Financial stability and depositor protection:

further consultation

July 2008

Cm 7436

BANK OF ENGLAND   HM TREASURY   FSA

Financial stability and depositor protection: further consultation

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

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Foreword

Over the past two decades, the financial integration of the world's economies has proceeded rapidly. The increasingly globalised and fast-moving nature of financial markets has brought many benefits to the UK as a financial centre, and to UK consumers, who enjoy access to a world-class range of innovative and secure financial services.

Increased financial globalisation also means that developments in one market can be quickly transmitted to others. The recent sustained period of disruption in global financial markets, starting in summer 2007, has had a widespread impact on firms and markets across the world, as well as in the UK. The consultation document *Financial stability and depositor protection: strengthening the framework* published in January this year, summarised actions being taken by the Treasury, the Financial Services Authority (FSA), and the Bank of England (together, the Authorities), to respond to these challenges, including on how to respond when a bank gets into financial difficulty.

In their January consultation the Authorities set out five key objectives, which have been strongly supported by stakeholders:

- 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 does get 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.

A full summary of the proposals to be taken forward to meet these objectives is provided in chapter 1. The remainder of the document follows up, in detail, on the proposals put forward in January. It explains the Authorities' plans, indicates where proposals have developed in the light of consultation, provides a response to issues that were raised during the consultation, and also seeks further views on a number of key outstanding questions.

The Authorities firmly believe that the UK has the right fundamental arrangements in place for its regime for regulating financial services and maintaining financial stability, and this view was strongly endorsed during the consultation. The principles- and risk-based regulatory regime, with the FSA, as single regulator, at its centre, is widely supported in the UK and has been emulated internationally. It has been tested over recent months and shortcomings in its execution have been identified, and are now being addressed by the FSA. The overall approach, which has served the UK well in the last ten years, will be retained, and strengthened.

The overall framework, with clear roles and responsibilities for the Treasury, the FSA and the Bank of England, and a Standing Committee of the three Authorities to ensure proper communication and coordination between, also remains a key feature at the core of the UK regime – again, strongly supported by respondents to the January consultation, and stakeholders more widely in the financial services sector. The Authorities are now taking forward proposals to strengthen the framework, including by providing additional statutory responsibilities and policy tools to the Bank of England, to ensure that it can fully deliver its financial stability role.

Reforms are also proposed to extend the range of tools available to the Authorities to deal with the very rare situations where a bank failure has become imminent. The proposed special resolution regime, while only for use in exceptional circumstances, will include significant new powers for the Authorities. A further publication, explaining the regime in more detail, and including draft legislative clauses will follow later in July. This will enable the Authorities to consult stakeholders on the detail of how the regime will operate in practice.

Changes are also being proposed to the operation of the UK's deposit compensation scheme – which will require action by the Authorities (including the Financial Services Compensation Scheme), and by the industry – to ensure that consumers understand, and have confidence in, the arrangements that will ensure they are swiftly and adequately compensated should a bank fail.

The Authorities are also taking a lead role in the work being taking forward internationally to improve the resilience of the financial system. Coordinated action by the international community is key to ensuring the global financial system is robust and resilient in future. The UK continues to support, and engage closely with, the work of the Financial Stability Forum in this area.

So the reforms proposed by the Authorities are designed to strengthen and build on the fundamentals of the UK regime and improve different aspects of its execution. The Authorities believe that the proposals put forward in this document will ensure that the UK continues to be well-placed to address current and future challenges facing global financial markets. They will continue to consult actively on these proposals, engaging with all relevant stakeholders, delivering a world-class regime for financial regulation and oversight in the UK.

1 INTRODUCTION AND OVERVIEW

The Financial Services Authority, the Bank of England and the Treasury published a consultation document *Financial stability and depositor protection: strengthening the framework* in January 2008. It set out a number of proposals to address issues raised by the recent period of sustained turbulence in global financial markets, to address five key 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 does get 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.

This chapter:

- provides an update of key events since the January consultation was published;
- summarises the Authorities' plans in relation to proposals set out in the January consultation, and some additional proposals brought forward since then; and
- summarises the recent consultation process and sets out next steps.

1.1 In 1997, the Government proposed a new system of financial regulation in the UK. The Financial Services and Markets Act 2000 (FSMA) created the regime for the single, independent, regulator for UK financial services, the Financial Services Authority (FSA). FSMA provides the FSA with powers to regulate a wide range of financial institutions. This basic framework has been very successful, reducing both regulatory duplication and unnecessary burdens on firms. Market participants cite the quality of the UK's framework for supervision as a key factor behind the ongoing growth of the financial services industry and of the UK as a leading global financial centre. This model of principles-based regulation by a single regulator has been emulated widely around the world.

1.2 Alongside this, the Government has introduced a framework for financial stability, under which a Tripartite Standing Committee of the Treasury, the FSA, and the Bank of England, is responsible for preserving systemic stability. While the increasingly fast-moving and international nature of financial markets has brought many benefits both to customers and to the UK as a financial centre, it also means that developments in one market can be quickly transmitted to others. Nevertheless, the framework for financial regulation and oversight has seen UK financial markets through periods of significant potential instability in the last ten years, including the "dot-com" bubble of 2000, and the aftermath of the events of 11 September 2001.

1.3 The recent sustained period of disruption in global financial markets, starting in the United States in the summer of 2007, has had a widespread impact, and financial firms and markets across the world, including in the UK, have been affected. The consultation document *Financial stability and depositor protection: strengthening the framework* (referred to as the 'January consultation') summarised actions being taken, and changes proposed by the Treasury, the FSA and the Bank of England (collectively 'the Authorities') to respond to these challenges, including on how to deal with a bank in difficulty.

1.4 The failure of a single bank,[1] building society or other deposit taking firm (for simplicity referred to as 'banks' unless more precision is needed), although a rare and potentially isolated event, may have a wider impact, and involve greater costs to the economy, than that of a non-financial firm of a similar size. As outlined in the January consultation, given the importance of financial stability, and the damaging effect which disruption to financial services can have on individuals, firms and the economy as a whole, it is important that the Authorities are able to deal with such threats to financial stability. The Authorities remain firmly committed to the fundamental elements of the framework established by the Government from 1997 onwards, including the independent single-regulator model of financial supervision, the importance of principles-based regulation, and the operation of the framework for the preservation of financial stability, with clear roles and responsibilities for the FSA, Bank of England and the Treasury.

1.5 The January consultation set out a number of areas in which this framework could be strengthened. Responses to the consultation have supported this approach of maintaining the fundamental framework, whilst updating it to ensure the Authorities are able to meet the challenges of today, and tomorrow.

1.6 This document provides an update on these proposals, in light of consultation responses and events since January. The document also asks a number of specific questions where the Authorities' proposals have evolved or changed. Further detailed consultation questions will follow in a separate document, containing draft legislative clauses and further detail relating to proposals for the special resolution regime (SRR), to be published by the end of July. Many of these proposals will be taken forward through a new Bill, which the Government intends to introduce after the summer parliamentary recess.[2]

UPDATE ON RECENT EVENTS

Global financial markets

Continuing difficulties

1.7 Financial markets continue to be affected by the broad-based re-pricing of risk and de-leveraging set in train by rising levels of default in the US sub-prime mortgage market in the second half of 2007. Uncertainty about banks' financial positions and the associated loss of market confidence have led to a sharp reduction in liquidity in some credit markets, ongoing strain in money markets and a tightening in availability and standards of credit to households and companies. Banks have continued to hoard liquidity due to concerns about their own liquidity positions and their confidence in counterparties. These risks were highlighted by the decision by US securities house Bear Stearns to seek secured funding from JP Morgan Chase & Co. and the Federal Reserve Bank of New York in March.

[1] 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.

[2] References in this document to new primary legislation are, unless otherwise specified, references to this new Bill.

1.8 Whilst there have been tentative signs of a limited recovery of financial activity in some credit markets since March, central bank lending surveys suggest tight credit conditions are likely to persist. Interbank funding markets remain under considerable pressure, though there have been some improvements since March following actions by major central banks.

International action

Financial Stability Forum

1.9 As set out in detail in the January consultation, the recent financial turbulence has been global in nature and requires coordinated action by the international community. After initiating work in autumn 2007 to analyse the causes of market turbulence and propose an appropriate global response, the Financial Stability Forum (FSF)[3] presented its report, Enhancing Market and Institutional Resilience, to G7 Finance Ministers in April 2008[4]. It recommended action in five areas:

- strengthening prudential oversight of capital, liquidity and risk management;
- enhancing transparency and valuation;
- changes in the role and uses of credit ratings;
- strengthening the authorities' responsiveness to risks; and
- robust arrangements for dealing with stress in the financial system

1.10 The report was strongly endorsed by the G7 Finance Ministers, who committed to its rapid implementation, including delivering on some priority actions within 100 days. The UK Authorities fully support this work, and are taking steps both here in the UK and through international fora to ensure the FSF's recommendations are implemented. The FSF provided an update on progress to the G8 Finance Ministers meeting in Osaka on 14 June, which explained that implementation of the priority actions are on track and that good progress is being made on the other recommendations in the FSF report.

European Union

1.11 As a key global marketplace, the EU also has a strong role to play in shaping the appropriate international response. The Economic and Financial Affairs Council (ECOFIN) endorsed a programme of work in autumn 2007 on the issues raised by the market disruption, which envisages work continuing during 2008. A progress report was presented to the European Council in the spring.

Developments in the UK

1.12 The recent turbulence in the financial markets has also required action by individual firms and authorities to address immediate issues that have arisen. A number of developments in the UK since the January consultation was published are relevant to the reforms set out in the rest of this publication.

Northern Rock

1.13 In summer 2007 Northern Rock plc found itself unable to finance its activities because of a business model that was heavily exposed to market turbulence. In light of

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

[4] Available at http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf

those severe difficulties, the Authorities took action to maintain financial stability, whilst protecting consumers and the interests of the taxpayer.

Banking (Special Provisions) Act 2008

1.14 Earlier this year it became clear that, in light of prevailing market conditions, no institution was prepared to make an offer to take over Northern Rock that was judged adequate to protect the taxpayer. As a result, the Banking (Special Provisions) Act was taken through Parliament and received Royal Assent on 21 February 2008. The Government then took Northern Rock into a period of temporary public ownership, as the best way of meeting its stated objectives of maintaining financial stability, safeguarding depositors' money and protecting the interests of the taxpayer. Northern Rock is being run on a commercial basis, at arms length from the Government. The Treasury will, on behalf of the taxpayer, and like any other responsible shareholder, play an active role in holding the company to account for its performance. The Chancellor has approved the business plan for the company drawn up by its Executive Chairman, Ron Sandler.

1.15 The Banking (Special Provisions) Act provides the Authorities with powers to facilitate an orderly resolution to maintain financial stability or protect the public interest. The key securities or property transfer powers provided by the Act are temporary and lapse in February 2009, a year after the Act was passed. The proposals set out in this document are intended to provide a permanent set of measures to strengthen financial stability and protect depositors.

FSA audit report

1.16 Another important development since the January consultation was the publication in March of the FSA's independent internal audit report into its supervision of Northern Rock.[5] This report identified specific weaknesses in the supervision of Northern Rock, but reinforced the suitability of the overall principles- and risk-based regulatory approach. As part of this report, the FSA announced details of a supervisory enhancement programme, including the following elements:

- increased senior management engagement with high-impact firms;
- increased focus on prudential supervision, including liquidity and stress testing;
- increased numbers of supervisory staff engaged with high impact firms and the creation of a new group of supervisory specialists; and
- improved use of information and intelligence.

1.17 Chapter 3 sets out more detail on the FSA's response to the audit report and its relationship with the wider proposals to reduce the likelihood of future bank failure.

Special Liquidity Scheme

1.18 Following the re-emergence of serious strains in the term money markets in March 2008, the Bank of England continued its expanded three-month repo open market operations (OMOs) against wider collateral in its March and April operations, as part of further global central bank action, also involving the European Central Bank, the Federal Reserve, the Bank of Canada and the Swiss National Bank. In addition, in April 2008, the Bank of England launched a Special Liquidity Scheme to allow banks to swap, for a limited period of time, their high quality, but temporarily illiquid, mortgage-backed and other securities for UK Treasury Bills, subject to appropriate haircuts.[6] Each

[5] http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2008/nr.shtml

[6] A haircut rate is a measure that reduces the value of any collateral used in a loan, to ensure that the lender remains protected against loss, even if the collateral declines in value due to adverse market movements.

swap will be for a period of one year and may be renewed for a total of up to three years. The Scheme aims to improve the liquidity position of the banking system and increase confidence in financial markets. Usage of the scheme – which is uncapped – will depend on market response and conditions.

Banks raising capital

1.19 Since the onset of the market turmoil, the major UK banks have undertaken significant capital raising initiatives. The value of capital raising by major UK banks increased over the second half of 2007, compared with the first half of that year, and remained strong into 2008. Over the past year the major UK banks have bolstered their capital ratios, in particular their tier 1 capital ratios, by raising over £45bn of capital through rights and other capital issues. The major banks are also undertaking other initiatives such as disposing of non-core assets to strengthen their capital position.

1.20 As recently announced, the FSA and the Treasury will establish a sub-group of the High-Level Group on City Competitiveness to consider current market practices around equity raising, and whether they can be made more efficient and orderly.

Crosby review

1.21 As discussed in Chapter 2, in April 2008 the Chancellor of the Exchequer asked Sir James Crosby to advise on options for improving the functioning of mortgage finance markets. Improving these markets will make an important contribution to stabilising the cost and supply of UK mortgages. He will present an interim report to the Chancellor in Summer 2008 and proposals at the Pre-Budget Report.

POLICY PROPOSALS

Objectives

1.22 The Treasury, the Bank of England and the FSA remain firmly committed to the UK's framework for financial regulation and ensuring the maintenance of financial stability. The Authorities also recognise the importance of strengthening this framework, to ensure that it continues to operate effectively within the context of today's fast-moving and international financial markets. The January consultation set out proposals to address five key policy objectives for reform:

- strengthening the stability and resilience of the financial system, in the UK and internationally;
- 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 action by the Authorities.

1.23 The Authorities remain committed to these objectives. The need for reform remains clear, and the proposals set out by the Authorities reflect measured and proportionate changes, to mitigate the risks to financial stability, and to protect depositors, whilst building on the UK's principles-based framework for financial regulation. The Authorities have been listening carefully to stakeholder views, and undertaking additional analysis over the past few months, and consequently have modified earlier proposals in some places. A summary of proposals, and how these will be taken forward, is set out below. Detailed discussion of the proposals in each area is set out in the chapters following this introduction.

Stability and resilience of the financial system

FSF's report and conclusions

1.24 Chapter 2 explains the steps that are being taken to strengthen the resilience of the global financial system. The UK supports, and is taking a lead role in this work. The FSF's April 2008 report is consistent with the Authorities' views on the appropriate international response to market disruption, as set out in the January consultation, and the Authorities are taking action, both in the UK and in international fora, to ensure that the FSF's recommendations are implemented fully and rapidly, including:

- strengthening prudential oversight of capital, liquidity and risk management through co-ordinated action by national and international bodies, particularly the work of the Basel Committee on Banking Supervision[7] to strengthen the Basel II capital requirements for structured credit and securitisation activities, and through enhancing supervision of liquidity and risk management;
- enhancing transparency and valuation in securitisation markets through robust risk disclosures by financial institutions and accelerated work by the International Accounting Standards Board (IASB) to enhance accounting and disclosure standards related to off-balance sheet entities and the valuation of structured products;
- changes in the role and uses of credit ratings, including through improvements by credit rating agencies (CRAs) in three key areas: the quality of the rating process, including managing conflicts of interest; expanded information on structured products, including differentiated ratings for corporate and structured finance products; and the enhanced assessment of the underlying data quality. The European Commission has recently suggested that an EU registration system and external oversight regime for CRAs be considered. The Authorities support the objective of strengthened and independent external monitoring of CRA performance against internationally agreed standards. Given the global nature of CRAs' business there would be considerable benefits to an internationally consistent solution to avoid regional differences in standards; and
- learning the lessons around improving the Authorities' responsiveness to risks, and arrangements for dealing with stress in the financial system.

