few months previously. This has undermined confidence in structured finance ratings more generally.

2.7 Banks that rely on the securitisation markets to distribute loans that they have originated are now unable to do so. Banks have been left needing to fund growing stocks (or 'warehouses') of assets that they had not expected to retain on their balance sheets. The drying up of liquidity has also forced some banks to support their sponsored ABCP conduits and SIVs, and in some cases to take these vehicles' assets back on balance sheet, adding to pressures on the banks' capital.

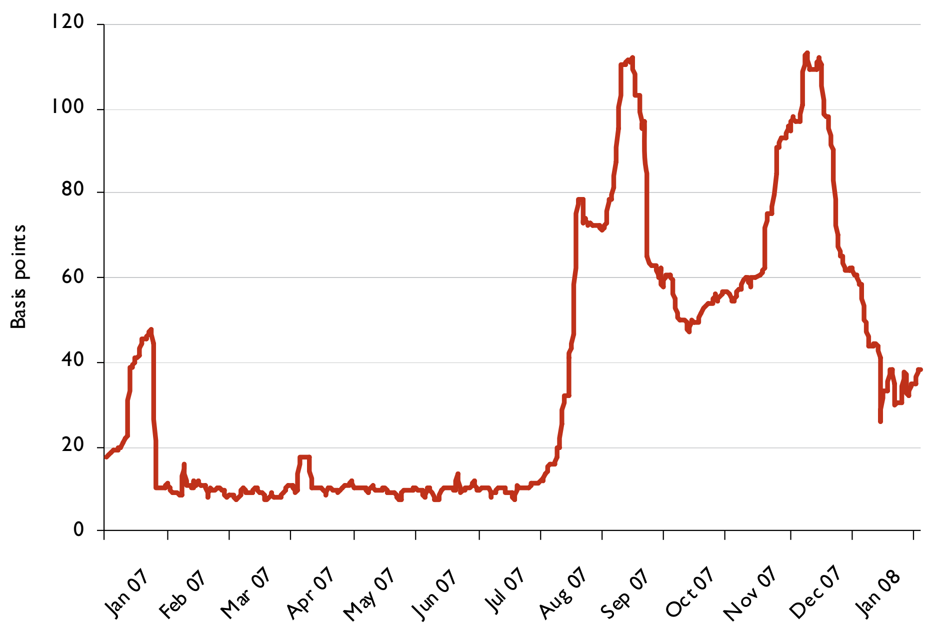
2.8 In the UK, the most visible impact has been the funding difficulties faced by Northern Rock plc. Its reliance on wholesale market funding, identified by the Treasury Select Committee as the primary cause of its difficulties, led it to seek emergency liquidity assistance (ELA) from the Bank of England in September 2007, when it became unable to secure sufficient funding from the wholesale markets. Publicity about the position of the firm precipitated a sudden withdrawal of funds by retail customers. Since then, the Authorities have put in place funding arrangements to enable the firm to take strategic decisions about its future.

Inter-bank markets

2.9 Problems in the ABS market spread to the inter-bank lending market as the lack of transparency about individual banks' exposures to losses led to heightened concerns about counterparty credit risk causing banks to stockpile liquidity to meet increased, but uncertain, needs. There have been improvements in the inter-bank markets in recent weeks. Money markets have had a positive start to the year following the orderly management by banks of year-end pressures and the coordinated interventions by central banks to ease these pressures. Three-month sterling Libor/OIS spreads[11], fell back from over 100 basis points in early December 2007, to below 40 basis points as of 29 January 2008.

[11] London inter-bank offered rate / Overnight swap index - spreads between three-month sterling Libor and expected policy rates.

Chart 2.1: Three-month sterling Libor/OIS spreads



Source: Bloomberg

2.10 However, problems remain in many of the medium-term securitisation markets, including the RMBS market, reflecting uncertainties about:

- the prospects for US housing markets and for the global economy;
- the balance sheets of individual financial institutions; and
- the integrity of the 'originate and distribute' model of banking.

Recent central bank actions

2.11 It is important to distinguish between actions to deal with the immediate problems in the markets and actions that should be taken to help prevent future crises. Regarding the former, central banks around the world, including the Bank of England, the Federal Reserve and the European Central Bank (ECB), have taken action in response to the disturbances in money markets since August 2007.

2.12 The Bank of England, the Federal Reserve and the ECB use operations in the short-term money markets to implement monetary policy. In each case, by managing the aggregate supply of reserves to commercial banks relative to demand framed in terms of reserves targets (or requirements), central banks seek to ensure that overnight money market rates are broadly in line with the policy rate. Central banks provide reserves via open market operations (OMOs) of varying maturities, but the net provision of reserves needs to be in line with targets. Both regular and exceptional OMOs have been used to implement monetary policy in response to the disturbances in money markets since August 2007.

United Kingdom

2.13 A distinctive feature of the UK system is that, each month, banks choose the level of reserves they wish to target over the 'maintenance period' between meetings of the Monetary Policy Committee. Banks can therefore access more central bank money by, in aggregate, setting themselves higher targets. Compared with August, the aggregate level of reserves targets rose cumulatively by 37 per cent in a series of steps between September and December, before falling slightly in January. Since mid-September, the reserves targets have met with smaller short-term open market operations given the lending to Northern Rock.

2.14 In September, to address the possibility that reserves targets had not been set sufficiently high to reduce elevated overnight market rates, the Bank of England offered reserves above the amount required to meet targets, and also widened the ranges around banks' reserves targets within which reserves are remunerated at Bank Rate in order to accommodate that additional supply. The Bank of England has since maintained wider ranges around reserves targets, providing banks with extra flexibility to manage their day-to-day liquidity.

2.15 In September and October, the Bank of England also held a series of special term auctions to supply three-month funds against a much wider range of collateral than is eligible in its regular operations, including raw mortgages. These funds were not taken up as the minimum spread to the expected policy rate set by the Bank of England was above the equivalent market spread.

2.16 In December, to help alleviate concerns that money market conditions would be unusually tight over the year-end, the Bank of England provided a significant amount of reserves via a five-week operation, reducing the size of its regular one-week operations by an equivalent amount.

United States

2.17 In early August, the Federal Reserve Bank of New York (FRBNY) provided more reserves through its operations than were needed to meet banks' reserves requirements, causing the overnight rate to fall below the policy rate. These 'excess reserves' were subsequently drained, so that reserves returned to more normal levels in subsequent maintenance periods. The Federal Reserve in August approved a 50 basis point reduction in the rate on its Discount Window 'primary credit' facility and increased the maturity of such borrowing from overnight to 30 days, renewable. In November, the FRBNY undertook a longer-term operation to provide reserves over the year-end.

Euro area

2.18 Since August, the ECB has provided additional reserves early in each maintenance period, but subsequently drained them later in the period (so-called 'front loading'). The supply of reserves in each maintenance period as a whole has been unaffected. In December, a larger-than-required amount of reserves was provided over the year-end. The average maturity of the ECB's operations has also been lengthened, with a greater share of reserves supplied in exceptional three-month operations in August and September, which were re-offered in November and December.

Coordinated central bank action

2.19 In December, five major central banks announced coordinated measures to address elevated pressures in funding markets. The Bank of England increased the size of its scheduled Long Term Repo operations in December and January 2008, lending more at three months against a wider range of high-quality collateral. The Federal Reserve established a Term Auction Facility to provide term funds to a larger group of institutions than are eligible to participate in its regular OMOs, and against the wide range of collateral eligible in its Discount Window rather than the instruments eligible in its routine OMOs. The European Central Bank (ECB) and Swiss National Bank extended these (dollar) auctions to their own counterparties by means of temporary reciprocal currency arrangements (swap lines) with the Federal Reserve. The ECB did not extend collateral for these auctions as it routinely lends in its OMOs against a wider range of collateral than the Bank of England or the Federal Reserve.

INTERNATIONAL RESPONSE

Key issues

2.20 The Financial Stability Forum (FSF) is analysing the underlying causes of market turbulence, with a focus on events in the markets for structured products. This will take into account ongoing work by international bodies, such as the work by the Basel Committee on Banking Supervision on firms' liquidity risk management practices. The FSF Working Group gave an initial report on its work programme to the G7 on 19 October and will prepare a draft report to the G7 in February, with the final report to the April G7.

2.21 Similar work is under way in the European Union (EU). The Economic and Financial Affairs Council (Ecofin) has endorsed a programme of work on recent market turbulence, focusing on broadly the same issues as the FSF. The Prime Minister issued a joint statement with the French President and the German Chancellor on 19 October regarding recent turbulence in the financial markets.

2.22 There is considerable international consensus on the key issues raised by recent events. Broadly speaking, work by the FSF and the EU is focusing on the same issues:

1. effective prudential risk management within banks and other financial institutions, including liquidity, market and credit risk management practices; and
2. issues relating to the securitisation markets, including:
    - prudential regulation of financial institutions, particularly in relation to their exposure to off-balance sheet vehicles;
    - accounting and valuation procedures for complex structured products; and
    - the role of credit rating agencies in structured finance.

2.23 These issues are discussed below. It is important that work on these areas continues to be taken forward at an international level to ensure a coordinated response. In addition there is a need for more joined-up institutional arrangements internationally. This is discussed in Chapter 6.

2.24 Market solutions are likely to be a key element to delivering greater transparency and more resilient financial markets. It is too early to say how markets themselves will respond to the lessons from recent events, so it is important that the international authorities avoid precipitate reactions. The international response should aim to identify longer-term lessons from the recent turbulence about the behaviour of markets and, where necessary, to design appropriate responses. It is also important to recognise that some actions aimed at preventing similar bouts of financial turbulence in the future could be counter-productive in addressing the current difficulties in the markets.

STRENGTHENING RISK MANAGEMENT BY BANKS

2.25 Market turbulence over recent months has highlighted the need for better prudential risk management and stress testing practices within banks and other financial institutions, particularly in relation to liquidity risk. A key lesson is that in times of stress, liquidity in financial markets, even those that have historically been very liquid, can dry up very suddenly. A loss of liquidity can significantly increase the risk of failure of a bank, particularly if there is a corresponding fall in consumer confidence and a sudden increase in demand for access to deposits.

2.26 Adequate risk management is a factor which the FSA takes into account in considering whether the ‘threshold conditions’ set out under Schedule 6 to the Financial Services and Markets Act 2000 are satisfied. The threshold conditions are the minimum standards for a bank becoming and remaining authorised. They include ‘adequate resources’ and, when considering this condition, the FSA will have regard to all the bank's financial resources, non-financial resources and means of managing them; for example, capital, provisions against liabilities, holdings of or access to cash and other liquid assets, human resources and effective means by which to manage risks.

2.27 The nature and extent of the systems and controls which a bank will need to maintain to manage its risks will depend upon a variety of factors including the nature, scale and complexity of its business and the markets in which it is operating. Banks are required by the FSA to carry out appropriate stress testing and scenario analysis, including taking reasonable steps to identify an appropriate range of realistic adverse circumstances and events.

2.28 This section:

- describes the new international framework for the prudential regulation of banks, known as Basel II; and
- discusses action in relation to stress testing and liquidity risk management.

Basel II and the Capital Requirements Directive

2.29 On 1 January 2007, the FSA's final rules and guidance implementing the Capital Requirements Directive (CRD) in the UK came into effect following extensive consultation with the industry, with all banks using the CRD framework from 1 January 2008. The CRD implements in the EU the new Basel Accord, Basel II, agreed by the Basel Committee in June 2004.[12] Basel II and the CRD are designed to recognise new and continuing developments in financial products, incorporate advances in risk measurement and management practices, and more precisely assess regulatory capital charges in relation to risks.

2.30 The new framework consists of three 'pillars':

- Pillar 1 sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk;
- under Pillar 2, firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1 and must take action accordingly;

[12] Source: http://www.bis.org/publ/bcbs107.htm

- Pillar 3 aims to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

2.31 In a number of respects the introduction of CRD/Basel II marks a significant improvement in the prudential regulation of banks. However, questions have been asked about the impact that the increased risk sensitivity of CRD/Basel II might have on credit supply and the economic cycle. Box 2.2 summarises the work being done in the UK and internationally to monitor and assess the impact of the CRD/Basel II on the cycle.

Box 2.2: The impact of CRD/Basel II on credit supply and the economic cycle

Concerns have been expressed that the measures of risk companies and regulators use to determine banks' capital requirements under CRD/Basel II could be pro-cyclical. Banks' capital requirements will be determined partly by internal ratings assigned to banks' exposures (and partly by stress testing and supervisory review). Cyclical downgrades in internal ratings could cause minimum capital requirements to rise significantly, potentially prompting banks to tighten credit supply. This could adversely affect the provision of funds in aggregate, and hence affect financial stability and the economic cycle.

The FSA and the Bank of England have recently developed a system that will enable the Authorities to examine the sensitivity of aggregate minimum capital requirements to credit conditions, and to monitor the impact of changes in these requirements on both actual capital and lending. Internationally, the Basel Committee has established a Basel II Capital Monitoring Group that will share national experiences in monitoring the level and cyclicality of capital requirements, and an EU Task Force on the impact of the new capital framework has recently been set up.[13]

Stress testing

2.32 Stress testing is one way for market participants to look at the impact of extreme events and to assess their capacity to manage these events. Stress tests help to strengthen internal risk management by indicating the mitigating actions that may be required to protect the business. The impact of recent market turbulence on financial institutions suggests that some firms' stress-testing practices were inadequate, particularly in relation to more extreme scenarios and taking steps to protect themselves against these risks.

2.33 The revised Basel II capital framework has been a driver of stress testing developments within banks. Under this framework, banks have to undertake stress testing and use the results to plan their use of capital over the economic cycle. The Committee of European Banking Supervisors (CEBS) has published two sets of guidelines on stress testing.[14] The FSF and the EU are both assessing the lessons from recent events in relation to transparency and valuation, and the implications of the market turbulence of recent months for banks' liquidity, market and credit risk management practices.

[13] The European Commission is committed, through Article 156 of the Capital Requirements Directive, to 'periodically monitor whether Basel II … has significant effects on the economic cycle and … consider whether any remedial measures are justified.'

[14] Firstly in January 2006 as part of the guidelines on the Supervisory Review Process, and secondly a separate paper in December 2006 giving additional guidelines on this subject. http://www.c-ebs.org/pdfs/GL03.pdf and http://www.c-ebs.org/documents/GL03stresstesting.pdf

2.34 In the UK, stress testing is tailored according to the size, nature and complexity of the bank. The FSA is using its supervisory reviews to assure that banks do in fact conduct adequate and appropriate firm-specific stress tests. In a letter to bank CEOs in October 2006, 'Stress testing thematic review', the FSA reported on a thematic review of stress testing practices at ten large firms in the banking, building society and investment banking sectors. This included several examples of what the FSA considered to be good practice.

2.35 **The FSA will intensify its work with banks to improve stress testing in light of recent events**. The Authorities believe that the focus of this work should be on:

- ensuring that stress-testing results inform and challenge the ongoing risk management at banks and serve as triggers for senior management to consider their risk mitigation strategy;
- stress testing in relation to more extreme scenarios;
- liquidity risk (discussed further below), where recent events have demonstrated the inadequacy of many banks' previous stress testing (for example in relation to market-wide stresses such as the disruption of one or more secondary markets);
- the recognition in stress tests of dependencies between markets; and
- testing for plausible stresses from off-balance sheet vehicles arising from legal or reputational links between the vehicle and the bank.

2.36 At an international level, **the Authorities will work with international partners to encourage a stronger consensus on the importance of stress testing, in particular at group level and by multinational banks. The Authorities will work to consider whether the stress-testing standards under Basel II are sufficiently robust.**

Consultation questions

2.1) Do you agree with the actions being taken by the Authorities in the UK to improve stress testing by banks?

2.2) Have the Authorities correctly identified the issues on which international work on stress testing and risk management should focus?

Liquidity risk

2.37 In an orderly, well-functioning market, an adequately capitalised bank should always be able to obtain sufficient liquidity to meet its needs. However, at times of stress, when market participants hoard liquidity due to uncertainty about their own needs, banks may have little or no access to the money and asset markets. One of the key aspects of recent market turbulence has been the speed with which liquidity dried up and the extent to which this spread beyond the directly affected markets.

2.38 In December 2007, the FSA released a discussion paper which considers the liquidity requirements for banks and building societies with a view to addressing practical shortcomings and improving standards of liquidity risk management.[15] This is

[15] *DP 07/7 'Review of the liquidity requirements for banks and building societies*, FSA, December 2007.

discussed further in Box 2.3. Factors that the FSA may take into account in the regulation of liquidity are the liquidity of instruments and routine liquidity provision by central banks. The Bank of England has announced a review of this element of its money market operations, and will in due course publish a revised 'Red Book' describing its operations in the sterling money markets.

Box 2.3: FSA Discussion Paper 07/7 on liquidity requirements

The main purpose of the FSA's discussion paper is to review some of the lessons to be learned for managing and regulating banks' liquidity from recent market turbulence and to set out preliminary ideas for reform. The preliminary conclusions of the discussion paper are that a principles-based approach is right, but that the application of quantitative liquidity requirements remains necessary. The paper re-emphasises the primary responsibility of firms' boards and management for maintaining adequate liquidity and managing their liquidity risk. Recent events have exposed key limitations in banks' liquidity and risk management which need to be improved through ongoing dialogue between supervisors and firms in the following areas:

- the quality and robustness of banks' stress testing, which the paper highlights as an essential tool of liquidity risk management;
- the use of liquidity insurance;
- the quality and effectiveness of contingency funding plans; and
- the nature and frequency of information available.

After considering the responses to the discussion paper, and taking stock of relevant work by the Authorities and regulatory developments on liquidity in the Basel Committee and the EU, the FSA expects to publish more definitive proposals for taking forward its liquidity policy during the summer of 2008.

2.39 At an international level, the CRD/Basel II framework for capital regulation addresses liquidity regulation in relation to stress testing, scenario analysis and contingency plans. International discussions on liquidity regulation are being led by the Basel Committee and the CEBS. The Basel Committee is due to publish a report on liquidity regulation in early 2008. The FSF Working Group analysing recent market turbulence is considering what lessons should be drawn from recent liquidity risk management problems, drawing on the work by the Basel Committee.

2.40 The Authorities will work with international partners to ensure that standards are consistently high across banking groups, and encourage more consistent approaches to liquidity regulation. Given the international nature of financial markets, the Authorities will work towards greater consistency in international approaches to liquidity regulation.

2.3) Have the Authorities correctly identified the issues on which the work on liquidity regulation should focus?

IMPROVING THE OPERATION OF SECURITISATION MARKETS

2.41 As described above, market turbulence has particularly affected a number of markets for ABS. Securitisation is likely to remain an important element of the modern financial system. However, effective risk transfer requires transparency about the risk being transferred for it to be effectively priced. Recent market turbulence has highlighted a number of issues that can arise in relation to the operation of ABS markets, including:

- difficulties in valuing ABS, given the complexity of some structures and the fact that they may trade in illiquid markets, if at all;
- the role and methodology of credit rating agencies in providing information to the markets and investors about the risks associated with structured products, and investors' reliance on ratings; and
- lack of transparency as to who is ultimately carrying risk, particularly in relation to banks' exposures to the losses suffered by off-balance sheet financing vehicles on ABS.

Accounting and valuation of structured products

2.42 The ABS used to repackage and sell loans are often complex and frequently trade in illiquid markets, if traded. This makes these products difficult to value, and can result in originators, distributors and end investors relying on complex models, rather than market signals, to value them.

2.43 Accounting standards generally require that these instruments are valued at 'fair value'. Where an active market exists, fair value will be the market price, though models can be used in the absence of an active market. CRD/Basel II set out 'prudent valuation guidance' which requires that downward valuation adjustments be made for a range of factors, including illiquidity and model risk.

2.44 Significant challenges are presented by current market conditions. The market turbulence has led to the sudden disappearance of markets for important classes of complex financial instruments. Financial firms have faced a significant challenge in valuing these assets: they have had to place even greater emphasis on using 'mark to model' approaches.

2.45 A number of initiatives are under way, internationally and in the UK, to help ensure that banks' financial statements give a true and fair view, based on full disclosure of banks' losses during the recent market turbulence. At an international level, the FSF and the EU are assessing the lessons from recent events in relation to transparency and valuation, drawing on work by other committees (for example, the Basel Committee's assessment of whether there is a need for further guidance for banks on their approach to the valuations used to calculate regulatory capital). In December, the audit firms' Global Public Policy Committee published a summary of key IFRS principles for valuation and risk disclosure.[16] In the UK, the Financial Reporting Council (FRC) has taken a number of steps to respond to current market conditions, such as issuing a set of questions which audit committees may wish to ask when reviewing draft accounts.

2.46 These initiatives should help to increase market confidence and reduce concerns among market participants about uncertainties around counterparty risk. The Authorities have been, and will continue to play, an active role in these initiatives.

[16] Global Public Policy Committee, *Determining fair value of financial instruments under IFRS in current market conditions*, December 2007

2.47 The Authorities believe that the use of fair value accounting in relation to structured products is appropriate. The increasing use in recent years of fair values in accounting for financial instruments has brought many advantages. Fair value is a clear attempt to measure 'true' economic value. Furthermore, under the traditional 'historic cost' accounting approach to valuation there is a danger that provisioning against losses may not take place in a timely manner. As recent events have shown, when market liquidity dries up 'marking-to-market' can be problematic given the dearth of transaction information available. In such circumstances it is important that firms have, and apply consistently, valuation processes that make full use of available third party information.

2.48 Given the degree of uncertainty surrounding the values of some instruments in current market conditions, adequate disclosure of valuation methods by preparers of accounts will be a crucial aspect of ensuring that accounts give a true and fair view. The Authorities encourage auditors to be consistent in their approach to dealing with the audit of the year-end valuations, including ensuring that there are sufficient disclosures to give a true and fair view. The Authorities will work with accounting standard setters, including the International Accounting Standards Board (IASB) and the UK Accounting Standards Board, to consider whether there is a case for further, more detailed guidance to ensure more consistent valuation and disclosure.

2.49 Regarding longer-term lessons, it is important not to rush to take regulatory action before the markets have had time to adjust to recent events. It is also important not to prejudge the impact that new accounting standards will have on the valuation of structured products. A new accounting standard for Financial Instruments: Disclosures[17] has become mandatory for 2007 accounts. This standard requires significantly enhanced disclosures, including in relation to fair values.

2.50 The Authorities will work with their international counterparts to ensure that:

- **firms' valuation approaches are consistent with the relevant accounting standards and the CRD/Basel II prudent valuation guidance; and**
- **accounting standards require adequate disclosure about the uncertainties around valuations, their significance for the entity and how these risks are being managed.**

2.51 The Authorities believe that particular consideration should be given to whether disclosure is adequate in relation to:

- the risks associated with new products, where there may only be a short run of historical data on asset performance to use for model-based valuations; and
- the impact on valuations of unexpected correlations emerging between seemingly different assets across and within portfolios, and of loss of market liquidity.

2.52 The Authorities will also encourage the markets to find ways to increase transparency of valuation methodologies and, to the extent appropriate, move towards greater standardisation of methodologies for valuation.

[17] Issued as IFRS 7 by the IASB, and incorporated into UK accounting standards as FRS 29.

2.4) Do you agree with the actions being taken by the Authorities to encourage full and consistent valuation and disclosure by banks?

2.5) Have the Authorities correctly identified the issues on which international work on accounting and valuation of structured products should focus?

Credit rating agencies

2.53 While it has brought many benefits, the 'originate and distribute' model of banking has reduced some of the incentives for those originating the loans and constructing the financial instruments to assess and monitor ongoing credit quality. There may be a long chain of participants between the originator of the loans underlying ABS and the end investor. This may reduce the information available to investors about the quality of the underlying loans, as well as the degree of transparency in the financial markets about where risks are ultimately held.

2.54 Credit rating agencies (CRAs) play a key role in addressing the informational asymmetries between issuers of ABS and investors. CRAs provide information to market participants about the credit risks associated with structured products and monitor the continued creditworthiness of the underlying borrowers. The relative complexity and lack of information on the assets underlying ABS has meant that the information provided by CRAs has had a greater influence in determining the values of illiquid structured credit products than for corporate and sovereign securities.

2.55 Certain structured credit products have created significant challenges for CRAs during the second half of 2007. CRAs have been particularly criticised for the perceived slowness with which they moved to downgrade US sub-prime RMBS in 2007. This has undermined confidence in ratings of structured products and highlighted concerns about:

- conflict of interest for CRAs, in that they are paid by issuers rather than investors. Some have argued that this creates an incentive for CRAs to offer a favourable rating to get a rating fee. Particular concerns have been raised about the potential for CRA analysts to provide advice on the design of securitisation products they rate. In addition, CRAs are paid by issuers when the instrument is being prepared for sale. Issuers individually do not explicitly pay for post-issuance monitoring costs for a particular rated security (although initial rating fees will be set at levels that will generally cover these). It has been argued that this results in insufficient incentives for CRAs to carry out post-issuance monitoring of the creditworthiness of the assets underlying structured products;

- the information content of ratings, in that CRA assessments are intended to cover only credit risk (and not liquidity and market risk). In addition, whilst the CRAs' methodologies are typically available, the value and rationale of some of the key assumptions made may not be fully explained. Rating definitions are also different between the major CRAs (for example, some agencies focus on the relative probability of default while others focus on the loss that would be incurred given default), so a similar score by different CRAs is not always strictly comparable; and

- over-reliance on ratings by investors. Ratings tend to be prominent or even hard-wired into the investment mandates of investors and they are a prominent part of Basel II and other regulatory regimes. Credit risk assessments undertaken by asset managers with limited resources may be highly influenced by ratings. The problems caused by this over-reliance on ratings have been compounded by the fact that some investors appear not to have fully appreciated limitations in the information content of ratings. Particular problems arise when investors mistakenly use a credit rating as a signal of relative stability of the market price of the asset being rated.

2.56 Given that the major CRAs operate globally, it is important that any actions to address concerns about the role of CRAs are coordinated internationally. **The Authorities will work with international counterparts in the FSF and the EU to look at the role of CRAs in structured finance. The Authorities will also support the work of the International Organisation of Securities Commission's (IOSCO) taskforce on CRAs, which has recently been reviewing the applicability of its Code of Conduct for CRAs to structured finance business**. An IOSCO report on this is expected in February 2008.

2.57 Some commentators have suggested that potential conflicts for CRAs could be addressed if the investor paid for the rating. However, this might not be feasible given the speed with which information can now be freely distributed. It is also important to recognise that CRAs need to maintain the credibility of their opinions; a CRA that develops a reputation for bias in favour of the issuer is likely to lose business.

2.58 The Authorities are, however, pressing the major CRAs to make proposals to address potential conflicts of interest, in particular arising out of:

- the provision of advice on the design of securitisation products; and
- the remuneration structures for ratings.

2.59 The Bank of England suggested, in its October 2007 Financial Stability Report, that the following improvements could be made to the information content of credit ratings:

- publish information on the expected loss distributions of structured products, to illustrate the tail risks around them;
- provide a summary of the information provided by originators of structured products;
- produce explicit probability ranges for their scores on probability of default; and
- develop separate measurements for products on dimensions other than credit risk.

2.60 The Bank of England proposed that CRAs consider adopting the same scoring definitions to reduce the risk of misperception by investors. The Bank of England is participating actively in a review by the Committee on the Global Financial System on the information provided by the CRAs and its use by investors in relation to structured financial products.

2.61 The Authorities believe that the preferred approach to tackling such issues is through market action, and where appropriate through changes to the IOSCO Code of Conduct on Credit Rating Agencies. However, it is important to recognise that prudential credit ratings are a regulatory tool, in that supervision within the CRD/Basel II framework places reliance on the use of rating opinions to determine risk weightings for capital purposes. Therefore regulators have a strong interest in ensuring that ratings are viewed as reliable and that the information content of ratings is sufficient. If the issues summarised above are not adequately addressed by the markets, alternative measures to remedy these issues should be considered.

2.62 Investors also need to learn lessons from recent events. In particular, investors need to develop a more sophisticated use of ratings. Market participants that consider investing in new asset classes, such as structured products, should not use ratings as a substitute for appropriate levels of due diligence, nor draw – potentially misplaced – inferences from ratings that the behaviour of structured securities share the same characteristics, including liquidity characteristics, as more familiar comparably-rated corporate securities. Recent losses and illiquidity in such asset classes have ensured these issues are in the forefront of investors' minds, and market practice is already adapting rapidly in response. There will be a role for coordinating bodies – such as industry groups and international fora – in clarifying and codifying new practice.

2.63 For some years now, predating the financial market problems associated with Enron, the Government has sought to improve the quality of investor decision-making by addressing market failures in the operation of the institutional investment chain (the market relationships and intermediaries which connect institutional investors with the companies in which they invest). The principal focus of this policy has been improving the efficiency of institutional equity investment but it raises similar questions – about investor and public confidence in markets, the focus of regulation, independence of advisers such as auditors, and the quality of governance – to those discussed here. The Government has sought to influence the quality of decision-making through more transparency, stronger governance and accountability and reducing conflicts or interest, using where possible comply-or-explain codes, or best practice developed with stakeholder input, to achieve this.

2.64 **The Authorities will keep the development of investor practice in relation to structured products under review to determine if further measures are needed to assist markets to achieve an appropriate outcome. In addition, the Authorities will consider the implications for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large.**[18]

[18] In September 2007, the US Treasury announced the formation, under the direction of the President's Working Group on Financial Markets, of two advisory groups – composed respectively of investors and asset managers – to develop best practice for private pools of capital to enhance investor protection and systematic risk safeguards, consistent with the President's Working Group's principles-based guidance. The hedge fund working group is reviewing industry standards and best practices in relation to valuation, risk management and disclosure.

2.6) Have the Authorities correctly identified the issues on which international work on credit rating agencies should focus?

2.7) Do you agree with the Authorities' proposals to improve the information content of credit ratings?

2.8) Do you agree with the Authorities that the preferred approach to restoring confidence in ratings of structured products is through market action and, where appropriate, changes to the IOSCO Code of Conduct on Credit Rating Agencies?

Transparency of banks and exposure to off-balance sheet vehicles

2.65 The growth of the non-bank financial sector over recent years has been driven in part by the expansion of the securitisation markets. Banks have in many cases set up investment vehicles, which purchase long-maturity ABS and other assets from their sponsor bank or other banks and fund this by issuing short-maturity asset-backed commercial paper (ABCP) or other securities. As recent events have shown, the contractual obligations of banks to these vehicles in the form of contingent liquidity facilities, or even non-contractual reputational considerations, can require a bank to provide funding for and/or reabsorb the assets backing these structures at a time of severe stress in the market. This may place strain on the bank's own capital and funding.

2.66 There are both prudential regulatory and accountancy issues regarding the exposure of banks to SIVs and conduits:

- from a prudential perspective, a key challenge for regulators in setting capital ratios and agreeing liquidity policies is to anticipate the extent of a bank's commitments to off-balance sheet vehicles and to ensure that these exposures attract an appropriate capital charge and that banks set aside adequate liquidity; and
- from an accounting perspective, it is necessary to determine when exposures should be accounted for on an entity's balance sheet – that is, deciding what should be consolidated.

2.67 CRD/Basel II includes a dedicated framework for assessing the regulatory capital that needs to be held in relation to securitisations. The capital that banks are required to hold against liquidity lines to conduits and SIVs will generally be higher. CRD/Basel II should also increase transparency about banks' off-balance sheet exposures, improving market discipline. Pillar 3 of CRD/Basel II requires substantially enhanced transparency and disclosure by banks in relation to securitisation.

2.68 Under international accounting standards (which in the EU are compulsory for group accounts of listed companies) the consolidation decision is made by looking at where control, and risks and rewards, lie. As the turbulence has unfolded, application of these criteria has led to some vehicles which had been off-balance sheet becoming consolidated onto their sponsor's balance sheet. One factor has been support from a sponsor in excess of that contractually required – for example, to protect the sponsor's wider reputation in the market place.

2.69 The FSF and the EU are assessing the implications of recent events for the prudential regulation of financial institutions, particularly in relation to their exposure to off-balance sheet vehicles. The IASB is re-examining the accounting standards for consolidation, with a discussion paper planned for the second half of 2008.

