

Banking Reform Discussion Responses  
Banking Reform Team  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

4 December 2007

**Banking Reform – Protecting Depositors: response to the discussion paper**

Dear Sirs

The City of London Law Society ("CLLS") represents approximately 12,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to Government consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS Financial Law Committee, made of solicitors who are experts in their field, have prepared the comments below in response to the Treasury's Banking Reform – protecting depositors discussion paper.

The members of the working party comprise:

Dorothy Livingston, Herbert Smith LLP  
David Ereira, Linklaters  
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The discussion paper seeks responses on questions in two areas: the financial services compensation scheme and with regard to critical banking functions (including how they may be preserved in the event of an insolvency affecting a deposit taking institution). A number of these questions (e.g. the precise definition of critical banking functions) are best answered by experts in retail banking and we do not deal with those questions in any detail in our response. The Members of the Financial Law Committee that has drawn up this response are regular advisers on banking

transactions in the wholesale market and on issues related to banking regulation and the insolvency of financial institutions. They have drawn on their expertise in those fields.

As solicitors practising in the City of London, all Members of the CLLS are concerned for a healthy and respected banking system at retail and wholesale level. Our comments reflect that concern. We wholeheartedly endorse the Government's overall objectives for the financial system of stability, competitiveness and consumer confidence stated at paragraph 1.12 of the discussion paper. We welcome the early publication of the discussion paper and the open debate which it invites.

The key questions for the consultation appear in Appendix B. We state each question with our response.

### **2.1 Do you agree that these are the right objectives? Are any of these objectives more important than others?**

We think that this is intended to be a reference to the objectives listed in paragraph 2.10 dealing specifically with reforms aimed at giving depositors the confidence that is a necessary underpinning to financial stability, rather than the wider policy objectives stated at 1.12. The objectives for any reform are stated to be:

- *it must be well understood by retail depositors, with consumers confident that they are protected by an appropriate, credible and reliable guarantee that can operate in a timely fashion;*
- *it must maintain wider market confidence with full transparency about the framework (including its funding) that would operate in the case of disruption to banking services; and*
- *it must preserve the critical banking services appropriate to retail, business and wholesale customers of a bank for such time as is necessary to effect an orderly transition to an alternative banking provider; while*
- *it must maintain the UK's reputation as the pre-eminent location for financial services; and*
- *it must protect the taxpayer interest and ensure an appropriate sharing of costs between all parties.*

Broadly we agree with those objectives. It seems to us that any reform which is to achieve the wider policy objectives must also achieve the objectives listed. Above all, the reforms as a whole must achieve market confidence at all levels that an orderly transition of services can be achieved in a short timescale and will be effectively funded.

We note that the discussion paper considers only some areas where reform is possible: namely the Financial Services Compensation Scheme ("FSCS") for depositors and the possibility of a separate insolvency scheme for financial institutions aimed at preserving critical banking functions. We believe that reforms confined to these areas are unlikely to completely address the stated objectives at 2.10. We believe that it will be necessary also to address the pre-insolvency regulatory regime: in particular the triggers for effective intervention. It is also necessary to address how funding can be safeguarded (given the interaction with European Community law) and the fact that the FSCS is an "ex post" scheme with no long term invested funds.

## **2.2 What other issues should the Government consider when reviewing the framework for depositor protection?**

We have indicated other areas for examination in answer to question 1. The framework for review should, however, in our view be wider than depositor protection and include systemic protection. By looking back to the cause of the current problems, a more robust "early stage" review process might be developed which could limit the circumstances where there is need to fund the pay-out of retail deposits and/or reduce the exposure in the process for doing so.

Important systemic issues seem to us to include:

- resolving the relative positions of the Bank of England and the European Central Bank. The latter is not regarded a State for the purposes of the State aid rules in the EU Treaty, and is free to take appropriate immediate action to protect financial stability, including making loans to specific financial institutions. The Bank of England needs a similar economic freedom in relation to the Sterling zone: the UK Government should consider with its European partners how this is best safeguarded.
- considering how monitoring of individual financial institutions and of the overall financial situation can best be integrated so as to facilitate decision making processes which identify and take action at a point before consumer concerns become manifest. These functions are currently split between the FSA and the Bank of England.
- arriving at clear Treasury guidelines to the extent that the Treasury has powers of intervention in relation to particular potential support/transfer operations.

All in all, the drawing up of a clear blueprint for identifying and dealing with this type of systemic risk as well as "one off" failure (e.g. BCCI) would be reassuring to the markets. That framework would both provide a "road-map" for the future and a framework within which to test (without waiting for a "natural experiment" to emerge) the robustness of measures put in place or contemplated to address the concerns raised by recent events.