Supervisory colleges

1.25 The UK Government proposed the establishment of supervisory colleges for the ongoing prudential supervision of all large, complex and internationally active cross-border financial groups. It therefore fully supports the FSF recommendation to establish international colleges of supervisors for each of the largest global financial institutions by the end of 2008. Reflecting the unique institutional structure in the EU, the Government has proposed that supervisory colleges be established in EU law, fully supports the conclusions of the May ECOFIN Council on colleges, and will play a full part in its translation into law through the ongoing discussions on sectoral legislation.

[7] The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business, where this is not the central bank.

Cross-border stability groups

1.26 Work is also underway to improve cross-border arrangements for dealing with weak banks. The FSF is taking forward its proposal that for the largest cross-border financial firms a small group of supervisors and central banks is set up to address specific cross-border crisis management planning issues. At EU level the Government is fully committed to the EU Memorandum of Understanding on cross-border financial stability.

Reducing the likelihood of banks failing

1.27 Whilst it is important for market discipline that firms – including banks – should be allowed to fail, the potential impact of a bank failure on consumers and financial stability means that a key objective of the Authorities is to reduce the likelihood that individual banks face serious difficulty. Effective regulation and liquidity support arrangements are extremely important.

Regulatory intervention

1.28 The January consultation outlined the existing, wide-ranging regulatory interventions already available to the FSA and concluded that only a small number of additional regulatory powers were required. Responses to the consultation, as well as the FSA's independent internal audit report on its supervision of Northern Rock, confirmed this overall approach as the right one. Many respondents expressed the view that the effectiveness of normal supervision should be improved. Consistent with this, and as noted earlier, the FSA has put in place a supervisory enhancement programme.

1.29 The FSA operates a risk-based approach to supervision and firms will, in the normal course of events, experience different intensities of supervision. However, there will be circumstances in which a particular firm may face increased risk, posing a greater threat to the FSA's objectives, to financial stability or to the interests of consumers. In these circumstances the FSA responds, as would be expected, by stepping up its scrutiny of the firm: the January consultation document referred to this as "heightened supervision" by the FSA.

1.30 This is not a separate supervisory regime or set of powers but a normal application of the supervisory process. An individual firm will be subject to additional regulatory attention in response to a particular set of problems or crystallised risks, particularly where there is a potential threat to the firm's current, or future, compliance with the Threshold Conditions (the statutory conditions which the FSA uses to judge whether a firm is meeting, and will continue to meet, the regulatory thresholds for authorisation).[8] The firm's Board and senior management retain at all times the primary responsibility for managing the risks a firm faces. Reflecting the circumstances that require the additional attention, an intensification of supervision will be bespoke to each firm, and so a number of regulatory and non-regulatory tools may be employed to deal with each individual case as appropriate.

Supervisory information

1.31 The January consultation set out proposals around the collection and management of information, to assist the Authorities in their work. Given the role that the Bank of England and the Treasury have in maintaining financial stability, as set out in more detail in Chapter 3, **the Government confirms its intention to legislate to facilitate the FSA obtaining and sharing information that the Bank of England and the Treasury require for purposes related to financial stability.**

[8] The Threshold Conditions are set out in Schedule 6 to 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: http://fsahandbook.info/FSA/html/handbook/COND. The three conditions most relevant for this ongoing assessment are close links (COND 2.3), adequate resources (COND 2.4) which includes adequate financial resources, and suitability (COND 2.5).

1.32 Additionally, as set out in the January consultation, **the FSA will publish a consultation paper, setting out proposals on the provision of additional information by banks to demonstrate that they are meeting Threshold Conditions, on an ongoing and forward looking basis.**

1.33 Market abuse undermines investor confidence and can damage the integrity of the system. As proposed since January, the Government will also be ensuring that FSA has the necessary powers to tackle market abuse, including new powers relating to granting immunity from prosecution. While not a part of the forthcoming Bill, **the Government will take the earliest opportunity to bring forward legislation to provide the FSA with additional powers.**

Liquidity provision and disclosure

1.34 Like other central banks, the Bank of England is able to provide emergency liquidity support to banks when they experience extreme liquidity difficulties. It is important that such support can be delivered in an effective manner. The Authorities set out a number of proposals in the January consultation to help achieve this. These included proposals recognising that, whilst transparency in financial markets is important, there may be special circumstances when a period of non-disclosure of such assistance is desirable. **The Government will be taking forward:**

- **legislation to provide the Bank of England with statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and other central bank functions;**
- **secondary legislation, consulting where appropriate, to amend the Settlement Finality Regulations 1999 to ensure that collateral provided to the Bank of England in connection with its functions may be realised more effectively;**
- **legislation so that any charges granted to a central bank in connection with its functions as a central bank will be exempt from registration.**

1.35 The January consultation indicated that the Government intended to legislate to remove the requirement for the Bank of England to release weekly returns detailing its summary balance sheet. For the most part respondents to the January consultation were supportive of the proposal. **The Bank of England has been consulting on whether or not to continue publication of the weekly return.**

1.36 As part of its July 2008 quarterly consultation paper, **the FSA will consult on changes to the Disclosure and Transparency Rules to clarify that an issuer in receipt of liquidity support from a central bank may have a legitimate interest to delay disclosure of that fact.**

Contractual barriers to action

1.37 To help the Authorities to take action to preserve financial stability, **the Government is also seeking views on whether to legislate to provide that restrictions on borrowing (including negative pledges) and other provisions having a similar effect are nullified to the extent that they would prevent financial assistance by the Authorities for the purposes of financial stability or are otherwise triggered by steps taken by the Authorities.**

Lending to building societies

1.38 **The Building Societies (Financial Assistance) Order 2008 was approved by Parliament in June of this year.** This Order, under the Banking (Special Provisions) Act 2008, removes statutory barriers to the Bank of England lending to building societies, where financial stability is threatened.

1.39 In line with the January consultation **the Government will bring forward legislation to ensure that floating charges may be granted by building societies in relation to the provision of liquidity support by central banks.**

Oversight of payment systems

1.40 Robust and effective payment systems are essential to the functioning of financial markets and the economy. Therefore, following consultation on the issue in the January consultation, **the Government intends to legislate to formalise the Bank of England's role in the oversight of payment systems to ensure the robustness of payment systems which, if a disruption in the operation of the system were to occur, would be likely to lead to systemic and system-wide consequences.**

Reducing the impact of banks failing

1.41 It is envisaged that, in the great majority of cases, the tools discussed above will be sufficient to resolve situations in which a bank is likely to fail. Even if a bank is unlikely to be able to survive as an independent going concern the Authorities should, in most cases, be able to reach a resolution (for example a takeover by another institution) through discussion with the firms concerned and the use of the normal regulatory powers. However, there may be a small number of cases in which these tools prove insufficient, and a resolution is only possible on the basis of additional intervention by the Authorities. To deal with such situations, the Authorities have proposed the introduction of a special resolution regime (SRR).

1.42 In contrast to many other countries, the UK has no special regime for dealing with banks in such circumstances and the Authorities' powers are therefore limited. Current insolvency procedures do not offer an appropriate platform for dealing with a failed bank for a variety of reasons, not least the fact that depositors are likely to be deprived of access to their accounts, and that insolvency is incompatible with the Authorities' objectives around securing faster depositor payout. Additional powers are therefore needed, in situations where voluntary action by the firm and regulatory options are judged insufficient, to secure broader public interests in:

- managing the risks to financial stability;
- protecting the public finances;
- protecting depositors; and
- ensuring continuity of key banking and payment arrangements.

Special resolution regime

1.43 Therefore, as proposed in the January consultation, **the Government intends to legislate to introduce a "special resolution regime"** , comprising a set of new, and existing, tools to permit the Authorities to take control when a bank is judged to be failing, and all other options have been deemed insufficient. These tools will include:

- a transfer of part or all of the failing bank to a private sector third party;
- a transfer of part or all of the failing bank to a publicly-controlled bridge bank;
- a new bank insolvency procedure;

- the power to take a bank into temporary public sector ownership; and
- the existing option to support any of these tools by providing financial support to a failing bank through funding or the provision of guarantees, subject to legal and other constraints.

1.44 In the January consultation, the Authorities proposed that the SRR would be initiated on a regulatory trigger, and consulted on questions relating to which Authority should have responsibility for implementation of the SRR. Consistent with this, and building on the views expressed during the consultation, **the Government proposes that:**

- **initiation of the regime will be subject to an assessment by the FSA, as the firm's supervisor, that the firm had failed (or was likely imminently to fail) to meet its Threshold Conditions**, and that the alternative options to remedy the situation through voluntary actions and regulatory intervention were unlikely to be sufficient to bring the firm into compliance with the Threshold Conditions in the near future. Thus, the FSA will have the power to trigger the SRR;
- **the operation of the SRR and the resolution tools within it will be the responsibility of the Bank of England**, including responsibility for deciding which resolution tool to use;
- the Bank of England's operation of the SRR will be subject to the requirement that **any decision requiring the use of funds for which the Chancellor of the Exchequer is responsible, or with implications for the public finances, would require the authorisation of the Chancellor of the Exchequer;**
- **the Chancellor of the Exchequer will remain responsible for ensuring compliance with the UK's international obligations**
- **any decision involving the temporary public ownership of an institution will be for the Chancellor of the Exchequer,** in particular given the potential implications for the public finances.

1.45 In practice, any decision to trigger the special resolution regime, and to deploy one or more of the tools within it, would only be taken following intensive discussion and consultation between the Treasury, the Bank of England, and the FSA, at each stage of the decision-making process through the Standing Committee. Nevertheless, for reasons of accountability, it is important to clarify the lead responsibility of each institution based on their mandate and expertise:

- the FSA for supervisory decisions and regulatory actions, including the ongoing supervision of any firm while it continues to operate in the SRR;
- the Bank of England for liquidity support and, in line with the new proposals outlined below, operation of the special resolution regime; and
- the Treasury for public finances and the overall public interest.

1.46 The Financial Services Compensation Scheme (FSCS) which delivers the payment of compensation., will also need to be involved in the assessment of the readiness of a bank for payout of its depositors.

1.47 The objective of the Bank of England, in operating the regime, will be to protect the financial stability of the UK, to protect public finances, to protect depositors, and to ensure continuity of key banking services. These objectives will need to be balanced against the need to ensure sufficient protection for property rights, and the rights of creditors and counterparties of the failing banks. It is therefore proposed that the operation of special resolution tools by the Bank of England will be required to follow clear criteria set out in the legislation, and will also be subject to a set of additional defined safeguards. In particular, since the tools potentially involve disruption to property rights, the legislation will provide for appropriate compensation mechanisms.

1.48 The new bank insolvency procedure will ensure that, in cases where closure of the failing bank and payout of depositors is seen as the most appropriate option, there is a specifically tailored insolvency vehicle for achieving this aim. The Government proposes that the decision to use the new insolvency procedure within the SRR would be taken by the Bank of England, and implemented through an application to the Court.

Resolution of building societies

1.49 In line with views expressed in response to the January consultation document, **the Government intends to legislate so that building societies are subject to a special resolution regime, similar to that for banks.**

1.50 **The Government also intends to bring forward an Order so that on winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and the society's members.**

1.51 More information on the proposed special resolution regime and the safeguards applicable to it, including some draft legislative clauses will be published for consultation before summer Parliamentary recess later in July.

Requirements on banks

1.52 Following consultation on the issue in the January consultation **the Government intends to bring forward legislation so that, in addition to its role in ensuring payout to depositors in the event of the failure of a deposit-taking firm, the FSCS can also be called on to contribute to costs arising from the use of resolution tools**. Such a contribution, which (as with depositor payout) would be met from industry levies collected by the FSCS, would be made after resolution had concluded and would be independently assessed, and would be subject to a cap of the net amount which the FSCS would otherwise have been required to pay in compensation to eligible depositors in the event of the failure of the firm.

1.53 **The FSA intends to work further with banks to ensure that indirect members of payment systems have contingency plans in place, in the event their sponsor bank fails**.

1.54 As proposed in the January consultation document, **the Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.**

Effective compensation arrangements

1.55 Effective compensation arrangements are a key part of protecting customers and enhancing confidence in the banking system. The Authorities recognise the benefits for consumers of having a unitary compensation scheme. The Authorities set out a number of proposals to improve the compensation arrangements in the January consultation. The plans for taking these proposals forward are set out in summary below.

Compensation limit

1.56 **The FSA intends to consult in autumn 2008 on changes to the FSCS compensation limits for all sectors and changes to other factors used in the FSCS compensation calculation.** At this stage, the consultation paper is expected to propose as the lead option an increase in the compensation limit for protected deposits to £50,000, on a per person per bank basis.

1.57 **The FSA will explore with the financial sector ways for customers to cover amounts above the compensation limit (including temporary high balances) and the appropriate coverage for client accounts and similar arrangements**.

Faster compensation payout

1.58 As set out in the January consultation, delivering speedy compensation pay out is a key goal of the Authorities. Ensuring that depositors have quick and ready access to their deposits is crucial in enabling people to continue to pay bills, and undertake everyday financial transactions. **The Authorities remain committed to a target of seven days for providing the depositors of a failed bank with access to at least a proportion of their funds, and the balance within the following few days, consistent with the aim of minimising disruption for depositors.**

1.59 To achieve this, **the Government intends to legislate:**

- **to enable the FSA to collect information from firms that the FSCS requires (and share this with the FSCS) before default, and ensure the FSCS can obtain information directly from firms as soon as a firm is declared in default;**

- **to ensure there are no barriers to the Bank of England, once resolution is invoked, being able to collect and share with the FSCS relevant information on the bank in question; and**

- **to give the FSA the power to make new rules to specify the circumstances in which consumers need to make a formal claim to the FSCS before receiving a compensation payment and to allow for the automatic conferral of rights on the FSCS to make recoveries in place of claimants.**

1.60 In addition, to facilitate faster payout, **the FSA intends to consult on:**

- **new rules requiring banks to have readily available information, including balances, on the accounts held by depositors eligible for compensation from the FSCS;**

- **the eligibility criteria for depositors to qualify for FSCS compensation payments; and**

- **on a move to gross payments of FSCS compensation.**

1.61 The information provided by banks will need to be reviewed on an ongoing basis to confirm its accuracy and usefulness. **The FSA will consult on how the information held by banks will be reviewed, including through options for the ongoing, routine involvement of the FSCS.**

1.62 The Authorities remain of the view that demanding targets for payouts are essential for consumer confidence. The Authorities have, during the recent consultation, received a number of suggestions from the banking industry on how to make these and other changes work on a practical level to increase the speed of payout. As set out in Chapter 5, the Authorities will continue to work with the industry through the forthcoming consultation to ensure that the resultant model of payout is workable and provides depositors with confidence that they will get their funds quickly.

1.63 As proposed in the January consultation **the Authorities will work with banks and the appropriate trade associations to ensure that depositors can open up a new account quickly enough to facilitate fast compensation payments and minimise disruption.**

FSCS management and operations

1.64 Following feedback, and further analysis, the Government has concluded that it is not necessary to legislate to give the FSCS more flexibility to manage a wide range of claim volumes. The Government is considering including in the forthcoming legislation a number of minor measures relating to claims handling and compensation payments.