2.70 **The Authorities will work with their international partners in the FSF and the EU to identify whether:**

- **there remain incentives under the CRD/Basel II framework for banks to minimise their regulatory capital requirements by holding assets in SIVs and other funding vehicles; and**
- **if so, whether this might reduce the total amount of regulatory capital in the financial system below the level that the Authorities consider desirable.**

2.71 To the extent that the FSF and EU work identifies that there are deficiencies in the CRD/Basel II prudential rules in this regard, the Authorities believe that the best way to address these is through the prudential rules that apply to banks, not through directly regulating funding vehicles.

2.72 While there is no evidence of significant shortcomings in the approach to consolidation in accounting standards, **the Authorities recommend that the IASB considers in particular whether reputational risks are properly taken into account in decisions about consolidation. In conducting their review, the IASB should take into account that banks themselves are likely to learn lessons from recent events and change their behaviour accordingly, for example, in relation to reputational risk.**

2.9) Have the Authorities correctly identified the issues on which international work on banks' exposures to off-balance sheet vehicles should focus?

SUMMARY

2.73 This chapter has set out the following proposals:

1. In relation to stress testing:
   - the FSA will intensify its work with banks to improve stress testing in light of recent events;
   - the Authorities will work with international partners to encourage a stronger consensus on the importance of stress testing, in particular at group level and by multinational banks; and
   - the Authorities will work to consider whether the stress-testing standards under Basel II are sufficiently robust.
2. In relation to liquidity regulation:
   - the Authorities will work with international partners to ensure that liquidity regulation standards are consistently high across banking groups, and encourage more consistent approaches to liquidity regulation.
3. In relation to accounting and valuation of structured products:

- the Authorities will work with their international counterparts to ensure that firms' valuation approaches are consistent with the relevant accounting standards and the CRD/Basel II prudent valuation guidance; and

- the Authorities will work with their international counterparts to ensure accounting standards require adequate disclosure about the uncertainties around valuations, their significance for the entity and how these risks are being managed; and

- the Authorities will encourage markets to find ways to increase transparency of valuation methodologies and, to the extent appropriate, move towards greater standardisation of methodologies for valuation.

4. In relation to credit rating agencies:

   - the Authorities will work with international counterparts in the FSF and the EU to look at the role of CRAs in structured finance. The Authorities will also support the work of the IOSCO taskforce on CRAs, which has recently been reviewing the applicability of its Code of Conduct for CRAs to structured finance business;

   - the Authorities will keep the development of investor practice in relation to structured products under review to determine if further measures are needed to assist markets to achieve an appropriate outcome; and

   - the Authorities will consider the implications for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large.

5. In relation to transparency of banks and exposure to off-balance sheet vehicles:

   - the Authorities will work with their international partners in the FSF and the EU to identify whether there remain incentives under the CRD/Basel II framework for banks to minimise their regulatory capital requirements by holding assets in SIVs and other funding vehicles, and if so whether this might reduce the total amount of regulatory capital in the financial system below the level that the Authorities consider desirable; and

   - the Authorities recommend that the IASB consider in particular whether reputational risks are properly taken into account in decisions about consolidation.

3 REDUCING THE LIKELIHOOD OF A BANK FAILING

3.1 A key objective for reform is to reduce the likelihood that individual banks, building societies or other deposit-taking firms (for simplicity, 'banks') face difficulty in the future. Realising this objective requires, in the first instance, emphasis on the responsibility of the senior management and boards of banks to direct their operations and manage risk appropriately, as discussed in the previous chapter. In addition, the Bank of England, the FSA and HM Treasury (the 'Authorities') must ensure that they are aware of developments in individual banks and have effective tools for intervention, where appropriate. It must be noted, however, that it is neither possible nor desirable to design a regulatory system that removes the possibility of any bank ever failing.

3.2 This chapter sets out:

1. the existing regulatory and supervisory framework, and a new proposal to require banks to provide particular information to the FSA at short notice;
2. new proposals to allow the FSA to collect and share information with the Authorities in relation to financial stability;
3. new proposals for the regulation of payment systems; and
4. changes to the framework for provision and disclosure of liquidity assistance.

REGULATORY INTERVENTIONS

The FSA's existing powers

3.3 Where the FSA judges that a bank runs a risk of breaching threshold conditions[19], or the interests of consumers are at risk, it has available a wide range of regulatory powers and sanctions to address the problem. It is important that the range and escalation of current powers are clearly understood by all stakeholders. The following section summarises the FSA's powers, and the circumstances in which they are intended to be used.

Routine supervision

3.4 In the course of routine supervision, the FSA can use information provided by a bank to judge whether:

- the bank's business plan lacks credibility;
- the bank may, at some future point, fail to satisfy the threshold conditions; or
- there is a threat to consumer protection.

Heightened supervision

3.5 Events, whether bank-specific or market-wide, may cause the FSA to consider moving to a heightened supervisory regime. Such events would be identified in the course of bank-specific risk assessments, visits, thematic reviews or 'skilled persons reports' (a report prepared by an independent expert in relation to an identified issue).

[19] Threshold conditions are set out in FSMA and include: legal status; location of offices; close links (that might prevent effective supervision); adequate resources; and suitability. Supporting guidance can be found in the FSA Handbook.

Corrective action

3.6 If, at any point, the FSA's analysis is that there is an increased probability that a bank may not meet the threshold conditions, or that it would be otherwise desirable in the interests of consumers, the FSA will normally first ask the bank to consider voluntary action to address the situation. Examples of such action would include banks:

- allocating more resource to the 'problem' areas;
- presenting concrete plans to exit a certain area of business or to stop offering a certain product; and
- strengthening risk management processes in specific areas.

3.7 Experience suggests that, in the majority of cases, banks will take appropriate action. However, if they are not willing to cooperate, the FSA has powers to oblige them to take a prescribed course of actions.

'OIVOP powers'

3.8 Should a bank fail to comply with the escalation of FSA interventions set out above, the FSA has powers (in particular, under section 45 FSMA ('Own Initiative Variation of Permission' or OIVOP)) to require a bank to take action. The OIVOP power allows the FSA to take action against a bank to vary, or cancel, its permission including ceasing to offer certain products when it appears that the bank in question is failing or likely to fail to satisfy threshold conditions, or to protect the interests of existing or potential consumers.

3.9 When considering the use of its OIVOP powers, the FSA must always take into consideration the type of difficulties being encountered by the bank, and the nature and scale of the bank's business. In highly complex and rapidly evolving situations, it may be difficult for the FSA to frame the variation of permission in such a way as to address the problems identified. This would be further compounded in the case of larger and more complex banks, where the range of activities and products place practical difficulties in the way of using the powers. So there may be cases in which there are practical problems with implementing the OIVOP powers.

3.10 The paragraphs that follow set out a number of radical ways in which the OIVOP powers can be used. The addition of 'special resolution regime' powers (discussed in Chapter 4) would provide:

- a credible prospect that failure to implement the OIVOP can mean that the problem bank's business may be removed in its entirety from the control of the bank; and
- a powerful incentive for a bank to cooperate as fully as possible with the terms of the FSA's OIVOP.

Specialist support

3.11 The OIVOP power can be used to require the board of a bank to appoint specialists. This might be an individual with a particular skill in an area of business that was at the root of the bank's difficulties. An outside specialist could bring knowledge and experience and make recommendations to the board. These recommendations could be substantial and their implementation, if accepted, might require the extensive restructuring of the bank's business and/or the sale of its assets or its deposit book to another bank.

Removal of directors

3.12 An OIVOP power is aimed at the bank itself so can only be used to mitigate those risks that the bank itself can control. An OIVOP could not, therefore, be used to remove the bank's directors. However, if the FSA were to determine that the directors were not fit or proper, it does have the power to remove the approval for directors of a bank to carry out controlled functions.

3.13 The interventions and powers that are already available to the FSA are wide-ranging. In order to support the reforms outlined in this document, the Authorities judge that the FSA requires a small number of additional powers. These are set out below. The FSA has also instigated an internal review (due to report in March 2008) into the lessons of the events surrounding Northern Rock in 2007, and what changes these suggest for the FSA's risk assessment and risk mitigation practices in general. The Government and the FSA will consider the findings of this review, and also the conclusions of the recent Treasury Select Committee Report, in taking final decisions about powers for the FSA and their exercise.

Consultation Questions

3.1) To what extent do the FSA's range of existing powers reduce the likelihood of failure of a bank, and under what circumstances would they not be effective?

3.2) Are the FSA's existing powers, and in particular the application of them, clear, and how could they be further clarified?

FSA supervisory information requirements

3.14 The FSA intends to consult on new rules to require banks to be in a position to provide additional evidence to the FSA at short notice that they are meeting threshold conditions on an ongoing and forward-looking basis.

3.15 Regulatory reporting by banks is an important supervisory tool for the identification of risk, helping the FSA to determine the sector-wide and bank-specific actions that it should take. Current requirements include routine reporting in relation to a comprehensive range of banking risks, such as liquidity and capital. Typically, data will be provided to the FSA on a quarterly basis. For larger banks, the FSA maintains a continuous regulatory relationship to develop a detailed understanding of the risk posed by these banks to financial stability and consumer protection.

Forward-looking assessment

3.16 The FSA needs to be able to make early, forward-looking and accurate assessments of a bank's risk of not meeting the threshold conditions for authorisation. To facilitate early assessment, the FSA intends to consult on the introduction of new rules that would require the management of UK banks to provide additional evidence to the FSA at short notice that they are meeting threshold conditions on an ongoing and forward-looking basis. This would include details of strategies for meeting any shortfalls in a bank's liquidity or capital.

3.17 The circumstances in which the FSA would make a request for information will vary. For example, information on the bank's status may be sought at short notice where there was:

- a bank-specific event which was likely to have a negative impact on market sentiment towards that bank; or
- an external market-wide event that would have a negative impact on the markets from which the bank normally accesses funding (leading to the drying up of normally available sources of liquidity).

3.18 In these types of eventuality, the FSA would want reassurance that the bank was able to meet the threshold conditions. The FSA would expect banks to take responsibility for initiating contact, but would be to be able to make explicit requests where this did not happen and where the FSA held specific concerns.

3.19 This information would be used by the FSA to decide the best course of action if problems were identified, including the exercise of FSA powers (discussed above), and would also inform the decision to alert the Financial Services Compensation Scheme (FSCS) so that it could commence preparations for possible compensation payments (discussed in Chapter 5).

3.20 The FSA would need this information within a short period of time, given how quickly some events can affect a bank's position. The exact period of time would be determined by the FSA at the point the request is made and would take into account the relevant circumstances at the time. As a guide this would likely be 12 hours from close of business, the following working day.

3.21 The FSA recognises that additional information requirements may increase costs for banks. For example, all banks would be required to maintain systems to meet such a request. Wherever possible, the FSA will aim to ensure that requests for information build upon data that banks already hold and use for their own strategic planning.

3.22 Delivery of this would require changes to FSA rules, following consultation, and operational changes by both the FSA and banks.

3.3) To what extent are the annual and one-off costs of the new information requirement on banks proportionate? Can they be quantified?

3.4) How effective would the new information requirement be in identifying and addressing a sudden deterioration in a bank's financial soundness?

Information sharing by the FSA

3.23 The Government proposes legislation to ensure that there is no statutory impediment to the FSA obtaining and sharing information that the Bank of England and HM Treasury require for purposes related to financial stability.

3.24 The Authorities all have important roles in working towards the common objective of financial stability. For example, the Bank of England produces a twice-yearly Financial Stability Report, and both the Bank of England and the FSA have a responsibility to produce a systemic risk assessment for HM Treasury in the event of potential financial instability.

3.25 In the context of the Memorandum of Understanding (MoU) governing the Authorities activities in maintaining financial stability, it is principally the FSA that gathers relevant information. This is primarily collected to allow the FSA to undertake its activities as regulator, rather than in its shared role for financial stability, as set out in the MoU. The Bank of England also has power to collect information from banks, but not information about particular customers and not explicitly about financial stability.

3.26 To ensure that the Authorities are able to carry out their financial stability roles fully, the Government intends to ensure that the FSA can obtain and share any information that the other Authorities require for purposes related to financial stability.

Arrangements to ensure the efficient collection and immediate sharing of information will be reflected in the MoU.

3.27 In addition, the Government intends to bring forward legislation to enable the FSA to collect information that the FSCS requires in order to make compensation payments. This is discussed in Chapter 5.

3.5) Are there circumstances in which it would not be appropriate for the FSA to collect and share the information that the Bank of England or HM Treasury require?

Oversight of payment systems

3.28 The Government proposes legislation to provide for a new and flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework.

3.29 Almost every economic transaction involves some form of payment, so robust and effective systems for payment and settlement are essential to the functioning of financial markets and the economy. Payment systems are networks, linking key financial firms to customers. The inter-linkages between payment systems, banks and other financial intermediaries mean that problems with a payment system have the potential to spread through the financial system, which endangers the stability of the financial infrastructure more widely and ultimately affects businesses and consumers.

3.30 The Bank of England currently has non-statutory responsibility for ensuring the resilience of payment systems, while the FSA has responsibility for the regulation of members and for other elements of market infrastructure (for example, clearing and settlement systems).

3.31 Lack of formal powers means that the Bank of England, in seeking to ensure that payment systems are robust and resilient, has to rely on transparency, expertise and persuasion, shared interests and also, importantly, its operational involvement with the key wholesale payment systems and their members. However, where the Bank of England's operational involvement is limited, its ability to influence systems' rules and resilience is largely dependent on what can be achieved through formal dialogue with management and its published assessments of compliance with international standards in the Bank of England's annual *Payment Systems Oversight Report*.

3.32 Problems in the large value wholesale systems have the potential to lead to liquidity difficulties for banks and to contagion, and could therefore threaten financial stability. Retail systems are of importance to consumers and their failure has the potential to cause considerable inconvenience to large numbers of people. An internal Bank of England review of payments responsibilities in the first half of 2007 concluded that, while responsibility for oversight of wholesale systems may sit well with the Bank of England's responsibilities for monetary policy and financial stability, oversight of significant retail systems might be better undertaken by the FSA.

3.33 The Authorities believe it is appropriate to establish a clear and robust framework for the oversight of payment systems. The Bank of England's responsibilities, and its operational role as a central bank, mean that it will naturally continue to be closely involved in the design, management and operation of high-value wholesale inter-bank payment systems; and the fact of that involvement itself provides considerable leverage to ensure that these systems function in a prudent and effective way. However, as outlined above, for wholly or largely retail systems the oversight role may fit more naturally with the FSA.

3.34 The Government is therefore proposing to take a power to enable it to assign oversight responsibilities to the appropriate authority. This power will be sufficiently extensive to ensure that:

- the relevant authorities are properly equipped, where necessary, with appropriate powers and duties to take on the oversight responsibilities assigned to them, depending on the nature and characteristics of the payment system in question; and
- the framework for oversight is sufficiently flexible to be able to respond to the evolution of payment systems over time.

3.35 The details of the regime to be implemented under the framework will be the subject of further consultation.

> 3.6) Do you agree with the proposal for a new and flexible regime for payment systems oversight and, if so, how should its scope be defined?
>
> 3.7) Which elements of such a payment systems regime should be effected through statutory powers?

LIQUIDITY ASSISTANCE AND DISCLOSURE

3.36 In its role as central bank, the Bank of England is able to lend to individual banks facing temporary liquidity problems. It is important that this role can be carried out in an effective manner. The section below sets out proposals that:

- clarify the circumstances in which disclosure of emergency liquidity assistance (ELA) may be delayed;
- would provide protection for the Bank of England in discharging its responsibilities; and
- would remove the restrictions on building societies from accessing liquidity from the Bank of England, bringing them more into line with banks.

Disclosure of liquidity assistance

3.37 The disclosure that a bank has received ELA from the Bank of England is information that is potentially of value and significance to markets, shareholders and consumers. The UK has long been a champion of transparency in the financial services industry. It supports the approach that put transparency at the heart of the EC Market Abuse Directive (MAD).

3.38 Swift and fair disclosure by issuers of price-sensitive information is a vital element of that transparency, enhancing market integrity. Selective disclosure can lead to a loss of investor confidence and less efficient economic outcomes. However, ELA may also be a very short-term solution for a solvent bank and immediate disclosure could, by leading to a loss of consumer confidence, exacerbate any liquidity problems.

In these circumstances, there may be strong arguments for delaying disclosure until the temporary problems have passed.

3.39 Where ELA is given, a number of participants may have obligations to disclose information:

- issuers of securities have obligations under the FSA's Disclosure and Transparency Rules, which implement the MAD disclosure provisions, to disclose information that is 'inside information'. ELA from the Bank of England may constitute such information;
- all companies are obliged under the Companies' Acts 1985 and 2006 to put certain charges on their own registers of charges without delay and to register them at Companies House within 21 days. This may include where security has been granted to the Bank of England in return for ELA;
- the Bank of England is required to prepare and publish a weekly summary balance sheet which shows the Bank of England's main assets and liabilities – from this information it is possible to speculate that ELA has occurred during the course of a given week; and
- if the Government provides a guarantee to the Bank of England for its liquidity assistance operations, then Parliament must be informed.

3.40 In today's markets, maintaining confidentiality of ELA to a bank may be extremely difficult. There is a strong possibility that such lending could quickly become public knowledge. A rapid loss of consumer confidence following an unplanned disclosure would be likely to prove a greater risk than a timely, but planned, announcement to the market. However, the Authorities have been reviewing what could be done to provide additional flexibility to reduce the risk that the provision of ELA results in a loss of consumer confidence and creates a situation that the lending is designed to help prevent. Three changes are proposed, set out below.

Clarification of the disclosure regime

3.41 **The FSA will come forward with a proposal to make a limited clarification to the guidance in the Disclosure and Transparency Rules.** Under these rules, firms are required to disclose information that is inside information. However, it is possible to delay disclosure, provided:

- the firm has a legitimate interest in delaying disclosure of the information;
- delaying disclosure of the information would not be likely to mislead the public; and
- confidentiality of the information can be maintained.

3.42 The FSA's proposed amendment may, for example, clarify that the bank will have a legitimate interest in delaying disclosure of liquidity assistance for a short period. However, banks do not have an unconditional ability to delay disclosing receipt of liquidity assistance, because the conditions of ensuring confidentiality and not misleading the public still need to be met. The FSA will also explore whether any other disclosure requirements applicable to banks in financial difficulties may be relevant.

Registering charges at Companies House

3.43 The Government is seeking views on whether the requirement for a company to put charges over its assets on to a register of its own and to register them at Companies House should be disapplied for banks in receipt of liquidity assistance.

3.44 Under the Companies Act 2006, any company is obliged to register charges over certain types of assets within 21 days. A company is also required to maintain a register of all charges created by it at its registered office and to provide copies on request.

3.45 The registration requirement may be of limited value for banks as it does not apply to certain types of security that may be particularly significant to banks, in particular those covered by the EC Collateral Directive. The requirement does, however, apply to floating charges and fixed charges on land – which are likely to be significant to banks and applicable to the type of security that may be offered to the Bank of England. Registration of these charges may therefore indicate that a bank has received liquidity support from the Bank of England. The Government is seeking views on whether the Companies Act should be amended so that the requirement for companies to register charges over assets should not be applicable to banks in receipt of liquidity support from the Bank of England.

3.46 Removing the requirement would reduce the information available, in particular to shareholders and creditors, as regards a bank's affairs. It would therefore increase the risk of a third party advancing money to the bank unaware of the security provided to the Bank of England and the possible implications for the repayment of its debt.

3.8) To what extent is the current provision to register charges at Companies House relevant to banks? Do you agree that it is appropriate to amend it?

3.9) Should any exemption for banks only apply to receipt of ELA, or should there be a more general exemption for all types of lending?

3.10) Would extending the 21-day period be a viable, alternative proposition?

Weekly returns

3.47 The Government proposes legislation to remove the requirement for the Bank of England to release weekly returns and will consider other statutory reporting requirements related to the Bank of England that have the effect of disclosing operations.

3.48 The Bank Charter Act 1844 requires the weekly publication of a summary balance sheet of the Bank of England. This may lead to conjecture about ELA lending where the Bank of England's balance sheet has expanded, either in line with the scale of actual liquidity support or for some entirely independent reason.

3.49 The Government proposes repealing the relevant provisions of the Bank Charter Act 1844 so that weekly returns are no longer a statutory requirement. In practice, the Bank of England publishes a wider range of statistics than is required under its statutory obligation. The removal of the requirement for a weekly summary increases the discretion the Authorities can exercise where it is deemed necessary to do so for financial stability purposes, and is similar to provisions in the later Bank of England Act 1998. This allows the Bank of England to delay specific disclosure of liquidity support in its annual accounts until the conditions that gave rise to the assistance have improved.

3.11) What would be the effect of removing the 'weekly return' reporting requirement? What other statutory reporting requirements disclose liquidity assistance?

Protection for the Bank of England

3.50 The Government proposes legislation granting the Bank of England statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and central bank functions.

3.51 The Bank of England has a role in ensuring the stability of the financial system as a whole. The Government believes that there is a case for providing immunity, it is proposed that the immunity would not extend to the Bank of England's usual or contractual relationships with third parties (for example, in relation to market counterparties and other commercial agreements), and exclude instances where the Bank of England acted in bad faith or involved breaches of the Human Rights Act.

3.52 The FSA and the FSCS have statutory immunity in relation to their responsibilities under FSMA. The Government will consider whether this needs to be extended in relation to the additional powers proposed in these reforms.

3.12) Do you agree that the Bank of England should be provided with statutory immunity for any acts or omissions which relate to its role in providing financial stability and central banking functions?

3.53 The Government proposes legislation to ensure that realisation of any collateral provided to the Bank of England, in connection with carrying out its responsibilities in relation to financial stability and central bank functions, is fully effective whenever carried out.

3.54 To ensure that realisation of collateral provided to the Bank of England is fully effective, the Government is proposing an enhancement to the existing provisions implementing the EC Settlement Finality Directive. In particular, the provisions that insulate collateral provided to the Bank of England from the effects of insolvency should ensure that realisation of the collateral provided to the Bank of England is fully effective whenever carried out.

3.13) Do you agree that it is appropriate to ensure that realisation of the Bank of England's security is fully effective whenever carried out?

Access by building societies to liquidity assistance

3.55 The Authorities want to ensure that the liquidity available to a building society from the Bank of England is similar to that which is available to a bank.

3.56 Under current provisions, there are restrictions on building societies:

- in the amount of funding they can borrow from the Bank of England; and
- in their ability to pledge collateral to the Bank of England.

3.57 The Government proposes legislation so that funds provided by the Bank of England are exempted from the calculation of the proportion of building societies' funding which arises from wholesale funding.

3.58 Building societies are required by the Building Societies Act 1986 to raise at least 50 per cent of their funding from retail depositors (the 'funding limit'). However certain items can be disregarded for the purpose of calculating the funding limit. The Government proposes adding to this list funds provided by the Bank of England, so that building societies are not restricted in the amount that they may borrow from the Bank of England. This would help reduce legal uncertainty by eliminating the risk that Bank of England lending operations to building societies would result in a breach of the duties of the directors of the society, and removes an impediment to their ability to borrow from the Bank of England.

> 3.14) Do you agree that funds provided by the Bank of England should be exempted from calculation of building societies' wholesale funding?

3.59 The Government proposes legislation to allow building societies to grant floating charges to the Bank of England as security.

3.60 There is a statutory restriction prohibiting building societies from granting floating charges over their assets. This was introduced to protect members of building societies from the risk that secured lenders might exercise an inordinate degree of control over the management of the society, and is still desirable in relation to the general business activities of societies. The Government proposes modifying this to allow building societies to grant floating charges to the Bank of England as security.

3.61 Without this change, a building society does not have the ability to offer to the Bank of England effective security over what might be one of the few types of collateral (typically mortgage loans and related cash collection accounts) that it has available to it in a sufficient quantity and in a realisable form. In the light of the statutory restriction, the Bank of England cannot rely with any certainty on the value or adequacy of the collateral provided to it in connection with liquidity assistance. The proposed change would eliminate the risk that Bank of England collateral operations to building societies are unenforceable or otherwise void.

3.62 The proposed changes will allow for the provision of liquidity to building societies on terms similar to those of banks.

> 3.15) What risks are there to building societies granting floating charges over their assets to the Bank of England?

SUMMARY

3.63 This chapter has set out the following proposals:

1. To improve the regulatory and supervisory framework:

    - the FSA intends to consult on new rules to require banks to be in a position to provide additional evidence to the FSA at short notice that they are meeting threshold conditions on an ongoing and forward-looking basis;

- the Government proposes legislation to ensure that there is no statutory impediment to the FSA obtaining information that the Bank of England and HM Treasury require for purposes related to financial stability; and
- the Government proposes legislation to provide for a flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework.

2. To ensure the Bank of England is able to lend in an effective manner:

- the FSA will come forward with a proposal to make a limited clarification to the guidance in the Disclosure and Transparency rules;
- the Government is seeking views on whether the requirement for a company to put charges over its assets on to a register of its own and to register them at Companies House should be dis-applied for banks in receipt of liquidity assistance;
- the Government proposes legislation to remove the requirement for the Bank of England to release weekly returns and will consider other statutory reporting requirements related to the Bank of England that have the effect of disclosing operations;
- the Government proposes legislation granting the Bank of England statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and central bank functions; and, to the extent necessary, to extend the immunities currently available to the FSA and the FSCS in line with their additional powers proposed in this reform;
- the Government proposes legislation to ensure that realisation of any collateral provided to the Bank of England in connection with carrying out its responsibilities in relation to financial stability and central bank functions, is fully effective whenever carried out;
- the Government proposes legislation so that funds provided by the Bank of England are exempted from the calculation of the proportion of building societies' funding which arises from wholesale funding; and
- the Government proposes legislation to allow building societies to grant floating charges to the Bank of England as security.

4 Reducing the impact of a failing bank

4.1 A bank, building society or other deposit-taking firm (for simplicity, 'banks') facing significant risk of failure may present a real public concern given the possible costs to its depositors and to the rest of the economy. Although failure is rare, banks themselves, and the Bank of England, the FSA and HM Treasury (the 'Authorities'), need to take actions to minimise these costs.

4.2 This chapter sets out proposals to:

1. introduce a 'special resolution regime', within which the Authorities would have a range of tools available to achieve a more orderly resolution of a failing bank;
2. have similar resolution tools available to deal with building societies; and
3. ensure that banks have in place arrangements to lessen the impact of their failure, should it occur.

Special resolution regime

4.3 The Government proposes legislation to introduce a 'special resolution regime' (SRR) for banks.

4.4 Recent events have shown that a bank experiencing difficulties can unsettle consumer confidence, leading to a risk of wider system instability. Therefore, to complement provisions for adequate compensation (see Chapter 5), tools are needed to help resolve failing banks in a manner that supports continued access to banking functions or rapid and orderly payments to depositors.

4.5 However, the Authorities currently have limited tools available to maximise the chances of a successful resolution of a failing bank prior to formal insolvency. Furthermore, current insolvency procedures do not offer an appropriate platform for dealing with a failed bank for a variety of reasons, including that:

- any uncertainty around the resolution of a failing bank carries significant risks of contagion to other banks, and therefore to financial stability;
- depositors are likely to be deprived of access to their accounts, which would be incompatible with objectives around securing fast payout for depositors; and
- the destruction of any residual franchise value is likely to rule out the chances of a rescue or turnaround for the bank.

4.6 The Government therefore proposes to create an SRR to ensure that the Authorities have a range of tools available to take greater control of a failing bank to resolve these issues. This regime would be available to all failing banks, prior to insolvency, while the bank retained some net worth.

4.7 Most industrialised countries have a unique regime for banks either defined in law (for example, the US and Japan), or through specific exemptions carved out for financial firms from the general insolvency law (for example, France and Italy). In proposing the following regime, the Authorities have considered and built on tools available in other jurisdictions. The Treasury Select Committee report also recommends the creation of a form of special resolution regime for banks.

Trigger and process for the special resolution regime

4.8 The introduction of a SRR for banks in the UK would be a significant step. These tools may involve a substantial degree of intervention and, in specific circumstances, may interfere with the property rights of those involved. There would therefore need to be a clear escalation of regulatory interventions (as set out in Chapter 3), with the SRR being initiated only in the rare circumstances where this escalation did not itself succeed in turning round a bank in difficulties.

Trigger

4.9 The Authorities believe that a decision to subject a failing bank to the application of the tools in the SRR should be based on regulatory triggers, in line with principles in European Community law governing the reorganisation and winding-up of banks[20]. As such, it is proposed that the FSA would take the decision after consultation with the Bank of England and HM Treasury.

4.10 The detailed circumstances for initiating any of the tools in the SRR would be described in guidance, such as that set out in the FSA Handbook, including quantitative and qualitative criteria. The decision would be based on consideration of some or all of the following factors:

- that there was a significant risk that the bank concerned would fail the relevant threshold conditions in future (in particular, the conditions of adequate resources or suitability);
- that the available regulatory powers to manage that risk had been exhausted; and
- that further options were needed to protect the stability of the financial system or the interests of depositors.

4.11 The Government believes that the SRR should be the process to resolve failing banks, and that this should not be circumvented by the commencement of normal insolvency proceedings by the management or creditors of the bank. This issue is considered in proposals below relating to the proposed new bank insolvency procedure.

Consultation questions

4.1) Do you agree that there should be a special resolution regime for banks?

4.2) Do you agree that the trigger for a bank entering a special resolution regime should be based on a regulatory judgment exercised by the FSA after consultation with the Bank of England and HM Treasury?

4.3) Do you agree that the trigger should be linked to regulatory guidance material?

Decisions

4.12 Prior to the formal decision to operate any of the tools in the SRR, the Authorities should have reached, and be in a position to implement rapidly, decisions on which tools from the regime to use. Resolution options would need to be initiated

[20] Credit Institutions Reorganisation and Winding-up Directive (2001/24/EC)

quickly to maintain depositor and creditor confidence, secure financial stability and preserve any value in the bank.

4.13 In determining whether it is appropriate to use one or more of the SRR tools the Authorities will take into account whether, in the circumstances, the failure of the bank concerned could have systemic implications for financial stability. Any resolution tool involving public money would require approval by HM Treasury and public financial support would only be used to reduce any risk to financial stability.

Tools

4.14 Proposed new tools in the regime include:

- **powers to allow the Authorities to direct and accelerate transfers of banking business to a third party, in order to facilitate a private sector solution;**
- **powers to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a 'bridge bank'**, as is possible in the United States and Canada;
- **powers to allow the Authorities to appoint a suitable person, or 'restructuring officer', to carry out the resolution;** and
- should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank was appropriate, **a 'bank insolvency procedure' to facilitate fast and orderly payment of depositors' claims under the FSCS.**

4.15 These tools, considered in more detail below, would provide the Authorities with considerable control over a failing bank. To the extent that these powers would not provide the Authorities with sufficient control over the bank in particular circumstances, **the Government is also considering legislation to allow the Authorities to take temporary ownership of all or part of a bank as a last resort**.

4.16 Existing tools for provision of financial support to a failing bank, such as public sector liability guarantees or capital injections, would also be considered along with the new options in the SRR. Any SRR tool will need to make provisions to deal with banks' other activities in addition to their principal banking business.

Public interest

4.17 These tools, which require or effect the transfer of the whole or part of the bank's business outside normal consent regimes, must be justified on the basis of the gains to legitimate public policy interests. The Authorities believe the use of these SRR tools can be justified on the basis of the wider public interest in:

- the prevention of damage to financial stability;
- continuity of banking arrangements with minimum disruption for a failing bank's customers; and
- facilitating the protection of the interests of depositors.

Appeals

4.18 The Government would ensure that there are appropriate appeal mechanisms, and would also provide the arrangements to ensure the fundamental rights of stakeholders – including the shareholders and counterparties of the failing bank – affected by use of the SRR tools are protected. In considering these arrangements, it is important to have in mind that these tools would be deployed to secure the wider public interests in mitigating the systemic damage that could arise from the failure of a bank. Although it cannot be ruled out that there are circumstances where compensation would be required to secure the compatibility of these measures with fundamental rights, careful consideration would need to be given to whether, in practice, any compensatable value remained in a bank where such intervention was warranted.