This framework would look to a rather longer timeframe and enable more robust reforms. In the context of immediate action, initial improvements with regard to FSCS seem practicable and potentially worthwhile, but the question of whether a separate insolvency or other approach to handling the preservation of critical banking functions would be appropriate is more complex and requires thorough examination of the issues and also interaction with EU laws governing the regulation and insolvency of credit institutions. We believe that this study will take longer and require wider consultation – we think it unlikely that there is a "quick fix" within the confines of a special administration process. Further, initial action on FSCS may need to be revisited when the overall examination of issues is more developed.

## **2.3 What other issues should the Government consider when reviewing the framework for depositor protection?**

In relation to depositor protection, we consider that speed of response is vital to user confidence (and not only for individual consumers, but for business users and financial trading partners). The extent to which prompt action can be funded by State or industry financed resources (or a combination thereof) is important not only in the operation of a deposit protection scheme such as

FSCS, but in relation to any measures for the transfer of the critical banking functions to another institution (including a "bridge bank") as a means of preserving consumer confidence.

**3.1 Should the level of coverage be increased from £35,000? If so, to what level and what are the benefits and costs of doing so? Should the bank deposit limits be related to those for other sectors, e.g. investment business and insurance?**

This is not our area of expertise, but common sense suggests that the level should be high enough to cover the majority of individual consumer deposits in savings and current accounts and should not give an incentive to withdraw (as the previous 90% guarantee in the scheme did). Indexation might help to preserve the value of the scheme in the public mind.

Of course these figures are of little comfort to most commercial users, which emphasises the importance of speedy transfer schemes for institutions whose counterparties are not largely individuals.

Improvements to the law on financial collateral, which we have discussed with the Treasury previously, could also be useful to assist smooth operation of the markets.

**3.2 Would it be desirable to put in place arrangements to better ensure that depositors are repaid in a more timely fashion? What issues would need to be considered in assessing any new arrangements?**

The European Directive on Deposit Protection Schemes requires that payout should be within a minimum of 3 months. However, even if this period were to be met, there would be significant advantages for a customer to withdraw funds while he/she can still do so and it would therefore be desirable to better ensure that depositors are repaid in a more timely fashion, using the records of the institution concerned, rather than relying on claims being made.

This need for speed also argues in favour of a scheme which has some form of pre-funding, rather than relying on identification of claims and then collection of funds from contributors. Whether that pre-funding comes from public or private resources or a mixture of the two is a policy issue.

Again the linking of public confidence with speed of response emphasises the importance of pre-identification of problems with a view to taking action which minimises calls on the scheme, especially in as in the recent (unusual) case where problems may relate to liquidity, not the balance sheet.

**3.3 What are the issues the Government should consider in relation to other parts of the FSCS?**

We have nothing to add to the response to 3.2.

**3.4 What issues should the Government take into account in any further review of the funding mechanisms for the FSCS?**

See our response to 3.2.

**3.5 Should the role of the FSCS be extended to promote access to banking services for depositors with failed banks?**

This is outside our field, but there are a large number of banks offering banking facilities and consumers should be able to make arrangements if they are to receive a payment from the FSCS. The critical need for consumers, business customers and other counterparties is at the point of failure, if that will deny them access to their funds for a time or permanently reduce their assets.

Steps to ringfence payments for customers received by the failed institution after failure and to ensure their speedy release to customers would be valuable as would the early transfer of any viable business to a solvent institution. We think this is probably a separate exercise from the operation of a deposit protection scheme: not least because the scheme is required under European law to be open to all credit institutions operation in the UK, whereas regulatory intervention and UK insolvency law can only be applied to credit institutions for which the UK provides the "home regulator".

### **3.6 The Government would be interested in views on the best way to help consumers understand how banking guarantee schemes affect them?**

This is outside our field: education from school age and clear advertising campaigns will play their part. We believe in the USA depositors are educated to spread risk between different institutions, which would address the inadequacy of limits for some consumers.

### **3.7 Do you agree with the concept of critical banking functions? If so, what banking services might be properly regarded as so critical to the modern economy that they should continue to be provided in the event of a bank failure?**

This is outside our competence to discuss in detail, but we note that the issues are unlikely to be wholly confined to services provided to individual consumers maintaining accounts largely in credit: current account services and overdraft facilities, as well as more specialised services (e.g. letters of credit, term and revolving credit facilities) are likely to be vital for many businesses and their employees to weather any disruption of their banking services. A deposit protection scheme does not address those concerns, but prudential arrangements leading to a quick transfer of viable business would be of value.