Consumer awareness

1.65 It is important that consumers are aware of the compensation scheme, and their entitlements under it. Therefore **the FSA and FSCS intend to review how consumers can be better informed about the current compensation scheme**

FSCS funding and liquidity

1.66 Ensuring that the FSCS has access to immediate liquidity is a key element of delivering faster payout. Therefore, as proposed in the January consultation, **the Government intends to legislate to ensure that the FSCS has access to immediate liquidity through borrowing from the public sector**, enabling the National Loans Fund to lend to the FSCS.

1.67 The Authorities have taken careful account of the views expressed during consultation on pre-funding for the FSCS. In the light of these views, they are not proposing to introduce such a scheme immediately. Nevertheless, they believe it is important to keep under review the option of pre-funding for the FSCS. **The Government therefore intends to include in the forthcoming legislation powers which would allow it to introduce pre-funding of the FSCS if it was considered appropriate to do so in the future.** The detail of any pre-funding arrangements would be set out in secondary legislation. The Authorities will continue to work with deposit-takers and other stakeholders in assessing the issue of pre-funding.

1.68 To provide the appropriate legal framework to support these changes, **the Government therefore proposes to use the forthcoming legislation to ensure that borrowing from the National Loans Fund will be repaid and to enable the Treasury to make regulations, if necessary, regarding FSCS pre-funding.**

Scottish and Northern Ireland banknotes

1.69 In line with its priority to provide protection to noteholders**, the Government intends to legislate to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland.** It proposes that commercial banks issuing banknotes will be required to hold assets (Bank of England banknotes and UK coin, and funds in interest-bearing accounts at the Bank of England) to the full value of their notes at all times, and ring-fenced for the benefit of noteholders.

1.70 **The Government also intends to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the UK**, by abolishing the funds attached rule in Scots law so far as it relates to cheques, and making any necessary consequential changes to related legislation.

Strengthening the Bank of England and coordination between the Authorities

1.71 Proposals were set out in the January consultation to strengthen the framework for financial stability, and for setting clear objectives, roles and responsibilities for each of the Authorities.

1.72 A key element of these proposals is to ensure that the Bank of England has the right statutory and operational framework to deliver against its core objective in financial stability, alongside its longer-established framework for implementing monetary policy. The Government will build upon the strengths of its monetary policy framework in bringing forward a number of measures to strengthen the financial stability role of the Bank of England. In particular **the Government intends to:**

- **provide the Bank of England with a statutory responsibility for contributing to the maintenance of financial stability;**
- **improve the policy instruments available to the Bank of England in support of financial stability, including through the special resolution regime ;**
- **legislate for the creation of a Financial Stability Committee to support the Governor and Bank of England, drawing upon external expertise ;**
- **give the Court a formal role in overseeing the Bank of England's performance on financial stability;**
- **legislate to require the Bank of England to consult with the Treasury, on a periodic basis, when setting the detailed financial stability objectives for the Bank of England and the remit for the FSC;**
- **bring forward legislation to restrict the size of Court to a maximum of twelve members, including a majority of non-executives, one of whom will Chair Court as has been the case in practice since 2003; and**
- **legislate to facilitate the reduction in the size of Court by terminating the membership of all non-executive members when the measures come into force, allowing for their subsequent reappointment.**

MPC appointments

1.73 Alongside these changes related to financial stability, the Government is committed to retaining the UK's monetary policy framework at the forefront of international best practice. In order to ensure the transparency and openness of the appointment process to the Monetary Policy Committee (MPC), **the Government will in future advertise vacancies for the Governor and Deputy Governors of the Bank of England and also for external members of the MPC, consistent with the principles of open competition.** The two Bank of England Executive Director posts which carry MPC membership will also be advertised in the future.

Revised MoU

1.74 As set out in January, coordination between authorities is essential if they are to carry out their responsibilities effectively. Therefore **the Authorities will, in light of the new legislation, clarify responsibilities within the Memorandum of Understanding, setting out the roles and responsibilities of the Treasury, the FSA and the Bank of England with regard to financial stability, including the relevant roles and responsibilities in relation to the SRR.**

CONSULTATION: RESULTS AND NEXT STEPS

The January consultation and responses

1.75 The January consultation was published on 30 January 2008, and responses were requested by 23 April. During the consultation period Ministers and officials from the Authorities, including the FSCS, met many representatives from banks, building societies, representative bodies, consumer groups and academics to discuss the proposals. In addition, seven policy themed workshops were held, providing opportunities to look at specific policy proposals in detail, and to get the views from experts and other interested parties on the conceptual, practical and legal issues arising from the proposals. In total over 100 written responses were received.

1.76 Respondents' views on individual issues are reflected throughout this document, where relevant policy proposals are discussed. In addition, annex B contains a more detailed summary of respondents' views on the specific questions asked in the January consultation. In addition, those consultation responses which were not submitted in confidence can also be found on the Treasury website at: http://www.hm-treasury.gov.uk/documents/financial_services/financial_stability_framework.cfm.

1.77 The Authorities have also looked closely at experiences in other countries. The Authorities, including the FSCS, have also participated in discussions in international fora on many of these issues, including at the OECD and EU on deposit guarantee schemes.

Next steps

1.78 This document outlines the Authorities' plans following the January consultation, and requests views on areas where there have been modifications to earlier proposals, or new proposals brought forward. Responses to this document are requested by 15 September 2008. Before the end of July, a further document will be published, setting out in more detail how the proposed SRR will operate and seeking views, including on draft legislative clauses, on the detailed operation of the regime.

1.79 Subject to the outcome of these consultations, the Government intends to bring forward legislation later in 2008. The Government will continue to discuss these proposals with the devolved authorities to the extent that any of them impact on their responsibilities. The FSA will consult on compensation limits in autumn 2008 and consultation on other changes to FSA rules will follow. Drawing on the lessons of recent months, the Bank of England will continue to review its own money market operations, including with a view to introducing a new, permanent facility that learns from the experience of the Special Liquidity Scheme.

2 Stability and resilience of the financial system

Disruption in global financial markets, starting in the second half of 2007, has presented direct challenges to banks and authorities throughout the world. As set out in the January consultation, given the interconnectedness and complexity of the financial system, actions are required both in the UK and internationally to enhance the stability and resilience of the global financial system. The 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 of financial markets.

This chapter:

- provides an update on events in the financial markets since the January consultation was published;
- updates on progress on the work programmes of the EU, the G7 and the Financial Stability Forum (FSF) to develop an appropriate response; and
- describes the steps the Authorities are taking to implement in the UK the recommendations in the FSF's report, *Enhancing Market and Institutional Resilience,*[1] which was presented to G7 Finance Ministers in April. These actions are focused on:
  - strengthening prudential oversight of capital, liquidity and risk management;
  - enhancing transparency and valuation – particularly in securitisation markets;
  - changes to the role and uses of credit ratings;
  - strengthening the authorities' responsiveness to risks; and
  - arrangements for dealing with stress in the financial system

Update on recent events

Recent events

Banks' financial positions

2.1 As described in Chapter 2 of the January consultation, rising US sub-prime mortgage defaults in the second half of 2007 set in train a broad-based repricing of risk and deleveraging by banks and other financial market participants. The adjustment has been protracted and, as banks have been unable to secure funding on assets in which markets have been closed, uncertainty about banks' financial positions increased in the United Kingdom and abroad.

2.2 This uncertainty has undermined confidence in banks and generated reluctance among market participants to trade with each other. Liquidity has fallen sharply in some credit markets, including most prominently many asset backed securities (ABS) markets, as well as structured credit markets and the leveraged loan market, contributing to falls in the market values of assets.

[1] Financial Stability Forum (2008), *Report of the Financial Stability Forum on enhancing market and institutional resilience,* 7 April 2008, available at: http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf

2.3 An adverse interaction between asset prices and banks' balance sheets has been evident in recent months across the world. As asset prices have fallen, the mark-to-market value of many financial firms' assets has also declined, leading to substantial write-downs at financial institutions. That has raised counterparty risk, in turn contributing to continued strains in money markets. In response to funding difficulties, banks have tightened the availability of credit to households and companies.

2.4 In these conditions, adverse news and rumours led to confidence in the resilience of individual institutions becoming fragile. Problems in financial markets intensified in mid-March when concerns about Bear Stearns triggered a wholesale funding run on that firm. Bear Stearns was not only unable to obtain funding in unsecured markets, but also could not secure funds against high-quality collateral. That led to a rapid fall in its liquid assets and the firm was forced to seek support from JP Morgan Chase & Co. and the Federal Reserve Bank of New York. JP Morgan Chase & Co subsequently acquired Bear Stearns.

Credit markets

2.5 Since late March there have been tentative signs of a re-emergence of activity in some credit markets. Several banks have disposed of some of the backlog of leveraged loans and ABS exposures in recent weeks. Banks globally – and in the UK – have also moved to raise their capital buffers. Commensurate with these developments, corporate credit spreads and the costs of buying default protection on banks have fallen back sharply from their peaks in mid-March.

2.6 But central bank lending surveys – including the Bank of England's 2008 Q1 Credit Conditions Survey[2] – suggest that tight credit conditions are likely to continue. For example, UK banks have withdrawn some mortgage products and spreads charged by banks on retail lending have widened.

Interbank markets

2.7 Interbank funding markets remain under considerable strain. But three-month interbank rates relative to expected policy rates remain below their peaks reached in September and December and have fallen back further following central bank actions described below.

2.8 Despite these improvements, there remains limited appetite among banks to lend to each other at longer maturities and inter-bank rates remain elevated relative to expected future policy rates. Although pressures are expected to dissipate further over time, the future path of inter-bank rates is uncertain, and may depend heavily on the return of non-bank lenders – most notably money market funds – to short-term bank funding markets.

Recent central bank actions

2.9 The Bank of England, the Federal Reserve and the European Central Bank (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 their 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. The January consultation summarised the actions that had been undertaken by major central banks

[2] Available at: http://www.bankofengland.co.uk/publications/other/monetary/creditconditionssurvey080403.pdf

between August 2007 and January 2008. This section provides an update on central bank actions since January.

United Kingdom

2.10 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. They are only limited in their choice of target by a ceiling, set by the Bank for each scheme member in relation to the size of its sterling liabilities, which exists to prevent an excessive level of aggregate reserves. Compared with August 2007, the aggregate level of reserves targets rose cumulatively by 37 per cent in a series of steps between September and December, ahead of the year-end. After declining slightly in the period to March, the aggregate reserves target then rose again, to a level 49 per cent higher in May than in August 2007. In view of the increase in the reserves targets, and to make room for any further increase in future months, the Bank of England raised the reserves target ceiling for each reserves scheme member with effect from May 2008.

2.11 Following a re-emergence of strains in term money markets in March 2008, the Bank of England offered reserves above the amount required for banks to meet targets (as it did in September 2007). The additional reserves were offered to help keep overnight market interest rates in line with the official Bank Rate. The Bank of England also continued its expanded three-month repo[3] OMOs in its March and April operations, as part of further co-ordinated central bank action. The size of the April operation was expanded further. The expanded three-month repos are being maintained for June and July, but with the size reduced following the introduction of the Special Liquidity Scheme (described below).

Special Liquidity Scheme

2.12 In April 2008, the Bank of England launched the Special Liquidity Scheme (the SLS) to allow banks to swap for a limited period of time their high quality – but currently illiquid – mortgage-backed and other securities for UK Treasury Bills, subject to appropriate haircuts. The SLS aims to improve the liquidity position of the banking system and increase confidence in financial markets.

2.13 The SLS has three key features. First, the asset swaps will be for long terms. Each swap will be for a period of one year and may be renewed for a total of up to three years at the discretion of the Bank. Second, the risk of losses on their securities remains with the banks. In addition, banks participating in the SLS must at all times provide as security to the Bank of England assets worth significantly more than the Treasury Bills they receive in return. Third, the scheme is designed to provide financing for legacy illiquid assets on banks' balance sheets. To that end, each participant's access to the SLS is limited to eligible securities, or underlying loans from which eligible securities could be formed, held on balance sheet at 31 December 2007.

United States

2.14 In March 2008, the rate on the Discount Window 'primary credit' facility was reduced from 50bps to 25bps and maximum maturity of term was increased from 30 to 90 days.

2.15 In March 2008, the Federal Reserve Bank of New York (FRBNY) announced a series of measures, including providing primary (non-bank) dealers with access to central bank liquidity. Initially the FRBNY announced the creation of a Term Securities

[3] The Bank of England's open market operations include short-term and long-term repos, which provide reserves in exchange for high-quality collateral. These transactions are conducted as sale and repurchase agreements (repos). The framework for the Bank of England's operations in the money markets (the 'Red Book') is available at: http://www.bankofengland.co.uk/markets/money/publications/redbook0506.pdf

Lending Facility that lends US Treasuries to primary dealers in exchange for other highly rated securities for up to 28 days, as part of co-ordinated central bank measures. Subsequently, the FRBNY announced a Primary Dealer Credit Facility to improve the ability of primary dealers to provide financing to participants in securitisation markets. The facility provides dealers with overnight funding in exchange for collateral and followed the wholesale funding run on Bear Stearns.

Euro area

2.16 Since August, the ECB has provided additional reserves early in each maintenance period, but subsequently drained them later in the period (so-called 'frontloading'). The supply of reserves in each maintenance period as a whole has been unaffected. 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 have subsequently been re-offered as they have matured. Since April, the ECB has also lent via six-month repo operations.

Swiss National Bank

2.17 In March 2008, the SNB resumed its monthly US dollar funding facility as part of the co-ordinated central bank measures described below. The frequency of these operations was subsequently increased to fortnightly in May.

Coordinated central bank action

2.18 In March 2008, five major central banks announced coordinated measures to address elevated pressures in funding markets. As described above, the Federal Reserve announced a new Term Securities Lending Facility to lend US treasuries to primary dealers for up to 28 days (rather than overnight) against other securities. The ECB and SNB announced a resumption of their US dollar funding facilities. The Bank of England announced a continuation of its expanded three-month repo OMOs against wider collateral for its March and April operations. Subsequently, the size of the Bank of England's April operation was expanded further. In May, the Federal Reserve increased the size of the amounts auctioned via the Term Auction Facility. In conjunction with this, the ECB and SNB increased the size and term of their reciprocal currency agreements.

UK Government action

2.19 The Government is taking steps to respond to the ongoing strains in the UK mortgage financing markets. These actions are summarised in Box 2.1.

Box 2.1: Government policy response

Covered bonds and residential mortgage-backed securities (RMBS) have grown in importance in recent years as a means by which UK lenders can finance mortgages. These markets have been effectively closed in the UK following the recent financial market disruption. This has led to higher funding costs for mortgage lenders and tightened lending conditions for many borrowers. The Government is looking at how to improve liquidity in the mortgage finance markets.

On 6 March, the Government brought into force a legislative framework for covered bonds in the UK. The new regime provides significant benefits for investors and issuers by reducing the amount of regulatory capital investors are required to hold and allowing UK issuers access to a larger European investor base. The Regulations comply with relevant EU legislation and therefore allow UK issued covered bonds access to a larger pool of potential investors, and the focus on quality and transparency (a theme of consultation) will strengthen confidence in the market in the longer term.

In March 2008, the Treasury published the Housing Finance Review (at Budget 2008), which discussed the recent and ongoing disruption in financial markets and the challenge this presents for the UK mortgage market. The contraction in market liquidity raises a number of issues, including difficulties around the valuation of mortgage-backed assets, and the lack of uniformity and transparency in these markets.

In April 2008, the Chancellor of the Exchequer asked Sir James Crosby to advise on options for improving the functioning of mortgage finance markets. Sir James has extensive financial sector experience and currently serves on the FSA Board as Deputy Chairman.