4.19 Views of shareholders of banks, commercial counterparties to banks and other stakeholders will form an important part of the policy development process in relation to these proposals. The Government also intends to consult with the European Commission and the Competition Commission to ensure that any new resolution proposals are compliant with state aid rules and competition law.

> 4.4) Do you agree with the special resolution regime process as outlined?
>
> 4.5) Do you agree that the potential abridgement of property rights in the special resolution regime can, in principle, be justified with a suitable public interest test?
>
> 4.6) What safeguards and appeal processes would be needed to support a public interest test for the special resolution regime?

New SRR tools – directed transfers

4.20 The Government proposes legislation to give the Authorities power to direct and accelerate transfers of banking business to a third party, in order to facilitate a private sector solution.

4.21 A desirable outcome for a failing bank could be to transfer all or part of its business to one or more healthy private sector banks. In many circumstances, this is likely to be the least costly resolution outcome for the Exchequer and helps maintain the bank's franchise value; it may also provide better returns to creditors and uninsured depositors than piecemeal liquidation.

Part VII of FSMA

4.22 While Part VII of FSMA makes provision for a transfer to happen, it requires a willing seller and willing buyer, an application to court and the chance for affected parties (the shareholders, employees, creditors and depositors) to have the right to be heard in court. This process can be lengthy, putting off potential buyers, and potentially reducing consumer and market confidence in the bank during the sale. The process may also be frustrated by an unwilling seller, or by other affected parties seeking to exercise rights to accelerate their entitlements under commercial agreements.

New power of directed transfer

4.23 The Government is therefore proposing a new power to allow the Authorities to speed up the transfer process, and, if needed, override the rights of the directors or shareholders of the failing bank to block the transfer. This power would not replace the conventional Part VII mechanism. It would be used where the Authorities have concluded, following other regulatory intervention action, that the bank should enter the SRR and that this is the most appropriate tool to use to ensure a rapid transfer of part or all of the bank's business. The power would necessarily contain wide-ranging provisions to effect the transfer, including for the adjustment of existing private law rights. For example, it may be necessary to override prohibitions in the bank's articles of association preventing, or placing restrictions on the transfer, or it may be necessary to adjust the contractual relationships between the bank and other parties and temporarily suspend the ability of counterparties to treat the Authorities' action as an event of default.

ECHR **4.24** The exercise of the power is likely to give rise to human rights considerations. To ensure that the exercise of the power is compatible with the European Convention on Human Rights (ECHR), it would be necessary to balance the rights of stakeholders and considerations of the public interest (such as those set out above) and also take into account any purchase price paid by the transferee. There would be no application to the court as is the case in the FSMA Part VII procedure, but appropriate mechanisms, as mentioned above, for challenge to the use of the power and the calculation of value or its distribution would be included.

4.7) Do you agree that the Authorities should have the power to direct a sale of all or part of a bank's business, possibly against the wishes of the directors or shareholders?

4.8) Is judicial review the correct mechanism for challenging a decision to institute the directed transfer?

4.9) Is the Financial Services Markets Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?

New SRR tools – bridge bank

4.25 **The Government proposes that the Authorities have the powers to take control of all or part of a bank (or of its assets and liabilities) through a 'bridge bank'.**

Transfer and restructuring **4.26** A proposal, to keep the bank solvent and ensure that its customers had continued access to banking services, would be to transfer all or part of a bank's business to a bridge bank. This would also ensure that the Authorities had control over the bank to achieve as efficient and timely a resolution as possible, for example, to:

- continue pursuing a private sector sale, especially by allowing time for potential acquirers to carry out due diligence on the business; or
- carry out a restructuring of the business.

4.27 The 'transfer of undertakings' mechanism involves a bridge bank acquiring some or all of the failed bank's assets and assuming some or all of its liabilities. The Government would arrange for the establishment of the company, appointment of suitable persons as its directors, and for its financial support so that it could obtain authorisation from the FSA with appropriate permissions to enable it to take over all or part of the business of the failing bank.

4.28 The Authorities would have the option of transferring some or all of the failing bank's assets and liabilities into a bridge bank. The residual company could then carry on its remaining business (if any) or be wound up in an orderly manner. The Treasury Select Committee report also recommends that a bridge bank mechanism be available to Authorities to deal with failing banks.

Running the bridge bank **4.29** The bridge bank would be permitted to carry on business for a limited period of time (indicatively up to twelve months, though this could be extended by order). New senior management and non-executive directors would usually need to be appointed. The restructuring officer (see below) is likely to have knowledge of the business, and so would be an appropriate person to be a director of the bridge bank.

4.30 The bridge bank's new management would draw up a business plan, to be approved by the Authorities, to run the bank in a conservative manner. The aim would be to preserve as much value as possible, pending the eventual sale of the bridge bank to a bidder, ideally as quickly as possible. While in operation, the bridge bank would maintain continuity of services for customers with respect to the assets, deposits and other liabilities transferred. It would also have the authorisation to conduct new business in line with the business plan submitted to the Authorities. This would assure continuity of banking services and ongoing performance of obligations for liabilities transferred into the bridge bank.

ECHR **4.31** Requiring a transfer to a bridge bank would clearly have implications for property, employment and other private law rights. As with the option of directed transfer, the resultant human rights compatibility of such action would need to be justifiable in light of the public interest considerations set out above. Compensation under the ECHR may be relevant in some (but not necessarily all) circumstances, but this is subject to the considerations discussed above.

4.32 The power to establish a bridge bank to acquire a business under public sector control would be established through primary legislation. It is proposed that the exercise of that power with respect to any particular bank would be taken forward through a negative resolution procedure statutory instrument.

4.10) Do you agree that, in tightly defined circumstances, the Authorities should be able to take control of a failing bank through effecting a transfer of some or all of its assets and liabilities to a bridge bank? Do you agree that that some flexibility in the description of these circumstances is also desirable?

4.11) Do you agree with the removal of shareholders' and directors' rights and temporary suspension of creditors' rights under this bridge bank proposal?

4.12) Is judicial review the correct mechanism for challenging a decision to transfer to a bridge bank?

4.13) Is the Financial Services Markets Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?

New SRR tools – bank insolvency procedure

4.33 The Government proposes legislation to introduce a modified insolvency process for banks – a 'bank insolvency procedure' – to facilitate fast and orderly payment of depositors' claims under the FSCS.

4.34 A failed bank is currently subject to ordinary insolvency procedures. These range from corporate rescue mechanisms, such as administration and a company voluntary arrangement, to winding up a company's affairs through formal liquidation. Current insolvency procedures appear to have significant weaknesses in relation to banks.

4.35 The Government therefore proposes to introduce a new 'bank insolvency procedure', a stand-alone insolvency regime for banks based on existing insolvency provisions and practices. The primary objective of the bank insolvency procedure would be to facilitate fast FSCS payout and provide the Authorities with control over entry to the procedure once they have determined that other SRR tools are not appropriate.

Facilitating the FSCS

4.36 The FSCS is not set up to process large volumes of claims in a short period of time although it has contingency arrangements including moving FSCS teams to the area of priority need and complementing FSCS teams with outsourcing arrangements. However there is currently no express requirement for the failed bank, or the insolvency practitioner, to work with the FSCS. In addition, to facilitate the FSCS, the insolvency practioner may also need to provide the FSCS with information about the level of claims (in circumstances where the FSCS has not been able to quantify these in advance).

4.37 The Government therefore proposes that the statutory objectives of the insolvency practitioner directing a bank insolvency procedure (the 'bank liquidator') would be to:

- assist and cooperate with the FSCS to coordinate rapid payments to eligible depositors or to effect a transfer of accounts to a third party (the ‘principal objective’); and
- without prejudicing the principal objective, to manage the resolution of the affairs of the bank in a way that best satisfied the interests of creditors as a whole.

Creditors

4.38 To facilitate a prompt FSCS payout, it is proposed that under the bank insolvency procedure no meeting of creditors could be held to nominate an alternative liquidator to the insolvency practitioner appointed by the Court. However, the bank liquidator would still be required to provide a report to creditors, including a summary of the financial position of the bank, the dividend expected to be paid, the reasons for the bank’s failure, and details of how to submit a claim in the proceedings. In addition, as a safeguard to creditors, they would be entitled to apply to the Court to examine the conduct of the bank liquidator.

4.39 The Government proposes that the bank insolvency procedure should be a stand-alone process and it is therefore envisaged that the bank liquidator will have similar powers to those that currently exist for both administrators and liquidators.

4.40 In keeping with existing insolvency procedures, it is anticipated that a failed bank would be dissolved when the resolution of its affairs had been completed, although provisions will be included to allow exit to a company voluntary arrangement where that procedure would maximise repayments to creditors.

Funding from insolvency

4.41 The Government also proposes to introduce legislation so that where there are monies readily available in the bank insolvency procedure, they may be used to fund the repayment of deposits that would otherwise have been made by the FSCS (in full or in part), subject to an indemnity from the FSCS to the insolvency practitioner to make good any shortfall against future recoveries. It is anticipated that the bank liquidator would work with the FSCS in reaching such a decision.

Depositor preference

4.42 The Authorities have considered the possibility of making depositors a preferential class of creditor, (i.e. to introduce depositor preference), but the likely adverse consequences of this for other creditors in insolvency proceedings and for banks generally, in terms of increased costs of credit, shorter loan periods and increased demand for collateral, appear to make this undesirable in the UK context. It is therefore proposed that the claims of the FSCS and depositors (whose claims are not settled by the FSCS) will continue to rank alongside the claims of other ordinary unsecured creditors. While a bank liquidator will have a duty to assist the FSCS to effect a repaid payout (i.e. to process depositor information at an early stage), the funding for any payout to depositors would be provided by the FSCS.

Notice period

4.43 The Government is seeking views on how best to control a bank's entry into insolvency proceedings. A 14-day notice period is proposed, as a comprehensive obligation to cover all forms of insolvency procedure applicable to banks.

4.44 This would also apply where a secured creditor proposes any other step to enforce their security. To enable this to work in practice, a further restriction is also proposed in relation to voluntary liquidation so that a bank could only be wound up voluntarily with the permission of the Court.

4.45 The purpose of including a 14-day notice requirement to the FSA would be to prevent a bank from being placed into normal insolvency proceedings before the decision has been taken on whether it should be placed in the SRR. It would allow for greater control over proceedings, either to facilitate alternative options or to allow for a decision that no special intervention or any of the SRR tools are required. It would not preclude the Authorities initiating special resolution options prior to any notice period. It is proposed that existing insolvency procedures would still remain available for banks but could only commence where adequate notice had been given to the FSA.

Control – authorities' right to trigger

4.46 Where the Authorities conclude that none of the other options in the special resolution regime are appropriate, it is proposed that the Authorities could apply to the Court on a without-notice basis for an order commencing the bank insolvency procedure and appointing an insolvency practitioner as bank liquidator. This would allow prompt action to be taken to protect the interests of depositors and other creditors, and should reassure consumers generally that where a bank has failed, compensation will be paid to them more quickly than under current arrangements.

4.14) Should a new bank insolvency procedure be introduced for banks and building societies as an option for the Authorities instead of normal insolvency procedures?

4.15) Do you think that there ought to be provision in the bank insolvency procedure for continued trading of some of the bank's business in the interests of depositors or other creditors? If so, how do you think this might work?

4.16) Should the objectives of a bank liquidator be limited to assisting a rapid FSCS payout to eligible depositors and then winding up the affairs of a failed bank? Should the proceedings have any other statutory objectives?

4.17) Should a bank insolvency procedure be subject to the overall supervision of the Authorities?

4.18) Should a bank insolvency procedure be a stand-alone regime in which the bank liquidator has the combined powers of an administrator and liquidator? Are any other powers required?

4.19) Should the FSCS cover any additional costs that a new bank insolvency procedure may incur?

4.20) Should further consideration be given to the introduction of depositor preference?

4.21) Do you agree that commencement into insolvency should be controlled by the Authorities, for example through requiring 14 days prior notice be given to the FSA? Should normal insolvency proceedings be retained alongside the bank insolvency procedure?

Governance and operation of the special resolution regime

Governance

4.47 The Government is seeking views on the governance arrangements that would be most suited to implementing the special resolution regime for failing banks.

4.48 As stated above, the implementation of the SRR will provide the Authorities with greater control over the resolution of a failing bank. Chapter 7 outlines proposals for the operational arrangements and coordination of action by the Authorities in providing support for banks. The Authorities are consulting on whether the SRR should be overseen by of one of the existing Authorities – HM Treasury, the Bank of England, the FSA or the FSCS. Whichever authority implements the regime will make use of market professionals, such as experienced bankers and turnaround professionals, where appropriate.

Management expertise

4.49 The Government is also seeking views on whether, building on the FSA's existing power to appoint an expert, the Authorities should have the power to appoint a suitable person or 'restructuring officer' to carry out the resolution.

Restructuring Officer

4.50 The use of SRR tools would require significant specialised management expertise. While the Authorities will formally decide on which of the tools to use, in advance of putting the bank into the SRR, there may be situations where it is appropriate for the Authorities to appoint a 'restructuring officer' to oversee the bank during the implementation of the tools.[21] For example, the restructuring officer could take over the power of the directors:

- during an accelerated transfer to help finalise a potential private sector resolution or facilitate a transfer to a bridge bank; or
- alongside any significant financial support provided by the Government, the FSCS or another private funder.

4.51 The Authority overseeing the implementation of resolution would set the objectives of the restructuring officer. It is proposed that the appointment would be made alongside implementation of the above tools, rather than as a prior separate step within the SRR, so that the market is reassured that resolution action is being taken. The services of the individual to be appointed could be, however, obtained before the initiation of the SRR, to advise the Authorities on the appropriate course of action.

4.52 The Authorities recognise that this would potentially be a significant step, suspending the operation of the normal governance provisions of the company. The directors would be able to do only what the restructuring officer agreed or required them to do. It is likely that the normal rights and powers of shareholders would be limited in a range of ways. Shareholders could, for example, be wholly or partly prevented from passing resolutions, which have legal effect.

4.53 It is proposed that the restructuring officer would report to the Authorities and would not be treated as a director for the purposes of the Companies Act 2006. Protections for creditors (for example, under the fraudulent and wrongful trading provisions of insolvency law) would also be suspended once the restructuring officer had been appointed. At that point, the conclusion would already have been reached that the public interest requires that the Authorities act to achieve the public policy objectives of maintaining financial stability and achieving the payment of insured

[21] With the exception of the bank insolvency procedure, where an insolvency practitioner would act as the bank liquidator.

depositors. These objectives would take precedence over the interests of the shareholders and creditors generally. It would be necessary to provide specific safeguards taking account of the special position of the restructuring officer and the interests of the taxpayer.

4.22) What should the governance arrangements for the SRR be?

4.23) Do you consider that introducing the office of the restructuring officer as part of the SRR would be a helpful and necessary development?

4.24) Do you have any comments on the specific implications for shareholders, creditors or directors from the appointment of the restructuring officer over and above those already raised by the other resolution tools?

Temporary public ownership

4.54 The Government is considering legislation to allow it to take temporary ownership of all or part of a bank as a last resort.

4.55 The options outlined above provide the Authorities with a significant amount of control over the resolution of a bank within the SRR, with a private sector solution usually being the most desirable outcome. There could be situations, however, in which it would be in the public interest for the Government to take ownership over the failing bank as a last resort, in order to be sure of achieving important objectives such as that of financial stability. Such circumstances would need to be very tightly defined, with respect to the Authorities' interest in protecting depositors and maintaining financial stability, and any public ownership would be temporary, until such time as a suitable resolution could be achieved. The power to take temporary public sector ownership of a bank would be through primary legislation, to be exercised by Ministers by statutory instrument.

4.25) Should the Government have the power to take temporary ownership of a failing bank, in order to facilitate a more orderly resolution? Under what circumstances would it be appropriate for this power to be exercised?

Resolution of building societies and other mutuals

4.56 The Government is consulting on whether all the tools within the special resolution regime should be available to building societies as well as banks.

4.57 Individuals who have a savings account[22] or mortgage with a building society are members and have certain rights to vote and receive information. Each member of a building society has one vote regardless of how much money they have invested or borrowed or how many accounts they may have. Historically, a building society facing difficulties has often been taken over by a larger society and before the issues have fully crystallised (although this is not the driver for the majority of inter society mergers). However although this reduces the risk of building societies failing, it does not remove the possibility altogether. For this reason, it is proposed that any failing building society may be placed into the SRR on the same basis as a failing bank.

[22] Shareholding members of the building society will be depositors, but not all depositors are shareholding members.

4.58 As with banks, it is proposed that any tool within the SRR will only be used where the Authorities have concluded, following other regulatory action, that the building society should enter the SRR and this is the most appropriate tool to use. This decision would be based on the process set out above. It is also proposed that an appropriate appeals mechanism will be provided.

Directed transfer powers

4.59 A building society can choose, on the recommendation of its board and subject to the approval of its members and confirmation by the FSA, to transfer all of its business to a company, i.e. demutualise. Legislation (Building Societies Act 1986 - 'the Act') permits the transfer of all of a society's business, and specifies the process which must be followed.[23] The society must provide details about the proposed transfer to its members, who vote on whether to approve the transfer to proceed further. Once this is done, the society must apply to the FSA for confirmation. The FSA makes its decision to accept or reject the application after assessing any written or oral representations made by members and others about the transfer. The FSA's confirmation decision cannot be appealed under the Act but is subject to judicial review.

4.60 If the FSA considers it expedient to do so, in order to protect the investments of shareholders (i.e. retail depositors) or other depositors, it has power under the Act to intervene to direct a society to transfer all of its business to a company or to merge with another building society. Even with a directed transfer, however, the society must still provide a notification of transfer statement containing similar information as required for a 'normal transfer' and members and others can make written and/or oral representations in respect of the transfer. Further, only a transfer of the entire business can take place in a directed transfer regime.

New power

4.61 The Authorities therefore propose bringing forward legislation to allow an accelerated transfer (or merger) similar to that proposed for banks. This would:

- permit a partial transfer to take place as a directed transfer, with the effect that a partial transfer under a 'directed transfer' should not cause the society to breach its regulatory requirements as a building society, for example 'the funding and lending limits'; and
- not provide for members and others to make representations regarding the transfer.

Bridge bank for building societies

4.62 The Authorities are seeking views on whether a similar bridge bank option should be available for failing building societies as for failing banks. As with banks, this tool would offer the Authorities time to find a private sector solution or undertake restructuring, with a view to an onward sale to a bank or building society. This would have implications for property, employment and other private law rights, as is the case with banks. This would effectively demutualise ownership of the property and interests transferred, at least for so long as they remained within the bridge bank. The building society could be compensated for any residual value in its business at the time of transfer to the bridge bank – and if appropriate could pass this on to its members.

Building society insolvency procedure

4.63 The Authorities propose that a new building society insolvency procedure be put in place, based on the model outlined for the bank insolvency procedure. It is proposed that the existing insolvency regime for building societies, set out in the Building Societies Act 1986, would remain, although entry into the existing regime

[23] The 1986 Act also sets out the procedures to be followed if one building society seeks to transfer its engagements (i.e. merge) with another society. These processes are similar, but simpler. The Act also permits the transfer of part of the engagements of one society to another.

would be subject to 14 days' notification and the written permission of the FSA. This is to allow the Authorities the opportunity of implementing the SRR for building societies.

4.64 As with the scheme for banks, the new procedure would have as its objective the rapid payout to depositors of sums due to them, followed by the swift winding up of the firm. To achieve this, it is proposed that the rights of members and creditors of the building society be somewhat curtailed to the extent that no meeting of creditors would be held to nominate an alternative liquidator to the insolvency practitioner appointed by the Court. However, the Court-appointed insolvency practitioner would be required to provide a report to creditors. Furthermore, the Authorities would fulfil the role of a creditors' committee in overseeing the proceedings and the actions of the insolvency practitioner.

Credit unions

4.65 Credit unions cannot be demutualised. Failing credit unions can, though this is unusual, be taken over by another credit union, but more frequently they are wound up. It is proposed at this stage that the SRR should not apply to credit unions, but that the power is taken by secondary legislation to be able to extend the SRR to credit unions if circumstances change in the future. HM Treasury is currently undertaking a review of credit union and cooperative legislation. It is therefore proposed that any related changes to the credit union regime should not be considered in the proposed legislation outlined in this document but be considered following that review and its recommendations.

> 4.26) Do you agree that the special resolution regime should be extended to building societies but not other mutuals?
>
> 4.27) Do you agree with the proposals for a new accelerated directed transfer procedure for building societies, similar to that proposed for banks?
>
> 4.28) Do you believe a form of temporary public sector control through a bridge bank should be provided for building societies?
>
> 4.29) Do you agree that a building society insolvency procedure should exist for building societies along a similar model for banks?

Protection of members' funds

4.66 **The Government proposes to make an Order to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members.**

4.67 Currently, members' funds (i.e. deposits held in the form of shares) rank below those of other creditors in the event of a building society's insolvency. The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 provides HM Treasury with the power to put members' funds on an equal footing with wholesale creditors in the event of a building society becoming insolvent. The Government is proposing to use this power to make an Order to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members (the retail customers). This would give members equal status to wholesale creditors. Transitional provisions would preserve the priority of existing debts and deposits until repaid or renewed. New deposits would rank with members funds from the start.

4.68 Following this consultation, the Treasury intends to publish a draft Order.

4.30) Do you agree that the Treasury should make an Order under the 2007 Act to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members?

REQUIREMENTS ON BANKS

4.69 Banks need to be adequately prepared to minimise the disruption arising from their own failure, to respond promptly and robustly to the failure of other banks in order to maintain market stability and to share in any costs that arise. Ensuring continued access to key infrastructure, such as payments systems, and ensuring that websites and call centres remain operational, is particularly important.

Funding the special resolution regime

4.70 **The Government is seeking views on whether the industry should contribute to funding the SRR. As part of this, it is considering whether to amend FSMA to allow the FSCS to contribute to the funding of the SRR. In addition, the Authorities are considering how best to enable the Bank of England to claim compensation from the FSCS where appropriate.**

4.71 The costs of a bank failure are currently borne by the industry (in their capacity as levy payers to the FSCS) only at the point at which the FSCS is engaged to compensate depositors. The tools available under the SRR would provide alternative means to provide continuity of banking services to depositors when a resolution other than insolvency and FSCS payments is sought. International experience suggests that these alternatives will often be less costly and disruptive than making compensation payments to depositors individually. Therefore, it may be appropriate for the industry, through levies to the FSCS, to contribute to the costs of the SRR.

4.72 Many deposit compensation schemes internationally are able to use their funds to support options, other than paying compensation to depositors, for resolving banks. In both the US and Canada, schemes have typically found paying compensation to be more expensive than other options. In the US system, where there is a concern that a bank failure may create systemic risk, special assessment can be made on banks to cover any losses incurred by the Federal Deposits Insurance Corporation in implementing measures similar to those that would be used in the SRR. There is also a precedent in the FSCS' existing arrangements for securing continuity of insurance cover or to take measures to safeguard the interests of policyholders of an insurer, including by transferring all or part of its business. Similar provisions currently exist in depositor protection arrangements in some other European countries, including France and Italy.

4.73 The Authorities are seeking views on whether the FSCS should be provided with the power to contribute to the cost of using SRR tools prior to insolvency, where this would help maintain financial stability, better protect the interests of depositors, or be no more costly for the FSCS than paying compensation. There are a number of ways in which such a mechanism might work. It would need to be developed in the context of EC state aid rules.

4.74 Primary legislation would be needed to give the FSA broader powers to make rules to provide for the FSCS to make payments other than for the purpose of paying compensation in this area.

Bulk transfers

4.75 One option could be for the FSCS to arrange a bulk transfer of deposits with any element of FSCS protection, from a failing bank to a new bank. This would most closely resemble the existing arrangements in FSMA for securing the continuity of long-term insurance policies, or for safeguarding the interests of policyholders.

4.76 Insurance policies and bank deposits are clearly very different and protecting the interests of insurance policyholders and bank depositors raise very different issues. But similar arrangements for arranging a bulk transfer of bank accounts as an alternative to paying compensation to depositors could be introduced – in effect, an arrangement in which the FSCS would be able to 'bulk buy' deposits at a new bank on behalf of the depositors in the failed bank. This proposal would raise a number of significant issues, not least the fact that individual depositors may not wish to be transferred to the new bank and whether the public interest in ensuring the continuity of some banking arrangements should be allowed to outweigh individual choice.

> 4.31) Should the industry contribute to the costs of an SRR?
>
> 4.32) Would mechanisms other than the FSCS be appropriate for addressing such cost issues? How might such mechanisms work?

Contingency planning

Communi-cations

4.77 A communication strategy is very important in managing a situation where a bank gets into difficulties. There are three main channels for communication during an upsurge in retail depositors' demand for funds:

- internet – the website must have the bandwidth capacity to cope with a significantly higher number of hits per day. In addition, all internet banking systems must continue to work under strain;
- telephone – there would likely be a very significant increase in the number of calls made to call centres during a bank run. Banks should therefore have agreed Q&A scripts, including information about the compensation scheme, and staff should be trained to deal with such enquiries. Plans should also be in place to increase significantly the resources used to take calls. One option would be to use the Central Office of Information – a Government department that has expertise and capacity for emergency communications, with the ability to construct a standalone call system, or 'patch in' to banks' existing systems; and
- branches – banks will need to think about staffing issues and opening hours. In addition, training for staff to deal with, for example, queue management during a potential run on a bank, will be necessary.

4.78 Banks should consider the extent to which they have plans in place in these areas. As discussed in Chapter 2, the FSA has been in discussions with firms on ways in which they might strengthen their ability to respond effectively to increases in outflows of retail deposits from their branch networks, telephone banking systems and over the internet. The FSA expect all firms that are exposed to such risks to give high priority to their planning and preparations. The FSA's supervisory teams will be focusing on banks' efforts in this area in the first half of 2008.

Agency banks

4.79 The FSA intends to work with banks to ensure that indirect members of payment systems, 'agency banks' have contingency plans in place in the event that their sponsor banks fails.

4.80 While most banks have access to payment systems, such as 'Bacs', not all banks are settlement members. For smaller firms, it is typically more cost effective to become an indirect member, with one of the settlement members acting as a 'sponsor'. Banks that are not settlement members are known as agency banks.

4.81 A risk arises with these arrangements in the event that, should a sponsoring bank fail, the agency bank will be unable to effect payments for a period of time. Agency banks should therefore ensure the appropriate contingency plans have been developed and agreed with at least one other settlement bank.

> 4.33) Are there any other mechanisms available to secure access to payment systems for agency banks in the event of a settlement bank failure?
>
> 4.34) Are there any contingency measures that banks could adopt to ensure that their organisation and structure are compatible with the tools proposed in the special resolution regime?

Financial collateral arrangements

4.82 The Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.

4.83 Financial collateral (such as cash or securities) is frequently used to reduce the credit risk (i.e. the risk that a counterparty fails) in a wide range of transactions. For example, a bank lending to, or entering into a derivatives transaction with, another bank can take collateral to cover the loss they would face if the counterparty bank failed. Taking collateral is a well-established and widely used risk management tool, which reduces the cost of borrowing. The International Swaps and Derivatives Association (ISDA) estimated the gross amount of collateral in use to be $1.335 trillion as of year-end 2006 in derivatives transactions alone. Collateral can be taken under different legal mechanisms – for simplicity, these are referred to here as 'collateral arrangements'.

Strengthening protection

4.84 For collateral to serve its purpose in protecting lenders there must be legal certainty that lenders can quickly and simply realise the collateral if the borrower or counterparty fails. There are already protections for some types of collateral arrangements. The EU has established a minimum level of protection for certain collateral arrangements, implemented in the UK in 2003. However, it has become increasingly clear that there are other uses of collateral in the financial markets which also merit protection in order to strengthen the robustness of the financial markets. The recent loss of confidence in the credit markets has reinforced the importance of legal protections when firms lend to each other. It is therefore timely to strengthen Government powers to make regulations in this area.

4.85 Taking such a power would enable the Government to amend the UK regime in the future without the need for primary legislation. The Government would consult on the scope of any future regulations to strengthen the protections available to financial collateral arrangements.

4.86 This power would be relevant to any firm that lends against financial collateral – mainly banks and investment firms, but also large corporates and other financial market participants such as pension funds and insurance companies.

> 4.35) Do you agree that the Government should take a power to enable it to make secondary legislation in relation to financial collateral arrangements, and with the proposed definitional scope? If not, why, and what would you suggest?
>
> 4.36) Do you have any suggestions as to future revisions to the financial collateral regime that should be considered?

SUMMARY

4.87 This chapter sets out the following proposals:

1. In relation to a special resolution regime, the Government:
   - proposes legislation to introduce a special resolution regime for banks;
   - proposes legislation to give the Authorities the power to direct and accelerate transfers of banking business to a third party, in order to facilitate a private sector solution;
   - proposes legislation to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a 'bridge bank', as is possible in the United States and Canada;
   - is also seeking views on whether, building on the FSA's existing power to appoint an expert, the Authorities should have the power to appoint a suitable person or 'restructuring officer' to carry out the resolution.
   - would welcome views as to whether the tools above achieve sufficient control of a failing bank, or whether legislation to allow the Authorities to take a bank into temporary public sector ownership as a last resort should be introduced;
   - proposes legislation, should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank was appropriate, to introduce a 'bank insolvency procedure' to facilitate fast and orderly payment of depositors' claims under the FSCS;
   - would welcome views on how best to control a bank's entry into insolvency proceedings; and
   - is consulting on whether all the tools within the special resolution regime should be available to building societies as well as banks.
2. Setting out requirements on banks:
   - the Government is seeking views on whether banks should contribute to funding the special resolution regime. As part of this, it is considering whether to amend FSMA to allow the FSCS to contribute to the funding of the special resolution regime;

- the FSA intends to work with banks to ensure that agency banks have contingency plans in place in the event that their sponsor banks fails; and
- the Government proposes to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.

5 CONSUMER CONFIDENCE AND COMPENSATION ARRANGEMENTS

5.1 Effective compensation arrangements are an essential part of the system for protecting consumers who have deposited money in banks, building societies or other deposit-taking firms (for simplicity, 'banks'). This protection is important in its own right and, by giving consumers confidence that their deposits are safe and accessible, effective compensation arrangements also reduces the likelihood of a run on a bank and supports confidence in the financial system as a whole.

5.2 The Financial Services Compensation Scheme (FSCS) is the UK's scheme for providing protection to customers in most areas of regulated financial services, including deposits, insurance policies and investment business.[24] This chapter discusses possible changes to the FSCS and other aspects of the UK's compensation system, including changes to:

1. the FSCS as it applies to bank deposits, including limits, calculations and protection for customers who have deposits above the FSCS limit;
2. speed up payments by the FSCS to depositors;
3. increase consumer awareness of the FSCS;
4. improve consumer protection in other ways should a bank fail; and
5. make other improvements to compensation arrangements.

COMPENSATION LIMIT AND COVERAGE

Compensation limit and calculations

5.3 **The FSA intends to consult on changes to the FSCS limit and other factors used in the compensation calculation.** The Authorities are seeking early views on these and related issues.

5.4 In considering the level of compensation, there are three main issues:

- the coverage;
- the degree of coinsurance; and
- the limit.

Coverage

5.5 The FSCS limit is currently set per person per bank. If a depositor has more than one account with a single bank, their compensation is calculated by reference to losses in respect of the total amount deposited in all their accounts with that bank. The FSA believes that this principle should continue to apply. The issue of who is eligible to claim under the scheme is considered in a separate section below. The treatment of customers who have both deposits and loans with the same bank is also considered below.

[24] Under FSMA, the FSA is responsible for setting up the FSCS and ensuring that it can carry out its statutory functions, and for making rules governing FSCS compensation and levies under the scheme. Subject to the rules, the FSCS is responsible for taking decisions on individual claims and for setting the levies.

