THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

12 September 2008

Our ref: ICAEW Rep 98/08

Your ref:

Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

By email: banking.reform@hm-treasury.gov.uk

Dear Sirs

CONSULTATION PAPER FINANCIAL STABILITY AND DEPOSITOR PROTECTION: SPECIAL RESOLUTION REGIME

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on *Financial Stability and Depositor Protection: special resolution regime.*

The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

Please contact Iain Coke, Head of the Financial Services Faculty or myself, should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 98/08

CONSULTATION PAPER FINANCIAL STABILITY AND DEPOSITOR PROTECTION: SPECIAL RESOLUTION REGIME

Memorandum of comment submitted in September 2008 by The Institute of Chartered Accountants in England and Wales in response to the Tripartite Authorities Consultation Paper *Financial Stability and Depositor Protection: special resolution regime*

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the Discussion Paper *Financial Stability and Depositor Protection: special resolution regime*

WHO WE ARE

2. The ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

1. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

4. The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators

MAJOR POINTS

5. We welcome the FSA's latest proposals for financial stability and depositor protection published on 1 July 2008 which give additional technical detail that we and other stakeholders have sought in relation to the special resolution regime (SRR).

6. We believe the consultation paper is a thought-provoking document which attempts to resolve the legal and practical issues that surround the concept of the special resolution regime in a constructive manner. We would emphasize that it is essential that invoking the SRR is seen very much as a last resort when all other options to deal with a failing bank have been unsuccessful.

7. We support the objectives of the SRR and are comfortable with the division of responsibility between the various Tripartite Authorities. It is entirely appropriate that the FSA should be the body to determine whether the conditions for entering the SRR have been met and, therefore, inappropriate for the FSA to be required to deal with the consequences of regulatory failure. We are comfortable, therefore, that the Bank of England should be responsible for implementing the SRR. It is also clear that the treasury must be responsible for decisions concerning public finances such as if there is a need for temporary public ownership,

8. In our response to the January consultation dated January 2008 we expressed our concerns as to how the SRR would work in conjunction with existing insolvency legislation and we appreciate that considerable efforts have been made within this document to address these concerns. We do however have significant concerns in relation to the measures relating to partial transfers, security interests, changing of contractual rights, property rights and netting. We believe that these provisions as drafted still have the potential to damage the UK's competitiveness and make London a less attractive location for doing business. We are pleased to note however, that the consultation paper does confirm that as a matter of principle the SRR should seek to maintain the priority and ranking of existing classes of creditors under existing insolvency law.

9. We are concerned that the proposals as drafted particularly those in relation to qualifying contracts have the potential to reduce innovation within the marketplace and, therefore, indirectly increase the cost of funding to the banks and consumers.

10. We also believe that the concept of nullifying group contracts and introducing obligations on group companies raise a considerable number of issues and would be worthy of its own consultation process. This proposal is neither necessary nor desirable and could potentially result in far- reaching commercial changes in terms of where firms decide to do business in the future.

11. We also note with some surprise the proposal that the Financial Services Compensation Scheme can be called upon to contribute to costs arising from the use of the SRR resolution tools. The FSCS exists to ensure that depositors are repaid up to the statutory limits as well as providing compensation for investment services customers of bank. In our view the current proposal is outside its current scope and it is unclear as to why the Tripartite Authorities believe that such a course of action is appropriate.

SPECIFIC QUESTIONS

12. Our answers to the specific questions raised by the FSA are set out below.

SRR objectives, roles and governance

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

We agree with the objectives set out in clause 4.

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

We believe that the FSA is the most appropriate body for making the decision as to whether or not a firm will enter the SRR.

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

We agree with the conditions for entering the SRR as set out in draft clause 7.

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

We believe the Bank of England is the most appropriate body to operate the SRR in the public interest as set out in draft clause 8. It should determine both which SRR tool to use and how to implement it.

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

We agree with the role of the Treasury as specified in the draft clauses.

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

In principle we agree that the SRR objectives should be supplemented by a code of practice.

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

Although we agree that there is a need for the SRR objectives to be supplemented by a code of practice we are conscious that this should be at a high level stipulating the principles that would be applied to a given set of circumstances. It is important to ensure that as far as possible the code of conduct is not so prescriptive that it in effect ties any one of the three Tripartite Authorities to following a course of action that they do not believe is appropriate in the given circumstances. We believe that this is particularly important in relation to the choice of which SRR tool to use given the different business models, legal structures and risk profiles of the range of businesses that could potentially be impacted by this Consultation Paper.

SRR tools: stabilisation powers and compensation

Question:3.1) What are your views on the breadth of the property transfer powers in clauses 14 to23? Are there particular powers that are lacking?