Improving mortgage finance markets will make an important contribution to stabilising the cost and supply of UK mortgages. Sir James Crosby is working closely with lenders, investors and also the Treasury, the Bank of England and the FSA. His work is focused on how the Government and the industry can work together on options that may improve mortgage-backed securities markets as a stable source of finance over the medium and longer-term, taking account of the work under way in these markets at international level. He will report initially to the Chancellor in the summer and present proposals at the Pre-Budget Report.

INTERNATIONAL RESPONSE AND FORWARD PLANS

EU and international response

2.20 In addition to reform in the UK, a coordinated international community response to recent events is also essential. In October 2007 G7 Finance Ministers asked the Financial Stability Forum (FSF)[4] to analyse the underlying causes of recent market turbulence and propose appropriate recommendations, with a focus on events in the markets for structured products. The FSF set up a Working Group to look at these issues.

2.21 As a key global marketplace, the EU also has a strong role to play in shaping the appropriate international response. In Autumn 2007 the Economic and Financial Affairs Council (ECOFIN) endorsed a programme of work on market turbulence on the issues raised by market disruption, which envisages work continuing during 2008, aimed at achieving the following objectives:

[4] 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.

- enhancing transparency for investors, markets and regulators;
- improving valuation standards, including of illiquid assets;
- reinforcing prudential rules and risk management in the financial sector; and
- improving market functioning including the role of credit agencies.

2.22 Progress at EU level against the objectives in the roadmap is discussed in more detail below. At the Spring Council in March, ECOFIN presented a progress update on the work programme to the European Council. The European Council has committed to come back to these issues as appropriate and at the latest in Autumn 2008.

2.23 A parallel workstream has also been initiated in the US. The US President's Working Group on Financial Markets issued a policy statement on 13 March with recommendations to improve the future state of U.S. and global financial markets. The recommendations, which are broadly consistent with those in the FSF report, focus on the following areas:

- reforms to the mortgage origination process in the United States;
- enhancements to disclosure and improvements to the practices of market participants with respect to securitised products;
- reforms to the credit rating agencies (CRAs);
- steps that global financial institutions should take to address the weaknesses in risk management and reporting practices that the market turmoil has exposed;
- steps that national and international authorities should take to ensure that prudential regulatory policies applicable to banks and securities firms provide strong incentives for effective risk management practices; and
- improvements to the operational infrastructure supporting OTC derivatives.

2.24 The President's Working Group plans to issue a statement in the fourth quarter of 2008 on progress against its recommendations, and will consider whether further steps are needed to address weaknesses in financial markets, institutions and related supervisory policies.

2.25 The Authorities have been heavily involved in both the FSF and ECOFIN work programmes, including working to ensure that the EU and G7 policy responses to strengthen the stability and resilience of financial markets are and remain consistent. The January consultation, which set out the joint emerging views of the Treasury, the FSA and the Bank of England on the issues being considered by the FSF and ECOFIN work programmes, has helped to influence these processes. Responses to the questions raised in Chapter 2 of the January consultation, which were generally supportive of the Authorities' position, are summarised in Annex B.

Final FSF report

2.26 The FSF presented its report, Enhancing Market and Institutional Resilience, to G7 Finance Ministers in April. The report contains detailed recommendations, with actions proposed in the following five areas:

- strengthening prudential oversight of capital, liquidity and risk management;

- enhancing transparency and valuation;
- changes in the role and uses of credit ratings;
- strengthening the authorities' responsiveness to risks; and
- robust arrangements for dealing with stress in the financial system.

2.27 In their statement of 11 April, G7 Finance Ministers strongly endorsed the report and committed to its rapid implementation, including identifying several of the FSF's recommendations as priority actions to be implemented within 100 days (see Box 2.2). The FSF provided an update on progress to the G8 Finance Ministers meeting in Osaka on 14 June,[5] which explained that implementation of the priority actions summarised in Box 2.2 are on track and that good progress is being made on the other recommendations in the FSF report. G8 Finance Ministers welcomed the progress that has been made and highlighted in particular the key role that the financial services industry has in acting upon the lessons learned from recent events. The FSF will present a comprehensive follow-up report to the G7 Finance Ministers meeting in the autumn.

Box 2.2: G7 priority actions

In their statement of 11 April, G7 Finance Ministers identified several of the FSF's recommendations among the immediate priorities for implementation within 100 days:

- firms should fully and promptly disclose their risk exposures, write–downs, and fair value estimates for complex and illiquid instruments. G7 Finance Ministers strongly encourage financial institutions to make robust risk disclosures in their upcoming mid-year reporting consistent with leading disclosure practices as set out in the FSF's report;
- the International Accounting Standards Board (IASB) and other relevant standard setters should initiate urgent action to improve the accounting and disclosure standards for off-balance sheet entities and enhance its guidance on fair value accounting, particularly on valuing financial instruments in periods of stress;
- firms should strengthen their risk management practices, supported by supervisors' oversight, including rigorous stress testing. Firms also should strengthen their capital positions as needed; and
- by July 2008, the Basel Committee on Banking Supervision (the Basel Committee) should issue revised liquidity risk management guidelines and IOSCO should revise its code of conduct fundamentals for credit rating agencies (CRAs).

2.28 The Authorities welcome the FSF report. The FSF's recommendations are consistent with the Authorities' views on the appropriate international response to market disruption, as set out in the January consultation. Implementing the recommendations requires actions by international bodies, such as the Basel Committee on Banking Supervision (the Basel Committee), national authorities (regulators and supervisors, central banks and governments) and market participants. As explained further below, the Authorities are taking steps, both in the UK and in international fora, to ensure that the FSF's recommendations are implemented fully and rapidly. Box 2.3 discusses some of the market-based initiatives under way to look at the lessons for market participants from the ongoing disruption in the financial markets.

[5] Available at: http://www.fsforum.org/publications/Update_Note_for_the_G8_Osaka_meeting_11_June.pdf

Box 2.3: Actions by market participants to implement FSF recommendations

The FSF report calls on market participants to take action in a number of areas, discussed elsewhere in this chapter, including in relation to: risk disclosures by market participants; financial industry compensation models; the operational infrastructure for OTC derivatives; transparency in the securitisation markets; valuation processes for structured products; and the role and uses of credit ratings.

Market participants are taking steps to address many of these recommendations. In addition, several initiatives by financial services industry representatives are under way to look at the lessons market participants should draw from the ongoing disruption in the financial markets, including:

- the Interim Report of the Institute of International Finance (IIF) Committee on Market Best Practices, published on 9 April, covers five areas: (i) risk management and credit underwriting standards; (ii) conduits and liquidity risk issues; (iii) valuation; (iv) ratings; and (v) transparency and disclosure. The IIF proposes developing a voluntary 'suite of best practices' that could be incorporated in a code of good conduct to which the world's leading financial institutions could subscribe. The IIF intends to extend its work, and include 'definitive recommendations for best practices', for a final report by June;
- the formation of the Counterparty Risk Management Group III (CRMPG III) was announced in April.[a] CPRMG III is co-chaired by E. Gerald Corrigan, Managing Director, Goldman, Sachs & Co., and Douglas Flint, Group Finance Director, HSBC Holdings Plc and comprises a small group of senior market participants. The aims of the Group are: (i) to identify opportunities for further improvements in risk management practices; (ii) to revisit the risks associated with complex financial instruments; (iii) to examine current accounting rules setting forth the criterion according to which certain classes of activities are booked on or off the balance sheet; and (iv) to examine areas where further and substantial strengthening of industry wide financial infrastructure is needed, with particular emphasis on the infrastructure supporting OTC derivatives. The report is expected to be published in July.

The Authorities emphasise the importance of market participants taking action to implement the FSF's recommendations, and welcome these and other market-based initiatives. The Authorities look forward to seeing the IIF and CPRMG bring forward proposals that are consistent with the recommendations in the FSF report and that can be translated into concrete actions by market participants.

[a] There have been two previous CRMPG reports. The first report was released in 1999 and reviewed market practice in the light of LTCM/Russia/Asia crisis. The second appeared in July 2005 and reviewed subsequent developments in risk management.

STRENGTHENING PRUDENTIAL OVERSIGHT OF CAPITAL, LIQUIDITY AND RISK MANAGEMENT

2.29 The market turbulence has highlighted the need for better prudential risk management and stress testing practices within banks and other financial institutions, particularly in relation to securitisation activities and liquidity risk management. While primary responsibility for the management of risk lies with firms' boards and senior management, prudential regulation plays a key role in sharpening the incentives for firms to better manage risk. Deficiencies have been identified in regulatory capital and liquidity requirements, and with unforeseen consequences. Regulation may also, in some cases, have contributed to problems by creating undesirable incentives for firms to structure their businesses in such a way as to lessen the impact of regulation. The January consultation emphasised in particular the need to:

- enhance stress testing by financial institutions;
- improve firms' liquidity risk management and the regulation of liquidity risk; and
- review the Capital Requirements Directive (CRD)/Basel II framework as it applies to off-balance sheet activities.

2.30 The FSF report includes a number of recommendations of steps that national authorities and international bodies should take to strengthen prudential oversight of capital, liquidity and risk management.

Capital requirements

Strengthening Basel II

2.31 The FSF report stresses that the Basel II capital framework needs timely implementation and calls on the Basel Committee to issue proposals in 2008 to strengthen capital requirements relating to certain securitisation and off-balance sheet activities.

2.32 The CRD, which implements Basel II in the EU, has already been fully implemented in the UK. On 1 January 2007, the FSA's final rules and guidance implementing the 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 FSA and the Bank are actively involved in the work of the Basel Committee to review Basel II as proposed by the FSF.

2.33 Any consequent changes to Basel II will first need to be considered in light of any necessary CRD review process before being implemented in the UK through revisions to the FSA Handbook. As Box 2.4 explains, the European Commission is currently engaged in a consultation on potential changes to the CRD. While many of the changes being considered through this process were already under consideration, the Commission's proposals in part reflect a response to the credit market turmoil that emerged in mid-2007.

Box 2.4: European Commission consultation on potential changes to the Capital Requirements Directive

The Basel Committee agreed the original Basel Accord in 1988. The purpose of the 1988 accord was to create an international standard that banking regulators could use when developing regulations about how much capital banks need to put aside to guard against financial and operational risks.

Basel II in 2004 revised the existing framework to make it more risk sensitive and representative of modern banks' risk management practices. It included an explicit measure for operational risk (risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events) and more risk sensitive risk weightings against credit risk. It also allowed firms to calculate their own requirements, and subject them to supervisory and market review. The new framework aimed to leave the overall level of capital held by banks collectively broadly unchanged on the original accord.

The Capital Requirements Directive (CRD) implements the Basel II accord into EU law and came into force on 1 January 2008. Through its negotiation in the EU, a number of issues were set aside pending a more detailed review.

The review now under way aims to strengthen financial stability, simplify and clarify elements of the Directive and learn lessons from the recent financial market disruption, covering, among other issues, four key areas:

- **large exposures:** regarding the maximum exposure a financial institution can have to a single entity, including exposures within a group and between banks;
- **definition of capital:** clarifying the type and quality of the capital financial institutions are required to hold as a buffer against potential losses;
- **supervisory arrangements:** aiming to strengthen supervisory coordination by improving cooperation and information exchange and reinforce the efficiency and effectiveness of supervision of cross border banking groups; and
- **securitisation:** changes concerning the way that institutions should manage credit risk and liquidity risk in the context of securitisation transactions and the capital treatment of liquidity facilities for securitisations.

The European Commission has been consulting on these potential changes. The Commission will submit its revised proposal to the Council of Member States and the European Parliament for discussion. The Treasury will represent the UK in these discussions, working with the FSA and the Bank of England, and is engaging actively with stakeholders to develop its position. The consultation can be found here: http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm

Pro-cyclicality in the Basel II framework

2.34 Banks are required to maintain minimum capital levels related to the risks that they run to provide them with protection against unexpected losses, including those arising from deteriorating economic conditions. As the January consultation noted, while the introduction of the CRD/Basel II marks a significant improvement in the prudential regulation of banks, 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. The FSF report calls on national supervisors and the Basel Committee to assess the cyclicality of the Basel II framework and take additional measures as appropriate.

2.35 Basel II ties capital requirements more closely to risks. At a minimum, banks must apply the standardised approach, where capital requirements are based on credit agency ratings of the assets held. Assets with low credit ratings will be assigned a higher risk weighting and attract larger capital charges than assets with higher ratings.

2.36 Banks that meet certain standards will be allowed to use the internal ratings based (IRB) approaches. IRB banks will still use external credit ratings to determine the risk weighting of their securitisation exposures, but capital requirements for other banking book assets will be based on the outputs of banks' own internal rating systems.

2.37 The Bank of England argues in its latest Financial Stability Report that Basel II in its current form is unlikely to reduce significantly tendencies in the financial system towards overextending credit in good times and then retracting sharply when conditions change.[6] In fact, there are concerns that it could even lead to additional procyclicality in the system. For example, an economic downturn could put downward pressure on regulatory capital ratios, including through losses that banks may incur, and through write-downs on the value of assets that banks are obliged to mark to market. Regulatory capital ratios can also deteriorate during a downturn as the riskiness of banks' portfolios increases.

2.38 The Basel Committee was aware of these concerns during the development of the Basel II regime. Safeguards were therefore built into Basel II, which aim to achieve a balance between capital requirements that are sensitive to risk and capital requirements that are relatively stable over the cycle.

2.39 Given that the CRD came fully into force on 1 January 2008[7] and Basel II has not been implemented in a number of key jurisdictions, it is difficult to assess at this stage how important this procyclicality effect is likely to be and how effective the safeguards in Basel II will be. The impact will be closely monitored. The Bank of England and the FSA have developed a system for examining the sensitivity of aggregate minimum capital requirements to credit conditions, and to monitor the impact of changes in these requirements on both capital and lending. 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 requirements has also been set up. The Authorities participate in both.

Liquidity management

2.40 As the FSF report recognises, one of the key lessons from recent market disruption has been the speed with which liquidity dried up in certain financial markets (for example the markets for residential mortgage-backed securities (RMBS)) and the extent to which this spread beyond these directly affected markets.

2.41 The FSA is currently conducting a review of its liquidity requirements for banks and building societies with a view to addressing practical shortcomings and improving standards of liquidity risk management. Box 2.5 provides an update on the progress of this review.

[6] Bank of England (2008), *Financial Stability Report – Issue No. 23*, April 2008, available at: http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf

[7] 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.

Box 2.5: Update on the FSA's review of liquidity requirements

In December 2007 the FSA consulted on its liquidity requirements in Discussion Paper (DP) 07/7 (Review of the liquidity requirements for banks and building societies), setting out preliminary ideas for reforming liquidity regulation. On 27 May the FSA published a Feedback Statement on the responses to the consultation. Key points raised by respondents included:

- agreement with the policy objectives set out in the DP, the FSA's current high-level standards and its principles-based approach, and on the need to continue coordinating work on liquidity both on the national and international level;
- emphasis on the close relationship between the central bank's role, actions and provisions and firms' internal liquidity risk management, as well as any measures developed by the FSA under a new regulatory regime;
- a review of stress-testing scenarios, contingency funding plans and assumptions on "liquid assets" in line with the lessons learnt over the past year;
- recognition of the value of internal models, but diverse opinions on the role they should play;
- agreement that the sterling stock regime, in its current form, is not as good a measure of liquidity as some of the possible alternatives and that the mismatch regime, suitably refined, could be a good starting point for a new regime;
- agreement that quantitative requirements are a necessary part of the liquidity regime but some scepticism about the usefulness of quantitative requirements to safeguard against long-term chronic liquidity stresses; and
- support for the FSA working towards obtaining a clearer picture of the liquidity positions of the markets and of individual firms.