### **3.8 For what period of time should any critical banking functions be maintained and how might this vary in different circumstances?**

We believe this is affected by a number of factors including:

- The timing of intervention.
- What arrangements are used to provide these functions.
- Whether the potential intervention is because of a "one off" failure or is caused by systemic disturbances which might affect other institutions.
- The way in which the intervention is funded.
- Whether there are any restrictions on what the consumer can access immediately.
- Any applicable considerations of European Community law: for example sectoral aid to a business in distress is limited to 6 months for a rescue phase and may only be extended if a reconstruction plan is in put in place; the rules relating to the winding up of credit

institutions will limit the ability of UK authorities to take action (other than through a deposit protection scheme) in the event of an event affecting a credit institution whose home regulator is in another State.

In most cases we would have thought that a solution could be achieved within 6 months to 1 year, once a formal intervention has occurred.

### **3.9 What issues should the Government consider in assessing possible arrangements, in addition to the FSCS already available, to deliver continuity of any critical banking functions in the event of failure?**

As we understand the FSCS, it does not provide any continuity of banking arrangements and it is difficult to see how it could do so without major restructuring. There would need to be arrangements whereby the FSCS could put in management to an affected institution and funding would need to be in place up front. Any form of insolvency process is likely to affect the ability of the institution to have funds that would enable it to continue to perform as a going concern. The FSCS appears limited to providing ex post compensation: we believe the aim in relation to that would be to make compensation speedy.

One difficult legal issue that arises in early payout is whether set-off should be allowed – for those with claims above the scheme limit or not qualifying who also owe money to the institution (personal loan, mortgage) set-off may be more advantageous overall financially than repayment of a deposit. We believe that consideration needs to be given as to whether to exclude set off (even where it might be mandatory under current insolvency rules) or to require claimants to elect either to claim or take the advantage of set-off, but not both. Compatibility with the rules on netting in the Financial Collateral Directive will also need to be considered.

It seems to us that the question of keeping critical banking functions going, as in recent events, would have to be handled separately from entitlement under the FSCS, although the right of funding parties to stand in the shoes of depositors vis-à-vis the FSCS should be provided for.

In that context, the consideration for intervention points, whether they are regulatory or insolvency linked and the form of support for continued trading would need careful examination. As mentioned in response to questions 2.1 and 3.5, we believe that the different EU regulatory frameworks for deposit protection schemes and for the regulation of credit institutions and the management of the insolvency of a credit institution requires that other intervention measures need to be considered and dealt with independently of the operation of the FSCS as a deposit protection scheme, apart from the recognition that in certain circumstances another funder could stand in the shoes of the individual depositors to make claims on FSCS.

### **3.10 What, if any, lessons can the Government learn from other sectors and other economies? For example from special administration regimes and pre-funded insurance type schemes such as the Federal Deposit Insurance Corporation in the United States?**

We do not consider that the UK special administration regimes are necessarily appropriate models for credit institutions. The creation of an administration would add to the difficulties of an institution suffering from cash flow difficulties only, since it would create wholesale cross defaults on all or the preponderance of its third party funding (triggering immediate demands for repayment). This would add to the cost of funding the continuation of banking operation, (which essentially involve borrowing and lending money) especially the repayment of deposits. While the moratorium aspect of an administration brings relief for trading and service businesses, it is

difficult to see how a banking business (including both good and bad aspects) can be continued on a basis that is fair to creditors, unless confined to a limited class of preferential creditors (e.g. individual depositors).

Whether there are any pre-insolvency steps that could be taken to transfer viable business out of an institution (e.g. to a bridge bank which would be put up for sale) is worthy of serious consideration. This would require considerable adjustment to insolvency law (e.g. to make such a transfer unimpeachable in a following liquidation and immune from an ordinary administration). It would also require careful consideration of the rights of shareholders. Again how this might be funded would require consideration, as well as whether this would be a national scheme for UK regulated institutions, or should be implemented on a pan-European basis. State aid treatment of Government funding or how it would obtain industry funding in whole or in part would need consideration separately from the funding of the depositor protection scheme, as its scope would be different.

Yet further back, before troubles arise, consideration could be given to the prudential tests applied to credit institutions, in particular in the context of assuring liquidity. This is a financial and economic question and could have wider impacts, so it would require very careful study. However, if safeguards were improved, then the need for intervention might be reduced or made less costly.

### **3.11 How do the needs of different groups of customers differ? How should the Government take account of this in the new framework?**

We have commented on the different needs of business customers at 3.7. Financial counterparties after an event of default will be concerned about access to assets over which they hold security as envisaged in the Financial Collateral Directive and, while this may be important to protect the integrity of the financial systems (clearing, stock trading and lending etc), this reduces the assets available to fund the continuing operations of the troubled institution. The use of pre-insolvency measures to ring-fence viable business may reconcile different needs, but would require very careful planning.

If you have any queries on this paper, please contact the Chair of the Financial Law Committee, Dorothy Livingston at Herbert Smith LLP on 020 7374 8000 or [dorothy.Livingston@herbertsmith.com](mailto:dorothy.Livingston@herbertsmith.com)

Yours faithfully

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