We are concerned by the breadth of the property powers we believe that it is essential that these are narrowly drawn so as to keep changes to existing legislation to a minimum. We are concerned that such wide powers have the potential indirectly to disrupt creditors rights, increase the cost of funding between banks, cost of borrowing for UK companies and, therefore, ultimately may well increase costs to consumers.

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

We do not believe that this is an appropriate question for the ICAEW to respond to and believe that this question should be addressed to insolvency practitioners.

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

We agree with this approach and believe that it is the simplest solution.

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

We do not believe that it is appropriate to limit the lifespan of a bridge bank to a fixed time period and can see no good reason for doing so. We believe that a reasonableness test should be applied as this will enable account to be taken of the nature of the business involved and the current economic outlook and global markets.

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

Please see response to Question 3.4 above.

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

We remain particularly concerned in terms of partial transfers. We agree that in certain circumstances they increase the chances of success in terms of both the operation and sale of a bridge bank and the chances of a private sector purchase. Nonetheless we remain concerned that this possibility will increase the cost of funding between banks, cost of borrowing for UK companies and, therefore, ultimately may well increase costs to consumers.

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

If the Authorities continue to intend to proceed with partial transfers despite the reservations expressed by many stakeholders in the responses to the January Discussion Paper, we would agree that it would be helpful to include partial transfers in the statutory guidelines.

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

These guidelines would provide some reassurance but only to a very limited extent.

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

Overall for the reasons given in the answer to Question 3.6 we do not believe that these partial powers should be exercised because of the potentially severe adverse consequences on the market as a whole. If it is decided that there should be such powers we believe that they should only be exercised where there is demonstrable consideration to the residual bank in terms of the

value which it will receive, even if the benefit to the residual bank is only a payment from the FSCS.

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

If the Authorities were to proceed with partial transfers despite the risk to the competitiveness of the UK marketplace, then it would be important for the Authorities to have a degree of flexibility.

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

We believe that the Bank of England should have the flexibility to make subsequent transfers between a bridge bank and a residual company provided that there is a demonstrable potential long-term benefit to the residual company.

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

We believe that the Bank of England should have the flexibility to make subsequent transfers between a bridge bank and a residual company provided that there is a demonstrable potential long term benefit to the residual company.

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

We believe that the Bank of England should only make subsequent transfers between a bridge bank and a residual company provided that there is a demonstrable potential long-term benefit to the residual company. In this context it should not be possible to move liabilities from the bridge bank to the residual company.

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

We believe that the bank resolution fund is an appropriate means for compensating creditors left in the residual company.

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

We believe that it is essential to preserve the current set-off and netting arrangements that have served well over many years.

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

We do not agree with the risks as defined in the consultation paper. We believe that it is extremely important that the integrity of set-off and netting prevails. If in practice this restricts the Bank of England's flexibility in certain situations that consequence needs to be accepted in the light of the serious potential risks of following alternative courses of action in terms of the UK marketplace.

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

We are not in favour of this approach and believe that it is likely to restrict innovation within the financial market place.

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

We refer you to our response to Question 3.15.

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

We believe that it is essential that the bilateral netting agreements entered into as a consequence of a structured finance deal are held to be enforceable to the same extent as they are today in an insolvency situation.

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

We recommend strongly that you do not change the current insolvency legislation any more than is absolutely necessary. Our current legislation has proved to be effective in several scenarios such as BCCI, and a series of smaller bank failures. In addition the current legislation has the advantage of clarity in that all parties are clear as to what their various rights and remedies are. The value placed by the commercial marketplace on certainty should not be underestimated. We believe that the SRR could be made to preserve the rights of creditors. It would be possible for example to allow transfers .to the bridge bank of assets, and senior liabilities, leaving junior liabilities in the residual bank. Any profits/sale proceeds of the bridge bank should then be paid over to the residual bank to pay off the junior creditors.

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

We agree that a safeguard to protect all security interests is likely to make a partial transfer more difficult. We believe though that it is essential for the commercial marketplace that the status quo is not disturbed and security interests are protected to the same level that they are currently.

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

We refer you to the answer in response to Question:3.21 above.

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

We believe that a special bank administration procedure would be required to deal with the residual company.

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

We believe that this procedure should also be applied if a partial transfer is effected to a private institution.

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

We believe that the special bank administration procedure should have specific objectives.

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

We agree with the objectives and agree that the objective of supporting the bridge bank must take priority.

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

We believe that the grounds for commencing or applying for special bank administration should be linked to the partial transfer of assets and liabilities to a bridge bank.

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

We do not believe that any other grounds should be included in the legislation.

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

The special bank administration procedure should be initiated automatically by the direct appointment of a special bank administrator by the Bank of England.

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

The special bank administrator should be subject to the overall direction by the Bank of England, with the court providing some level of oversight as well as ruling on any disputes arising in the resolution.