The FSA aims to publish a consultation paper in the autumn to set out proposals on sound practices for managing liquidity risk with a strong focus on stress-testing. These enhanced requirements will reflect the work currently under way in the Basel Committee, which has been issued for consultation. The FSA will also give consideration, in discussion with the industry and the Bank of England, to the type and range of data-based requirements, which should usefully complement proposals in relation to the sound risk management of liquidity.

2.42 The January consultation highlighted the importance of achieving greater consistency internationally in the regulation of liquidity risk. The FSF report also stresses this, and makes the following recommendations in relation to liquidity risk management internationally:

- By July 2008, the Basel Committee should issue for consultation enhanced sound practice guidance on the management and supervision of liquidity. National supervisors should closely check banks' implementation of the updated guidance; and
- Supervisors and central banks, led by the Basel Committee, should examine the scope for additional steps to promote more robust and internationally consistent liquidity approaches for cross-border banks.

2.43 The Basel Committee's Sound Practices paper was issued for public consultation on 17 June.[8] The sound practices are based on the fundamental premise that a bank's liquidity risk framework should ensure it maintains sufficient liquidity to withstand a range of stress events, including those that affect secured and unsecured funding. The new guidance raises standards in the areas of:

- measuring liquidity risk on and off balance sheet;
- allocating liquidity risk costs and benefits;
- managing intraday liquidity risk;
- stress testing and contingency funding planning;
- holdings of liquid assets to survive protracted periods of liquidity stress; and
- providing regular quantitative and qualitative public disclosures.

2.44 The guidance for supervisors is also more detailed, with principles on liquidity risk assessment, monitoring through reporting, remedial action, and cooperation with other supervisors and public authorities.

2.45 Work is also under way in the EU. The Committee of European Banking Supervisors (CEBS) released for public consultation on 17 June an in-depth analysis of a range of factors with implications for liquidity risk. The report is closely aligned to the Basel Committee's Sound Practices paper.

2.46 The FSA and the Bank of England are actively involved in this work by the Basel Committee and CEBS. The FSA will take into account developments in EU and international work on liquidity risk management in its review of its own liquidity requirements.

Risk management

2.47 The FSF report notes that recent events have highlighted significant differences in risk management practices among even the largest and most sophisticated firms. The report calls on firms' boards and senior management to take steps to strengthen risk management practices, with input from national supervisors. The Basel Committee and national supervisors should strengthen guidance in a number of areas, including stress testing, the management of firm-wide risks, the management of exposures to leveraged counterparties, and off balance sheet and securitisation activities.

2.48 The FSA is participating actively in the Basel Committee's work on stress testing. The FSA plans to issue a Consultation Paper on stress testing in Q3 2008 and continues to hold – jointly with the Bank of England – periodic workshops on stress testing. The FSA plans to undertake a review of credit risk stress testing that IRB firms have undertaken, and it is planning follow up work to its 2006 "Dear CEO" letter on stress testing (as suggested in the Northern Rock internal audit report).

2.49 The FSF report also calls on national regulators and supervisors to work with market participants to mitigate the risks arising from remuneration policies. Box 2.6 summarises the Authorities' position on this issue.

[8] Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision*, June 2008, available at: http://www.bis.org/publ/bcbs138.pdf.

Box 2.6: Financial institutions' compensation structures

There has been additional attention in recent months on whether undesirable incentives created by some financial institutions' remuneration structures can help to explain why those institutions exposed themselves to such a large amount of risk. The Governor of the Bank of England, Mervyn King, summarised the issue in testimony to the Treasury Select Committee on 29 April:

"I think that banks themselves have come to realise, in the recent crisis, that they are paying the price themselves for having designed compensation packages which provide incentives that are not, in the long run, in the interests of the banks themselves and I would like to think that would change".[a]

The Authorities believe that compensation schemes can, and in some cases appeared to, encourage excessive risk taking. This view is echoed by market participants. The IIF's Interim Report identifies an increased emphasis on short-term profitability in financial reporting and bonus payouts, which created incentives for firms and individual employees that conflicted with sound underwriting and risk management practice.[b] The investment bank UBS identifies systemic deficiencies in its compensation policy as a contributory factor to the huge writedowns it has suffered.[c]

The IIF report identifies several principles that it believes should be followed in order to design remuneration structures that create desirable incentives:

- incentive compensation should be closely related to shareholders' interests and long-term firm-wide profitability by use of deferrals;
- compensation should take better account of the cost of capital (not just revenues). Financial targets should better reflect a risk-adjusted basis; and
- transparency of compensation policies, criteria and alignment with business strategy, is needed to improve accountability to shareholders.

The FSA's Chief Executive, Hector Sants, explained its position on these issues in a recent speech:

"From the regulatory point of view, it is not our role to dictate the quantum of individual remuneration, that is for the market, but we do need to consider the implication of remuneration structures when judging the overall risk of individual institutions. We will do this with increased intensity."[d]

[a] Oral evidence taken before the Treasury Committee, 29 April 2008.

[b] Institute of International Finance (2008), *Interim report of the IIF Committee on Market Best Practices*, April 2008.

[c] UBS (2008), *Shareholder report on UBS's writedowns,* 18 April 2008.

[d] IMA AGM dinner, 20 May 2008.

Operational infrastructure for OTC derivatives

2.50 Derivative instruments have been a feature of modern financial markets for several decades. They play an important role in managing the risk of underlying securities such as bonds, equity, currency and short-term interest rate positions. Against this background, the OTC derivatives market has increased in size at a rapid pace. The BIS semiannual survey of OTC derivative markets (November 2007) showed notional amounts outstanding totalled $516 trillion at the end of June 2007, 135 per cent higher than in the 2004 BIS survey. These instruments play a central role in modern financial markets by facilitating the hedging and transfer of credit and default risk.

2.51 While the OTC derivative market infrastructure has coped quite well during the recent turmoil, both the FSF and the US President's Working Group argue that improvements are needed to ensure that it can continue to manage the high volume of transactions and the complexity of the instruments. Concerns surrounding the possible impact on the OTC markets, given the deficiencies in infrastructure, were one of the factors that led to the authorities' intervention in, and the subsequent acquisition by JP Morgan Chase of, Bear Stearns. The FSF report recommends that market participants act promptly to ensure that the settlement, legal and operational infrastructure that currently supports the OTC derivatives markets is sound, and that the financial industry develop a longer-term plan to bolster reliability and robustness.

2.52 The Federal Reserve Bank of New York (FRBNY) and a group of supervisors, including the FSA, have been working over recent years with dealer firms on OTC credit and equity derivative issues, in particular addressing confirmation backlogs. Despite high trade volumes for credit derivatives in 2008, firms have coped well in meeting their operational backlog commitments. At a meeting on 9 June market participants and regulators agreed on a series of steps to improve further the OTC derivatives infrastructure, including:

- further automation of credit derivatives;
- developing a central counterparty for credit derivatives;
- incorporating auction based settlement into standard derivatives documentation;
- reducing the volume of outstanding credit derivative trades via mechanisms such as early terminations; and
- improving standards across all OTC classes (equity, interest rates, foreign exchange and commodities).

ENHANCING TRANSPARENCY AND VALUATION

2.53 As explained in the January consultation, the ongoing market disruption has highlighted a number of issues around transparency and valuation, particularly in securitisation markets, including:

- 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; and
- difficulties in valuing ABS, given the complexity of some structures and the fact that they may trade in illiquid markets, if at all.

2.54 Sound disclosure, accounting and valuation practices are essential to achieve transparency, to maintain market confidence and to promote effective market discipline. The FSF report sets out recommendations to improve market transparency in the following areas:

- risk disclosures by market participants
- accounting and disclosure standards for off-balance sheet entities;

- valuation; and
- transparency in securitisation processes and markets.

Risk disclosures

2.55 As noted in Box 2.2, in their April statement G7 Finance Ministers strongly encouraged financial institutions to make robust risk disclosures in their mid-year 2008 reporting consistent with leading disclosure practices as set out in the FSF's report. This will help to reduce uncertainty, improve confidence between financial institutions and encourage the restoration of normal functioning of markets. The FSF also calls on investors, industry representatives and auditors to work together on an ongoing basis to develop principles that should form the basis for useful risk disclosures and identify the types of risk disclosures that would be most relevant and useful to investors at the time. Regulators, supervisors and standard setters should be consulted on these efforts, and a more prescriptive approach could prove necessary if the market-led approach proves inadequate.

2.56 UK banks have continued to provide additional disclosures beyond those presented in recent years. Ahead of any possible amendments to International Accounting Standards Board (IASB) disclosure requirements (mainly in IFRS 7), the Authorities have encouraged UK banks to continue to provide additional disclosures relating to higher risk exposures. A number of major UK banks are making disclosures that are in line with those noted in the FSF report (and further explained in the Senior Supervisors Group report on leading disclosures of high risk exposures). As markets evolve, and products develop, disclosures must also change, and it is necessary for UK banks to work with market participants, regulators and auditors to ensure their disclosures remain the most relevant and appropriate.

Off-balance sheet entities

2.57 The FSF report calls on:

- the IASB to improve accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters towards international convergence (as noted in Box 2.2 this was identified as a priority by G7 Finance Ministers); and
- the Basel Committee to issue further guidance in 2009 to strengthen disclosure requirements under Pillar 3 of Basel II.[9]

2.58 The IASB is accelerating its work to implement these recommendations. It plans to deliver exposure drafts on derecognition and consolidation issues, and related disclosures, by the end of 2008. The IASB's work on off-balance sheet entities is part of its convergence programme with the US accounting setter, the Financial Accounting Standards Board (FASB).

2.59 The Authorities recommend that the IASB assesses the need for enhanced disclosures on off-balance sheet entities and also for on-balance sheet entities where there may be substantial risks that are not currently captured in IFRS disclosures. For example, risks may arise from contingent cash flows between entities in a group, which

[9] The Basel II framework consists of three 'pillars': Pillar 1 sets out the minimum capital requirements a firm 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; Pillar 3 aims to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

would not necessarily be captured in group accounts, because intragroup exposures 'disappear' on consolidation. The Authorities recommend that the IASB consider in particular whether reputational risks are properly taken into account in decisions about consolidation. The IASB should draw on, and work with, the Basel Committee in its current review of the securitisation disclosure requirements under Pillar 3 of Basel II.

Valuation

Application of fair value

2.60 The FSF report notes that potential weaknesses in valuation practices and disclosures, and the difficulties associated with fair valuation in circumstances in which markets become unavailable, have become apparent during the turbulence. Financial institutions have encountered particular problems in valuing financial instruments when previously active markets have become illiquid.

2.61 There is also some evidence that asset backed securities market valuations are overshooting downwards, giving a distorted signal to participants of longer-term realisable values (and therefore of current losses). While the markets are probably making some adjustments for this, the Bank of England highlights in its latest Financial Stability Report the risk that uncertainty about value and counterparty risk, and continued illiquidity, could lead to further overshooting. In turn, this could increase the real costs of adjustment.

2.62 Some have argued that this apparent overshooting is being caused in part by the application of fair value accounting rules. Accounting standards generally require that instruments like ABS 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.[10] The concern is that the fair value accounting rules are amplifying market stress due to the requirement to value and disclose at prices that in effect may be distressed.[11]

2.63 The concept of 'fair value' has hitherto been articulated by the accounting standard setters primarily in the context of active markets, or at least active markets in related instruments which could be used to calculate an external indicator of value. The market turbulence has highlighted the need for the standard setters to analyse and provide more guidance on the meaning of 'fair value' in illiquid markets, including circumstances in which there is a sharp divergence between any available external indicators and discounted cash flow approaches. The difficulties in applying fair value accounting when markets are illiquid has led to calls from some quarters (for example the Institute of International Finance, the global association of financial institutions) for the application of mark-to-market accounting rules to be modified.

2.64 As explained in the January consultation the Authorities believe that the use of fair value accounting in relation to structured products remains appropriate. Fair value is a clear attempt to measure 'true' economic value, providing a basis for better decisions by markets and regulators. That said, the ongoing market disruption has raised legitimate concerns about how fair value accounting is applied in distressed market conditions. The appropriate policy response is through guidance to improve the

[10] This differs from the traditional 'historic cost' approach, which is, broadly, based on the actual amount of money paid for assets (adjusted for e.g. provisioning against losses).

[11] Specifically, there have been concerns about the extent to which available external prices adequately reflect fair values. Traditional reference points for certain instruments such as many collateralised debt obligations (CDOs) and asset backed securities (ABS) – such as the ABX index and CDS spreads – imply unrealistically high levels of default and loss-given default. The levels of these indices probably reflect factors such as adverse investor sentiment towards new investment in these asset classes, lack of funding liquidity for potential investors, possible 'fire sales' and perhaps short selling for hedging or speculative purposes.

consistency of application of fair value accounting rules across firms and increase transparency, for example in relation to uncertainties around valuations. The FSF report calls on the IASB to enhance its guidance on valuing financial instruments when markets are no longer active (as noted in Box 2.2 this was identified as a priority by the G7 Finance Ministers).

Variations in valuation approaches

2.65 Concerns have also been expressed about variations between financial institutions in their approaches to accounting for and disclosing changes in the value of their assets. There is variation internationally in the disclosure of write-downs against the high risk exposures held by banks. Much of the variation may flow from different hedging and trading strategies, or different valuation methodologies.[12] However, it is often difficult to identify consistently the source of this variation from the disclosures in banks' financial statements. Work undertaken by the Committee of European Securities Regulators (CESR) and CEBS has indicated that firms' disclosures about valuations, methodologies and the uncertainty associated with valuations could be improved.

2.66 The FSF report calls on the IASB to strengthen its standards to achieve better disclosures about valuations, methodologies and the uncertainty associated with valuations. The Authorities strongly encourage the IASB to draw upon the work being undertaken by international and European regulators on disclosures (for example, the work of the Senior Supervisors Group, CEBS and CESR), to assess whether their findings indicate the need for enhancements to IFRS.

IASB work programme

2.67 The IASB has set up expert advisory panel to examine whether existing IASB requirements and guidance on the accounting and valuation of structured products could be improved. The advisory panel, which had its first meeting in early June, should draw upon the analysis undertaken by European banking and securities regulators. A specific area the Authorities call on the IASB to review is the current requirement that when any of an unrealised value loss on an available-for-sale security (broadly an investment security) is regarded as due to impairment, the entire loss has to be recognised immediately in the profit and loss statement. It is not clear this position is conceptually sound, and it creates an incentive for firms to delay timely recognition of impairment.

Market action

2.68 Market participants also need to improve their approaches to valuation. The FSF Report calls on financial institutions to establish rigorous valuation processes and make robust valuation disclosures. The FSA is in close dialogue with major financial institutions and audit firms to discuss the lessons that can be learnt in these areas from the recent market turmoil.

Basel Committee and IAASB

2.69 The FSF Report also calls on the Basel Committee to issue for consultation during 2008 guidance to enhance the supervisory assessment of banks' valuation processes and reinforce sound practices. A project by the Basel Committee's Accounting Task Force has identified the need for sound practices in the areas of governance and controls, risk management and measurement, dealing with valuation uncertainty and external reporting.[13] Following this initial project, the Basel Committee is working on guidance for supervisors on how they should evaluate banks' approaches to governance and controls, the quality of banks' measurement approaches and the appropriate use of a diverse set of information to improve the reliability of valuations. The FSA continues to play an active part in working within the Basel Committee to

[12] *Financial Stability Report*, Bank of England, April 2008, No. 23, p45

[13] Basel Committee on Banking Supervision: Fair Value Measurement and Modelling: An Assessment of Challenges and Lessons learned from the Market Stress, available at http://www.bis.org/publ/bcbs137.htm .

develop the draft guidance for public consultation in 2008 which aims to enhance the supervisory assessment of banks' valuation processes and reinforce sound practices.