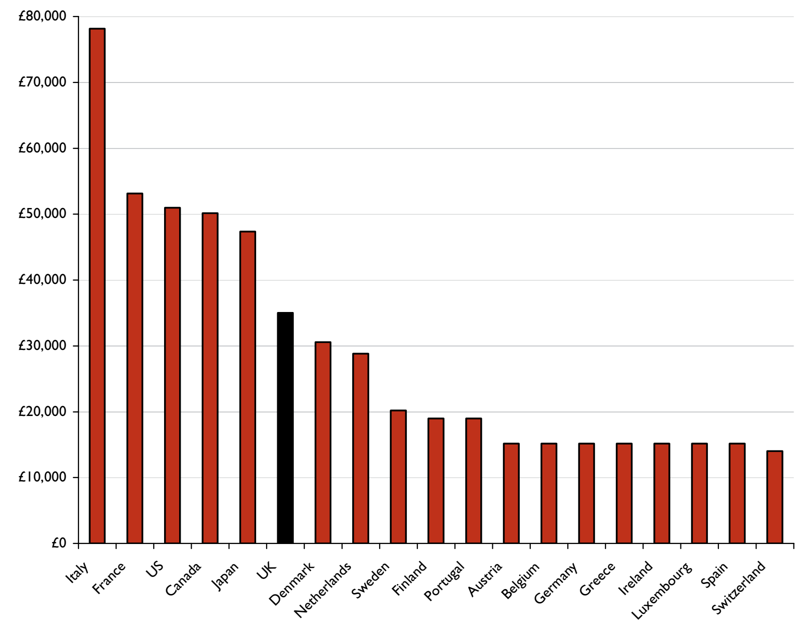
Coinsurance and risk sharing

5.6 Prior to 1 October 2007, depositors were covered for 100 per cent of the first £2,000 of a claim, and 90 per cent of the claim between £2,000 and £35,000, giving a maximum compensation payment of £31,700. The idea behind this was that an element of coinsurance would encourage customers to take some responsibility for considering all aspects of the financial choices that they made. Certain countries, including Austria, the Netherlands and the Republic of Ireland, have an element of coinsurance in their depositor-guarantee schemes. However, a lesson from recent events was that coinsurance, and the knowledge that less than 100 per cent of a claim is covered, can create incentives for depositors to withdraw their funds at the first sign that a bank is in difficulties. As recommended by the Treasury Select Committee, the Authorities do not intend to revert to coinsurance for bank deposits.

Limit

5.7 The current FSCS compensation limit for deposits is £35,000. The chart below indicates how this compares to similar schemes in other countries, including several EU Member States whose compensation limits are equal to the minimum required by the EC Deposit Guarantee Schemes Directive (€20,000).[25, 26]

Chart 5.1: Comparison of limits of other countries' deposit-guarantee schemes



Source – publicly available information

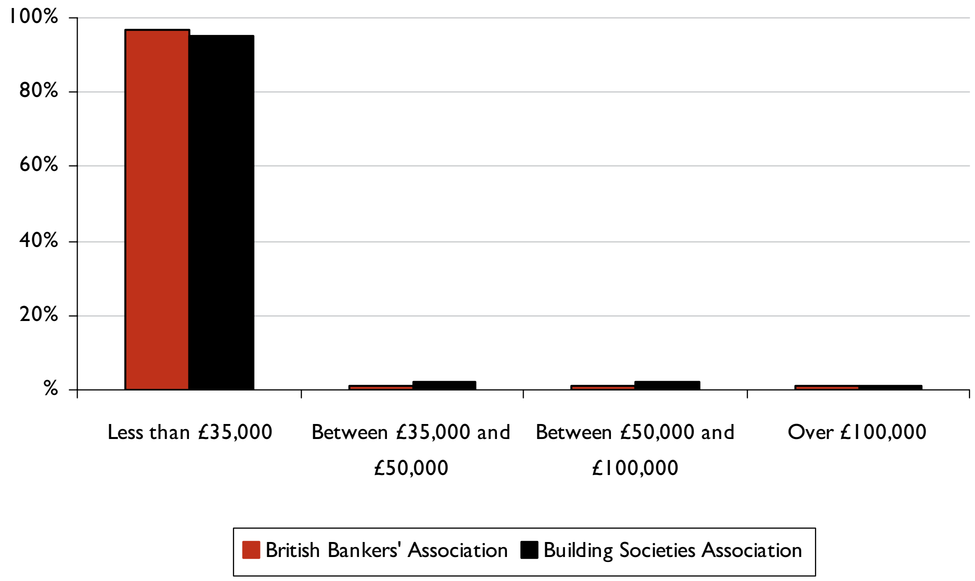
5.8 Chart 5.2 gives an indication of the distribution of UK retail account balances by number of accounts. It shows that the vast majority of retail deposit accounts hold less than £35,000. It also shows that increasing the limit would not have a significant impact on the number of depositors covered.[27]

[25] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes.

[26] The limits for Austria, the Netherlands and the Republic of Ireland include a degree of coinsurance. The limit shown for Germany is for the statutory compensation scheme: there are several voluntary schemes for different parts of the banking sector which offer high or, in some cases, unlimited compensation. The exact rules for payment, and hence the total amount recovered, may also differ from one scheme to another.

[27] It should be noted that a change to the eligibility criteria and a move to gross payments, both considered below, would also have an impact on the percentage of depositors and depositors covered at particular limits.

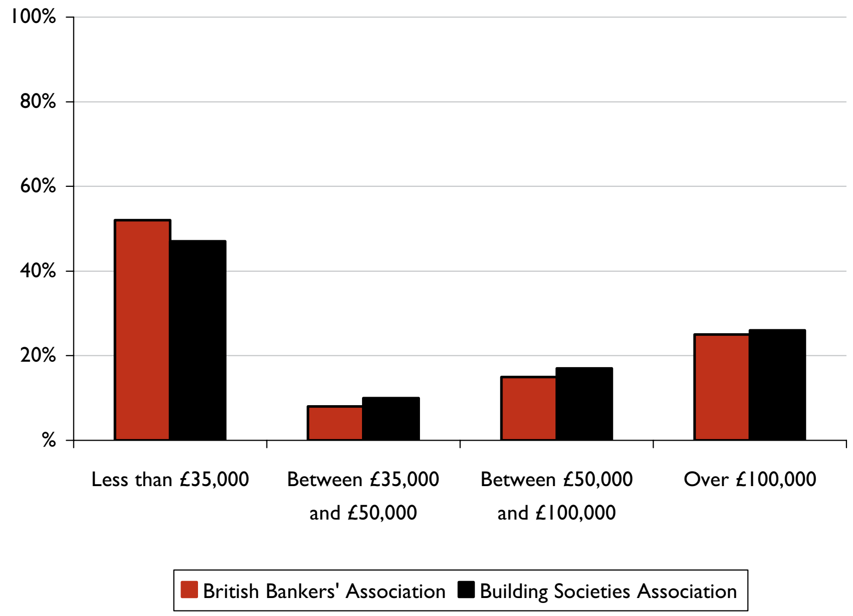
Chart 5.2: Distribution of UK deposit accounts (by number)



Sources: BSA data – responses from 49 societies representing 99 per cent of the sector's assets; BBA data – based on two large UK banks

5.9 Chart 5.3 gives an indication of the distribution of retail account balances by value. It shows that approximately 50 per cent of retail deposits are held in accounts with balances less than £35,000. Taken together, Chart 5.2 and Chart 5.3 show that the top three per cent of deposit accounts hold approximately 50 per cent of total deposits in the UK.

Chart 5.3: Distribution of UK deposit account balances (by value)



Sources: BSA data – responses from 49 societies representing 99 per cent of the sector's assets; BBA data – based on two large UK banks

5.10 An increase to the limit would therefore increase the value of deposits covered by significantly more than it would increase the number of depositors covered. The potential cost of the scheme to the levy-payers would increase broadly in line with the increase in the value of deposits covered.

5.11 The FSA is responsible for setting the compensation limits that apply to the FSCS and it intends to consult on the FSCS compensation limits (including those applying to other financial products) soon after the end of this consultation. Stakeholders have already put forward a range of views on the the limits including no change (i.e. £35,000) and the introduction of higher limits (for example £50,000 or £100,000). The consultation will need to consider a range of factors including:

- the appropriate level of consumer protection;
- simplicity and consumer understanding;
- the implications for other products covered by the FSCS; and
- the extent to which temporarily high balances can be covered by other means (see section below).

5.12 The FSA is also reviewing how recoveries from the winding up of a failed bank are allocated between depositors and the FSCS, which affects the distribution of the final cost of a failure.

Consultation questions

5.1) How would a higher compensation limit affect consumer confidence?

5.2) How would a higher compensation limit affect the responsibility consumers have for their financial choices?

5.3) How would a higher compensation limit for deposits affect consumer perception of other financial products?

Coverage of balances above the compensation limit

5.13 **The FSA will explore with the financial sector ways for customers to cover amounts above the compensation limit.**

5.14 While only a small minority of people have deposits over the current FSCS limit, a much higher proportion are likely, at some point in their lives (such as house sale, inheritance or receipt of a pension lump sum), to have deposits in their bank account for purely transactional purposes which greatly exceed the compensation limit. Some of these balances may be temporary; others may be longer lasting. Even where they are only held in an account for a short period for time, there will still be a risk of bank failure in that period and a small number of depositors will always be potentially affected in this way. Rather than a general increase in the compensation limits, a number of options have been identified to address the issue of higher balances including:

- relying on customers to spread their balances among a number of banks. This is already possible but may not be a realistic option for customers who have to hold large sums of money for a short period;

- private deposit insurance. Customers could purchase private insurance to cover their higher balances. However, there is currently no market for this product in the UK and it is not clear whether or how such a market could be developed; and
- applying an increased (possibly unlimited) FSCS compensation limit to accounts which meet certain conditions, such as being non-interest bearing, or allowing balances above the compensation limit to be placed in certain special accounts.

Client accounts

5.15 **The FSA will also consider the appropriate coverage for client accounts and similar arrangements.**

5.16 A consumer may find that their own account(s) and their funds in a professional adviser's client account are with the same bank. Under the current rules, they are able to claim compensation only up to the FSCS limit for the aggregate balance in these cases. There may be other, less obvious circumstances where consumers may find their claims are subject to the cap where they had little influence on where accounts are opened.

5.17 The FSA intends to consult on these options and the Authorities are seeking early views on these, and related issues.

> 5.4) Which of the solutions to cover balances above the compensation limit is the most practical, desirable and/or proportionate, and why?
>
> 5.5) What types of large balance should be subject to additional protection, and in what circumstances?
>
> 5.6) Are there other circumstances, apart from client accounts, where consumers have little influence on where accounts are opened? What are your views on how the issue of client accounts might be addressed in relation to compensation payments?

FASTER COMPENSATION PAYMENT

5.18 As the Treasury Select Committee has acknowledged, the speed of release of funds to depositors is of critical importance. The FSCS normally processes deposit claims in relation to relatively small deposit-taking firms within one month of receiving a completed application form from claimants. More time would be needed in a complex failure involving a high volume of claims and depositors could be left without access to their funds for several months.

Ambition for speed of payments

5.19 **For these reasons, it is proposed that for deposit compensation, the FSCS should aim to make compensation payments within one week of a bank closing.** This would be an ambitious goal and a comprehensive package of reforms would be needed before it could be achieved, including:

- a new process to enable the FSCS to speed up payments;
- ensuring that the FSCS has early access to information;
- simplifying the eligibility criteria for FSCS payments;
- allowing gross payments to be made;

- streamlining the claims process;
- providing liquidity to the FSCS; and
- working with the industry to speed up opening new accounts at other banks.

New process

5.20 A new process to make compensation payments within one week will need some changes to rules and operational improvements to reduce the time needed:

- to finalise customers' end-of-day balances after a bank has closed;
- to set up the payments (for example, to print a large number of cheques in a short timeframe); and
- to open new accounts to enable customers to access their money.

5.21 The new process would include:

- **Before a bank fails** – the FSA spotting that a bank is in difficulties, and providing information to the FSCS for it to prepare to make compensation payments;
- **Day one** - the bank closing, customers opening accounts with new banks (using an expedited process described below) and FSCS beginning to quantify eligible depositors' claims and to make arrangements for payment;
- **Day seven** – the FSCS sending compensation cheques to customers and new banks providing debit cards to their new customers;
- **Day eight** – cheques arriving at customers' addresses;
- **Day nine** – customers depositing cheques at their new banks and receiving instant access to funds.

Interim payments

5.22 There could be circumstances (for example, where a bank's systems prove to be highly unreliable), when it may not be possible for the FSCS to pay depositors in full within one week. In those circumstances, the FSCS would seek to make interim payments within a week, with the balance following as soon as practically possible. In such an event, it would be important that the timetable for making payments was communicated clearly to consumers.

> 5.7) What are your views on a one-week target for FSCS payment?
>
> 5.8) How feasible would it be for banks to provide instant access to the funds provided by FSCS cheques as soon as they are deposited?
>
> 5.9) Are there other means to ensure consumers have access to funds within one week, including alternative payment methods to cheques?
>
> 5.10) How effective would interim payments be in mitigating consumer detriment when a full payout is not possible within a week?

Early access to information

5.23 The Government proposes legislation to enable the FSA to collect information that the FSCS requires and share this with the FSCS, at the first sign of difficulties in a bank.

5.24 The FSCS needs to obtain and check a range of information about customers before it can make payments to them. Currently the FSCS only has the power to require information from a bank after claims have been made, leaving it with little or no preparation time. Giving the FSCS access to information before claims are made is therefore essential, but there are significant risks in allowing the FSCS to have direct access to a bank before it was in default. These include that it could:

- be a clear sign that the bank concerned was in difficulties;
- result in a fall in consumer confidence; and
- undermine efforts the bank was making to find a solution to its difficulties (for example, by finding a buyer for its business).

Role of the FSA

5.25 This suggests that it should be the FSA that collects, and shares with the FSCS at the first sign of difficulties in a bank, information that the scheme needs for its purposes. If weaknesses in the systems of the bank in question were identified, the FSA would also need to be able to take the appropriate steps to require the bank to remedy the defects. The FSA would ask for this information through normal supervisory channels. This would reduce the risk that its production was seen (for example, by bank staff) as unusual. The information would need to be regularly tested in a way that ensures that it was fit for purpose and compatible with FSCS systems. This regularity would also reduce the risk that such requests were seen as unusual.

5.26 Having collected the information, the FSA would then be able to pass it to the FSCS through a 'gateway'. The circumstances and method by which this would be done would be set out in a new memorandum of understanding between the FSA and the FSCS.

FSCS direct involvement

5.27 The Government also proposes legislation to ensure that the FSCS can require and obtain information directly from firms at the earlier of the date a claim is made, or the date when the firm is declared in default. There are no practical difficulties in allowing the FSCS to obtain information directly from a firm once it has been declared in default.

Information-holding requirements

5.28 The FSA intends to consult on new rules requiring banks to have readily available information on the account balances of FSCS-eligible depositors.

5.29 One of the major obstacles to fast payments is the different ways in which banks hold information and the different systems they use to store data. The FSCS therefore has to analyse and reformat the data before it can calculate the payments due to depositors. This can be very time-consuming.

5.30 The FSA intends to consult on new rules to enable it to obtain standardised information from banks. This information would include:

- details of eligible depositors;
- aggregate deposit liabilities for individuals;

- the type of account that the depositor has (for example, fixed term, notice); and
- a single view of each customer, including address details and list of customer accounts (discussed below).

5.31 Banks would be required to provide this data at short notice, in a secure and simple format. Data on the actual amounts in each consumer's account would not be required until the bank had been closed down and the FSCS needed to start processing claims.

Single view of customer

5.32 Eligible depositors are entitled to compensation up to the FSCS limit across all their accounts in the same bank. The FSCS therefore needs to have access to information that gives a single view of each customer. In addition, the FSCS needs to ensure that joint accounts and cases where a depositor holds accounts in different capacities (for example, as trustee or agent) are correctly dealt with. Deposits in joint accounts would need to be allocated to the relevant account holders, usually in equal shares.

Costs and benefits

5.33 Not all banks' systems can currently provide a single view of all customer accounts and some banks may therefore need to upgrade their infrastructure. There will be costs in doing this but investing in such systems may also provide commercial benefits.

Data protection

5.34 The FSA and the FSCS will need to ensure that adequate data protection measures are in place at all times where consumer bank details are being taken from the bank and provided to the FSCS.

> 5.11) How quickly could banks make the changes to have the necessary information readily available on account balances of FSCS-eligible depositors, and what would be the cost to them?
>
> 5.12) Should banks follow a common data standard or format, and, if so, what would this entail?
>
> 5.13) What information should be included in a single customer view and what would be the implications for firms of different information requirements?

Eligibility

5.35 The FSA intends to consult on new rules to simplify the eligibility criteria for FSCS payments.

Complexity

5.36 There are currently detailed eligibility criteria for the FSCS and this adds to the complexity of, and time taken for, processing payments. This complexity may also make it difficult for some consumers to understand whether they are eligible for compensation.

5.37 To avoid delaying the vast majority of payments when the eligibility of only a small number of depositors is likely to be in issue, the FSA intends to consult on new rules to make all depositors eligible for FSCS payments, with the three exceptions set out under the EC Deposit Guarantee Schemes Directive:

- deposits made by other credit institutions on their own behalf and for their own account;
- deposits that have the nature of equity; and

deposits arising out of transactions in relation to money laundering.

5.38 The FSA also intends to continue to exclude the directors of the failed bank and possibly senior managers or others, where the FSCS is of the opinion that they have been responsible for, or contributed to, the bank's difficulties.

5.39 The FSA will discuss with banks whether it is possible to place a 'flag' on accounts which are not eligible for FSCS payments, thereby allowing the FSCS easily to identify which accounts are ineligible for compensation.

5.40 Such changes would mean that a number of account holders who are not currently covered by the FSCS would be covered under the proposed changes. These include:

- corporate (including third sector) customers, regardless of size;
- collective investment schemes;
- government bodies, international bodies, etc; and
- pension and retirement funds.

5.41 The FSA will consider whether the simplified eligibility criteria would apply for other activities covered by the FSCS.

5.14) How would banks place a 'flag' on accounts that are not eligible for FSCS payments?

5.15) Are there other classes of depositor that should be ineligible for FSCS compensation payments, and, if so, why?

Gross payments

5.42 The FSA intends to consult on a move to gross payments. The Government will consider including compatible provisions on set-off in the proposed bank insolvency procedure to ensure that making gross payments to eligible depositors will give a fair result for different customers and the FSCS.

Net payments

5.43 At present, FSCS claims are calculated on a net basis; customers' outstanding debts to the failed bank are netted against their deposits to arrive at the amount of the claim. Where, on that net basis, customers owe the bank money, they will not be eligible for any compensation payment under the FSCS, regardless of the size of the deposit they hold with the bank. This makes it more complicated for depositors to understand their level of coverage and means that customers with both short-term deposits and illiquid long-term loans held at the same bank (for example, a mortgage) may suffer a loss of liquidity following a bank failure.

5.44 Net payment is consistent with the calculations which would be made on the winding-up of a failed bank under insolvency law, when 'set-off' (the process of netting off a customer's mutual credits and debits with an insolvent company) would apply. Making the necessary calculations could add to the time needed to make payments.

5.45 With gross payments, a customer would be entitled to a compensation payment based on the amount of their deposits up to the FSCS limits. Although a customer with loans would still be required to pay these back to the failed bank, these would be ignored for the purposes of determining claims payable by the FSCS.

Bank insolvency procedure

5.46 The Government is therefore proposing to include provision within the proposed bank insolvency procedure (see Chapter 4) 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.

> 5.16) To what extent would gross payments help maintain depositor confidence and speed up payment?
>
> 5.17) To what extent are gross payments justified by maintaining depositors' access to liquidity as well as by accelerating payments by the FSCS?
>
> 5.18) What are your views on the link between FSCS gross payment and set-off?
>
> 5.19) Are any other measures necessary to better align FSCS rules and the provisions of the proposed bank insolvency procedure?

Streamlined claims process

5.47 The Government proposes legislation, and the FSA intends to consult on new rules, to remove the need for consumers to make a formal claim to the FSCS and to remove the need for claimants to make a formal assignment of their rights to the FSCS in all cases when they receive compensation.

5.48 Currently, once a bank becomes insolvent, the FSCS or the insolvency practitioner posts a letter to all deposit holders that includes a form that they must fill out and submit (by post) to the FSCS to qualify for FSCS payments. The FSCS then considers the claim, decides if the claimant is entitled to compensation, and then writes to the claimant with payment (or rejection). Claimants are also required positively to assign their rights to make claims against third parties to the FSCS when accepting a compensation payment.

5.49 It is proposed that the FSCS should make compensation payments based on the records of the failed bank and that, by accepting the FSCS payment (for example, paying in the cheque):

- the claimant would be deemed to have accepted this process (to avoid removing their rights to do something else, such as claim from the estate); and
- the claimant's rights against the estate of the failed bank (and any relevant third party) with respect to his protected deposits would be assigned automatically to the FSCS.

> 5.20) What are your views on the removal of the formal claims process? What risks would be involved in the FSCS automatically sending out cheques and how can they be mitigated?

FSCS funding and liquidity

5.50 The Government proposes to ensure that the FSCS has access to immediate liquidity through borrowing from the Government or the Bank of England, and potentially, through the introduction of an element of pre-funding.

Pre-funding

5.51 The FSCS is chiefly funded on a 'pay as you go' basis, with annual levies on firms based on the expected outgoings, including compensation payments, for the following year. The levies are set by the FSCS within limits laid down in rules made by the FSA. The FSA recently made some new rules on FSCS funding to implement a unified funding model covering all sectors of financial services which will come into force on 1 April 2008.[28] The scheme also has the power to borrow. It can currently call upon a commercial loan facility of around £50 million.

5.52 To facilitate fast payments to customers of a medium or large bank, access to immediate liquidity would need to be increased substantially. One way to achieve this would be to introduce an element of pre-funding to allow the FSCS to build up a reserve fund over a period of years. The fund would provide some immediate liquidity to the FSCS and reduce the need for borrowing. It would also:

- reduce the chance of the FSCS needing to raise large levies immediately after a bank's closure, at a time when firms may be least able to afford such a cost;
- ensure that a failed firm contributes to the costs it imposes on the FSCS; and
- facilitate the application of risk-based levies (see below).

5.53 The Treasury Select Committee has identified two disadvantages of a 'pay as you go' approach to financing the FSCS:

- it may not provide consumers with appropriate confidence in the compensation scheme; and
- banks are likely to have to pay levies in times of stress.

5.54 However, there are some significant disadvantages to moving to pre-funding which also need to be considered, including:

- it could take a number of years to build up a fund of significant size, and over that period there would be an impact on contributing firms;
- if pre-funding was introduced, there would be an opportunity cost as the fund would need to be invested in liquid securities with potentially lower returns; and
- unless and until a substantial fund had been built up, the FSCS would continue to need to borrow to have access to substantial liquidity, which would be repaid out of subsequent levies, in order to make compensation payments in the event of the default of a major bank.

5.55 Primary legislation would be needed to allow the FSA to make rules which provide for pre-funding.

Borrowing from the Authorities

5.56 Whether or not there is pre-funding and a fund has been built up, there might be occasions when it could not cover all defaults, so the FSCS would still need access to other sources of liquidity. The FSCS currently has commercial borrowing facilities but the total amount of payments required if a substantial bank failed might make it difficult to raise sufficient funds in the market. The Authorities are proposing that the FSCS be able to borrow from the Government or the Bank of England.

[28] See FSA Policy Statement 07/19, *FSCS Funding Review Feedback on CP07/5 and made text*, November 2007.

5.57 In the case of a medium-sized to large bank, any borrowing from the Government would have significant implications for the fiscal rules, and interest would be charged to comply with EC state aid rules. Any borrowing from the Bank of England would have to be structured to comply with EC monetary financing and state aid rules.

5.21) What are your views on including an element of pre-funding in the FSCS?

5.22) What steps would need to be taken to ensure that pre-funding would be compatible with other elements of the FSCS funding arrangements?

5.23) What are your views on whether the FSCS should be permitted to borrow from the Government or the Bank of England?

Opening new accounts

5.58 The Authorities will work with banks and the appropriate trade associations to ensure that consumers can open up a new account quickly enough to facilitate fast payment by the FSCS.

5.59 If a bank fails, its customers could lose access to banking services. For example, direct debits would no longer be honoured and there would no longer be an account into which wages – or compensation payments from the FSCS – could be paid. Chapter 4 outlines proposals within a special resolution regime to resolve banks facing difficulties in a manner that ensures continuity of banking services. However, consumers still need to be able to open accounts with a new bank quickly.

5.60 Where new accounts need to be opened, the Authorities believe that they should be ready in time to receive FSCS payments as soon as these are sent. A new bank account with at least basic functionality (access to debit card, direct debits and credits) would therefore need to be available within one week of the request to set it up.

Money laundering rules

5.61 Under the Money Laundering Regulations, banks are required to apply customer identification and due diligence measures to new customers. In circumstances where banks are unable to obtain on a timely basis verification information to satisfy the anti money laundering requirements, they would be allowed to use the provisions in Regulation 17 of the Money Laundering Regulations 2007 which allows firms to rely on the verification checks already carried out by other authorised persons.

5.62 This would allow the customers' new bank to rely on the failed bank's identification checks instead of performing its own at the point of opening an account. In turn, the failed bank should be a position to confirm to the customers' new bank that its identification checks are up to date and that it holds verification records. The bank would be obliged to make these promptly available on receipt of a request from a former customer's new bank. The new bank should conduct ongoing monitoring of the new customer's account and perform their own identification and verification checks within a reasonable period of time on a risk sensitive basis.

5.63 When opening a new account, customers would be required to bring a letter or account statement from the failed bank and some form of proof of identity. Where this is not possible, it is proposed that identification checks would be undertaken with the assistance of the failed bank.

5.64 The Government believes that the UK Payments Council should explore further the possibility of standardising account numbers, with a view towards greater portability of bank accounts. This could reduce the costs to businesses and the time it takes to switch accounts between institutions.

Account switching

5.65 One way to arrange for the opening of new accounts quickly would be to build on existing initiatives to speed up the switching of customers' accounts between banks. Currently, it can take an average of 8 to 12 weeks for customers to switch accounts within the UK. This includes the time it takes for all direct debits and credits to be transferred. The European Commission announced on 21 November 2007 that by mid-2008 the banking industry should have established a common set of rules to the benefit of all customers with regards to quicker account switching. On 26 November 2007, the UK Payments Council issued a consultation paper[29] which noted that in the past, efficiencies, such as standardisation of account numbers, have been considered although this proposal had not been pursued as it was not considered to be a cost effective solution.

> 5.24) How soon could streamlined procedures for opening accounts be introduced so that the one-week target for opening a new account can be met?
>
> 5.25) Are there additional risks which need to be considered with this faster account opening method?
>
> 5.26) How else could the account opening process be sped up?
>
> 5.27) What else would be needed to enable banks to provide instant access to funds following the deposit of a FSCS compensation payment?

CONSUMER AWARENESS

5.66 The FSA intends to consult on how consumers can be better informed about the current compensation scheme.

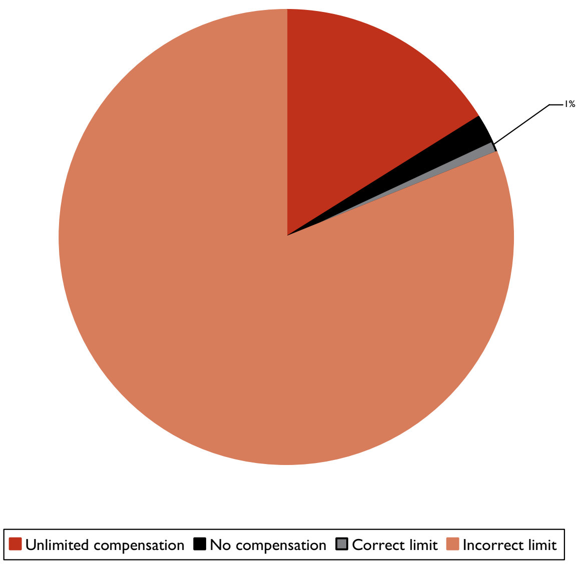
Poor Awareness

5.67 A recent consumer survey[30] has confirmed that consumer knowledge of compensation arrangements is generally poor, and that there remains a lack of knowledge about the existing compensation scheme for depositors. For example, Chart 5.4 illustrates that only one per cent of respondents correctly identified the current FSCS limit. Chart 5.5 illustrates that consumers generally do not remember being made aware of the arrangements when they open an account or purchase a financial product.

[29] Payments Council, *National Payments Plan: Consulting on change in UK payments*, November 2007

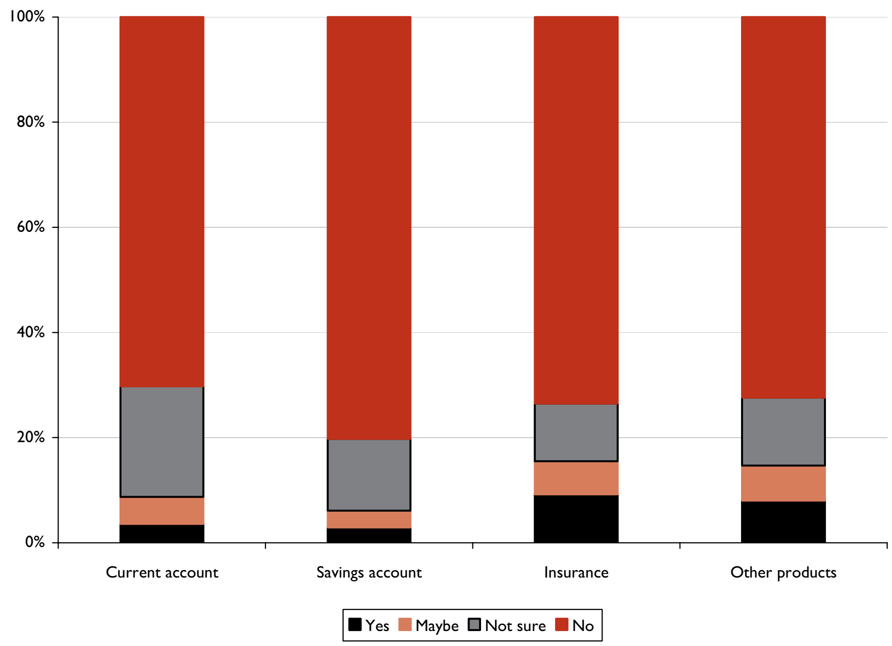
[30] FSA Omnibus Survey, January 2008 (unpublished)

Chart 5.4: Consumer awareness of the current FSCS deposit compensation limit



Source: FSA Omnibus Survey January 2008 (unpublished)

Chart 5.5: Consumer awareness of FSCS limit at account opening



Source: FSA Omnibus Survey January 2008 (unpublished)

5.68 New requirements could be placed on banks by the FSA to inform:

- all existing customers of the current FSCS limit (a one-off requirement);
- future or new customers by ensuring that marketing literature about financial products contains clear information about the FSCS;
- all customers, in the event of a change to the limit; and
- individual customers when their deposit exceeds the limit.

5.69 Customers will also need to be made aware that the balances held under different brand names of the same bank will be aggregated before the FSCS limit is applied. This will need to be distinguished from cases where the customer has accounts with different banks in the same group (where the compensation limit applies separately to each bank).

> 5.28) What notification requirements on compensation should apply to banks, and how can they be made less burdensome? Would these have an effect on market stability or depositor confidence?
>
> 5.29) How should disclosure requirements be imposed?

OTHER PROTECTION FOR CONSUMERS

Protecting vulnerable consumers

5.70 **The Department for Work and Pensions (DWP) and HM Revenue and Customs (HMRC) will introduce contingency plans to ensure that consumers can receive benefits and tax credits in the event of a bank failure.**

5.71 The Family Resources Survey indicates that approximately 60 per cent of the UK population are in receipt of at least one state benefit or tax credit. The largest single group of recipients are pensioners. The Government has a policy of requiring benefits and tax credits to be paid through bank accounts. In the event that consumers no longer have access to their bank accounts, there could be potentially large costs to those people who are reliant on benefits and tax credits as their primary, or only, source of income.