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

In principle we agree that transparency is a legitimate regulatory tool and that it is necessary for a structured framework to be provided. Most importantly, we believe that it is essential for all parties to ensure that data is only utilised in appropriate circumstances.

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

We believe that these powers should mirror the existing insolvency legislation.

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

We believe that these powers should mirror the existing insolvency legislation exactly and that no additional powers to this would be necessary.

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

We agree. This needs to be very carefully defined as in practice it means that in effect the Bank of England is taking over the role of the creditors' committee. There would though need to be further clarity around the role of the Bank of England in this context.

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

The Bank of England should be responsible for considering and agreeing to with or without modification, the special bank administrator's proposals.

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

We believe that the Bank of England should fulfil the functions of a creditors' committee.

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

The rights of creditors should be amended but only to the extent absolutely necessary so as to ensure that the objectives of the special bank administration procedure can be met.

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

We believe that there should not be any change to the ordinary statutory code of priority of creditors in the special bank administration procedure and believe that some of the other proposals which indirectly achieve this should be modified so as to ensure that this is not the case. We do not believe that depositors should receive preferential status. There is no need for this in that they are already adequately provided for by the depositors compensation scheme.

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

We believe that it is essential for any changes to the existing legislation to be kept to an absolute minimum and that the current legislation should be mirrored as far as possible.

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

We agree.

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

We agree that it is essential for flexibility to be maintained .given the different business models, legal structures and risk profiles of the range of businesses that could potentially be impacted by this Consultation Paper.

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

We agree.

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

We agree.

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

We believe that if you have a bank resolution fund the use of it should be mandatory both in terms of the bridge bank and in terms of temporary public ownership.

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

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

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

In terms of a purchase by a private sector purchaser a price would normally need to be agreed in advance before the transfer between the purchaser and the Authorities took place. We would recommend that rather than employing an independent valuer the Authorities should ensure that they were entitled contractually to rely on the view of the experts that they would undoubtedly have employed prior to any sale taking place and that such a view provided it was taken in good faith and by at least two independent experts, should not be open to challenge by third parties. This would also have the considerable advantage of certainty from a purchaser's perspective.

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

We see no need for an independent valuer for the reasons described in the answer to Question 3.46 above.

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

We see no need for an independent valuer for the reasons described in the answer to Question 3.46 above and therefore no need for a clause defining principles of valuation. Normal commercial principles should apply.

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

We do not believe that this is appropriate for the reasons detailed in the answer to Question 3.46 above.

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

We would refer you to our response to Question: 3.46.

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

The FSCS exists to ensure that depositors are repaid up to the statutory limits as well as providing compensation for investment services customers of bank. The costs that should be covered by the FSCS under the Authorities proposal are those that relate to the payment of compensation to depositors. All other costs should be borne by the entity within the SRR exactly the same as would happen in the context of the current insolvency legislation. It is not appropriate (as we commented previously) in April 2008 for industry to contribute to the SRR.

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

We do not believe that there are any additional costs of resolution that should be borne by the FSCS. The FSCS exists to ensure that depositors are repaid up to the statutory limits as well as providing compensation for investment services customers of bank It is not appropriate (as we commented previously in April 2008) for industry to contribute to the SRR.

SRR tools: bank insolvency procedure

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

We believe that these provisions should mirror the current insolvency provisions.

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

We believe that these provisions should mirror the current insolvency provisions.

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

We believe that these provisions should mirror the current insolvency provisions.

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

We believe that these provisions should mirror the current insolvency provisions.

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

We agree with the provisions for the end of the bank insolvency procedure.

Building societies and other issues of scope

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

We agree. It is important the SRR arrangements for building societies should mirror that of those for banks.

Question:5.2) Do you agree that the Authorities should have powers to disapply statutory requirements including the principal purpose and lending and funding limits, for the residual element of a building society following a partial transfer?

We agree.

Question:5.3) Do you agree that there should be a special building society administration procedure for building societies in the event that part of a building society's business is transferred to a bridge bank?

We agree.

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

We agree that temporary public ownership would be a useful tool for resolving a failing building society in some circumstances.

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

There would need to be a mandatory demutualisation in this situation. It would be essential given the significant number of small mutual investors that the messaging was managed with considerable care.

Question:5.6) Should a set of principles be established to determine how compensation is distributed between members of building societies? If so, what would be the most appropriate fair and equitable principles?

We believe that a set of principles should be established and that industry and stakeholder groups should be consulted as to what would be fair and equitable.

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

We believe that the risks are far outweighed by the benefits.

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

We do not believe that former members should have a say in how compensation is distributed. We are of the view that, as far as possible, it is important for the provisions to remain analogous to those of banks.

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

We believe that this question raises a considerable number of issues and would be worthy of its own consultation process. This course of action is neither necessary nor desirable and could potentially result in far reaching commercial changes in terms of where firms decide to do business in the future.

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