2.70 Given the current challenges for banks in their valuation of financial instruments where markets are illiquid, and the associated disclosures, external audit has become even more important as a key element supporting market confidence. To assist auditors, the UK Auditing Practices Board provided a summary of key audit points in existing audit standards which are of particular relevance in the market turmoil. In the UK, auditors follow international standards on auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). The IAASB has met with the larger global audit networks to discuss their experience of auditing in the recent market turmoil, and to assess whether and to what extent any further guidance is necessary to enhance the ISAs.

EU work

2.71 The FSA has also contributed to the work being undertaken by CEBS and CESR in analysing these issues around valuation. This work suggests that there is scope for more guidance in establishing what constitutes an active market and observable data and the inputs firms should consider where they are using valuation techniques to establish fair values.

Transparency in the securitisation process

2.72 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. While market turbulence has particularly affected a number of markets for ABS, securitisation is likely to remain an important element of the financial system. However, effective risk transfer requires transparency about the risk being transferred for it to be effectively priced.

2.73 The FSF report recommends that securities market regulators work with market participants to enhance transparency at each stage of the securitisation chain, including by enhancing and standardising information about the pools of assets underlying structured credit products and by increasing transparency around the underwriting standards for the underlying assets.

2.74 A number of initiatives are under way aimed at increasing transparency in the securitisation process. The European Commission has asked the European financial services industry to lead proposals on enhancing the transparency of European securitisation markets. On 8 February a number of industry bodies, including the European Banking Federation, the European Securitisation Forum, the London Investment Banking Association (LIBA) and the Securities Industry and Financial Markets Association (SIFMA), together with representatives from banks and other market participants, delivered proposals in the following areas:

- to provide a periodic report on securitisation market data, starting in June 2008;
- to identify information that would be relevant and useful in achieving an appropriate level of transparency in respect of the secondary market for securitisation;
- to make information related to securitisation transactions more consistently available, particularly in relation to the assets underlying securitisation products; and

- the development of CRD good practice guidelines on securitisation disclosures.

2.75 In May the ESF, International Capital Market Association (ICMA), LIBA, the International Swaps and Derivatives Association (ISDA) and SIFMA issued an exposure draft of "Structured Products: Principles for Managing the Distributor-Individual Investor Relationship", which sets out principles that firms should keep in mind in their dealings with individual investors in structured products.

2.76 As mentioned in Box 2.1 above, Chancellor of the Exchequer has asked Sir James Crosby to advise on options for improving the functioning of mortgage finance markets, and report initially in the summer and present proposals at PBR. These may include measures aimed at strengthening investor confidence and improving the robustness of the market.

CHANGES TO THE ROLE AND USES OF CREDIT RATINGS

Concerns about credit ratings

2.77 Credit rating agencies (CRAs) play an important role in evaluating and disseminating information on structured products. Recent events have highlighted the following issues about the role of credit ratings in modern financial markets:

- **ratings of structured products**: the ratings of certain structured credit products created significant challenges for CRAs, which were particularly exposed 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. It has been argued that CRAs devoted insufficient resources to initial due diligence and subsequent ongoing monitoring of the securities they rated and the mortgage collateral underlying them;

- **conflicts of interest**: credit rating agencies are paid by issuers rather than investors, which some argue creates an incentive to offer a favourable rating to get a rating fee. Particular concerns have been raised about the potential for CRA analysts to advise on the design of securitisation products they are rating;

- **information content of ratings**: CRA assessments are intended to cover only credit risk and not liquidity and market risk. Rating definitions are also different between the major CRAs. CRAs have also been criticised for not providing enough information about the uncertainties around their ratings of structured products (for example due to a short run of historical data on which to base their assessments); and

- **over-reliance on ratings by institutional investors**: ratings tend to be prominent or even hard-wired into investors' mandates. Particular problems arose because investors mistakenly interpreted a good credit rating as a signal that the asset traded in a liquid market and that the market prices of highly rated assets and tranches would be relatively stable.

Changes by CRAs

2.78 The FSF has recommended that CRAs make changes in three key areas:

- **the quality of the rating process**: CRAs should improve the quality of the rating process and manage conflicts of interest in rating structured products;

- **differentiated ratings and expanded information on structured products:** CRAs should differentiate ratings on structured finance from those on bonds, and provide more information on the risk characteristics of structured products; and

- **CRA assessment of the underlying data quality:** CRAs should enhance their review of the data input and the due diligence performed on underlying assets by originators, arrangers and issues involved in structured products.

2.79 A number of international bodies have also brought forward recommendations to address these concerns, including:

- the International Organisation of Securities Commission's (IOSCO) taskforce on CRAs published revisions to its voluntary Code of Conduct Fundamentals for Credit Rating Agencies on 28 May. These changes are intended to address issues which have arisen in relation to the activities of CRAs in the market for structured finance products;

- CESR in May produced its second annual report to the European Commission on the voluntary compliance of CRAs with the IOSCO Code and measures for addressing issues within the credit rating industry;[14]

- the European Commission mandated the European Securities Markets Expert Group (ESME) in November 2007 to provide advice on a series of questions concerning the role of CRAs, in particular in the field of structured finance. ESME's report to the European Commission was published earlier this month;[15] and

- the Basel-based Committee on the Global Financial System (CGFS) has been reviewing what went wrong in rating structured finance products and what can be done to address the shortcomings. The Bank for International Settlements (BIS) will publish the CGFS report in early July.

2.80 The Authorities believe that the revisions to the IOSCO Code provide a useful minimum benchmark for the actions that CRAs should take to address concerns about their activities in the markets for structured products. The Authorities also note additional steps that have been taken to address areas of concern, including:

- the announcement by the SEC on 11 June of a series of rules to strengthen the SEC's regulatory regime for CRAs in the US. This includes proposals to require the public disclosure of the information CRAs use to determine a rating of a structured product, including information on the underlying assets; and to make all of their ratings and subsequent rating actions publicly available;

- the announcement by the New York Attorney General on 5 June that he had reached agreement with Standard & Poor's, Moody's and Fitch concerning their ratings of RMBS. This includes agreements by the CRAs to move to a

[14] CESR (2008), *CESR's second report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance*, May 2008.

[15] ESME (2008), *Role of credit rating agencies: ESME's report to the European Commission*, June 2008.

fee-for-service structure and require from banks and other lenders due diligence data on loan pools for review prior to the issuance of ratings; and

- steps by CRAs themselves to strengthen the quality of ratings, enhance the rating process, better manage conflicts of interest and enhance transparency. The agencies have committed to actions to strengthen the internal governance of their ratings operations and the range and transparency of the information provided to capital markets that accompany their ratings.

2.81 The Authorities believe that it is important that any changes CRAs make to improve their business practices are not limited to their activities in certain jurisdictions, but are rolled out consistently across all jurisdictions in which they do business.

External monitoring of CRAs

2.82 There are ongoing international discussions on the appropriate means to ensure that CRAs take the necessary steps to improve the quality and information content of credit ratings and better manage conflicts of interest. The European Commission, under the French Presidency, has suggested that an EU registration system and external oversight regime for CRAs be considered with a view to ensuring that CRAs comply with a set of standards and principles on an ongoing basis. CESR has recommended that an international standard setting and monitoring body should be set up to develop and monitor compliance with international standards.

2.83 The Authorities support the objective of strengthening independent external monitoring of rating agency performance against international standards. The Authorities believe it is important to take a proportionate, principles- and risk-based approach, and to consult thoroughly, in the assessment of what form this monitoring should take, and should consider non-regulatory as well as regulatory measures. Given the global nature of CRAs' business there would be considerable benefits to an internationally consistent solution to avoid regional differences in standards. The Authorities intend to continue working closely with their European and international partners to achieve an appropriate and consistent framework for monitoring CRAs.

Investors' reliance on credit ratings

2.84 The FSF report also calls on investors to address their over-reliance on ratings and investor associations should consider developing standards of due diligence and credit analysis for investing in structured products. This issue was also highlighted in the consultation document published in January, and the Authorities committed to keep under review the development of investor practice and to consider the implications for investors of the recommendations of the Hedge Fund Working Group and the US President's Working Group on Financial Markets.

2.85 It is clear that some banks and other investors placed too great a reliance on credit ratings in assessing the suitability of structured investments, to the detriment of their own due diligence. Investment managers' sponsors and clients expect, and should put pressure on managers to undertake, a comprehensive assessment of the risk and return of investments selected, which should go beyond a simple risk assessment based on third party credit ratings. Reflecting this, the reports by both the Hedge Fund Working Group and the US President's Working Group on Financial Markets highlight the importance of not only putting in place, but also of periodically reviewing, robust internal risk management processes. This has been accompanied by a recognition among investment managers of the need to place less reliance on third party credit ratings and to do more internal analysis. The Authorities welcome this progress as well as market participants' commitment to go further in this area.

Role of ratings in regulation

2.86 Regulators allow firms to use recognised CRAs' ratings to calculate capital requirements under some approaches to credit risk where it is not feasible for them to make assessments of their own. (The role of credit ratings in banks' risk assessments for regulatory capital purposes under Basel II is described at paras 2.35 to 2.37 above.) The FSF report notes that the official recognition of credit ratings in regulatory and supervisory frameworks may have played a role in encouraging investors' over-reliance on ratings. The FSF recommends that authorities review the role that they have assigned to CRAs in regulations and supervisory rules to ensure that they have not placed undue reliance on them as a substitute for independent evaluation. This is a principle the Authorities would strongly endorse whenever CRA ratings are considered in framing regulation. Consistent with this, the US SEC has proposed changes to its rules which would replace current ratings-based restrictions on money market fund and other investments with requirements for qualitative assessments which would encompass credit risk and liquidity. The Joint Forum (a cross-sector group of banking, insurance and securities supervisors) will be considering this issue.

STRENGTHENING AUTHORITIES' RESPONSIVENESS TO RISKS

2.87 Some of the weaknesses that have come to light were known or suspected within the global financial community prior to their manifestation and work was already under way at international levels that – if it had already been implemented – might have reduced the impact of the problems experienced. Authorities need to enhance the prioritisation and coordination of their risk assessments and international policy development work, and increase the effectiveness of their communication with markets.

2.88 The FSF identified three areas where the authorities' responsiveness to risk should be strengthened:

- **translating risk analysis into action:** supervisors, regulators and central banks will take additional steps to more effectively translate their risk analysis into actions that can mitigate their risk;
- **improving information exchange and cooperation among authorities:** authorities' exchange of information and cooperation in the development of good practices will be improved at national and international levels; and
- **enhancing international bodies' policy work:** international bodies will enhance the speed, prioritisation and coordination of their policy development work.

Translating risk analysis into action

2.89 The FSF report recommends that national supervisors:

- ensure they have adequate resources and expertise to oversee the risks associated with financial innovation; and
- formally communicate at an early stage concerns about a firm's risk exposures and the quality of the firm's risk management.

2.90 In March, and in the light of a review carried out by its internal audit division into its supervision of Northern Rock,[16] the FSA identified a number of areas for improvement in the execution of supervision. These are being advanced rapidly by the FSA's management via a dedicated supervisory enhancement programme. This is described in more detail in Chapter 3.

Improving international cooperation

Supervisory colleges for cross-border firms

2.91 Supervisory exchange of information and cooperation among supervisors to address cross-border issues for the largest financial groups takes many different forms reflecting the supervisory practices of the global regulators. The value of enhanced cross-border cooperation has been emphasised by the recent market turmoil. The Government believes it is important that supervisors dealing with cross-border groups work more closely together to identify, prioritise and agree a supervisory programme for addressing risks to the group as a whole.

2.92 To facilitate this enhanced cooperation, the Government proposed the establishment of supervisory colleges for the ongoing prudential supervision of all large and complex and internationally active cross-border groups. These colleges, which already exist for some financial institutions, allow a better understanding of the activities and financial soundness of the firm, improve risk mitigation, and aid supervisory cooperation and effectiveness. Supervisory colleges have the potential to bring clear benefits for the prudential supervision of groups, including:

- by being tailored to the individual firm, the college directly meets the supervisory challenges posed by the firm;
- the involvement of those authorities within whose jurisdiction the firm has a significant presence. This particularly benefits host country supervisors, which gain greater information on the group, and an enhanced role in its oversight. This is important in the case of high impact branches of banks within the EU, where host states currently have few powers and minimal prudential oversight of firms. It is also important for subsidiaries where host authorities have a key role but lack full knowledge of the group's activities;
- providing a structured framework for information collection and exchange, the establishment of regulatory programmes and the delegation of supervisory tasks; and
- increasing the efficiency of supervision by removing duplication, thereby reducing costs for firms and supervisors.

2.93 The FSF report recommends the establishment of international colleges of supervisors for each of the largest global financial institutions by the end of 2008. The FSA is actively engaged in the work on supervisory colleges taking place in the FSF.

2.94 The operation of colleges at the international level must be structured to produce the most effective supervisory outcome. Given the potentially large number of supervisors and jurisdictions involved, this may necessitate a differentiated or tiered system. There are three categories to which a host state supervisor might be allocated:

[16] FSA (2008), *The supervision of Northern Rock: a lessons learned review*, FSA Internal Audit Division, March 2008, available at: http://www.fsa.gov.uk/pubs/other/nr_report.pdf.

- **Category A:** host supervisors of key entities (either subsidiaries or branches) whose activities are central to operations and viability of the group. In general this will be because the scale or the activities undertaken by the entity is fundamental to the soundness (or in a crisis, the survival) of the group;

- **Category B:** host supervisors of entities (whether subsidiaries or branches) whose activities are not fundamental to the operations or survival of the group, but whose failure could nevertheless have systemic consequences for the host state concerned. These host supervisors would not be part of the core college that conducts a prudential review of the group as a whole, but they would be involved in a dialogue about the group and the group's operations in the host state, and through the extensive two way sharing of information the supervisory oversight of the domestic operations of the firm would be enhanced; and

- **Category C:** those entities whose failure would not have a significant impact either on the group or the host state. The supervisors overseeing these entities would have a single point of contact with the home supervisor from whom they would receive information.

2.95 Reflecting the unique institutional set-up in the EU, the Government has proposed that supervisory colleges be established in EU law. The exact composition of each college, together with its method of operation, will need to be determined on a case by case basis, depending on factors such as the number of host jurisdictions and the nature of its operations. It is important to balance the need to ensure that colleges are small enough to be effective, with the legitimate needs of all host jurisdictions to be provided with information and have an input. The Government fully supports the Conclusions of the May ECOFIN Council on colleges, and will play a full part in its translation into law through the ongoing discussions on sectoral legislation.

Enhancing international bodies' policy work

2.96 The Authorities proposed in January that the FSF and IMF enhance their cooperation and provide the international community with an early warning system on the threats to financial stability and the global economy from the international financial system. The FSF report includes a series of recommendations on enhancing international bodies' policy work that are consistent with the Authorities' proposals.

Early warning system

2.97 In April G7 Finance Ministers called on the IMF and FSF to work together to enhance the early warning capabilities of key risks to financial stability. The Authorities welcome this and propose that the IMF should in the next few months continue working to focus its surveillance more closely on macro-financial sector issues, and in particular the links and transmission mechanisms between financial markets and the global economy. The IMF should then, working in close collaboration with the FSF, be in a position to present an assessment to the FSF of the most important risks and vulnerabilities from the financial system, with a matrix of the likelihood and potential impact of each risk. The FSF can then identify the appropriate mitigation responses for each of the risks for regulators and market participants at the local, regional and global level. The IMF and FSF should then report on the risks and response to financial stability at the Spring and Annual Meetings of the IMFC.