Contingency plans

5.72 To protect these vulnerable customers, DWP and HMRC will put in place contingency plans to ensure customers of an insolvent bank would still have access to their benefits and tax credit payments. For example, this could include plans for these people to receive their benefit or tax credit payments via pre-paid electronic cards that may be used at several outlets, such as Post Offices. This change will not require the Government to take any new legislative powers.

> 5.30) What would be the best way for DWP and HMRC to make payments in the event that consumers did not have access to their bank accounts?

Protection for holders of banknotes issued by commercial banks in Scotland and Northern Ireland

5.73 The Government proposes legislation to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland, and to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the United Kingdom.

5.74 The Government's priorities in regulating the issue of banknotes by commercial banks are to ensure that note holders, as creditors, have appropriate protection in the event of a banknote issuing bank becoming insolvent and that banknote issuance does not distort competition in the banking industry.

Previous Consultation

5.75 As stated in the consultation document 'Banknote issue arrangements in Scotland and Northern Ireland' published by HM Treasury in 2005, the Government proposes to enhance commercial banknote-holder protection by:

- requiring commercial issuing banks to maintain sufficient and appropriate banknote-covering assets at all times;
- defining the purpose of those banknote-covering assets in an insolvency; and
- modernising the existing regulatory framework.

Scottish cheques

5.76 The Government intends to remove the 'funds attached rule' in Scottish law, insofar as it relates to cheques, to ensure that the effect of the presentation of cheques for payment is the same throughout the United Kingdom and that drawers and payees of cheques in Scotland are not at a relative disadvantage.

5.77 The Government intends to take forward these proposals within its legislation on banking reform providing it remains appropriate in light of this consultation.

OTHER CHANGES TO COMPENSATION ARRANGEMENTS

Increasing FSCS management flexibility

5.78 The Government proposes legislation to ensure that the FSCS has the management flexibility it needs to manage a wide range of claim volumes.

5.79 The FSCS is currently able to recover its expenses from the levy-payers, including the general running costs of the FSCS, the costs of assessing and paying compensation, and the actual cost of the compensation payments it makes. Management expenses for a particular period can only be recovered from the levy-payers if they are below a limit fixed in rules and there are concerns that these provisions reduce the ability of the FSCS to process a very large number of claims quickly.

5.80 The Government is considering bringing forward legislation to:

- give the FSA more flexibility in setting limits on management expenses;
- allow the FSCS to delegate decision making about compensation, for example, to an insolvency practitioner); and

- give the FSCS a greater ability to make trade-offs between the costs of processing claims and its management expenses.

5.31) What are your views on the proposed changes to increase FSCS management flexibility?

5.32) Are there other possible changes which could increase management flexibility for the FSCS or enable it to process a large volume of claims quickly in the most cost-effective way?

Risk-based levies

5.81 The FSA is seeking views on the advantages and disadvantages of introducing risk-based levies or other ways of bringing behavioural factors into levy calculations.

Incentives

5.82 At present the FSCS charges a levy to all contributors in the same category based on one common factor. For deposit takers, this is the amount of protected deposits and each bank is levied on its share of total protected deposits in the UK. Banks judged to be at higher risk of default would pay higher levies than other, lower risk institutions. On the one hand, it would mitigate excessively risky behaviour. On the other, it would duplicate the FSA prudential requirements.

5.33) What are your views on the use of risk-based levies or on the introduction of behavioural factors into the calculation of the levies?

SUMMARY

5.83 This chapter has set out the following proposals:

1. In relation to compensation limits and coverage:

    - the FSA intends to consult on changes to the FSCS compensation limit and other factors used in the compensation calculation;
    - the FSA will consider the appropriate FSCS coverage for client accounts and similar arrangements; and
    - the FSA to explore with the financial sector ways for customers to cover amounts above the compensation limits.

2. In relation to faster compensation payment:

    - the Government proposes legislation to enable the FSA to collect the information the FSCS requires, and share it with the FSCS at the first sign of difficulties in a bank, and to enable the FSCS to obtain information from firms at the earlier of when a firm is declared in default or the date a claim is made;
    - the FSA intends to consult on new rules to simplify the eligibility criteria for FSCS payments;
    - the FSA intends to consult on a move to gross payments and for compatible provisions on set-off to be included in the new bank insolvency procedure;

- the Government proposes legislation and the FSA intends to consult on new rules to remove the need for consumers to make formal claims for compensation and to remove the need for claimants to make a formal assignment of their rights to the FSCS in all cases when they receive compensation;
- the Government is seeking views on ways to ensure that the FSCS has access to immediate liquidity, including pre-funding; and
- the Authorities to work with banks and appropriate trade bodies to ensure that consumers can open a new account quickly enough to facilitate FSCS payments.

3. In relation to consumer awareness, the FSA intends to consult on how consumers can be better informed about the FSCS.

4. In relation to other protection for consumers:

   - DWP and HMRC will introduce contingency plans to ensure that consumers can receive benefits and tax credits in the event of bank failure; and
   - the Government proposes legislation to strengthen the arrangements underpinning bank banknote issuance by commercial banks in Scotland and Northern Ireland and to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the UK.

5. In relation to other changes to compensation arrangements:

   - the Government proposes legislation to ensure that the FSCS has the management flexibility it needs to manage a wide range of claim volumes; and
   - the FSA is seeking views on the advantages and disadvantages of introducing risk-based levies or other ways of bringing behavioural factors into levy calculations.

6 Strengthening the Bank of England

6.1 As discussed in the next chapter, effective coordination between authorities is a vital component of their ability to manage risk in the financial system – in establishing and implementing appropriate regulation, identifying and supporting action to mitigate risks to the stability of the system and being able to respond effectively to deal with the consequences when firms do get into difficulties.

6.2 An important enabler of effective coordination is clarity about objectives and the governance structures which support and oversee their delivery. The chapter covers proposed changes to the objectives and governance of the Bank of England, including:

1. providing the Bank of England with a statutory role in the area of financial stability;
2. changes to the size and composition of the Bank of England's Court.

Bank of England's objectives

6.3 The Bank of England is the UK's central bank. Its roles and functions have evolved and changed over its three-hundred year history. It has been the Government's banker since its foundation in 1694 and, since the late 18th century, it has been banker to the banking system more generally. The Bank of England also manages the UK's foreign exchange and gold reserves. Today, the Bank of England has two core purposes – monetary stability and financial stability.

Monetary stability

6.4 The first objective of any central bank is to safeguard the value of the currency in terms of what it will purchase at home, and in terms of other currencies. Monetary policy is directed to achieving this objective, based on four clear principles:

- clear and precise objectives;
- full operational independence for the Monetary Policy Committee of the Bank of England (MPC);
- openness, transparency and accountability; and
- credibility and flexibility.

6.5 In May 1997 the Government gave the MPC operational independence to set monetary policy. The Government is responsible for defining, on an annual basis, what is meant by price stability. In practice, this has been done by specifying a particular inflation target. The then Chancellor last wrote to the Governor of the Bank of England on 21 March 2007, re-confirming the target as two per cent as measured by the 12-month increase in the Consumer Price Index (CPI).

6.6 The Bank of England implements the MPC's monetary policy decisions through its financial market operations, setting the interest rate at which it lends to banks and other financial institutions. The Bank of England has close links with financial markets and institutions. This contact informs a great deal of its work, including its financial stability role and the collation and publication of monetary and banking statistics.

6.7 The changes proposed below, to the objectives and governance of the Bank of England, do not affect its monetary stability objective, including the MPC's role in determining monetary policy.

Financial stability

6.8 The Government proposes legislation to formalise the Bank of England's role in the area of financial stability and to give its Court a formal role in overseeing the Bank of England's performance in this area.

6.9 The Bank of England's role in financial stability arises by virtue of its role:

- in monetary policy;
- in respect of payment systems in the UK; and
- operationally as banker to the banking system.

6.10 However there is no reference to financial stability in the Bank of England Act 1998. The lack of a statutory objective in this area contrasts with monetary policy, where the objective and the accountability arrangements are clearly defined in law. In contrast, the Bank's role in financial stability has been somewhat more loosely defined, allowing for some public ambiguity over the scope of its role in this area. Placing the Bank's financial stability objective on a statutory basis would form a firm foundation from which to clarify the Bank's role in this area, and to provide for enhanced accountability arrangements relating to the Bank's financial stability activities.

6.11 The Authorities therefore believe that, as part of the reforms, it would be useful to formalise the Bank of England's role in the area of financial stability through legislation. In addition, the Court – the Bank of England's governance body – should have a formal role in overseeing the Bank's performance in this area.

Consultation questions

6.1) What are the benefits of formalising in statute the Bank of England's role in the area of financial stability, and giving its Court responsibility for overseeing its performance in this area?

GOVERNANCE OF THE BANK OF ENGLAND

6.12 The current governance and accountability framework is set by the 1998 Bank of England Act, which provides for a Court of Directors, a Committee of Non-executive Directors within Court, as well as the MPC. Court consists of the Governor, two Deputy Governors and 16 Directors. The Directors are all non-executive. The Governors are appointed by the Crown for five years and the Directors for three years. Details of the current Court can be found in the Bank of England's Annual Report.[31]

6.13 Under the Act, the responsibilities of Court are to manage the Bank of England's affairs, other than the formulation of monetary policy. Court's responsibilities include determining the Bank of England's objectives and strategy, and ensuring the effective discharge of its functions and the most efficient use of its resources.

Changes to Court

6.14 To support the Bank of England's enhanced statutory role in financial stability, the Government proposes legislation to amend the provisions governing the size and composition of the Court. The Bank of England also intends to modernise the arrangements for meetings of the Court.

6.15 The Government has, in consultation with the other Authorities, considered the current governance arrangements under which the Bank of England operates. To

[31] http://www.bankofengland.co.uk/publications/annualreport/index.htm

ensure that it is able to perform its enhanced role in the area of financial stability in an efficient and effective manner, the Government has considered whether changes to the Bank of England's governance arrangements would be sensible, in particular:

- with nineteen members, the current Court is much larger than the corporate norm. A smaller board would be more effective;
- current legislation specifies that the chair of Court should be the Governor. However, corporate governance best practice suggests the chair should be an independent member. This has in fact has been the de facto practice of the Bank of England since 2003, at the suggestion of the Governor; and
- non-executive appointments to Court should clearly be made with a view to ensuring they have the relevant expertise, given the Court's duties.

6.16 The aim of these proposals would be to achieve:

- a clear legal mandate for the Bank of England in the area of financial stability; and
- a smaller, more effective Court with responsibility for overseeing the Bank's work in financial stability.

6.17 None of these changes would affect the Bank of England's independence in the field of monetary policy, an indispensable component of the UK's framework for economic stability.

> 6.2) To what extent would the proposals improve the ability of the Court of the Bank of England to oversee the Bank's performance, including its proposed enhanced role in the area of financial stability?

SUMMARY

6.18 This chapter has set out proposals relating to the objectives and governance of the Bank of England, including:

- legislation to formalise the Bank of England's role in the area of financial stability and to give its Court a formal role in overseeing the Bank of England's performance in this area;
- to support the Bank of England's enhanced statutory role in financial stability, legislation to amend the provisions governing the size and composition of the Court; and
- the Bank of England also intends to modernise the arrangements for meetings of the Court.

7 Effective coordination

7.1 The primary responsibility for managing risk in individual firms lies with the managers and directors of those firms. However, as the previous chapters show, there is also a role for authorities – in establishing and implementing appropriate regulation, identifying and supporting action to mitigate risks to the stability of the system as a whole and being able to respond effectively deal when firms do get into difficulties. Effective coordination between authorities is paramount for them to carry out their responsibilities, especially in stressed circumstances.

7.2 With a single financial regulator (the FSA) the UK avoids some of the coordination problems in financial crises which spread across traditional banking, insurance and financial market lines. But coordination between HM Treasury, the FSA and the Bank of England (the 'Authorities') remains important.

7.3 Effective coordination requires clarity about objectives. But it is also important, if regulation and other policy instruments are to be effective, that markets can rely on the independence of regulators and central banks when carrying out their responsibilities. As set out in the previous chapter, the governance of these organisations is therefore critical.

7.4 Furthermore, just as regulatory standards have rightly increasingly been set at an international level to respond to global market developments, so it is essential that financial authorities across the world can work together effectively. This needs to happen both in normal times and in more stressed circumstances.

7.5 The chapter covers:

1. coordination between the Authorities in the UK, including:
   - setting out the current tripartite arrangements; and
   - operational arrangements and the Memorandum of Understanding between the Authorities.
2. coordination internationally, including:
   - strengthening the operation of the IMF and FSF;
   - an early warning system in relation to financial stability risks; and
   - the management of cross-border crises.

Coordination in the UK

Tripartite arrangements

Current arrangements

7.6 The tripartite structure in the UK was established in 1997. It brings together, in a model which has been followed in some other countries, those authorities with responsibilities connected to financial stability – HM Treasury, the FSA and the Bank of England.

7.7 The arrangements are set out in a Memorandum of Understanding (MoU), agreed in 1997, and amended to reflect updated arrangements in March 2006. The key elements are set out in Box 7.1. It includes provision for the Chancellor, the Governor of the Bank of England and the Chairman of the FSA to meet in the form of a Standing Committee. In normal times, this Committee meets roughly monthly (with the members represented by their deputies) to review the key systemic risks to the UK's financial intermediaries and infrastructure, and to coordinate the Authorities' response and contingency plans.

Box 7.1: Responsibilities of the tripartite authorities [a]

HM Treasury is responsible for:

- the overall institutional structure of financial regulation and the legislation which governs it, including the negotiation of EC directives;
- informing, and accounting to Parliament for the management of serious problems in the financial system and any measures used to resolve them, including any HM Treasury decision concerning exceptional official operations as set out in the MoU; and
- accounting for financial sector resilience to operational disruption within government.

HM Treasury has no operational responsibility for the activities of the FSA and the Bank of England and shall not be involved in them. But there are a variety of circumstances where the FSA and the Bank of England will need to alert HM Treasury about possible problems: for example, where a serious problem arises, which could cause wider financial or economic disruption; or where there is, or could be, a need for a support operation. This list is not exhaustive, and there will be other relevant situations. In each case it will be for the FSA and Bank of England to decide whether HM Treasury needs to be alerted.

The Bank of England contributes to the maintenance of the stability of the financial system as a whole – one of its two core purposes. This involves:

- ensuring the stability of the monetary system as part of its monetary policy functions. It acts in the markets to deal with fluctuations in liquidity;
- overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad. As the bankers' bank, the Bank of England stands at the heart of the payments system. It falls to the Bank of England to advise the Chancellor, and answer for its advice, on any major problem arising in these systems. The Bank of England is also closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk;
- maintaining a broad overview of the system as a whole. The Bank of England is uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor (financial stability)). Through its involvement in markets and payments systems it may be the first to spot potential problems. The Bank of England advises on the implications for UK financial stability of developments in the domestic and international markets and payments systems and assesses the impact on monetary conditions of events in the financial sector; and

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[a] This box presents an abridged version of the tripartite MOU

Box 7.1 continued

- undertaking, in exceptional circumstances, official financial operations, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

The FSA's powers and responsibilities are set out in the Financial Services and Markets Act 2000. Within the scope of the Act, it is responsible for:

- the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies;
- the supervision of financial markets, securities listings and of clearing and settlement systems;
- the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where the nature of the operations has been agreed according to the provisions of the MoU, and the operations do not fall within the ambit of the Bank of England defined in the MoU; and
- regulatory policy in these areas, including that intended to promote the resilience to operational disruption of authorised firms and Recognised Bodies. The FSA advises on the regulatory implications for authorised firms and Recognised Bodies of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

Revising the MoU

7.8 The Authorities continue to believe that these arrangements – based on coordination between the three organisations, each with their own responsibilities – remains the right structure. They do not believe that fundamental changes to the responsibilities of the three organisations are required. However, they recognise that some practical improvements and clarifications to the arrangements may be beneficial. These proposals are set out more fully below.

Operational arrangements and the MoU

Coordination in crisis

7.9 **The Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements.**

7.10 COBR is the mechanism through which the Government coordinates its response to a large-scale disruptive event. It brings together the relevant departments and agencies and facilitates timely decision-making with clear lines of responsibility and accountability.

7.11 The Authorities propose to:

- make a clearer distinction between 'normal' and 'crisis' conditions, with the calling of a meeting of the tripartite standing committee used, where it is decided to be appropriate, to trigger the activation of a more robust and intensive set of coordination arrangements;
- learn lessons about improving external communications during a financial crisis, as recommended by the Treasury Select Committee, including the involvement of the Financial Services Compensation Scheme (FSCS) where appropriate, while noting that there might also

be occasions when it would be more appropriate for the Authorities to meet without publicity; and

- ensure that the Authorities have sufficient skilled, flexible resources available to deliver these arrangements.

Information sharing

7.12 The FSA and the Bank of England will consider the scope for greater combined initiatives to develop common understanding, building, for example, on existing cooperation through the Bank of England's Financial Stability Board.

7.13 As part of this, improvements will be made to the arrangements whereby the Bank of England is kept informed about developments in individual institutions when, taken together or individually, they represent a risk to the stability of the financial system. In particular, enhancements will be made in the procedures for sharing data. The FSA and Bank of England will also consider the scope for greater combined initiatives to develop common understanding, for example, by building on the existing practice of conducting joint thematic work on key issues such as stress testing, and deepening existing cooperation in respect of the Bank of England's Financial Stability Board.

7.14 There should also be a greater expectation that the Bank of England should be more directly involved with individual firms if there is perceived to be a significant likelihood of emergency liquidity assistance being required, to allow adequate preparations to be made, and the swift implementation of decisions.

Decision making

7.15 The Authorities also propose to clarify responsibilities within the Memorandum of Understanding for decisions around providing support to firms – in particular emergency liquidity assistance.

7.16 It is proposed that:

- decisions on the provision of financial support to individual institutions should be discussed amongst the Authorities, as now, with the Chancellor authorising any ELA operations. These discussions will include the terms of those operations, such as the price and acceptable collateral. Operations beyond normal ELA, involving financial support from the Exchequer, including their terms, will be decided by the Chancellor; and

- the MoU should explicitly state that the Bank of England is responsible for the provision of general liquidity, while giving HM Treasury and the FSA the capacity to make representations to the Bank of England in relation to such decisions, and recognising the need for the Bank of England in its liquidity operations to keep the overnight interest rate in line with Bank Rate.

7.17 The Authorities propose to take forward these changes at the operational level and through changes to the MoU. The Authorities will publish a revised MoU following responses to this consultation.

Consultation questions

7.1) To what extent will the proposals enable an improved handling of a financial crisis?

INTERNATIONAL COOPERATION

7.18 Financial markets are increasingly global in nature, and the risks, including contagion, are increasingly international. Risks which have developed in one market can quickly spread across a range of markets across the world, and have the potential to impact on the growth prospects of the global economy. It is therefore vital that the appropriate structures are in place to provide early warning of these developing risks, and to act where possible to mitigate these risks. Where shocks to the financial system occur it is vital that effective crisis management arrangements are in place to ensure that cross-border problems can be responded to and contagion of crises averted.

7.19 At the international level, the key bodies for monitoring international financial and economic stability issues are the FSF and the IMF. While both bodies have provided important analysis of risks to financial stability, and are undertaking significant work in response to the recent financial market turbulence, there is great potential for them to improve their impact further, and explore how they can work together more effectively to help deliver a more robust framework for international financial stability. There is also a strong case for better cross-border crisis management arrangements.

Financial Stability Forum

7.20 **The Authorities will work with international counterparts to pursue changes to improve the effectiveness of the FSF.**

Role

7.21 The Financial Stability Forum (FSF) is an important international forum for discussion of global financial market and stability issues. It brings together finance ministries, supervisors and central banks of the world's major financial centres with international financial institutions, including the Bank for International Settlements (BIS), and regulatory bodies, including IOSCO and the Basel Committee.

7.22 The FSF has been working closely with central banks, standard setters, and other international bodies such as the IMF and the BIS to analyse the recent market turbulence and develop the appropriate policy response.

Improvements proposed

7.23 However, the FSF can do more to increase the impact of its work to ensure that, where specific issues are identified, effective action is taken by regulators and financial sector participants. It could strengthen its role in ensuring that the international financial and regulatory environment is developed to maximise market efficiency and financial stability. To strengthen further its general analytical capability and to increase its ability to promote implementation of required policy responses across a range of policies the Authorities propose that the FSF should:

- improve the co-ordination of international work on financial stability issues by taking a high-level oversight role;
- strengthen its role in bringing together regulators and standard setters to help implement global standards;
- take a lead role in developing mitigation actions to global financial market and stability issues and work to enhance the effective implementation of these mitigation strategies;
- strengthen its role in international crisis management issues through promoting best practice in crisis preparedness and response,

examining the challenges of international crisis management, and improving cross-border co-ordination and communication;

- improve the spread of best practice in financial stability issues through greater publicity of its work; and
- support IMF surveillance through identifying and reviewing key financial issues which should be included in IMF surveillance work.

7.24 It should do this through:

- working to build a broad consensus for the FSF to take an oversight role of the international committees working on financial stability issues; and
- drawing on the resources of its members, private sector expertise, and the IMF, in improving analysis around risks, and the potential responses to them.

International Monetary Fund

7.25 The Authorities propose that the IMF considers how to improve further the focus of its financial sector surveillance.

Role

7.26 The IMF, with 185 members, is required according to its Articles to oversee the international monetary system to ensure its effective operation. In order to do so, it carries out a range of economic and financial surveillance activities and provides advice to its members. The most high profile elements of these are its World Economic Outlook, its Global Financial Stability Report, and its surveillance reports on individual members. The IMF also provides financial assistance to help members overcome temporary balance of payments problems and offers technical assistance and training on a range of macroeconomic and financial issues.

7.27 The IMF is endeavouring to sharpen its focus on the areas and issues where it has a comparative advantage. It is seeking to improve the integration of its various surveillance activities, to make them more efficient, more effective and more focussed on spillovers between countries. It is also seeking to better integrate financial sector issues into its surveillance activities.

Improvements proposed

7.28 In the context of an overall strengthening of the IMF's surveillance function, the Authorities propose that the IMF considers how to improve further the focus of its financial sector surveillance by:

- identifying the links from developments in the financial system to the wider economy and to external stability, in part through an assessment of the national balance sheet;
- using cross-country comparisons systematically to draw out common lessons to improve understanding of interlinkages and emerging trends and risks; and
- working with other bodies to consider improvements to the Financial Sector Assessment Programme (FSAP) and Reports on the Observance of Standards and Codes (ROSCs) to see how they can be adapted to provide more focussed, flexible and timely analysis of relevant financial developments; and

- ensuring financial sector surveillance is better integrated with the work of regulators and standard setters, including the FSF, by working with them to identify the issues it should be looking at and how to ensure its recommendations gain traction with national authorities.

An early warning system for global financial risks

7.29 The Authorities propose that the FSF and IMF enhance their cooperation to bring together the intelligence gathered from IMF surveillance and from FSF members.

7.30 The FSF and IMF can offer much to global financial stability through enhancing their current work. However, they will be able to achieve even more through working together. The Authorities propose that the IMF and FSF should, drawing on their existing work on reporting and surveillance, provide the international community with an early warning system on the threats to financial stability and the global economy from the international financial system.

Cooperation

7.31 To achieve this, it is proposed that the FSF and IMF enhance their cooperation to bring together the intelligence gathered from IMF surveillance and from FSF members. The IMF should identify the top risks and vulnerabilities to the international financial system, with an assessment of the potential impact and likelihood of each risk. The FSF should identify and report on the appropriate responses by national and international regulators and market participants in particular, to these risks and report on progress with mitigation actions. The intention would be to publicise widely this joint international financial stability monitoring report setting out the key risks, to ensure a greater understanding of vulnerabilities, and the need, and options for mitigating actions. These reports should build on more in-depth written reports of the IMF and FSF covering financial sector developments at the time of the IMF Spring and Annual Meetings.

7.32 For this cooperation to be fully effective, the FSF should also:

- carry out a strategic oversight and coordinating role of the international regulatory and standard setting bodies to ensure international regulatory policy development is both coordinated and focused on the priorities;
- develop mechanisms to increase interaction with the global financial services industry, to better understand the challenges facing industry; and
- raise the profile of its work in the international community, both public and private sector.

7.33 This system would provide public and private sector decision-makers with a sophisticated forward-looking analysis of developments in global financial markets that have the potential to impact on the macro-economy. It would thereby help the international community implement a more effective rapid response to emerging crises that require a multilateral response.

7.34 It would also be important to ensure there is effective international political authority to the IMF/FSF work. In this context the Authorities propose that the international financial stability monitoring reports should be presented to a joint meeting of the FSF and the IMF's International Monetary and Financial Committee.

This should improve the legitimacy and accountability of the work, and strengthen the commitment to act on it.

7.35 This is not to say that this, in itself, will provide a defence against financial instability and contagion. There will need to be robust and effective national mechanisms to ensure the risks to financial stability are identified and responded to and the IMF/FSF report will be one of a number of sources of information available to the authorities. The Authorities will need to assess the risks from a UK perspective to achieve an analysis and assessment of the risks as appropriate to the UK economy. However, a more effective mechanism at the international level could help to increase the resilience of the global financial system and help mitigate the likelihood and impact of financial market instability.

7.2) To what extent would the proposals strengthen the operation of the IMF and FSF?

7.3) To what extent would the proposal for the IMF and FSF to work together to develop an early warning system be helpful in improving risk identification and financial sector resilience at the international level? How would this best be implemented?

Managing cross-border crises

7.36 The Authorities will continue to work constructively with international counterparts to improve international crisis management arrangements and to ensure the UK authorities are well prepared to respond to international financial crises, building on ongoing initiatives in the EU and FSF, and working bilaterally with key partners who share exposures to specific risks.

7.37 Improving the identification, monitoring and mitigation of risks will be vital to improved stability in global financial markets. However, this can never remove risks and financial sector shocks will still occur. Therefore, it is crucial that countries have in place effective arrangements to manage cross-border financial crises.

7.38 Growth and integration in financial services has increased rapidly over recent years, with businesses increasingly operating across borders, and many major financial groups truly global in their operations. This integration of markets and internationalisation of businesses presents real opportunities for economic efficiency and growth. However, it also brings with it challenges.

7.39 In the EU, significant steps have been taken in improving the cooperation and coordination of Member State authorities in managing cross-border crises through the agreement of an MoU to support cooperation in crisis situations between supervisors, central banks and finance ministries of Member States. The MoU contains a set of principles and procedures for sharing information and assessments on potential crises to enable authorities to best act to preserve overall stability of the financial system in individual countries and in the EU as a whole.

7.40 However, there are improvements that can be made to these arrangements in the EU. In September 2007, EU Ministers and Governors discussed the next steps needed to develop cross-border financial stability arrangements. The main actions now being carried forward include updating the MoU to include common principles for international financial crisis management, a common analytical framework for the assessment of the systemic implications of a potential crisis, and common practical guidelines for crisis management. Further work is also underway to examine how information exchange and cooperation can be enhanced among authorities and to enhance the tools available for preserving cross-border financial stability. The recent market turbulence has emphasised the importance of this work, and the UK continues fully to support it. The Authorities also welcome the work being done by the EU on the operation of deposit guarantee schemes, in which the Financial Services Compensation Scheme is participating through the European Forum of Deposit Insurers.

7.41 It is important, in addition, that consideration is given to the global dimension, rather than just a European focus. Financial integration is happening at the global level, and firms are operating on that same scale. Therefore, crisis management cooperation must also be at this global level. The work in Europe has taken this global concern into account in drawing up its recommendations, and the FSF has facilitated work at the international level to improve international crisis coordination arrangements. The UK Authorities and the FSF held a workshop in 2006 on planning and communications in financial crises as part of the FSF work to improve cross border co-operation. The workshop identified several ways authorities could enhance their cross-border crisis arrangements including:

- identifying and sharing best practice and international lessons from financial crises;
- promoting closer coordination between smaller groups of countries with particularly important institutional or capital market links; and
- holding crisis management exercises at the international level. This work continues to be taken forward and needs to remain a key priority for the FSF and for national financial authorities.

> 7.4) To what extent will these proposals aid authorities in managing international financial crises?

SUMMARY

7.42 This chapter has set out the following proposals:

1. In relation to tripartite arrangements:
    - the Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements;
    - the FSA and the Bank of England will consider the scope for greater combined initiatives to develop common understanding; and
    - the Authorities propose to clarify responsibilities within the Memorandum of Understanding for decisions around providing support to firms – in particular emergency liquidity assistance.
2. In relation to international coordination:
    - the Authorities will work with international counterparts to pursue changes to improve the effectiveness of the FSF;
    - the Authorities propose that the IMF considers how to improve further the focus of its financial sector surveillance;

- The Authorities propose that the FSF and IMF enhance their cooperation to bring together the intelligence gathered from IMF surveillance and from FSF members; and
- the Authorities will continue to work with international counterparts to improve international crisis management arrangements and ensure the UK authorities are well prepared to respond to international financial crises, building on ongoing initiatives in the EU and FSF, and working bilaterally with key partners who share exposures to specific risks.

A

IMPACT ASSESSMENT

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of the banking reform Bill	
Stage: Consultation stage	**Version:** CON/01	**Date: 30 January 2008**

Related Publications: Discussion Paper, Banking reform - protecting depositors; Consultation, Financial stability and depositor protection: strengthening the framework

Available to view or download at:

http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_liveindex.cfm

Contact for enquiries: banking.reform@hm-treasury.gov.uk **Telephone:**

What is the problem under consideration? Why is government intervention necessary?

Banks are an important part of a well-functioning economy. Banking failures and financial instability may impose severe costs on the economy. To guard against this, banks are regulated and subject to supervision by the Authorities. Recent events have highlighted a number of areas for improvement to the UK regime for maintaining financial stability and protecting depositors.

The case for government intervention is set out in detail in the evidence base.

What are the policy objectives and the intended effects?

The UK Authorities are proposing action targeted at achieving five objectives:

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

What policy options have been considered? Please justify any preferred option.

A wide range of policies for reform are being proposed. These are set out in detail in the evidence base to this summary sheet.

Proposals which were raised in the Discussion Paper that are not not being taken forward are also examined in the evidence base.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

An implementation stage impact assessment will be produced when the Bill is introduced in Parliament

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:

Alistair Darling .... Date: 30 January 2008

Summary: Analysis & Evidence

Policy Option: Banking reform proposals	**Description: See the evidence base for a detailed analysis of the costs and benefits of each of the proposals**

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' One-off costs relate to the FSCS undertaking capital investment to streamline the claims process and advance costs of the bridge bank tool. The majority of annual costs reflect lost seigniorage income from commercial banknotes. The FSCS liquidity option of pre-funding would significantly increase annual costs.	
One-off (Transition)	**Yrs**		
£ 1.5m - 3.0m	1		
Average Annual Cost (excluding one-off)			
£ 100.2m - 100.6m		**Total Cost** (PV)	**£ 1,460m - 1,470m**

Other **key non-monetised costs** by 'main affected groups' Many costs are non-monetised. This is because they will only be incurred in the case of financial instability, a bank failure, or a bank getting into difficulties. Thus they are contingent on unpredictable and infrequent events. They will vary by institution, the financial climate etc.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' There are no monetised one-off benefits. Monetised annual benefits largely reflect seigniorage income from commmerical banknotes (transfer from issuing banks to Exchequer). Ongoing benefits also include a reduction in admin costs associated with Scottish cheques.	
One-off	**Yrs**		
£			
Average Annual Benefit (excluding one-off)			
£ 100.3m		**Total Benefit** (PV)	**£ 1,460m**

Other **key non-monetised benefits** by 'main affected groups' There are significant non-monetised benefits: these are derived from reducing the likelihood and impact of financial instability and bank failure. Thus they are contingent on a unpredictable and infrequent events and will vary by institution, the financial climate etc.

Key Assumptions/Sensitivities/Risks The real discount rate used is 3.5%. The cost to commerical banks of lost seigniorage income is based on an interest rate assumption of 5.5% (current base rates). This cost also assumes that number of commerical banknotes in circulation remains constant. The £100m estimate is heavily dependent on these assumptions.