2.98 The early warning system process should not stop there. The FSF should take responsibility for overseeing the international response, setting out the necessary action that should be taken by national and international authorities, regulators, standard-setters and financial market actors, and monitoring the impacts of implementation. This process should raise the profile of financial stability risks to policy-makers, supervisors and market participants throughout the globe, encouraging a timely and coordinated response to these risks before they crystallise, and an informed and rapid response if they do. The Authorities call on the IMF and FSF to deliver the first early warning system report to the Annual Meetings of the IMFC.

Cooperation between IMF and FSF

2.99 As part of enhanced cooperation between the FSF and IMF, the IMF will report the findings from its monitoring of financial stability risks to FSF meetings, and in turn will seek to incorporate relevant FSF conclusions into its own bilateral and multilateral surveillance work. The Authorities welcome this progress and encourage them to continue to deepen their collaborative work, building on the institutions' respective areas of comparative advantage.

International Monetary Fund

2.100 The Authorities also welcome the work programme currently underway at the IMF to strengthen its role on financial sector issues. The IMF is working in close cooperation with national authorities, supervisors, international standard setters, the Financial Stability Forum, and the private sector, among others. It is now well placed to go further in three key areas:

- making more of existing work: this should include clearer, more concise, and more pointed assessments of risks to international financial stability; greater integration of multilateral perspectives and macro-financial sector surveillance, including the lessons from Financial Sector Assessment Programme (FSAP) reports, into bilateral surveillance; and greater emphasis on regional surveillance, including regional financial sector inter-linkages;
- a strengthened intellectual framework: the international community needs to improve its understanding of the transmission mechanisms within global financial markets and between financial markets and the real economy. The IMF is well placed to undertake research in this area; and
- improvements to the IMF's toolkit for macro-financial sector surveillance: this should include a more explicit quantitative assessment and prioritisation of risks to international financial stability (as explained in the early warning system section); developing a more flexible working model under which the IMF can examine high-priority financial issues that are common to a number of countries; and reforming FSAPs to make them more flexible, operationally relevant and timely and less resource intensive.

2.101 The forthcoming Triennial Surveillance Review and the Statement of Surveillance Priorities and Responsibilities offer opportunities to place these issues at the heart of the IMF's work programme.

ARRANGEMENTS FOR DEALING WITH STRESS IN THE FINANCIAL SYSTEM

2.102 Market turbulence has also focused attention on arrangement for dealing with stress in the financial system, both domestically and on a cross-border basis. The FSF has identified the following areas for improving the management of financial stress:

- **central bank operations:** Central banks' operational frameworks should be sufficiently flexible in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral, to deal with extraordinary situations; and

- **arrangements for dealing with weak banks:** authorities will clarify and strengthen national and cross-border arrangements for dealing with weak banks.

Central bank operations

2.103 Central banks' operating frameworks should be able to supply liquidity effectively when markets and institutions are under stress. The extended tensions in inter-bank markets, which have continued with varying intensity since August 2007, have severely tested these frameworks, and, as discussed above, central banks have responded in a variety of ways, including innovations in the instruments that they use and levels of coordination in their responses.

2.104 The FSF report calls on central banks to draw lessons from market disruption in relation to their ability to supply liquidity effectively when markets and institutions are under stress. Through the CGFS, based in Basel, the central banks, including the Bank of England, are actively investigating the lessons to be drawn from these recent experiences for their operational frameworks, for their communications with markets, and for the steps that might be advisable across central banks to address liquidity needs in globalised financial markets. The BIS will publish a report by the CGFS in early July. A key lesson that central banks around the world have taken from recent months is that, in stressed conditions, any bank that is seen to come to the central bank to borrow – whether in regular standing facilities, or in a discount window or support operation – can become 'stigmatised' in the market. Drawing on this and other lessons the Bank of England is conducting a review of its own money market operations, with a view to introducing a new, permanent facility that learns from the experience of the Special Liquidity Scheme.

Arrangements for dealing with weak banks

Domestic

2.105 The FSF report recommends that a set of international principles be agreed for deposit insurance systems, and that national authorities review their national deposit insurance arrangements against these principles. The FSF also calls for national authorities to review their arrangements for dealing with weak and failing banks. These issues are covered more fully in Chapters 4 and 5.

FSF crisis management planning group

2.106 While existing systems for cross-border crisis management have not been severely tested during the current turbulence, the global nature of the market disruption highlights the importance of robust cross-border arrangements for dealing with weak banks.[17] The FSF report recommends that for the largest cross-border financial firms, the most directly involved supervisors and central banks should establish before end-2008 a small group to address specific cross-border crisis management planning issues. The objective of this group will be to improve official sector preparedness for a financial crisis affecting one or more major cross-border financial institutions. Areas which the group could usefully examine include problems relating to bank liquidity and the provision of emergency liquidity support and the functioning of markets and infrastructure in a financial crisis. The group's formal remit

[17] It is important in this context to distinguish between the college arrangements put in place for ongoing prudential supervision (discussed at paras 2.91 to 2.95 above) and arrangements for cross-border crisis management.

and membership will be decided by the FSF in September 2008. The Bank of England and the FSA are likely to be members of this group.

EU Cross Border Stability Groups

2.107 The Government is fully committed to the EU Memorandum of Understanding (MoU) on cross border financial stability that came in to force on 1 June 2008. Amongst other things, the MoU encourages the formation of Cross Border Stability Groups (CBSGs) by central banks, supervisors and finance ministries with common financial stability concerns to help them to prepare to manage a crisis afflicting one or more specific cross-border firms. CBSGs would complement the work of supervisory colleges, whose focus is on day-to-day supervisory issues. Specifically, they could seek to identify and remove practical and specific obstacles to effective cross-border crisis management, help to develop and maintain a common vocabulary, build an information set for use in in-crisis risk assessment and build personal familiarity between individuals within authorities.

2.108 The FSA is leading the EU's work on establishing a generic modus operandi for CBSGs through the Task Force on Crisis Management (TFCM) established by the European System of Central Banks' Banking Supervision Committee (BSC). The Authorities will work with their counterparts within the EU to establish the appropriate CBSGs and will also continue to engage with key non-EU authorities on practical financial crisis management preparations.

3 REDUCING THE LIKELIHOOD OF BANK FAILURE

The potentially significant negative impact on consumers and financial stability of the failure of a bank means that a key objective for reform is to ensure that preventative measures and tools are used effectively to reduce the likelihood of failure. This chapter:

- sets out the Authorities' latest thinking and proposals to ensure they have effective tools for reducing likelihood of bank failure. These cover three main areas:
  - effective principles-based regulation: including the FSA's supervisory enhancement programme, risk based approach to supervision and new regulatory powers;
  - the Bank of England's ability to provide appropriate liquidity assistance, including proposals to deal with disclosure issues; and
  - the effective oversight of payment systems: an important component of the financial system identified as requiring more formal oversight in future, given the potentially systemic impact of difficulties.
- the chapter also summarises respondents' views to the proposals in the January consultation, covering the three areas set out above; and
- seeks further views where the Authorities have modified or expanded on the January proposals.

3.1 The primary responsibility for the conduct, success or failure of any deposit-taker (for simplicity, 'banks') rests with the management of the firm. This responsibility is undertaken within a framework of regulation and supervision, designed to address market failures, protect consumers, and prevent problems that pose systemic risks to the wider economy. Effective principles- and risk-based regulation is therefore fundamental, and is the primary means the Authorities have to reduce the likelihood of failure.

3.2 In addition to effective regulation, this chapter sets out the Authorities' plans to ensure effective liquidity provision, and more formal oversight of payment systems given the potentially systemic impact of difficulties.

THE IMPORTANCE OF REGULATION

3.3 Whilst the primary responsibility for the conduct of a bank lies with its management, regulation and supervision is a fundamental element of reducing the likelihood of bank failure, and the UK's principles-based framework received a lot of support from respondents to the January consultation.

Supervisory enhancement

3.4 As with any supervisor, one of the key roles of the Financial Services Authority (FSA) is to provide regulatory challenge to a bank's management in "normal" times, in order to identify and take steps to mitigate the risks resulting from inappropriate business models or lack of necessary controls. As set out in the January consultation, the FSA already has a wide range of powers and sanctions, to enable it to fulfil this role.

3.5 In March 2008, the FSA published details of a supervisory enhancement programme, in response to weaknesses identified in the supervision of Northern Rock. The programme has been welcomed by the financial services industry and includes a number of measures to strengthen the existing regulatory approach. The programme aims to enhance the FSA's supervisory process and thereby assist in preventing crises. The main features of the programme are:

- a new group of supervisory specialists will regularly review the supervision of all high-impact firms to ensure FSA internal procedures are being rigorously adhered to;
- the number of supervisory staff engaged with high-impact firms will be increased, with a mandated minimum level of staffing for each firm;
- the existing specialist prudential risk department of the FSA will be expanded following its upgrading to divisional status, as will the resource of the relevant sector teams;
- the current supervisory training and competency framework for FSA staff will be upgraded;
- the degree of FSA senior management involvement in direct supervision and contact with high-impact firms will be increased;
- there will be more focus on liquidity, particularly in the supervision of high-impact retail firms; and
- there will be raised emphasis on assessing the competence of firms' senior management.

3.6 The FSA is implementing the supervisory enhancement programme to improve its day-to-day engagement with firms. As is currently the case, firms will, in the normal course of events, experience differences in the intensity of supervisory attention. This is a natural consequence of the FSA's risk-based approach to supervision: not all firms are equally risky, and each firm is not equally risky across time.

3.7 As set out in the January consultation, there will be circumstances in which a firm may face increased risk, posing a greater threat to financial stability or to the interests of consumers. In these circumstances the FSA will respond by stepping up the intensity of its supervision, referred to here as "heightened supervision". This approach was widely supported by respondents to the January consultation. This is not a separate supervisory regime or set of powers but a normal application of the existing supervisory process where there is a potential threat to compliance with key Threshold Conditions.[1]

3.8 Supervision is bespoke to each firm, and a number of regulatory and non-regulatory tools may be employed to manage a given situation to lower the risks and threats to financial stability and depositor interests. The key objective of heightened supervision is to find solutions to a particular problem. It would usually include increased information sharing across the Tripartite and FSCS[2] and with international regulators as appropriate. A further characteristic is the preparation for the possibility

[1] The Threshold Conditions are set out in Schedule 6 to 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: http://fsahandbook.info/FSA/html/handbook/COND.

[2] The FSCS will also have ongoing, routine involvement in assessing the adequacy of the data provided by firms on eligible depositors and their account balances.

that the particular problem will not be adequately solved and that stronger action by the Authorities, moving to resolution, may be necessary. Going forward, the FSA's approach in this area will build on the lessons learnt by the Authorities over the last year.

New regulatory powers

3.9 As set out above, and in detail in the January consultation, the FSA will use a number of regulatory tools to lower the risks and threats to financial stability and consumer interests.

Obtaining and sharing information

3.10 The January consultation set out proposals around the collection and management of information, to assist the Authorities in their work. Given the role that each of the Tripartite Authorities has in maintaining financial stability, **the Government confirms its intention to legislate to facilitate the FSA obtaining and sharing information that the Bank of England and the Treasury require for purposes relating to financial stability.** The FSA already shares considerable information with the Treasury and the Bank of England and will continue to work to ensure that these information requirements are met. The Bank of England and the FSA will continue to be able to make requests to each other on the collection and sharing of information to enable them to fulfil their roles. The Bank of England will have the right to request the FSA to obtain from firms the data necessary for it to fulfil its financial stability functions (as set out in Chapters 4 and 6). The FSA will act as the data collection agency so that there is one point of contact for firms for the collection of such data.

3.11 Respondents were supportive of this policy proposal and agreed that ensuring the Authorities were able to obtain and share information in support of preventative measures and maintaining financial stability was a sensible approach. A number of respondents highlighted the sensitivity of the material that the Authorities will share and the associated need for data security.

Additional supervisory information

3.12 As proposed in the January consultation, **the FSA will publish a consultation paper, setting out proposals on the provision of additional information by banks to demonstrate that they are meeting Threshold Conditions, on an ongoing and forward looking basis.** The new reporting requirements outlined by the FSA's Integrated Regulatory Reporting programme are expected to fill many of the information gaps that have been identified. The FSA plans to publish a consultation paper that will contain more detail, including a cost benefit analysis of whether additional, or more frequent, data would be appropriate to assist in achieving the objectives of financial stability and depositor protection.

3.13 Responses to the January consultation raised questions about the nature of the information and the timescales over which banks would be asked to provide such information. In response to this the FSA will be giving further consideration to the nature of the information required, and the timescales in which banks will be asked to provide it, and reflect this in the forthcoming consultation paper.

Market abuse

3.14 Market abuse undermines investor confidence and can damage the integrity of the system. As proposed since January, the Government will also be ensuring that FSA has the necessary powers to tackle market abuse, including new powers relating to granting immunity from prosecution. While not a part of the forthcoming Bill, **the Government will take the earliest opportunity to bring forward legislation to provide the FSA with additional powers.**

LIQUIDITY SUPPORT ARRANGEMENTS

Liquidity framework

3.15 Through the provision of liquidity to the financial system, the Bank of England plays a key role in contributing to maintaining financial stability and implementing monetary policy. Banks routinely borrow from the central bank against the security of their assets. In response to the stresses in financial markets, central banks worldwide have extended their lending facilities. Since August 2007, the Bank of England has increased the amount of central bank money made available to financial institutions in response to demand. As set out in Chapter 2, in April 2008 the Bank of England introduced a Special Liquidity Scheme to allow banks and building societies to swap temporarily their high quality – but temporarily illiquid – mortgage-backed and other securities for UK Treasury Bills. The scheme aims to improve the liquidity position of the banking system and increase confidence in financial markets.

Actions to facilitate liquidity support

3.16 The January consultation identified a number of proposals that would improve the framework for liquidity assistance and respondents were generally positive about the proposals. Therefore, as part of strengthening the Bank's role in financial stability, and ensuring it has the appropriate instruments to fulfil its new statutory role (see Chapter 6) the Government intend to legislate to provide new powers set out below.

Bank of England immunity

3.17 As proposed in the January consultation **the Government intends to legislate to provide the Bank of England with statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and other central bank functions**. This immunity is necessary to give the Bank of England, when fulfilling its financial stability responsibilities, the same degree of protection as the other Authorities.

Clarifying the Bank's position as a creditor

3.18 In addition, **the Government will introduce secondary legislation, consulting where appropriate, to amend the Settlement Finality Regulations 1999 to ensure that collateral provided to the central bank in connection with its functions may be realised more effectively**, in particular to insulate collateral provided to the Bank of England from the effects of insolvency.

Financial assistance for building societies

3.19 In the January consultation the Government proposed legislation to remove statutory barriers that could prevent building societies from receiving liquidity assistance from the Bank of England. Respondents, including building societies and their representatives, were supportive of this approach.

3.20 The Banking (Special Provisions) Act 2008 gave the Government the powers to bring forward secondary legislation to achieve this policy proposal in respect of financial assistance provided for the purpose of maintaining UK financial stability. **The Building Societies (Financial Assistance) Order 2008 was approved by Parliament in June of this year.**

3.21 In line with the January consultation **the Government will bring forward legislation to ensure that floating charges may be granted by building societies in relation to the provision of liquidity support by central banks.**

Liquidity disclosure

3.22 There are circumstances where inappropriate disclosure can seriously hamper the effectiveness of assistance offered by the Authorities. The Authorities remain committed to market transparency and appropriate disclosure of information and recognise that striking the right balance between the transparency afforded by disclosure and the protection afforded by secrecy is very difficult. The Authorities have given extensive consideration to circumstances where a firm could be forced to make disclosures that would highlight that it was in receipt of liquidity assistance and whether non-disclosure to allow liquidity assistance to be effective is justifiable. The proposals outlined below are considered a proportionate response to ensure that the Authorities can take action in support of preventing a bank failure, whilst not creating any adverse impact on the disclosure regime required for normal market activities.