Price Base Year 2007	Time Period Years 20	**Net Benefit Range** (NPV) **£ -0.2m to -7.2m**	**NET BENEFIT** (NPV Best estimate) **£ -3.5m**

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			Varies by proposal	
Which organisation(s) will enforce the policy?			Varies by proposal	
What is the total annual cost of enforcement for these organisations?			£ 0.05m	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ n/a	
What is the value of changes in greenhouse gas emissions?			£ n/a	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)					(Increase - Decrease)
Increase of	£ Negligible	Decrease	£ Negligible	**Net Impact**	**£**

Key:	Annual costs and benefits: Constant Prices	(Net) Present Value

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

INTRODUCTION

A.1 The consultation document discussed the proposed banking reforms of HM Treasury, the Bank of England, and the Financial Services Authority (FSA) (the Authorities). This consultation stage impact assessment sets out the case for Government intervention, the policy options that have been considered, and an initial, high-level analysis of the benefits, costs and likely impact of the proposed reforms.

A.2 An implementation stage impact assessment will be published when the banking reform Bill is introduced in Parliament. This will contain a more detailed analysis of the likely benefits, costs, and impact of the reforms, taking into account policy development occurring in the light of this consultation.

A.3 Accordingly, contributions are now sought which may improve the analysis of the benefits, costs and risks arising from these reforms.

> A.1) Do you have information that would improve the analysis of this impact assessment?

A.4 Only the reform proposals to be included in the banking reform Bill are included in this impact assessment. FSA consultation on those measures not requiring primary legislation, which are instead implemented through FSA rules, will include, as required by the Financial Services and Markets Act 2000 (FSMA), a detailed cost-benefit analysis. As such, these reforms are not analysed in detail. Nevertheless, the Authorities welcome views on the likely impact of these measures, which will assist the FSA in both developing its policies and conducting the cost-benefit analysis.

Case for government intervention and regulation in the financial sector

A.5 The financial sector plays a vital role in the global economy. It intermediates between savers and borrowers through the investment chain, allowing savings to be allocated to worthwhile investment; helps firms and individuals manage risk, through insurance and other financial products; and allows them to store, access and move wealth, through deposit accounts and payment systems. For this reason, and given the interrelationships between firms in the sector, the stability of the financial sector is always a concern.

A.6 Banks, building societies and other deposit-taking firms (for simplicity referred to as 'banks' unless otherwise specified) are the repository of the majority of the UK's immediately available liquidity. They are key components in the country's core payments mechanism and are a key source of finance for households and businesses that do not have access to capital markets. Banks are also fundamentally different from industrial and commercial companies: by taking deposits their liabilities are "money" and so are essential parts of a well-functioning modern economy. Furthermore, banks are unique in the sense that markets cannot provide full insurance against liquidity shocks, whereas banks can provide full insurance (except in the case of a run) due to their ability to pool a large number of independently distributed risks. Crucially, banks' role in maturity transformation and their associated dependence on access to liquidity make them vulnerable to losses of depositor confidence, which may lead to bank runs and wider systemic consequences.

A.7 Bank failures are therefore capable of undermining financial stability, especially if they lead to a loss of depositor confidence in other banks. Given this, any failure of such a firm is likely to have significant economic costs, which will fall on both the customers of the particular firm, and also on the wider economy. These are set out in more detail in the section, 'Costs of financial instability and bank failure'.

A.8 Major banking crises are rare in the UK. However, the consequences of a banking crisis stand to be extremely serious. Furthermore, as consolidation in the financial sector continues to increase, the consequences of a failing bank may also increase.[1]

A.9 To guard against the risk of financial instability, banks are regulated and subject to supervision by regulatory authorities – in the UK by the FSA. In normal conditions, there should be no conflict between managing the business to maximise shareholder value and ensuring the security of depositors' money. But once insolvency or major liquidity problems threaten, shareholders' interests may well diverge from those of depositors and of the wider public interest in financial stability. Shareholders' incentives may mean a willingness to take greater risks, whereas the maintenance of depositor confidence and avoidance of insolvency would be best provided by risk-minimising strategies (which may reduce growth of business) and the injection of new equity, diluting existing holders' rights. The bank's management may simply take a different – more optimistic – view of the bank's future prospects and the risks its activities impose on the financial system than the Authorities. These issues give grounds for Government intervention and regulation.

A.10 Recent events have demonstrated both the importance of consumer confidence to ensuring financial stability, and that the current arrangements for dealing with banks in distress do not adequately uphold that confidence in certain circumstances, thus exacerbating the threat of financial instability. Moreover, the current framework may not adequately deal with existing market failures, particularly relating to the liquidity regime and the compensation scheme, in particular:

- consumers do not have sufficient awareness of, or confidence in, the current compensation arrangements;
- the powers available to the Authorities to reduce the likelihood or impact of a bank failing need to be updated and expanded;
- the existing regime for resolving failing banks through the application of general corporate insolvency law is inadequate; and
- changes to the UK regime need to take place in the context of changing international markets and the need for greater international coordination.

A.11 In order to rectify the issues outlined above, the Authorities propose a package of reforms.

Policy objectives

A.12 The Government's overall objectives for the financial system are stability, effective competition and consumer confidence.

A.13 The Authorities propose action, both in the UK and internationally, targeted at achieving five objectives:

[1] Group of Ten, Report on Consolidation in the Financial Sector, 25 January 2001

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

What policy options have been considered?

A.14 The Discussion Paper, *Banking Reform – Protecting Depositors*, outlined the Authorities' initial ideas for policy change. It asked a wide range of questions, and invited responses on many different issues. These have contributed to proposals for reform that the Authorities have worked up since the publication of the Discussion Paper in October 2007. It is these emerging conclusions which are set out in the consultation document. This consultation stage impact assessment evaluates each proposal in turn (including policy options, where applicable) against the alternative of no Government intervention.

A.15 The evolution of the reform policy development has meant that some areas of policy examined in the Discussion Paper are no longer being considered by the Authorities, and hence are not presented as options for reform in the consultation document. An evaluation of these policies is included in this impact assessment, setting out the reasons why the Authorities have not decided to take these forward.

Structure of this consultation stage impact assessment

A.16 This consultation stage impact assessment is set out as follows:

1. Introduction;
2. Costs of financial instability and banking failure;
3. Groups affected by the reform proposals;
4. Analysis of reforms; and
5. Impact on small firms.

A.17 The template at the beginning of this impact assessment covers the whole package of reforms. A detailed treatment of each proposal can be found in the analysis sections.

A.18 The aggregate totals for the costs and benefits associated with these proposals, as set out in the summary boxes in the template, only include proposals for which the Government proposes primary legislation. Where the Government is seeking views on the introduction of primary legislation, the costs and benefits are not included in the summary box.

COSTS OF FINANCIAL INSTABILITY AND BANK FAILURE

A.19 The proposals for reform address the difficulties with the current UK regime and the risks they pose to financial stability and consumer confidence. In doing this, they aim to reduce the costs of a future banking crisis by taking steps to reduce either the likelihood or impact of such an event. This section sets out the costs associated with financial stability and bank failure under the current framework, and discusses their implications.

A.20 Costs are broken down between three groups:

- Depositors;
- Borrowers; and
- The financial sector and the economy as a whole.

Costs to depositors

A.21 The failure of a single bank can impose costs on the economy through a number of channels, and even if the disruptive effects are not large enough to make a significant impact on output at an aggregate level, they can cause significant disruption to individual consumers. These effects may be particularly pronounced if the bank has a significant geographic or sectoral concentration of business.

A.22 In the UK, approximately 90 per cent of the population have a current account.[2] Furthermore, the five largest banking groups provide a considerable proportion of current account facilities. Basic banking functions, particularly the ability to make and receive electronic payments, have become extremely important to everyday life in the UK: over 90[3] per cent of wages are paid directly into bank accounts, approximately 98[4] per cent of benefits are paid into a bank account (or Post Office card account) and over 75[5] per cent of adults in the UK have at least one Direct Debit. A bank failure of any medium or large firm is therefore likely to have widespread social and economic implications for large numbers of individuals, households and businesses.

A.23 Under current arrangements, if a bank were to fail, depositors would suffer as a result of three separate effects:

- through loss of liquidity, due to the nature of sight accounts (current accounts and instant access savings accounts) as immediate sources of cash;
- through loss of access to payment systems, due to the transactional role of current accounts; and
- through loss of wealth, where current and savings accounts (including notice accounts) are used as a form of investment (to the extent that the depositor's balance sheet exceeds the Financial Services Compensation Scheme (FSCS) compensation limit).

[2] *Family Resources Survey*, 2005-06

[3] 'bacs', http://www.bacs.co.uk/BACS/Consumers/Bacs+Direct+Credit/

[4] Department for Work and Pensions

[5] 'bacs', http://www.bacs.co.uk/BACS/Consumers/Direct+Debit/

Loss of liquidity

A.24 Economic literature and experience of past failures document that the main consequence of a retail bank failure is the opportunity cost to depositors from losing access to their deposits (that is, the loss of liquidity). Loss of liquidity occurs if depositors at the failed bank are unable to access any of their funds after failure until the proceeds from the sale of the bank or its assets are distributed: in essence current accounts become long term savings, and there are further liquidity losses when credit lines cannot be relied upon or drawn down by borrowers to meet business needs (such as paying their bills and loans). For anything other than a small bank failure, enough consumers will be affected for the loss of liquidity to be rapidly and widely publicised. This could, in turn, increase the probability of a run developing at other, healthy banks.

A.25 Customers would face a loss of liquidity between the failure of the bank and the point at which they receive compensation from the FSCS and recoveries from the estate of the failed firm. Under current arrangements, this could last several months. If current and savings accounts are a large proportion of total deposits in the economy (as in the case of the UK), the resulting illiquidity may also have macroeconomic consequences.[6]

A.26 If a bank involved in cash handling and distribution were to fail, then there could be some disruption to cash circulation, as banknote-sorting capacity could be reduced and distribution of cash to ATMs and banks and firms around the country would be disrupted. Substitution by firms and individuals to other methods of payments (for example, debit card transactions or cheques) may result.

Loss of access to payment systems

A.27 Under the current membership rules, a default event (for example administration or insolvency) will generally mean exclusion from a payments system. Since it is access to payment systems which provides bank accounts with their functionality (that is, the ability to access and move funds in a practical fashion), customers would find their ability to manage their finances significantly impaired if their bank is excluded from payment systems (although this impact will be lessened if a consumer has access to more than one bank account). For this reason, the consultation document also sets out the case for the formal regulation of the UK payment systems.

Loss of wealth

A.28 Should a bank fail and the FSCS pays out compensation, a small portion (data suggests that the current limit of £35,000 covers approximately 97 per cent of all UK depositors)[7] of depositors will not be fully covered by the FSCS. If the total funds invested in a single firm by a depositor are above the FSCS compensation limit, then they may lose some or all of their deposits above the limit. However, this is not necessarily a welfare cost. If depositors are fully informed about the deposit protection limit, then the investment decision (to put money in a deposit account only protected up to the FSCS limit) may be viewed as the outcome of a maximising portfolio choice problem (in which the investor has invested above the limit in order to trade-off greater risk for greater expected return). However, this full information assumption is clearly imperfect and so, in reality, such a loss of wealth would impose a welfare cost (proportionate to the amount lost and their total wealth) for this small group of individuals.

Costs to borrowers

A.29 The size of the costs associated with bank failure will vary from borrower-to-borrower but are likely to be highest where firms (especially) or individuals

[6] See, for example, Anari, Kolari & Mason, *Bank Asset Liquidation and the Propagation of the Great Depression*, Journal of Money, Credit, and Banking, August 2005.

[7] BBA and BSA data.

are unable to easily signal their creditworthiness to another lender. In this case, the long-term relationship between the borrower and their bank has value as it enables the bank to more effectively evaluate the borrower.

A.30 This asymmetric information problem is most commonly associated with small firms, for whom the costs of signalling their creditworthiness through the production of credible public information (for example, agency ratings, detailed financial statements) are too high, or firms in specialised industries where lending decisions require detailed knowledge of individual projects.

A.31 Even if firms are able to find another lender, they may face higher borrowing costs if lenders are less able to assess firms' soundness, and may therefore require higher returns in recompense. Information gathered by the incumbent bank allows it to price risks more efficiently and this mitigates the problem of adverse selection (that is, 'safe' borrowers are charged lower rates than 'riskier' borrowers). The less-informed outside lender pools all borrowers together, which distorts investment decisions (safe borrowers are overcharged and under-invest; risky borrowers are undercharged and over-invest). Switching costs may be higher if other banks believe that the failed bank's loan book was of poor quality, as this may impact adversely on their view of the soundness of the failed bank's customers.[8]

Costs to the financial sector

A.32 The cost of funding the FSCS is covered by the UK financial sector in the event that the eventual recoveries from a failed bank are insufficient to cover the payment of insured depositors. The UK has a limited history of bank failure but the experience of the FDIC (Federal Deposit Insurance Corporation) in the United States shows that the approximate cost (to the FDIC) of resolving failing financial firms was around 14 per cent of the deposits of the firm during the period 1990-2007. However, given the highly concentrated nature of the UK banking system, this US analogy may underestimate the average cost of a bank failure in the UK.

A.33 Financial market participants are likely to face disruption if the failed bank acted as a counterparty, correspondent or market maker for them. Asset 'firesales' by the distressed firm would add to this disruption.

A.34 Disorderly bank failures might therefore be expected to impact adversely on London's standing as a financial centre through two channels: firstly, through a loss of confidence by depositors; and secondly, through a loss of confidence by financial market participants. These costs are likely to be a mixture of one-off and ongoing.

[8] See for example, Slovin., Sushka, & Polonchek, *The Value of Bank Durability: Borrowers as Bank Stakeholders*, Journal of Finance, 1993; and Kang & Stulz, *Do banking shocks affect borrowing firm performance?*, Journal of Business, 2000

Box A.1: Aggregate costs of financial crises

Financial crises result in both direct costs to the taxpayer, and impact on real economy activity. Estimating the cost of financial crises is very difficult but a number of studies have produced estimates of aggregate costs.

For example, Hoggarth et al (2001)[9] explore both kinds of costs on the basis of a sample of 24 banking crises. Based on data collected by Caprio & Klingebiel (1999)[10], they report average fiscal costs of 23 per cent of GDP for twin crises (banking and currency crises) and of 4½ per cent of GDP for pure banking crises. Output losses (relative to trend) are found to average 15-20 per cent of GDP for a sample of 47 banking crises; however, this figure varies considerably from crisis to crisis. Losses are typically much larger for twin crises than banking crises alone.

Further work

A.35 It may be feasible to use macroeconomic models to assess the impacts of the banking reform package on the UK economy. Such a modelling could be used to understand the influence of investor expectations of the returns on UK banks and the riskiness of assets on the costs and benefits of these proposals.

A.36 The Authorities have undertaken to carry out such modelling over the course of the consultation period, which may inform on the analysis of costs and benefits presented in the implementation stage impact assessment.

SECTORS AND GROUPS AFFECTED

A.37 These proposals will affect the following groups:

- **Depositors** – over 90 per cent of households in the UK have some form of deposit account.[11] The size of the UK deposits market is estimated at £860 billion.[12]
- **Banks** – There are 154 banks incorporated in the UK.[13]
- **Building societies** – There are 59 building societies in the UK.[14]
- **Credit unions** – There are 559 registered credit unions in the UK.[15]
- **Authorities** – HM Treasury, the Bank of England and the FSA (including the FSCS)

[9] Hoggarth, Reis & Saporta , *Costs of banking system instability: some empirical evidence*, Bank of England Financial Stability Conference on Bank and Systemic Risk, 2001

[10] Caprio & Klingebiel , *Episodes of systemic and borderline financial crises, World Bank*, 2003)

[11] *Family Resources Survey* 2005-06

[12] FSA, *FSCS Funding Review – Feedback on CP07/5 and made text*, November 2007

[13] FSA, List of banks as compiled by the FSA on 31 December 2007

[14] Building Societies Association, http://www.bsa.org.uk/keystats/index.htm

[15] FSA, *2006 Annual Statistics*, February 2007

ANALYSIS: REDUCING THE LIKELIHOOD OF A BANK FAILING

Consultation proposal: Information sharing between the Authorities

Description

A.38 The Government proposes legislation to ensure that there is no statutory impediment to the FSA obtaining and sharing information that the Bank of England and HM Treasury require for the purposes related to financial stability.

A.39 Currently, in the context of the Tripartite Memorandum of Understanding (MoU), it is principally the FSA that gathers information on the firms that it authorises and supervises, using its information-gathering powers under FSMA. However, the FSA is not permitted to collect information that the Bank of England or HM Treasury may require but which the FSA itself does not require.

A.40 To ensure each of the Authorities is able to fully carry out its role, the Government proposes legislative changes to ensure there is no statutory impediment to the FSA obtaining any information that the other Authorities require as they require it. For example, the changes would ensure that the definition of the functions for which the FSA has power to collect data under FSMA would allow it to collect data also for the Bank of England's financial stability purpose outlined in the Tripartite MoU.

Benefits

A.41 Each of the Authorities has a key role in maintaining financial stability. Currently, the FSA's scope to collect information is limited to doing so for their functions as outlined in FSMA. The Bank of England's power to collect information is limited to its monetary policy role. These changes will ensure that the FSA has the power to collect data also for the Bank of England's financial stability purpose – which includes both normal times and in-crisis contributions to maintaining financial stability. Improving information gathering and sharing is likely to enhance the response of the Authorities to issues relating to financial stability.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing financial instability.

Costs

A.42 Costs for supervised firms and the Authorities will depend on any increases in information requirements. The Authorities intend to codify arrangements in a Memorandum of Understanding to ensure arrangements to collect and share information are as efficient as possible. The Authorities are assessing what, if any, information (in addition to that already provided by the FSA) might be needed by them in times in financial stability, and will aim as far as possible to minimise any additional reporting burden on firms.

Quantification: Contingent on any increases in ongoing data requirements.

Groups affected

A.43 Directly: the Authorities and supervised firms which are required to supply additional information.

Competition assessment

A.44 This measure should not have a significant impact on competition.

Risks **A.45** There is a risk that this proposal may significantly increase the amount of information requested by the FSA from the firms it supervises, which may have cost implications for both firms and the FSA. To mitigate this risk, and as noted above, the Authorities will codify arrangements to ensure the efficient collection of information in a Memorandum of Understanding.

Consultation proposal: Oversight of the UK payment systems

Description **A.46** **The Government proposes legislation to provide for a new and flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework.**

A.47 The Bank of England currently has non-statutory responsibility under the Tripartite MoU for the oversight of payment systems, while the FSA has the responsibility for the regulation of their members and for other elements of market infrastructure (for example, clearing and settlement systems) in which payment systems are sometimes embedded.

A.48 The Authorities believe it is appropriate to establish a clearer and more robust framework for the oversight of payment systems.

Consultation **A.49** The Authorities will work together to analyse the objectives of oversight, assess the current oversight arrangements and propose any changes to the current regime as needed. The Authorities will issue further consultation on this proposal.

Consultation proposal: Registration of charges

Description **A.50** **The Government is seeking views on whether the requirement for a bank in receipt of liquidity assistance to put charges over its assets on to a register of its own and to register them at Companies House should be dis-applied for assets provided as collateral.**

A.51 Under current legislation, certain forms of charge or charges over certain categories of asset (which may be applicable where the Bank of England provides them with liquidity support against relevant collateral) must be registered within 21 days of the creation of the charge concerned. Companies are also required to maintain a register of all charges created by them at their registered office and to provide copies of this on request.

A.52 Removing the requirement on banks to register charges over certain assets would mean that liquidity assistance could not be identified from the register at Companies House.

Benefits **A.53** There are no significant one-off or ongoing direct benefits associated with this measure. While there may be some administrative savings, these are unlikely to be material.

Quantification: Negligible.

A.54 In the event that the Bank of England has given ELA, non-disclosure (through means of removing the requirements for banks relating to the registration of charges) could help preserve market and consumer confidence and allow stability to return to a bank. The disclosure of liquidity assistance and the negative connotations attached to receiving liquidity support from the Bank of England may harm consumer confidence and cause the type of problems that the liquidity assistance was intended to prevent.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing a financial instability.

Costs

A.55 There are no significant one-off or ongoing direct costs associated with this measure.

Quantification: Negligible.

Groups affected

A.56 Directly: any bank receiving liquidity from the Bank of England that registers a charge against its assets. Indirectly: depositors of the bank, who may benefit if this action prevents a failure. It would also affect future creditors of the bank, who would be extending credit to the bank, unaware of the liquidity assistance.

Competition assessment

A.57 This measure should not have a direct effect on competition. However, there may be an indirect benefit to any bank receiving liquidity from the Bank of England not to register charges against its assets (and hence reveal that liquidity support has been given). However, the decision of whether to delay disclosure will normally be taken by the Authorities where it is judged that in doing so adverse impacts on the rest of the financial sector are minimised.

Risks

A.58 Any removal of the current registration requirement delays the discovery by the financial sector that a firm has received liquidity from the Bank of England. This reduces transparency.

Consultation proposal: Bank of England weekly returns

Description

A.59 **The Government proposes legislation to remove the requirement for the Bank of England to release weekly returns and will consider other statutory reporting requirements related to the Bank of England.**

A.60 Currently, the Bank of England publishes its balance sheet on a weekly basis. These returns contain a summary balance sheet showing the Bank of England's main assets and liabilities. While there is no requirement for these returns to do so explicitly, liquidity assistance may cause noticeable movements in the balance sheet.

A.61 It may not be in the best interests of financial stability for liquidity assistance to be disclosed immediately and in this fashion. Therefore the Government is consulting on removing this statutory requirement.

Benefits

A.62 There will be an ongoing cost saving to the Bank of England (and HM Treasury, as it pays for publication in the London Gazette) by not publishing the returns. However, this benefit is not estimated to be material.

Quantification: Negligible.

A.63 In the event that the Bank of England has given ELA, the Authorities may judge that the objective of maintaining financial stability is best served by delaying disclosure until the risk of a systemic disturbance has subsided. For example, a judgment may be taken that disclosure may exacerbate confidence problems in the financial sector. As such, benefits may be derived from amending statutory requirements which remove the powers of the Authorities to exercise discretion in disclosure.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing financial instability.

Costs **A.64** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected **A.65** Directly: the Bank of England. Indirectly: banks receiving ELA which is otherwise undisclosed except through means of the weekly return.

Competition assessment **A.66** This measure should not have a significant impact on competition.

Risks **A.67** The risk of this proposal is that it causes a reduction in transparency for the markets and consumers.

Consultation proposal: Bank of England statutory immunity

Description **A.68** **The Government proposes legislation granting the Bank of England statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and central bank functions.**

A.69 Currently, the Bank of England does not have similar statutory immunity to the FSA and the FSCS in discharging its responsibilities. However, risk of litigation may make it difficult for the Bank of England most effectively to discharge its responsibilities in full.

A.70 The Government therefore proposes that the Bank of England should have statutory immunity from liability in damages arising from carrying out its responsibilities in relation to financial stability and central bank functions.

Benefits **A.71** This proposal places the Bank of England on a level of parity with the FSA and the FSCS in discharging its responsibilities.

Quantification: It is not feasible to quantify this benefit. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving financial stability.

Costs **A.72** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected **A.73** Directly: the Bank of England.

Competition assessment **A.74** This proposal should not have a significant impact on competition.

Risks **A.75** To mitigate against the risks associated with this proposal, the Government proposes that the immunity would not extend to its usual or contractual relationships with third parties (for example, in relation to market counterparties and other commercial agreements), and exclude instances where the Bank of England acted in bad faith or involved breaches of the Human Rights Act.

Consultation proposal: Priority to collateral provided to the Bank of England

Description **A.76** **The Government proposes legislation to ensure that realisation of any collateral provided to the Bank of England, in connection with carrying out its responsibilities in relation to financial stability and central bank functions, is fully effective whenever carried out.**

A.77 To ensure that realisation of collateral provided to the Bank of England is fully effective, the Government is proposing an enhancement to the existing provisions implementing the EC Settlement Finality Directive. In particular, the provisions that insulate collateral provided to the Bank of England from the effects of insolvency should ensure that realisation of the collateral provided to the Bank of England is fully effective whenever carried out.

A.78 Therefore, the Government intends to legislate to make certain that collateral provided to the Bank of England has priority over all preferential creditors and that such collateral is otherwise enforceable.

Benefits **A.79** This measure removes a constraint on the Bank of England providing liquidity to a bank in difficulty. As a result, this should increase the potential range of circumstances under which the Bank of England can use this tool of assistance.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing a financial instability.

Costs **A.80** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.81 The effect would be to redirect some of the realisations in any insolvency procedure from preferential creditors to the Bank of England.

Quantification: The size of this transfer will be dependent upon the particular circumstances of the insolvency.

Groups affected **A.82** Directly: the Bank of England and other preferential creditors in the event that a bank that has received liquidity assistance goes into insolvency.

Competition assessment **A.83** This measure should not have an impact on competition.

Risks **A.84** There is a risk that this measure will affect lending to banks, in that in the event of insolvency, returns to these creditors may go down as a result of a change to their position. However, this risk should be small given that banks are generally asset-rich (and so even if the Bank of England has first priority, there should still be sufficient assets to distribute to preferential creditors).

Consultation proposal: Building society borrowing

Description **A.85** **The Government proposes legislation so that funds provided by the Bank of England are exempted from the calculation of the proportion of building societies' funding which arises from wholesale funding.**

A.86 Currently, building societies are restricted in their business activities by the statutory requirement that they raise at least 50 per cent of their funds from their members. The new Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 will enable them to increase the amount of funding from wholesale sources up to 75 per cent. However, certain items are exempted from the calculation of the proportion of funding which arises from wholesales funds.

A.87 The Government proposes to add funds provided by the Bank of England to the list of exemptions, hence removing any quantitative restriction on building societies receiving liquidity assistance from the Bank of England.

Benefits

A.88 In the event that the Bank of England provides ELA to a building society, this measure eliminates the risk that the operation would result in a breach of the duties of the directors of the society. This therefore removes an impediment to building societies' ability to receive ELA from the Bank of England (an important tool available to the Authorities to assist a firm in difficulties).

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing a bank failure.

Costs

A.89 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected

A.90 Directly: building societies receiving liquidity from the Bank of England in excess of the restriction. Indirectly: depositors of the building society, who may benefit if this action prevents a failure.

Competition assessment

A.91 This measure should have a positive impact on competition as the proposed change allows for the provision of liquidity assistance to building societies on terms similar to those of banks.

Risks

A.92 None identified at this stage.

Consultation proposal: Floating-charges and building societies

Description

A.93 **The Government proposes legislation to allow building societies to grant floating charges to the Bank of England as security.**

A.94 Currently, legislation prevents a building society from offering the Bank of England effective security over what may be its only available collateral (typically mortgage loans and related cash collection accounts) in return for liquidity assistance.

A.95 The Government proposes modifying this restriction to allow building societies to grant floating charges to the Bank of England.

Benefits

A.96 Liquidity assistance is an important tool available to the Authorities to assist a firm in difficulties. This change allows the Bank of England to grant liquidity support to a building society in exchange for collateral in the form of a floating charge, and in a timely and effective manner. As such, it should improve both depositor confidence and market confidence. It seeks to protect taxpayers' interests by liquidity assistance being secured by an effective charge against assets.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing a bank failure.

Costs **A.97** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected **A.98** Directly: a building society receiving liquidity from the Bank of England. Indirectly: consumers of the building society, who may benefit if this action prevents a failure.

Competition assessment **A.99** This measure should have a positive impact on competition as the proposed change allows for the provision of liquidity assistance to building societies on terms similar to those of banks.

Risks **A.100** There is a risk that this proposal could be considered to affect adversely the position of building society members (though this should be limited to the extent that the removal of these provisions is limited to security or borrowing in favour of the Bank of England).

ANALYSIS: REDUCING THE IMPACT OF A FAILING BANK

Consultation proposal: 'Special resolution regime' for banks

Description **A.101** **The Government proposes legislation to introduce a special resolution regime (SRR) for banks.**

A.102 Currently, the Authorities have limited tools available to maximise the chances of a successful resolution should a bank get into difficulties. Formal insolvency is an unattractive route to resolution for a bank for a variety of reasons, including the fact that it is likely to: deprive depositors access to their accounts, may not be compatible with objectives around securing fast payout for depositors, and will usually lead to the destruction of any residual franchise value in the bank, thereby reducing the likelihood of a rescue or turnaround.

A.103 Therefore, the Government proposes to introduce a special resolution regime for banks. The decision to put a bank into such a regime would be made by the FSA, after consultation with the Bank of England and HM Treasury. Once a bank was put into the special resolution regime, the Authorities would have a range of enhanced powers over a failing bank to achieve a more orderly resolution. These powers would include existing tools, such as:

- public sector liability guarantees; and
- public sector capital injections.

A.104 In addition, it is proposed that the Authorities would have four new tools for the purposes of resolution:

- provision to the Authorities of the power to direct and **accelerate transfers of banking business** to a third party, in order to facilitate a private sector solution;

- powers to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a **'bridge bank'**;
- powers to allow the Authorities to appoint a suitable person, or **restructuring officer**, to carry out the resolution; and
- should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank was appropriate, a **'bank insolvency procedure'** to facilitate fast and orderly payment of depositors' claims under the FSCS.

A.105 To the extent that these powers do not provide the Authorities with sufficient control over the bank in particular circumstances, the Government is also considering legislation to allow it to take all or part of a bank into **temporary public sector ownership**.

A.106 Each of these new tools is considered separately as part of this impact assessment. The position of building societies and other mutuals is considered separately.

Consultation proposal: Accelerated transfer of banking business

Description

A.107 **The Government proposes legislation to give the Authorities the power to direct and accelerate transfers of banking business to a third party.**

A.108 Currently, Part VII of FSMA makes provision for the transfer of a bank's business and the process involves a willing seller and a willing buyer agreeing the terms of the deal. However, it is a complex and lengthy process – usually lasting many months – owing to the time needed to prepare documentation and go through the courts, allowing all affected parties (for example, shareholders and employees) to be heard.

A.109 The Government therefore proposes that the Authorities should have the power to direct and accelerate such a transfer, and if necessary to override the rights of the directors or shareholders of the failing bank to block the transfer. There would be no application to the court, as is the case under the Part VII procedure.

Benefits

A.110 A private sector solution may be the optimal outcome if a bank which is likely to undermine financial stability gets into severe difficulties. In addition, a private sector solution may be the least costly to the Authorities (compared to other resolution options) and helps maintain the bank's franchise value. It may also provide a better return to creditors than piecemeal liquidation.

A.111 By managing the resolution process better, this reduces the risk of a bank failure leading to contagion passing to other banks, which could have a significant impact on the economy.

Quantification: It is difficult to be precise, but the process could be shortened by up to several months. Quantification of the benefit of a private sector solution that resolves a failed bank is not feasible, but see the 'Costs of financial instability and bank failure' section for the benefits of preventing a bank failure.

Costs

A.112 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.113 Effecting a transfer quickly may require the Authorities to have a better understanding of a failing bank's assets and liabilities – this would probably require additional resources (either from the bank itself or from consultants brought in for the purpose) once a bank enters the wider 'intensive management' process. However, if expertise outside of the Authorities or either transacting party is required, the cost is likely to be borne by the purchasing party (although this may vary depending on the circumstances).

Groups affected

A.114 Directly: the Authorities, the parties involved in a transfer, and the shareholders of the bank. Indirectly: customers, creditors, and employees of a bank that is sold using an accelerated transfer.

Competition assessment

A.115 This measure should not have a significant impact on competition. However, there is a risk that it may lead to higher concentration in an already concentrated banking market. The Government will work to ensure that this proposal meets the usual requirements of competition law.

Risks

A.116 Creditors may believe that potential losses will be greater if the bank's assets are transferred rapidly to another firm than if it enters administration. But administration is likely to be highly destructive in terms of the failed bank's balance sheet value and the markets should appreciate that likelihood. This misperception by creditors may accentuate liquidity problems when a bank is thought to be facing difficulties, which in turn may accelerate a slide into insolvency. Creditors may therefore seek greater security over a bank's assets, limiting the practical usefulness of this approach. One approach to mitigating this might be through increased and regular publicity of special resolution regime arrangements.

A.117 The use of the power would have implications for property and other private law rights, and its exercise is likely to give rise to human rights considerations. Its exercise therefore risks legal challenge and potentially claims for compensation. The Government seeks to mitigate this risk by ensuring a strong wider public interest rationale for such action and an appropriate mechanism for the calculation of value and its distribution.

A.118 There is a risk that EC and UK competition rules, which restrict the mergers of firms in cases where the market share created would leave the merged firm in a dominant position in the market, would limit the number of available purchasers of a bank. This may increase the time taken to effect a private sale (in order to allow for analysis of the competition impact), reducing the eventual price that could be obtained for the bank, and increasing the financial risk attached to any Exchequer funds invested in the bank. At the same time, the impact of the EC state aid rules will affect the terms of a sale to a private sector entity.

> **Consultation proposal:** Bridge bank

Description

A.119 **The Government proposes legislation so that the Authorities have the powers to take control of all or part of a bank (or of its assets and liabilities) through a bridge bank.**

A.120 Currently, the Authorities do not have such a power. If a private sector solution is not feasible initially, then it is likely, under the current framework, that a bank in distress would enter existing insolvency procedures and the Authorities would have little influence over proceedings.

A.121 The Government therefore proposes that the Authorities should have the power to transfer a bank into a bridge bank, where this is desirable. This mechanism involves a public sector controlled bank acquiring some or all or the failed bank's assets and assuming some or all of its liabilities.

Benefits

A.122 In the event of this power being used, a bridge bank gives the Authorities greater powers over a failing bank while it is still solvent. This gives the Authorities the opportunity to keep the bank's business afloat and ensure consumers have continued access to banking services. Simultaneously, it allows the Authorities to pursue a private sector solution (including allowing time for potential acquirers to carry out due diligence on the business) or carry out wholesale restructuring. If these measures are relatively effective in preserving the franchise value of a bank, it may encourage higher eventual private sector bids. If these mechanisms are successful, they will prevent the collapse of the business of the failing bank, and therefore reduce the systemic risk attached to its failure. Depositors will not be faced with the costs of a bank failure as they will retain access to the full amount of their deposits.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving access to deposits and banking services, and the benefits of preventing a bank failure.

Costs

A.123 There will be some one-off and ongoing direct costs associated with the bridge bank mechanism:

- **Advance costs to the Authorities** – there will have to be various 'on call' contracts with appropriately qualified experts, who may be called in at short notice to run a bridge bank and advise the Authorities. Additionally, there are likely to be some additional staff costs to the Authorities.

  Quantification: At this stage, these costs are estimated to be between £200,000 and £500,000 per year.

- **Advance costs to banks** – there should not be any significant advance costs to banks, given that the most likely way that a bridge bank will operate is that the Authorities will use its existing infrastructure.

  Quantification: Negligible.

A.124 In the event that a bridge bank is used, there will be ongoing costs associated with its establishment. These will vary depending upon the nature of any bridge bank created: a capital or liquidity injection may be required, but this will vary on a case-by-case basis.

Quantification: It is difficult to quantify these costs. However, indications from the United States may shed some light on their likely magnitude. The costs of resolving US bank failures using purchase and assumption (transferring the deposit franchise and as many other assets as possible to another firm) transactions (including, but not solely relating to, bridge banks) over the 1980-94 period was 13 per cent of failed bank assets, compared with a cost of 28 per cent for the closure and rapid depositor payoff option.

Groups affected

A.125 Directly: the Authorities and the directors and shareholders of the failing bank. Indirectly: creditors, employees and depositors of a bridge bank.

Competition assessment

A.126 It could be argued that the existence of a bridge bank has the potential substantially to distort competition, for example, if it is perceived as safer than a privately owned bank it may attract a large amount of deposits. However, as this period of public control is designed to be short, this is unlikely to have a material impact on competition, especially given that it is likely that the stigma attached to the bank will take time to erode. The bridge bank would need to be operated in a manner which complied with EC law requirements, particularly with regard to state aid and, at the point of transfer to a private sector entity, to competition issues (see below).

Risks **A.127** This measure would interfere with property rights, employment and other private law rights (although the longer term benefits to these groups may reduce concerns). As with the directed transfer option, the resultant human rights compatibility of such action would need to be justifiable in light of the public interest considerations set out in Chapter 4. The Government seeks to mitigate this risk by ensuring a strong wider public interest rationale for such action and an appropriate mechanism for the evaluation of such compensation (if any) as would be required to ensure compatibility with fundamental rights.

A.128 There is a risk that EC and UK competition rules, which restrict the mergers of firms in cases where the market share created would leave the merged firm in a dominant position in the market, would limit the number of available purchasers of a bank. This may increase the time taken to effect a private sale (in order to allow for analysis of the competition impact), reducing the eventual price that could be obtained for the bank, and increasing the financial risk attached to any Exchequer funds invested in the bank. At the same time, the impact of the EC state aid rules will affect the terms of a sale to a private sector entity.

Consultation proposal: Bank insolvency procedure

Description **A.129** **The Government proposes legislation to introduce a modified insolvency process for banks – a bank insolvency procedure – to facilitate fast and orderly payment of depositors' claims under the FSCS.**

A.130 Currently, banks are subject to normal insolvency procedures. These include the use of administration to try to effect a company rescue or liquidation to provide for the orderly winding up of a bank's affairs.

A.131 The Government is consulting on the introduction of a new bank insolvency procedure, which would co-exist with current insolvency procedures and provide the Authorities with an alternative to current insolvency remedies where required. As part of this, a statutory requirement would be created to require a 'bank liquidator' to assist the FSCS in processing depositor's claims.

A.132 Such a procedure would be invoked – and only the Authorities would have the power to do this – in circumstances where closure and rapid payments is the resolution option chosen.

The main changes to insolvency law required for this measure are:

- **Prior notice of insolvency proceedings** – to ensure that special resolution options, including initiating the bank insolvency procedure, are not frustrated by prior insolvency proceedings, it is proposed that existing insolvency procedures may not be commenced unless 14 days' notice has been given to the FSA (that notice will also apply where any other step is proposed by a creditor to enforce their security). To enable this to work in practice, it is also proposed that a resolution for voluntary winding up could not be passed without the permission of the court.

- **Restricted rights of creditors –** if the bank has failed, the Authorities would be able to initiate special resolution (either prior to or within the 14-day notice period) measures without delay. Creditors would not have any control over the resolution proceedings or objectives, even if closure and rapid payoff were chosen. Instead, the Authorities would generally oversee the proceedings and the actions of the restructuring officer or bank liquidator.

- **Specific statutory objectives for a bank liquidator –** in the event of the bank insolvency procedure being selected, the bank liquidator's objectives would be to: i) facilitate a rapid FSCS payout; and ii) wind up the affairs of the failed bank.

Benefits

A.133 Should the new procedure be used, the Authorities would have the power to initiate proceedings quickly and choose their preferred insolvency practitioner (whom it is likely will have been engaged pre-insolvency to prepare for such an event, including liaison with the FSCS to plan compensation payments). It is also proposed that under the bank insolvency procedure no meeting of creditors would be held to nominate an alternative liquidator to the insolvency practitioner appointed by the court. This should help facilitate a quick FSCS payout.

Quantification: Faster compensation payments decrease the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced. It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

A.134 Such a regime allows the Government to let a bank fail, and ensure so far as possible that depositors will receive their compensation quickly. Having this option as a credible threat gives appropriate incentives to banks' directors, reducing moral hazard.

Quantification: It is not feasible to quantify this benefit. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs

A.135 It is unlikely that there would be any material one-off or ongoing direct costs of a new insolvency procedure: it is not anticipated that existing contracts between a bank and its creditors would require rewriting or renegotiation. There will be an additional cost where a bank wishes to wind itself up voluntarily since those proceedings will only be allowed with the permission of the court.

Quantification: Negligible.

A.136 In the event that a bank enters this modified insolvency regime, it is not expected that the costs of the insolvency proceedings will materially increase. The objectives of the bank liquidator would be narrower than for current administration proceedings, because there will be no statutory company rescue objective. The bank liquidator will have the combined powers of an administrator and liquidator, so the proceedings may take less time than under current procedures. But the precise duration of the proceedings will depend on the complexity of the bank's affairs, including the nature and commercial appeal of its assets.

Groups affected

A.137 Directly: creditors of any bank taken into the bank insolvency procedure by the Authorities.

Competition assessment

A.138 As this measure is only an alternative set of proceedings, it is not expected that it will affect competition. Indeed, it may be argued that this measure improves competition as it ensures efficient working of the market, ensuring that insolvency is a viable option.

Risks

A.139 The most significant risk of this proposal is that it might not be in the best interests of all creditors of the bank, because the bank liquidator's primary objective will be to work with the FSCS to enable a prompt payment to eligible depositors. However, the bank liquidator will also be required to realise assets and repay creditors and here he would be expected to act in the interests of all creditors generally.

A.140 There is also a risk that the implementation of a bank insolvency procedure could impact on banking groups which contain non-banking lines of business such as insurance. There is a small risk that banks' cost of capital might increase, with wholesale funds supplies demanding higher rates or more collateral. The Authorities believe this risk is small because creditors should not be made any worse off under a bank insolvency procedure than they would under normal insolvency.

Consultation proposal: Management expertise: appointing a restructuring officer

Description

A.141 **The Government is seeking views on whether, building on the FSA's existing power to appoint an expert, the Authorities should have the power to appoint a suitable person or 'restructuring officer' to carry out the resolution.**

A.142 Currently, the Authorities do not have the power to appoint any such individual to oversee the resolution of a failing bank.

A.143 The restructuring officer could take over the power of the directors during an accelerated transfer, or take over the powers of the directors alongside any significant financial support provided by the Government, the FSCS or another private funder.

A.144 The Authorities would set the objectives of the restructuring officer, and the restructuring officer would report to the Authorities. It is proposed that any appointment would be made alongside implementation of the above tools, rather than a prior separate step within the special resolution regime, so that the market is reassured that resolution action is being taken.

Benefits

A.145 Should a restructuring officer be appointed, the benefits are that this measure allows the Authorities to exercise control over the bank while it is in the special resolution regime. With control comes speed, as the Authorities would not have a requirement to put any resolution proposal to the shareholders. Thus decisions could be made much quicker than under current arrangements.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing a bank failure.

Costs

A.146 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.147 Consideration will need to be given as to who will incur the costs of remuneration (a salary and any expenses incurred).

Quantification: The costs of a restructuring officer will depend upon the duration of the resolution process. It would not be unfeasible for the officer to be in office for up to a year, on a 'city-level' salary. The restructuring officer may also need to appoint a range of other people to assist with orchestrating a resolution. These costs will vary by the nature of the resolution being performed.

Groups affected

A.148 Directly: the restructuring officer and the bank he is appointed to: directors and shareholders of the bank. Indirectly: creditors (including depositors) of the bank, and parties that benefit from the increased financial stability that may result from a more orderly resolution.

Competition assessment

A.149 This measure should have not have a significant impact on competition.

Risks

A.150 There is a risk that the appointment of a restructuring officer may lead to creditors losing confidence in the resolution of the failing bank.

Consultation proposal: Temporary public sector ownership

Description

A.151 **The Government is considering legislation to allow it to take temporary ownership of all or part of a bank as a last resort.**

A.152 Currently, the Government does not have the power to take a bank into temporary public sector ownership.

A.153 The Government is consulting on whether the Authorities should have the power to take a failing bank into temporary public sector ownership, in order to be sure of achieving important public interest objectives such as financial stability.

Benefits

A.154 In the event of this power being used, temporary public sector ownership gives the Authorities control over a failing bank. This gives the Authorities the opportunity to keep the bank solvent and ensure consumers have access to banking services. Simultaneously, it allows the Authorities to pursue a private sector solution (including allowing time for potential acquirers to carry out due diligence on the business) or carry out wholesale restructuring. If these measures are relatively effective in preserving the franchise value of a bank, it may encourage higher eventual private sector bids.

A.155 If these measures are successful, they will prevent the collapse of the failing bank, and therefore reduce the systemic risk attached to its failure. Depositors will not be faced with the costs of a bank failure: they will retain access to the full amount of their deposits.

Quantification: It is not feasible to quantify these benefits at this stage. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving access to deposits and banking services, and the benefits of preventing a bank failure.

Costs

A.156 There should not be any significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.157 In the event that the Government brings a failing bank into temporary public sector ownership, it will have to pay appropriate compensation (if any).

Groups affected **A.158** Directly: the Government and any bank brought into temporary public sector ownership. Indirectly: creditors and depositors of a bank brought into temporary public sector ownership.

Competition assessment **A.159** It could be argued that the existence of a publicly controlled bank has the potential substantially to distort competition, for example, if it is perceived as safer than a privately owned bank it may attract a large amount of deposits. However, as this period of public control is designed to be short, this is unlikely to have a material impact on competition, especially given that it is likely that the stigma attached to the bank will take time to erode.

Risks **A.160** This measure would interfere with property rights, and other private law rights (although the longer term benefits to these groups may reduce their concern with this). As with the compulsory transfer option, the resultant human rights compatibility of such action would need to be justifiable in light of the public interest considerations set out in Chapter 4. The Government seeks to mitigate this risk by ensuring a strong wider public interest rationale for such action and an appropriate mechanism for the evaluation of such compensation (if any) as would be required to ensure compatibility with fundamental rights.

A.161 There is a risk that EC and UK competition rules, which restrict the mergers of firms in cases where the market share created would leave the merged firm in a dominant position in the market, would limit the number of available purchasers of a bank. This may increase the time taken to effect a private sale (in order to allow for analysis of the competition impact), reducing the eventual price that could be obtained for the bank, and increasing the financial risk attached to any Exchequer funds invested in the bank. At the same time, the impact of the EC state aid rules will affect the terms of a sale to a private sector entity.

Consultation proposal: Resolution of building societies and other mutuals

Description **A.162** **The Government is consulting on whether all tools within the special resolution regime should be available to building societies as well as banks.**

A.163 An impact assessment for each of these tools is set out in the analysis above.

A.2) Do you believe that the impact on building societies of the tools within the special resolution regime is different to that on other banks?

Consultation proposal: Funding the special resolution regime

Description **A.164** **The Government is seeking views on whether the industry should contribute to funding the SRR. As part of this, the Government is considering whether to amend FSMA to allow the FSCS to contribute to the funding of the SRR. In addition, the Authorities are considering how best to enable the Bank of England to claim compensation from the FSCS in those circumstances.**

A.165 Currently, the costs of bank failure are only borne by the industry (in their capacity as levy payers to the FSCS) at the point at which the FSCS is required to pay depositors.

A.166 As an alternative, the Government is seeking views on providing the FSCS with the power to contribute to the cost of using SRR tools prior to insolvency, where this would better protect the interests of depositors, and would be no more costly for the FSCS than paying compensation. There are a number of ways in which such a mechanism could work, including through:

- **funding a bulk transfer of deposits** – FSCS arranging a transfer of deposits with any element of FSCS protection from a failing bank to a new bank; and
- **providing more general support for the SRR**.

Benefits **A.167** Should a failing bank enter the special resolution regime, and the costs of a resolution are no more costly than potential compensation payments to eligible depositors, then the industry will be better off. At worst, they would not contribute to more than they would have been levied if compensation had been paid.

Quantification: It is not feasible to quantify these benefits: they will vary from circumstance to circumstance.

Costs **A.168** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.169 This measure should not increase the costs of resolving a failing bank, as banks would not pay any more than they would if compensation had been paid.

Groups affected **A.170** Directly: the FSCS, the failing bank, and the FSCS levy payers. Indirectly: the depositors, creditors and employees of the bank that benefit from its orderly resolution.

Competition assessment **A.171** This measure may have a significant impact on competition. If the FSCS makes a payment to support a takeover of a failing bank, this is, in effect, a transfer payment from the financial services industry and the buyer of the failing bank. Such payment would need to be compatible with the provisions of EC law governing state aid.

Risks **A.172** There is a risk that the Authorities may not estimate correctly either the costs of the SRR tools or of paying compensation to depositors in the failed bank.

Consultation proposal: Financial collateral arrangements

Description **A.173** **The Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.**

A.174 The Government will consult on the scope of any future regulations to strengthen the protections available to financial collateral arrangements.

Benefits **A.175** There are no significant ongoing or one-off direct benefits associated with this measure. If regulations are introduced that create new protections, these will be subject to a formal impact assessment.

Costs **A.176** There are no significant ongoing or one-off direct costs associated with this measure. If regulations are introduced that create new protections, these will be subject to a formal impact assessment.

Quantification: Negligible

Groups affected **A.177** The scope of possible future regulations is not known at present but would be likely to affect a wide range of financial market participants. It would be unlikely to directly to affect individual consumers.

Competition assessment **A.178** The power has no direct impact on competition. If regulations are introduced that create new protections, these will be subject to a formal impact assessment.

Risks **A.179** The power has no direct impact and hence no direct risks. The future use of this regulation will be subject to the usual better regulation checks and balances.

Policy Evolution

A.180 There are two policy areas raised in the Discussion Paper that the Authorities are not proposing to be part of the reform package. Each of these fit within the section of measures to reduce the impact of a bank failure. They are:

- preference of depositors in insolvency proceedings; and
- the concept of maintaining certain 'critical banking functions'.

Policy no longer under consideration: Depositor preference

Description **A.181** On insolvency there is a statutory order of priority for repaying creditors as set out below. For these purposes, depositors of a failed bank would be classed as ordinary unsecured creditors.

1. Costs and expenses of proceedings
2. Preferential Creditors (certain employee claims)
3. Prescribed part of assets subject to floating charge to be made available to unsecured creditors (where applicable)
4. Floating charge-holders
5. **Ordinary unsecured creditors (including bank depositors and FSCS)**
6. Interest payable on all claims
7. Postponed debts
8. Members

A.182 Depositor preference would elevate the claims of depositors and the FSCS on the assets of a failed bank over the claims of other creditors.

Benefits **A.183** There are no direct benefits to this measure, since it does not change the value of the realised assets (assuming the same discount rates for all parties); it only changes the distribution of the proceeds. Depositors may receive a better return if a bank enters insolvency proceedings. However, this may mean that other unsecured creditors are worse off, unless a full dividend was paid to them.

Costs **A.184** Similarly, for the reasons outlined above, there are no direct costs associated with this measure. However, there is a risk that the behaviours of creditors will change, which may incur additional costs for banks (see below).

Risks **A.185** Depositor preference increases the incentive for creditors to require security for their lending, through either fixed or floating charges. Alternatively, lenders may charge higher interest rates for loans due to the increased risk of loss. Depositor preference would also provide an incentive for lenders to shorten the terms of loans or seek alternative investments. There is therefore a risk that the liquidity of banks generally may be impaired.

Policy conclusion

A.186 Notwithstanding the fact that depositor preference is applied alongside the FDIC's deposit protection arrangements in the US, the Authorities consider the risks (and hence potential costs) too great with respect to the benefits. In addition, as approximately 97 per cent of depositors are fully covered by the current FSCS limit, it would only stand to benefit a small number of depositors and the FSCS.

Policy no longer under consideration: Preserving critical banking functions

Description

A.187 The Discussion Paper explored whether there exists a need to preserve some defined critical banking functions in the event of a bank failure. This would be in order to protect consumers and help maintain consumer confidence by ensuring an orderly transfer of services through continued access to critical banking functions.

Definition

A.188 The Authorities consider that there are a small number of 'core' critical banking functions, which may be appropriate for all banks. These functions include cash withdrawal, debit cards, direct debit and direct credit. Over 90 per cent of the UK population have a bank account[16] that provides these functions, and it is reasonable to assume that consumers would view these as the minimum required to allow them to continue their day-to-day living.

A.189 The Authorities believe that retaining access to payment systems and the functionality of the cash cycle should also be classified as core functions. The former is a requisite to full operation of current accounts, and the latter ensures the continuity of supply and distribution of banknotes and coins.

A.190 Certain other functions, for example access to savings accounts, overdrafts and credit cards, are judged to be excluded from the core list of critical banking functions.

Benefits

A.191 The benefits of maintaining critical banking functions are best assessed through analysing the costs of consumers not having access to these functions: the loss of critical banking functions would mean that it would not be possible for consumers to make or receive payments or have access to cash from their account.

A.192 The cost associated with this may be approximately proxied by the expenditure that a consumer might typically fund from a bank account. This is estimated to be in the region of between £1,000 and £1,500 per month per household.[17] These costs would be incurred from the point at which the customer lost access to their original bank account, to the point at which they were able to open a new account. Under current procedures, this process may take between one and two months including changing all direct debit, direct credit, and standing order provisions (a process which could take longer if a large number of customers were attempting to set up new accounts at the same time). However, some of this cost will be 'reclaimed' once a customer has a new bank account, as their consumption 'catches up' to make up for the period without access to their deposits. The opportunity costs of not maintaining critical banking

[16] *Family Resources Survey* 2005-06

[17] HMT analysis (based on calculations of average monthly expenditure including median private rent; utilities; council tax; groceries; late payment charges and charges for not utilising direct debit facilities).

functions, for instance the costs of late payment, and non-direct debit transaction costs, are estimated to be £100 per month for a typical household.[18]

Costs

A.193 There stand to be significant practical and operational barriers to maintaining critical banking functions in isolation. These are primarily because it is extremely difficult to separate banks' systems, that is, the infrastructure for what have been defined core critical banking functions is heavily intertwined with the infrastructure for all other banking services. As such, it would currently be impossible to maintain only a select number of banking functions. Meetings and responses to the Discussion Paper made clear that the costs to the industry of overcoming these barriers would be prohibitively expensive.

A.194 Additionally, any announcement that only a bank's critical functions were in operation is expected to trigger a retail run. However, it is not clear whether such a run would occur immediately or whether it would happen over a more protracted timeline. Regardless of whether it was immediate or over a longer period, it is expected that all depositors will withdraw any funds that they can access, potentially accelerating the failure of a bank. On this basis, the funding cost of maintaining critical banking functions is between £2,000 and £3,000 per household (the average balance in a current account)[19].

Policy conclusion

A.195 The costs of restructuring banks in order to allow critical banking functions to be separated out and preserved in operation are very large. So the Authorities do not believe there should be an explicit requirement to maintain and separate such functions. Instead, the Authorities propose to use other reforms to realise the benefits associated with maintaining services. In particular, the proposals for a special resolution regime give the Authorities the tools to allow the continuity of such services. In addition, measures to increase the speed of FSCS compensation payments reduce the amount of time consumers are without access to liquidity.

ANALYSIS: CONSUMER CONFIDENCE AND COMPENSATION ARRANGEMENTS

Consultation proposal: FSA has the power to collect information on behalf of the FSCS

Description

A.196 **The Government proposes legislation to enable the FSA to collect the information that the FSCS requires and share this with the FSCS at the first sign of difficulties of a bank.**

A.197 Currently, the FSCS does not have the power to obtain information from firms before claims for compensation have been made. This can reduce the time the FSCS would have to investigate a claim.

A.198 This proposed power would be used for the purposes of preparing for compensation payments to be made, should the bank fail. The FSA would ask for this information as part of its usual supervisory channels.

Benefits

A.199 In the event of a bank getting into difficulties, this measure allows the FSA and the FSCS to be better prepared to process payments quickly, should compensation be

[18] HMT Analysis (based on calculations of typical charges for late payment or for not using Direct Debit as the payment method).

[19] Mintel

required. A quicker compensation payment reduces the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs

A.200 The FSA and FSCS may use some additional resources (by way of administrative expenses) on potentially both a regular (in the case of ongoing supervision) and one-off (in the time preceding a set of payments) basis.

Quantification: In the case of the FSA this is likely to be absorbable within existing supervisory resources without difficulty. Some extra FSCS staffing, however, may be required. The cost of this has been estimated at less than £100,000 per year.

A.201 Banks should not incur materially higher resource costs as a result of this measure as it only relates to the provision of existing information to the Authorities.

Quantification: Negligible.

Groups affected

A.202 Directly: the FSA, the FSCS, and any bank required to provide information. Indirectly: any depositor benefiting from a quicker payment as a result of this measure.

Competition assessment

A.203 This measure should not have a significant impact on competition.

Risks

A.204 There is a risk that allowing the FSCS access to information before a bank's default could detrimentally affect consumer confidence and undermine efforts to resolve a potential failure. This risk will be mitigated by the FSA requiring this information as part of its usual supervisory process.

A.205 There is also the risk that this measure will unnecessarily increase the requirement on banks to provide information. This might occur, for example, if the trigger for determining when the FSCS requires access to information is set too early.

> **Consultation proposal:** Obtaining information from firms at an earlier stage

Description

A.206 **The Government proposes legislation to ensure that the FSCS can require and obtain information directly from firms at the earlier of the date a claim is made or the date when the firm is declared in default.**

A.207 Currently, the FSCS can only obtain information from a firm once a compensation claim has been made.

A.208 Under the proposed new powers, the FSCS would be able to obtain information from the time a firm goes into default, if that happens at an earlier stage.

Benefits

A.209 This proposal would allow the FSCS to begin preparation work for compensation payments earlier. A quicker compensation payment reduces the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs

A.210 There are no significant ongoing or one-off direct costs associated with this measure. This is because the amount of information being required is the same; it is just the timing that is different.

Quantification: Negligible.

Groups affected **A.211** Directly: the FSCS and the any bank going into default. Indirectly: eligible depositors of a failed bank who may benefit from quicker compensation payments.

Competition assessment **A.212** This measure should not have a significant impact on competition.

Risks **A.213** None identified at this stage.

Consultation proposal: Streamlining the FSCS claims process

Description **A.214** **The Government proposes legislation, and the FSA intends to consult on new rules, to remove the need for consumers to make a formal claim to the FSCS and to remove the need for claimants to make a formal assignment of their rights to the FSCS in all cases when they receive compensation.**

A.215 The current claims process involves two 'rounds' of written correspondence between the insured depositor and the FSCS. The objective of these rule changes is to remove these administrative stages.

A.216 The Government proposes that as part of a new process, claimants need not actually apply to the FSCS for compensation. The FSCS would instead make payments to depositors based on the records of the bank. If the depositors accepted the payments, they would be deemed to have assigned their rights to the FSCS.

Benefits **A.217** In the event of compensation payments being made, this measures allows the FSCS to process payments quicker than it would otherwise. Faster compensation payments decrease the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

A.218 Additionally, there may be an administrative cost saving in the event of a compensation payout, as there is likely to be a reduced checking time of claims, and less paperwork for individual claims to establish eligibility.

Costs **A.219** No significant ongoing costs associated with this measure are envisaged. However, it is likely that the FSCS will have to invest in its technology systems, in order to facilitate this proposal.

Quantification: At this stage, the capital investment for this measure is estimated at between £1.5 million and £3.0 million.

Groups affected **A.220** Directly: the FSCS. Indirectly: depositors eligible for compensation in the event of a bank failure.

Competition assessment **A.221** This measure should not have a significant impact on competition.

Risks **A.222** This measure carries risks associated with the FSCS sending out cheques (or using alternative payment methods) to all of the customers of a failed bank, including fraud. If a risk materialises, there may be additional costs associated with compensation payments (for example, pursuing those who may have committed fraud).

FSA consultation **A.223** Most of the changes required for this proposal can be achieved through changes to FSCS rules and by operational changes. The FSA is responsible for making and amending FSCS rules, and will consult on proposals where necessary. Some changes to primary legislation, however, will be needed in relation to automatic assignment of rights and to ensure the powers have a full legal basis.

Consultation proposal: FSCS access to liquidity for compensation payments

A.224 **The Government proposes to ensure that the FSCS has immediate access to liquidity through borrowing from the Government or the Bank of England, or potentially, through the introduction of an element of pre-funding.**

A.225 There are two possible options for changing the way the FSCS obtains access to liquidity for compensation payments. These are not mutually exclusive. An impact assessment for each of these new options is set out below. These options are:

- Pre-funding; and
- Borrowing – either from HM Treasury or the Bank of England.

A.226 Currently, the FSCS is funded on a 'pay as you go' basis, with annual levies on firms based on the expected outgoings, including compensation payments, for the following year. The FSCS covers all sectors of financial services; the funding of the scheme has been recently reviewed by the FSA after extensive consultation, and changes to bring in a unified funding model will be introduced on 1 April 2008. If unexpected payments need to be made, the FSCS can borrow until it has been able to collect sufficient levies to repay the borrowing and the interest on these loans.

A.227 At present, the FSCS has a commercial loan facility of around £50 million. To facilitate fast payments to customers of a medium-sized or large bank, access to immediate liquidity on a much larger scale would be needed and it is possible that, in the circumstances in which a major bank failed, it would be difficult to raise this money in the commercial market. In these circumstances, the Government is considering whether the FSCS should also have access to loans from the Government (see below) or the Bank of England.

Pre-funding

Description **A.228** The Government is seeking views on allowing the FSCS to provide an element of pre-funding.

Benefits **A.229** Pre-funding would reduce the need for the FSCS to meet its immediate funding needs by borrowing from the market, the Government or the Bank of England. It means that contributions are required at less stressed times, unlike a post-funded system when firms would be required to pay in what are likely to be stressed times. For large failures or for several simultaneous failures, there will still be a need for some post-funding, possibly still for substantial amounts. Pre-funding also ensures that a failed firm will have contributed to the costs of compensating its customers

Quantification: Monetising the benefit of pre-funding is difficult as it depends on the specific circumstances of individual bank failures. However, given the importance of banks to credit intermediation, there may be benefits to a smooth and non-cyclical FSCS levy.

A.230 So long as the fund is sufficient to cover the compensation payments required, it will allow for faster payments without borrowing. Faster compensation payments decrease the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs

A.231 The FSCS would be required to operate and manage the fund. This would be likely to require additional resources in terms of fund management expertise, which would possibly be outsourced. In addition, there would be some systems costs to monitor the fund, investments and returns involved, as well as costs associated with the communication to firms of the status of the fund.

Quantification: As a rough estimate, administrative and asset management costs could be in the region of between £0.5 million and £1 million (assuming the fund is passively managed).

A.232 Firms would need to expend capital on annual contributions to the fund (until the point the target fund size was reached) that they may have placed in alternative – and higher returning – investments. Contributing to a fund held in low-risk, liquid assets such as government gilts would mean that levy-paying banks' profits would be lower, though less risky, than were banks able to invest these funds elsewhere. There would, therefore, be opportunity costs for levy payers in establishing such a fund.

Quantification: This opportunity cost is the differential between the return to the assets in the fund (which are likely to be gilts) and the return on banks' equity, appropriately adjusted for the higher risk of bank equity, multiplied by the size of the fund levied from the industry.

The difference between mean equity and gilt returns is the equity risk premium. There is evidence that the UK equity risk premium is approximately 4.5 per cent. For the purposes of this approximation, this figure is halved to compensate for the higher risk of equities over gilts. By this estimate, if the fund were £13 billion, the annual opportunity cost to banks would be around £300 million.

A fund of 1.5 per cent of protected deposits in the UK would total roughly £13 billion. Pre-funded depositor compensation schemes in other countries typically hold funds of 1-2 per cent of protected deposits. However, whether this was the appropriate sum for the concentrated banking system existing in the UK would need to be considered. Further, it could take a number of years to build up a fund of such size.

Groups affected

A.233 Directly: FSCS levy payers and the FSCS.

Competition assessment

A.234 FSCS levies on banks are proportional to their market share of protected deposits, so introducing an element of pre-funding would not distort competition among existing deposit takers, regardless of their size. Steady funding over a number of years also tends to reduce the distortions to market entry and exit: there is no particular timing advantage or disadvantage to entering or leaving the market shortly after a large payout, as there is under current pay-as-you-go funding.

A.235 However, new entrants to the market will be required to begin paying levies immediately, rather than have a contribution 'holiday' until the next payout from the fund (unless the fund has grown to the point at which no increase is required – in which case a new entrant's contribution schedule is no different in its effects from current FSCS arrangements). This may deter entry into the sector.

Risks **A.236** There is a risk that pre-funding could encourage banks to switch subsidiaries from the UK to other member states.

Government lending to the FSCS

Description **A.237** The Government seeks views on whether the power of HM Treasury to lend to the FSCS should be formalised in legislation.

A.238 HM Treasury would become a creditor of the FSCS in the ordinary way – exactly as if the FSCS had borrowed from a commercial lender. The funds to repay the loans and interest charged would be provided from the levies raised by the FSCS.

Benefits **A.239** The benefit of this option is that it allows faster payment. Faster compensation payments decrease the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs **A.240** There are no significant one-off or ongoing direct costs associated with this option.

Quantification: Negligible.

Groups affected **A.241** Directly: the FSCS and HM Treasury. Indirectly: any depositor that benefits from a quicker compensation payment as a result of this option.

Competition assessment **A.242** This option should not have an effect on competition, if a commercial rate of interest were charged (which would be required in order to comply with EC state aid rules).

Risks **A.243** None identified at this stage.

Consultation proposal: Scotland and Northern Ireland banknotes and Scottish cheques

Description **A.244 The Government proposes legislation to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland, and to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the United Kingdom.**

A.245 As stated in the consultation document, *Banknote issue arrangements in Scotland and Northern Ireland*, published by the Treasury in 2005, the Government proposes to enhance banknote-holder protection by: requiring commercial issuing banks to maintain sufficient and appropriate banknote-covering assets at all times; defining the purpose of those banknote-covering assets in an insolvency; and modernising the existing regulatory framework.

A.246 The options of maintaining the current situation, implementing a voluntary agreement and legislating have all been considered. Legislating is the only option that would be effective in achieving the policy goals of ensuring that commercial banknote issuing banks maintain sufficient and appropriate covering assets at all times, of defining the purpose of those assets in the event of the insolvency of a commercial issuing bank and of modernising the existing regulatory framework.

Benefits

A.247 Implementation would have the following benefits:

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

Quantification: There would be an increase in seigniorage income to the Exchequer reflecting the cost to the note issuing banks (£100 million per year). Abolition of the ‘funds attached rule’ in Scottish law, insofar as it relates to cheques, would remove an administrative cost for clearing banks in Scotland estimated in 2003 to total around £0.3 million a year.

Costs

A.248 There would be a cost to the commercial banknote issuing banks reflecting the corresponding benefit to the Exchequer. The estimated cost is based on the assumption that, if the commercial banknote issuing banks were not required to hold covering assets at all times, they would invest elsewhere and receive interest at the official Bank of England rate on commercial bank reserves. This does not discriminate against note-issuing banks in Scotland and Northern Ireland relative to non-issuing banks, which have no access to a comparable investment income.

Quantification: The requirement to maintain sufficient banknote-covering assets at all times results in a cost to note issuing banks that reflects the corresponding seigniorage benefit to the Exchequer (£100 million per year).

A.249 There would be an additional resource cost to the issuing banks, arising from complying with the new regulatory framework. The Bank of England would incur costs in performing its regulatory role.

Groups affected

A.250 The banknote reforms will affect the three commercial banks that issue banknotes in Scotland and the four commercial banks that issue banknotes in Northern

Ireland. In terms of group ownership, six banking groups will be affected. The position of holders of Scottish and Northern Ireland banknotes, as creditors, will be affected in insolvency. The transfer of regulatory responsibility will affect HM Revenue and Customs and the Bank of England. The cheques reform will affect the four clearing banks in Scotland. Drawers and payees of cheques in Scotland will also be affected.

Competition assessment

A.251 There should be no detrimental impact on competition. On the contrary, implementation of the banknote reforms would help to level the playing field between commercial issuing banks and non-issuing banks, and implementation of the cheques reform would enable the clearing banks in Scotland to deal with cheques in the same way as banks in the rest of the United Kingdom.

Risks

A.252 None identified at this stage.

Consultation proposal: FSCS management flexibility in setting management expenses

Description

A.253 **The Government proposes legislation to ensure that the FSCS has the management flexibility it needs to manage a wide range of claim volumes.**

A.254 Existing legislation gives the FSCS the power to recover its expenses from levy payers, including the general running costs of the FSCS, as well as the compensation costs it incurs. But these are subject to different provisions that limit the time periods in which management expenses can be incurred and makes them subject to a cap set in FSA rules.

A.255 This cost recovery structure limits the management flexibility of the FSCS, and could constrain the FSCS in acquiring extra resources in an emergency (for example, in order to make rapid compensation payments in the event of a bank failure). It is therefore proposed to give the FSCS more flexibility in controlling its expenses through:

- Giving the FSA more flexibility in setting limits on management expenses;
- Allowing the FSCS to delegate decision making about compensation; and
- Giving the FSCS a greater ability to make trade-offs between the costs of processing claims and its management expenses.

Benefits

A.256 In the event of an emergency, this measure gives the FSCS the means to use appropriate resources so as to effect a rapid payout. A faster compensation payment reduces the costs to depositors of a bank failure as the length of the time that liquidity is lost is reduced.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of quick FSCS payments to depositors.

Costs

A.257 There are no significant one-off or ongoing direct costs associated with this measure.

Quantification: Negligible.

A.258 It is not expected that this will lead to an increase in FSCS's expenses except in the event of a large bank failure, and hence a large compensation payout. These costs would be passed onto the industry, through levies, in the usual fashion.

Quantification: The extent to which management expenses may increase will be dependent upon the size and number of compensation payments required.

Groups affected **A.259** Directly: the FSCS. Indirectly: any bank whose FSCS levies are affected by this measure.

Competition assessment **A.260** This measure should not have a significant impact on competition.

Risks **A.261** The main risk is that this flexibility will lead to an increase in unrecovered overpayments of compensation being made without a significant reduction in managements expenses incurred.

ANALYSIS: STRENGTHENING THE BANK OF ENGLAND

Consultation proposal: Statutory changes to the Bank of England

Description **A.262** **The Government proposes legislation to formalise the Bank of England's role in the area of financial stability and give its Court a formal role in overseeing the Bank of England's performance in this area. The Government also proposes legislation to amend the provisions governing the size and composition of the Bank of England's Court.**

A.263 Currently, the Bank of England does not have a formal statutory role in the area of financial stability. However, the Bank of England does have a statutory objective to discharge its monetary policy duties. Existing legislation also sets out the structure and responsibilities of Court. Court consists of the Governor, two Deputy Governors and 16 Directors. The Directors are all non-executive. The duties of Court are to manage the Bank's affairs, other than the formulation of monetary policy, which is the responsibility of the Monetary Policy Committee. There are a number of aspects of Court that are not consistent with corporate governance best practice.

A.264 The Authorities therefore propose to formalise the Bank of England's role in the area of financial stability through legislation, and to bring the structure of Court further in line with corporate governance best practice.

Benefits **A.265** These changes should improve the response of the Bank of England to issues relating to financial stability.

Quantification: It is not feasible to quantify these benefits. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preventing financial instability.

Costs **A.266** There are no significant one-off or ongoing direct costs associated with this measure.

Quantification: Negligible.

Groups affected **A.267** Directly: the Bank of England.

Competition assessment **A.268** This measure should not have a significant impact competition.

Risks **A.269** None identified at this stage.

IMPACT ON SMALL FIRMS

A.270 Small firms have been considered in this impact assessment in two ways:

1. As a consumer of banking services, a depositor; and
2. As a provider of banking services, a bank.

Small firms as a consumer

A.271 None of the proposals analysed in this impact assessment treat small firms differently to other consumers. In particular, under both the current and proposed rules, the FSCS would compensate small businesses for lost deposits if their bank became insolvent, up to the compensation limit.

> A.3) Do you agree that small businesses would not be affected by these proposals in a different way to other consumers?

Small firms as a provider

A.272 Some banks, particularly the smaller credit unions, may be classified as small firms. As such, they may be subject to some of the regulatory measures proposed in this impact assessment.

A.273 In drafting rules, the FSA has a duty to pay due regard to ensuring that regulation is proportionate and that the measures considered do not disproportionately affect small firms. In some circumstances, it may be desirable to exempt specific types of firms (for example, credit unions) from specific requirements.

B DISCUSSION PAPER RESPONSES

Introduction

B.1 HM Treasury, the FSA and the Bank of England (the Authorities) jointly published a discussion paper, *'Banking reform – protecting depositors'* on 11 October 2007. Views were sought on a range of questions as a pre-cursor to this formal consultation document. The discussion period ended on 5 December 2007. This annex summarises the responses to the discussion paper, and highlights where these have been considered in relation to the proposals set out in this consultation document. In total, 68 responses were received from a range of stakeholders including a number of banks, building societies, trade associations, consumer representatives, academics and individuals. This consultation is wider in scope than the discussion paper and therefore some of the proposals did not originally form part of the discussion paper.

Objectives for reform

B.2 There was broad support for the objectives for reform, as set out in the discussion paper. Some respondents felt the objectives and document itself should have focused more on some of the actions required to prevent bank failure and the associated disruption. The consultation document makes a number of proposals on preventative action. The objectives underpinning this consultation, as set out in Chapter 1, seek to ensure that financial stability and maintaining consumer confidence are central to the reforms.

Continuity of banking services

B.3 The discussion paper referred to critical banking functions and suggested that the functions associated with current accounts and access to payment systems were functions that should be maintained wherever possible, in the event of a bank failure. Most respondents agreed that the functions associated with day-to-day retail banking could be deemed as critical, and should therefore be maintained. However, some respondents highlighted that there were likely to be practical difficulties with separating the functions of a bank in this way.

B.4 The Government has brought forward proposals that aim to maintain the continuity of banking wherever possible, through a special resolution regime for banks, and by bringing forward proposals for a specific bank insolvency procedure. Both of these proposals would either maintain continuity of banking, for example, through a bridge bank, or are aimed at ensuring that where continuity of banking cannot be maintained (for example, during insolvency) that depositors are paid out quickly to minimise disruption.

Financial Services Compensation Scheme

B.5 The discussion paper covered several aspects of the FSCS, including:

- FSCS Limits;
- timing of payouts;

- funding the FSCS; and
- consumer awareness.

FSCS Limits **B.6** The discussion paper suggested that the future limits of the FSCS should be considered. Responses suggested that the Government and FSA consider carefully the evidence for increasing the limit, especially in light of the associated costs, while there was also support for higher limits on the grounds of consumer protection and confidence. The FSA has committed to consulting fully on the question of FSCS limits. Chapter 5 also includes some discussion of the issues. Comments received on the discussion paper and consultation document will feed into the FSA's forthcoming consultation.

Timing of Payouts **B.7** The discussion paper asked for views on the speed of FSCS payment. There was strong and widespread support for shortening the time that FSCS payments take. It was suggested that technology and access to information could provide a barrier to FSCS payment. Some respondents advocated paying more vulnerable customers first.

B.8 The Government and FSA have set out a series of proposals that would accelerate FSCS payout, with a commitment to make payments within one week of a bank closing, including ensuring that banks are able to provide information to the FSCS to facilitate payment, changes to the eligibility criteria and the use of technology for the claims process.

Funding the FSCS **B.9** The discussion paper sought views on whether the FSCS should be a pre-funded scheme. There was no consensus on this point with respondents making a range of arguments both for and against pre-funding. The Government believes that there is merit in having a further period of consultation on the subject of pre-funding and a risk-based levy. This consultation sets out further analysis of this issue and seeks views as to whether legislation should be brought forward to enable pre-funding of the FSCS. The consultation document also discusses whether or not the FSCS should be available to fund special resolution options.

FSCS and consumer awareness **B.10** The discussion paper sought views on how to improve the information and awareness that consumers have about the FSCS. A range of ideas and views was expressed by respondents, including the need for better publicity within bank branches and on literature that is sent to customers. There was also a view that improving consumer awareness had strong links with ongoing work to improve financial capability. The FSA proposes to consult on several measures aimed at improving consumer awareness. These are set out in Chapter 5.

Domestic and international comparisons

B.11 The discussion paper highlighted schemes both domestically and internationally used to resolve failing or failed companies. These included the UK's special administration schemes for utilities, railways and energy infrastructure and international schemes for resolving failed banks, notably the US Federal Deposit Insurance Corporation and the Canadian equivalent. Respondents had differing views on whether it would be possible to apply international schemes to the UK. There was a recognition that the UK financial banking system differed considerably from that of the US. While respondents felt that there may be useful lessons to be learned, there was some caution about whether international schemes could be imported into a UK framework. The Authorities are proposing a new resolution regime for banks, as set out in Chapter 4 of this consultation document.

C Summary of proposals for reform

Legislation

C.1 The Government proposes primary legislation following the consultation period:

- to ensure that there is no statutory impediment to the FSA obtaining and sharing information that the Bank of England and HM Treasury require for purposes related to financial stability;
- to provide for a new and flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework;
- to remove the requirement for the Bank of England to release weekly returns and will consider other statutory reporting requirements that have the effect of disclosing ELA operations;
- so that the Bank of England has statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and central bank functions;
- to ensure that the realisation of any collateral provided to the Bank of England, in connection with carrying out its responsibilities in relation to financial stability and central bank functions, is fully effective whenever carried out;
- so that funds provided by the Bank of England are exempted from the calculation of the proportion of building societies' funding which arises from wholesale funding;
- to allow building societies to grant floating charges to the Bank of England as security;
- to introduce a special resolution regime for banks;
- to allow the Authorities to direct and accelerate transfers of banking business to a third party;
- to allow the Authorities to take control of all or part of a bank (or of its assets and liabilities) through a 'bridge bank';
- should it become apparent that pre-insolvency resolution is not feasible, or that immediate closure of the bank is appropriate, to introduce a modified insolvency process for banks – a 'bank insolvency procedure' to facilitate fast and orderly payment of depositors' claims under the FSCS;
- to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements;
- to enable the FSA to collect information that the FSCS requires and share this with the FSCS at the first sign of difficulties in a bank;

- so that the FSCS can require and obtain information directly from firms at the earlier of the date a claim is made, or the date when a firm is declared in default;
- to enable depositors to receive compensation without the need for a formal claim to the FSCS;
- to remove the need for claimants to make a formal assignment of their rights to the FSCS in all cases when they receive compensation;
- to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland and to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the UK;
- to ensure that the FSCS has the management flexibility it needs to manage a wide range of claim volumes;
- to formalise the Bank of England's role in the area of financial stability and to give its Court a formal role in overseeing the Bank of England's performance in this area; and
- to amend the provisions governing the size and composition of the Bank of England's Court.

C.2 The Government is also seeking views on the introduction of the following primary legislation:

- to remove the requirement for a bank in receipt of liquidity assistance to put charges over its assets onto a register of its own and to register them at Companies House for assets provided as collateral;
- to allow the Government to take temporary public sector ownership of all or part of a bank as a last resort;
- to give the Authorities the power to appoint an expert, or 'restructuring officer' to carry out the resolution;
- as that all the tools within the special resolution regime should be available to building societies as well as banks;
- to allow the FSCS to contribute to the funding of the special resolution regime;
- to enable the Bank of England to claim compensation from the FSCS where appropriate;
- to introduce provisions on set-off in the new bank insolvency procedure to ensure that making gross payments to eligible depositors will give a fair result for different customers and the FSCS; and
- to introduce an element of pre-funding into the FSCS scheme.

C.3 The Government intends to bring forward secondary legislation:

- to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members.

FSA rules

C.4 The FSA intends to consult following the consultation period on:

- changes to the FSCS limits in all sectors;
- the appropriate coverage for client accounts and similar arrangements; and
- changes to other factors used in the FSCS compensation calculation.

C.5 The FSA intends to consult on new rules over the course of 2008:

- to require banks to be in a position to provide additional evidence to the FSA at short notice that they are meeting threshold conditions on an ongoing and forward-looking basis;
- to come forward with a proposal to make a limited clarification to the guidance in the Disclosure and Transparency rules;
- to require banks to have readily available information on the account balances of FSCS-eligible depositors;
- to simplify the eligibility criteria for FSCS payments;
- on a move to gross payments;
- to remove the need for a formal FSCS claim by consumers;
- as to how consumers can be better informed about the current compensation scheme; and
- on potentially introducing risk-based levies or other ways of bringing behavioural factors into levy calculations.

Operational changes

C.6 The following changes will be taken forward over the course of 2008, and on an ongoing basis:

- the FSA will intensify its work with banks to improve stress testing in light of recent events;
- the Authorities will work with international partners to encourage a stronger consensus on the importance of stress testing, in particular at group level and by multinational banks;
- the Authorities will work to consider whether the stress-testing standards under Basel II are sufficiently robust;
- the Authorities will work with international partners to ensure that liquidity regulation standards are consistently high across banking groups, and encourage more consistent approaches to liquidity regulation;
- the Authorities will work with their international counterparts to ensure that firms' valuation approaches are consistent with the relevant accounting standards and the CRD/Basel II prudent valuation guidance;
- the Authorities will work with their international counterparts to ensure accounting standards require adequate disclosure about the uncertainties

around valuations, their significance for the entity and how these risks are being managed;

- the Authorities will encourage markets to find ways to increase transparency of valuation methodologies and, to the extent appropriate, move towards greater standardisation of methodologies for valuation;
- the Authorities will work with international counterparts in the FSF and the EU to look at the role of CRAs in structured finance. The Authorities will also support the work of the International Organisation of Securities Commission taskforce on CRAs, which has recently been reviewing the applicability of its Code of Conduct for CRAs to structured finance business;
- the Authorities will keep the development of investor practice in relation to structured products under review to determine if further measures are needed to assist markets to achieve an appropriate outcome;
- the Authorities will consider the implications for investors in structured products of the recommendations of the advisory groups established in September 2007 by the US President's Working Group on Financial Markets to improve best practice in the operation of hedge funds and the hedge fund working group in the UK chaired by Sir Andrew Large;
- the Authorities will work with their international partners in the FSF and the EU to identify whether there remain incentives under the CRD/Basel II framework for banks to minimise their regulatory capital requirements by holding assets in SIVs and other funding vehicles, and if so whether this might reduce the total amount of regulatory capital in the financial system below the level that the Authorities consider desirable;
- the Authorities recommend that the IASB consider in particular whether reputational risks are properly taken into account in decisions about consolidation;
- the FSA intends to work with banks to ensure that indirect members of payment systems, ‘agency banks’, have contingency plans in place in the event that their sponsor banks fails;
- the FSA will explore with the financial sector ways for customers to cover amounts above the compensation limits;
- the Authorities will work with banks and appropriate trade bodies to ensure that consumers can open a new account quickly enough to facilitate fast FSCS payments;
- the Department for Work and Pensions and HM Revenue and Customs will introduce contingency plans to ensure that consumers can receive benefits and tax credits in the event of bank failure;
- the Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements;
- the FSA and the Bank of England will consider the scope for greater combined initiatives to develop common understanding, building on, for example, existing cooperation through the Bank of England’s Financial Stability Board;

- the Authorities propose to clarify responsibilities within the Memorandum of Understanding for decisions around providing support to firms – in particular emergency liquidity assistance;
- the Bank of England intends to modernise the arrangements for meetings of the Court;
- the Authorities will work with international counterparts to pursue changes to improve the effectiveness of the FSF;
- the Authorities propose that the IMF considers how to improve further the focus of its financial sector surveillance; and
- the Authorities will continue to work with international counterparts to improve international crisis management arrangements and ensure the UK authorities are well prepared to respond to international financial crises, building on ongoing initiatives in the EU and FSF, and working bilaterally with key partners who share exposures to specific risks.

D LIST OF QUESTIONS FOR CONSULTATION

D.1 The Authorities would welcome responses to the following questions. Not all questions will be relevant to all respondents – please feel free to choose those where you think you are best placed to respond. Please feel free to provide other information, as appropriate.

General

1.1) Please provide detail if you think that any of the proposals in this document:

- are necessary and proportionate;
- raise significant concerns; or
- could be improved?

1.2) To what extent are the proposals in this document mutually reinforcing?

1.3) The proposals in this consultation document, unless specified, are intended to be implement for banks, building societies and other deposit-taking firms. Please provide details where this is not appropriate.

Chapter 2

2.1) Do you agree with the actions being taken by the Authorities in the UK to improve stress testing by banks?

2.2) Have the Authorities correctly identified the issues on which international work on stress testing and risk management should focus?

2.3) Have the Authorities correctly identified the issues on which the work on liquidity regulation should focus?

2.4) Do you agree with the actions being taken by the Authorities to encourage full and consistent valuation and disclosure by banks?

2.5) Have the Authorities correctly identified the issues on which international work on accounting and valuation of structured products should focus?

2.6) Have the authorities correctly identified the issues on which international work on credit rating agencies should focus?

2.7) Do you agree with the Authorities' proposals to improve the information content of credit ratings?

2.8) Do you agree with the Authorities that the preferred approach to restoring confidence in ratings of structured products is through market action and, where appropriate, changes to the IOSCO Code of Conduct on Credit Rating Agencies?

2.9) Have the Authorities correctly identified the issues on which international work on banks' exposures to off-balance sheet vehicles should focus?

Chapter 3

3.1) To what extent do the FSA's range of existing powers reduce the likelihood of failure of a bank, and under what circumstances would they not be effective?

3.2) Are the FSA's existing powers, and in particular the application of them, clear, and how could they be further clarified?

3.3) To what extent are the annual and one-off costs of the new information requirement on banks proportionate? Can they be quantified?

3.4) How effective would the new information requirement be in identifying and addressing a sudden deterioration in a bank's financial soundness?

3.5) Are there circumstances in which it would not be appropriate for the FSA to collect and share the information that the Bank of England or HM Treasury require?

3.6) Do you agree with the proposal for a new and flexible regime for payment systems oversight and, if so, how should its scope be defined?

3.7) Which elements of such a payment systems regime should be effected through statutory powers?

3.8) To what extent is the current provision to register charges at Companies House relevant to banks? Do you agree that it is appropriate to amend it?

3.9) Should any exemption for banks only apply to receipt of ELA, or should there be a more general exemption for all types of lending?

3.10) Would extending the 21-day period be a viable, alternative proposition?

3.11) What would be the effect of removing the 'weekly return' reporting requirement? What other statutory reporting requirements disclose ELA?

3.12) Do you agree that the Bank of England should be provided with statutory immunity for any acts or omissions which relate to its role in providing financial stability and central banking functions?

3.13) Do you agree that it is appropriate for the Bank of England to be able to rely upon its security in all such circumstances?

3.14) Do you agree that funds provided by the Bank of England should be exempted from calculation of building societies' wholesale funding?

3.15) What risks are there to building societies granting floating charges over their assets to the Bank of England?

Chapter 4

4.1) Do you agree there should be a special resolution regime for banks?

4.2) Do you agree that the trigger for a bank entering a special resolution regime should be based on a regulatory judgement exercised by the FSA in close consultation with the Bank of England and HM Treasury?

4.3) Do you agree that the trigger should be linked to regulatory guidance material?

4.4) Do you agree with the special resolution regime process as outlined?

4.5) Do you agree that the potential abridgement of property rights in the special resolution regime can, in principle, be justified with a suitable public interest test?

4.6) What safeguards and appeal processes would be needed to support a public interest test for the special resolution regime?

4.7) Do you agree that the Authorities should have the power to direct a sale of a bank possibly against the wishes of the directors or shareholders?

4.8) Is judicial review the correct mechanism for challenging a decision to institute the directed transfer?

4.9) Is the Financial Services Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?

4.10) Do you agree that, in tightly defined circumstances, the Authorities should be able to take control of a failing bank through effecting a transfer of some or all of its assets and liabilities to a bridge bank? Do you agree that that some flexibility in the description of these circumstances is also desirable?

4.11) Do you agree with the removal of shareholders' and directors' rights and temporary suspension of creditors' rights under this bridge bank proposal?

4.12) Is judicial review the correct mechanism for challenging a decision to transfer to a bridge bank?

4.13) Is the Financial Services Tribunal the right forum for resolution of transactional issues such as valuation or distribution of proceeds among stakeholders?

4.14) Should a new bank insolvency procedure be introduced for banks and building societies as an option for the Authorities instead of normal insolvency procedures?

4.15) Do you think that there ought to be provision in the bank insolvency procedure for continued trading of some of the bank's business in the interests of depositors or other creditors? If so, how do you think this might work?

4.16) Should the objectives of a bank liquidator be limited to assisting a rapid FSCS payout to eligible depositors and then winding up the affairs of a failed bank? Should the proceedings have any other statutory objectives?

4.17) Should a bank insolvency procedure be subject to the overall supervision of the Authorities?

4.18) Should a bank insolvency procedure be a stand-alone regime in which the bank liquidator has the combined powers of an administrator and liquidator? Are any other powers required?

4.19) Should the FSCS cover any additional costs that a new bank insolvency procedure may incur?

4.20) Should further consideration be given to the introduction of depositor preference?

4.21) Do you agree that commencement into insolvency should be controlled by the Authorities, for example through requiring 14 days prior notice be given to the FSA? Should normal insolvency proceedings be retained alongside the bank insolvency procedure?

4.22) What should the governance arrangements for the SRR be?

4.23) Do you consider that introducing the office of the restructuring officer as part of the SRR would be a helpful and necessary development?

4.24) Do you have any comments on the specific implications for shareholders, creditors or directors from the appointment of the restructuring officer over and above those already raised by the other resolution tools?

4.25) Should the Government have the power to take temporary ownership of a failing bank, in order to facilitate a more orderly resolution? Under what circumstances would it be appropriate for this power to be exercised?

4.26) Do you agree that the special resolution regime should be extended to building societies but not other mutuals?

4.27) Do you agree with the proposals for a new accelerated directed transfer procedure for building societies, similar to that proposed for banks?

4.28) Do you believe a form of temporary public sector control through a bridge bank should be provided for building societies?

4.29) Do you agree that a building society insolvency procedure should exist for building societies alongside a similar model for banks?

4.30) Do you agree that the Treasury should make an Order under the 2007 Act to ensure that, on the winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and members?

4.31) Should the industry contribute to the costs of an SRR?

4.32) Would mechanisms other than the FSCS be appropriate for addressing such cost issues? How might such mechanisms work?

4.33) Are there any other mechanisms available to secure access to payment systems for agency banks in the event of a settlement bank failure?

4.34) Are there contingency measures that banks could adopt to ensure that their organisation and structure are compatible with the tools proposed in the special resolution regime

4.35) Do you agree that the Government should take a power to enable it to make secondary legislation in relation to financial collateral arrangements, and with the proposed definitional scope? If not, why, and what would you suggest?

4.36) Do you have any suggestions as to future revisions to the financial collateral regime that should be considered?

Chapter 5

5.1) How would a higher compensation limit affect consumer confidence?

5.2) How would a higher compensation limit affect the responsibility consumers have for their financial choices?

5.3) How would a higher compensation limit for deposits affect consumer perception of other financial products?

5.4) Which of the solutions to cover balances above the compensation limit is the most practical, desirable and/or proportionate, and why?

5.5) What types of large balance should be subject to additional protection, and in what circumstances?

5.6) Are there other circumstances, apart from client accounts, where consumers have little influence on where accounts are opened? What are your views on how the issue of client accounts might be addressed in relation to compensation payments?

5.7) What are your views on a one-week target for FSCS payment?

5.8) How feasible would be it for banks to provide instant access to the funds provided by FSCS cheques as soon as they are deposited?

5.9) Are there other means to ensure consumers have access to funds within one week, including alternative payment methods to cheques?

5.10) How effective would interim payments be in mitigating consumer detriment when a full payout is not possible within a week?

5.11) How quickly could banks make the changes to have the necessary information readily available on account balances of FSCS-eligible depositors, and what would be the cost to them?

5.12) Should banks follow a common data standard or format, and, if so, what would this entail?

5.13) What information should be included in a single customer view and what would be the implications for firms of different information requirements?

5.14) How would banks place a ‘flag’ on accounts that are not eligible for FSCS payments?

5.15) Are there other classes of depositor that should be ineligible for FSCS compensation payments, and, if so, why?

5.16) To what extent would gross payments help maintain depositor confidence and speed up payment?

5.17) To what extent are gross payments justified by maintaining depositors’ access to liquidity as well as by accelerating payments by the FSCS?

5.18) What are your views on the link between FSCS gross payment and set-off?

5.19) Are any other measures necessary to better align FSCS rules and the provisions of the proposed bank insolvency procedure?

5.20) What are your views on the removal of the formal claims process? What risks would be involved in the FSCS automatically sending out cheques and how can they be mitigated?

5.21) What are your views on the introduction of an element of pre-funding into the FSCS?

5.22) What steps would need to be taken to ensure that pre-funding would be compatible with other elements of the FSCS funding arrangements?

5.23) What are your views on whether the FSCS should be permitted to borrow from the Government or the Bank of England?

5.24) How soon could streamlined procedures for opening accounts be introduced so that the one-week target for opening a new account can be met?

5.25) Are there additional risks which need to be considered with this faster account opening method?

5.26) How else could the account opening process be sped up?

5.27) What else would be needed to enable banks to provide instant access to funds following the deposit of a FSCS compensation payment?

5.28) What notification requirements on compensation should apply to banks, and how can they be made less burdensome? Would these have an effect on market stability or depositor confidence?

5.29) How should disclosure requirements be imposed?

5.30) What would be the best way for DWP and HMRC to make payments in the event that consumers did not have access to their bank accounts?

5.31) What are your views on the proposed changes to increase FSCS management flexibility?

5.32) Are there other possible changes which could increase management flexibility for the FSCS or enable it to process a large volume of claims quickly in the most cost-effective way?

5.33) What are your views on the use of risk-based levies or on the introduction of behavioural factors into the calculation of the levies?

Chapter 6

6.1) What are the benefits of formalising in statute the Bank of England's role in the area of financial stability, and giving its Court responsibility for overseeing its performance in this area?

6.2) To what extent would the proposals improve the ability of the Court of the Bank of England to oversee the Bank of England's performance including its enhanced role in the area of financial stability?

Chapter 7

7.1) To what extent will the proposals enable an improved handling of a financial crisis?

7.2) To what extent would the proposals strengthen the operation of the IMF and FSF?

7.3) To what extent would the proposal for the IMF and FSF to work together to develop an early warning system be helpful in improving risk identification and financial sector resilience at the international level? How would this best be implemented?

7.4) To what extent will these proposals aid authorities in managing international financial crises?

Impact assessment

A.1) Do you have information that would improve the analysis of this impact assessment?

A.2) Do you believe that the impact on building societies of the tools within the special resolution regime is different to that on other banks?

A.3) Do you agree that small businesses would not be affected by these proposals in a different way to other consumers?

E How to respond

E.1 This consultation document is available on the HM Treasury website at www.hm-treasury.gov.uk. For hard copies, please use the contact details below.

E.2 The Authorities invite responses to the issues raised and the proposals in this consultation document. **Responses are requested by 23 April 2008**, during which time the Authorities will engage with relevant stakeholders.

E.3 Please ensure that responses to the consultation document are sent in before the closing date. The Authorities cannot guarantee to consider responses that arrive after that date.

E.4 Responses should be sent by email to:

banking.reform@hm-treasury.gov.uk

E.5 Alternatively, they could be posted to:

Banking Reform consultation responses
Banking Reform Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

E.6 When responding, please state whether you are responding as an individual or o behalf of an organisation.

Confidentiality

E.7 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain why you regard the information that you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances.

E.8 In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless and explicit request for confidentiality is made in the body of the response.

Code of practice for written consultation

E.9 This consultation process is being conducted in line with the Code of Practice for written consultation (www.cabinetoffice.gov.uk/regulation/code.htm) which sets down the following criteria:

- consult widely throughout the process, allowing a minimum of 12 weeks for written consultation during the development of the policy;
- be clear about what the proposals are, who may be affected, what questions are being asked, and the timescale for responses;
- ensure the consultation is clear, concise and widely accessible;
- give feedback regarding the responses received and how the consultation process influenced the policy;
- monitor the department's effectiveness at consultation, including through the use of a designated consultation coordinator; and
- ensure the consultation follows better regulation best practice, including carrying out an Impact Assessment if appropriate.

E.10 If you feel that this consultation does not fulfil these criteria, please contact:

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