Bank of England weekly return

3.23 The January consultation indicated that the Government intended to legislate to remove the requirement for the Bank of England to release weekly returns detailing its summary balance sheet. For the most part respondents to the January consultation were supportive of the proposal. **The Bank of England has been consulting further on whether or not to continue publication of the weekly return**.

3.24 In the January consultation, the Government also set out that it would consider other statutory reporting requirements related to the Bank of England that have the effect of disclosing its operations. The Bank of England's Annual Report and Accounts clarify that, in order to prevent a loss of confidence in the financial system, the financial effects of its liquidity assistance operations may not be identified explicitly in the Bank's financial statements until the need for confidentiality has ceased.

Registering charges

3.25 In the January document the Government consulted 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 applicable for banks in receipt of liquidity assistance. Having considered this matter further **the Government intends to legislate so that any charges granted to a central bank in connection with its functions as a central bank will be exempt from registration.**

3.26 The basis for the proposal is to recognise that the financial assistance by a central bank is generally carried out in support of public policy objectives, including maintaining price and financial stability for the economy as a whole. Exempting these transactions from registration will ensure maximum flexibility for the Bank of England in conducting its operations in support of financial stability and provide a clear and unambiguous provision for firms and markets to follow. The Government decided that options to extend the current 21-day period would not achieve the policy rationale.

Disclosure and transparency rules

3.27 As part of its July 2008 quarterly consultation paper, **the FSA will consult on changes to the Disclosure and Transparency Rules to clarify that an issuer in receipt of liquidity support from a central bank may have a legitimate interest to delay disclosure of that fact.**

Potential contractual barriers to effective action

3.28 The Government is seeking views on whether it should legislate to provide that restrictions on borrowing (including negative pledges) and other provisions having a similar effect are nullified to the extent that they would prevent financial assistance by the Authorities for the purposes of financial stability or are otherwise triggered by steps taken by the Authorities. Lenders, creditors and other providers of finance or protection use a variety of contractual provisions to protect their positions. For example, negative pledge clauses, where they are included in contracts, may specify that a borrower, having taken out a loan with a lender or issued debt securities to a bondholder, cannot subsequently grant security without consent of the lender or bondholder. The existence of such clauses could restrict or delay the Bank of England providing liquidity support. They could also have the result of increasing the level of risk that the Bank of England must absorb related to the liquidity assistance by preventing it from taking security over the borrower's unencumbered assets.

3.29 Similarly, contractual provisions which seek to give creditors rights to terminate financing agreements or otherwise modify agreements to the detriment of the borrower, specifically by reference to steps taken by the Authorities to reduce the likelihood or impact of an institution failing, may be counterproductive if they deter necessary actions either by the bank or the Authorities.

3.30 One solution would be to legislate to provide that restrictions on borrowing (including negative pledges) and other provisions of the kind described above are nullified to the extent that they would prevent financial assistance by the Authorities for the purposes of financial stability or are otherwise triggered by steps taken by the Authorities. The Authorities recognise that overriding these provisions would carry significant implications for providers of finance, which may affect the availability or cost of funding. In light of this, views are sought on the merits of a statutory override, as well as on a less interventionist approach which is described below.

3.31 An alternative to a statutory override would be to discourage, or perhaps prevent through regulatory guidance or rules, banks from entering agreements which include contractual provisions of the kind described above.

> 3.1) The Authorities are seeking views from respondents on the extent that contractual provisions, such as those set out above may prevent the Authorities from taking appropriate action; and the merits of the two approaches set out above.

OVERSIGHT OF PAYMENT SYSTEMS

3.32 Payment systems are important for the functioning of financial markets and the economy. The inter-linkages between payment systems, banks and other financial intermediaries mean that problems with payment systems have the potential to spread through the financial system, ultimately affecting business and consumers.

3.33 As proposed in the January consultation, the Authorities will provide a new framework for oversight of payment systems. **The Government intends to legislate to formalise the Bank of England's role in the oversight of payment systems to ensure the robustness of payment systems which, if a disruption in the operation of the system were to occur, would be likely to lead to systemic and system-wide consequences.**

3.34 Currently, the Bank of England undertakes oversight on a non-statutory basis, focusing on promoting the robustness and resilience of key UK payment systems, while the Financial Services Authority has a statutory responsibility for the regulation of Recognised Clearing Houses, which contain embedded payment systems. The Bank of England also acts as the designating authority for payment systems under the

Settlement Finality Directive,[3] with the FSA as designating authority for systems within Recognised Clearing Houses.

3.35 In addition to the Bank of England's interest in the resilience of payment systems, the Office of Fair Trading has statutory responsibility for issues of competition and access. The Payments Council – a self-regulatory body established in early 2007 with Government support – also has a strategic role in developing UK payment systems, focused particularly on promoting and delivering innovation, working openly and transparently with all interested parties, and ensuring the integrity of payment systems. However, these organisations are not focused primarily on robustness and resilience.

3.36 The Payment Services Directive,[4] which must be implemented by EU Member States by 1 November 2009, deals with conduct-of-business elements of payment service provision such as transparency of information and the rights and obligations of providers and users. This Directive also seeks to promote open and fair access to payment systems, in particular, those systems which have not been designated under the Settlement Finality Directive. The relevant Authority for most aspects of the Payments Services Directive will be the Financial Services Authority, but other bodies, including the Office of Fair Trading, will also have roles in implementation.

3.37 While all of these entities play an important strategic role, there remains a need for the Authorities to have statutory powers, instead of relying on moral suasion, in seeking to ensure robustness and resilience of payment systems which are of systemic or of system-wide importance.

Proposed Framework

3.38 To make certain that the Authorities have statutory backing to ensure and improve payment system robustness and resilience, the January consultation proposed the Treasury taking a power to enable it to assign oversight responsibilities to the appropriate authority, and to ensure that they were properly equipped with the relevant powers. This framework was intended to be sufficiently flexible to respond to the evolution of payment systems over time.

3.39 The responses to the consultation overwhelmingly advocated a single regulator model, with the Bank of England retaining this role, noting that this would be more effective in pooling expertise and reducing duplication than splitting oversight responsibilities between the Bank of England and the FSA, as indicated in the January consultation. A number of respondents also noted the important link between the oversight of payment systems by the Bank of England and the Bank of England's proposed statutory objective for financial stability.

3.40 In the light of the consultation response, the Authorities have refocused the original proposal, so that one Authority – the Bank of England – has formal oversight responsibility for systemically important payment systems. In essence, the revised proposal will therefore provide statutory backing to the Bank of England's existing responsibilities. The Authorities propose, as before, that there should be a recognition process for payment systems to ensure that only systems that are systemic or have system-wide importance are subject to formal oversight.

3.41 The key features of the proposed framework include:

[3] Directive 98/26/EC on settlement finality in payment and securities systems

[4] Directive 2007/64/EC on payment services in the internal markets

- the Bank of England established as the single overseer of recognised payment systems;
- a recognition system whereby the Treasury, following advice from the Bank of England, is able to recognise payment systems that are systemically or of system- wide importance;
- the Bank of England will continue to use its current oversight tools, but under the proposed legislation it will also have powers to draw on if necessary. These powers will provide for the Bank of England to gather information from any payment system about the nature and extent of the business and operation of payment systems; and
- in respect of ongoing oversight of recognised payment systems, the Bank of England's powers will include information gathering powers; the power to publish principles (subject to the Treasury's approval) and codes of practice to which payment systems must have regard; and enforcement powers.

Recognition process

3.42 Under the revised proposal the Treasury will recognise the payment systems that the Bank of England will oversee. The proposed recognition model requires an exchange of information and agreement between the Bank of England and the Treasury before a system can be recognised. The Authorities believe that this is the most appropriate model to ensure that all systems are viewed on their own merits, and not based on the existing interactions with the Bank of England.

3.43 The Authorities acknowledge however, that there are alternative methods to achieve a similar outcome, such as:

- allowing the Bank of England to make recognition orders following consultation with the Treasury, while also providing power for the Treasury to direct the Bank of England to recognise a payment systems where it has met the criteria set out in the legislation, but has not been recognised by the Bank of England;
- providing for the Bank of England to make recognition orders; and
- providing the Treasury the ability to make recognition orders, but also the power to delegate this power to the Bank of England.

Criteria

3.44 Under the proposed recognition process, the Treasury must have regard to a number of criteria when assessing whether a payment system should be recognised, such as:

- the number and value of the transactions that the system presently processes or is likely to process in the future;
- the nature of the transactions that the system processes;
- whether the transactions can be handled by other systems;
- the relationship between the system and other systems; and
- whether the system is used by the Bank of England in the course of its role as a monetary authority.

3.45 These criteria have been defined at a high level, so that as payment systems continue to evolve, it is possible to cover appropriate systems.

3.46 The Authorities also believe this framework provides the flexibility to allow the Treasury and the Bank of England to take a view of which systems are systemic or of system-wide importance. It is not the intent of the Authorities that payment systems which meet only some of the criteria will automatically be recognised: they also need to be viewed as systemic or of system-wide importance.

3.47 The Authorities would welcome views on whether these criteria provide enough guidance to payment systems which may be recognised, while also providing the Treasury with the necessary flexibility.

Recognised systems

3.48 Using the criteria in paragraph 3.43 the Authorities' preliminary assessment is that key wholesale systems such as CHAPS, Euroclear UK and Ireland, and LCH.Clearnet Ltd; and key retail systems such as Bacs, Cheque and Credit Clearing, the Faster Payments Service, and the Link Scheme may be recognised by the Treasury and overseen by the Bank of England as payment systems that would be recognised as having systemic or system wide importance.

3.49 It is not envisaged that credit and debit card schemes would be captured if the suggested criteria are implemented. This is an indicative list, and a final list would need to be drawn up following consultation and the implementation of legislation.

3.50 The Authorities believe that Euroclear UK and Ireland and LCH.Clearnet Ltd should be recognised as payment systems due to their importance to financial stability, despite those systems being embedded within Recognised Clearing Houses.

3.51 While not identified in the list above for recognition, CLS is also likely to be recognised, with the Bank of England's oversight undertaken as part of the existing cooperative oversight arrangements.

3.52 It is expected that the list of recognised systems will change over time as new systems emerge or the existing ones change significantly. However this list seeks to give an indication of the types of system that may meet the recognition criteria.

3.53 The Authorities would welcome views as to whether there are other systems which may be viewed as systemic or of system-wide importance, which the Treasury should consider for recognition.

Principles

3.54 The Bank of England will have the power to publish principles to which the managers of recognised payment systems are to have regard in the operation of the payment system.

3.55 Currently the Bank of England publishes an annual Payment Systems Oversight Report which summarises the developments in the key UK payment systems over the past year and explains the focus of the Bank of England's work in this field. This report includes assessments of the main UK payment systems against the internationally agreed Core Principles for Systemically Important Payment Systems (Core Principles).[5] The Core Principles for payment systems are intended to be sufficiently broad in scope to apply to a wide range of circumstances and to be useful over time. The Bank for International Settlements is of the view that systemically important payment systems should comply with all ten Principles, but notes that the level of compliance may vary across different payment systems.

[5] *Core Principles for Systemically-Important Payment Systems*, developed by the G10 central banks' Committee on Payment and Settlement Systems and published by the Bank for International Settlements.

3.56 It is envisaged that the principles that the Bank of England will publish in due course will be reflective of the Core Principles.

Powers

3.57 The revised proposal provides for the Bank of England to have powers to facilitate information gathering from all payment systems, and the ongoing oversight of recognised payment systems.

3.58 The proposals provide for the Bank of England to be able to gather information from all payment systems (not just those which are recognised) to enable it to assess systems which may be nearing the recognition criteria. It further provides that where separate from the payment systems, information can also be sought from the infrastructure providers.

3.59 The proposals include that the Bank of England will also have powers to publish codes of practice; review a system's rules; give direction to managers of recognised payment systems; require an expert report on the management and operations of the systems; censure publicly; impose penalties; disqualify a person from managing a payment system and require a payment system to cease certain activities or close the payment system.

3.60 The proposals provide for the Bank of England to be able to appoint an inspector to inspect the premises and infrastructure of payment systems and infrastructure providers.

3.61 It is the Authorities' view that ordinarily these powers should only be used once the Bank of England has requested change/application of principles through an informal manner, akin to the current oversight practices. In considering these powers the Authorities have sought to develop a graduated set of powers. A decision to close a payment system would not be taken lightly and, unless there were immediate systemic concerns, there would be a number of steps before this action were taken.

3.62 The Bank of England will continue to oversee the embedded payment systems within Recognised Clearing Houses. A Memorandum of Understanding will be developed between the Bank of England and FSA to ensure that there is effective coordination and minimal duplication between the Authorities. In those circumstances where other oversight tools have not worked and it is necessary to use statutory powers, the Bank of England and FSA will consult each other to agree which is best placed to undertake enforcement action, in doing so seeking to ensure that actions in relation to the embedded payment systems do not impact on the functioning of the Recognised Clearing Houses as a whole in a way that is detrimental to the FSA's objectives.

3.63 The Authorities are seeking views on whether the powers outlined above are necessary and appropriately graduated.

> 3.2) Are the criteria as set out, the right criteria and will they provide sufficient flexibility as payment systems evolve overtime?
>
> 3.3) Is there a preferred method for recognising payment systems?
>
> 3.4) Do you agree that the indicative list in paragraph 3.48 includes all the relevant payment systems which are of systemic or system-wide importance?
>
> 3.5) Are the powers, as set out above, necessary and appropriately graduated?

4 REDUCING THE IMPACT OF A FAILING BANK

As set out in the January consultation, the failure of a bank, although unlikely, would present a real public concern given the likely costs to depositors and the risks to financial stability and the wider economy. The Authorities therefore need to take action to reduce the impact of any failure.

In most cases the failure of a bank can be avoided through regulatory action or the normal functioning of the market (for example, through a takeover by another firm). But there may be cases where that is not possible. To deal with these, the Authorities intend to introduce a 'special resolution regime' (SRR). The January consultation included a range of questions on the structure and tools of the SRR and the role of the Authorities. This chapter now sets out the precise roles of the Authorities and the proposed SRR structure.

A detailed narrative and draft clauses for the SRR will be published for consultation before the summer Parliamentary recess in July.

This chapter:

- outlines at a high level the Authorities' proposals for the SRR covering;
    - the triggers, structure, objectives and governance arrangements for a special resolution regime.
    - the tools included within the special resolution regime:
        - a transfer of part or all of the failing bank to a private sector third party;
        - a transfer of part or all of the failing bank to a publicly-controlled bridge bank;
        - a new bank insolvency procedure;
        - the power to take a bank in to temporary public sector ownership; and
        - the existing option to support any of these tools by providing financial support to a failing bank through funding or the provisions of guarantees, subject to legal and other constraints.
- puts forward proposals for applying the SRR tools to building societies;
- proposes that the FSCS should be able to contribute to the funding of the SRR and makes other recommendations for requirements on banks; and
- summarises respondents' views on issues raised in the January consultation and seeks further views on a number of specific issues.

4.1 The previous chapter set out the wide range of tools and powers at the Authorities' disposal for action to prevent a situation arising in which a bank is likely to fail. It is envisaged that, in the majority of cases, these tools will be sufficient to resolve such a situation. Even if a bank is unlikely to be able to survive as an independent going concern the Authorities should, in most cases, be able to reach a resolution (for example a takeover by another institution) through discussion with the firms concerned and the use of normal regulatory powers. However, there may be a small number of cases in which these tools prove insufficient, and a resolution is only possible on the basis of additional intervention by the Authorities. To deal with such rare situations, the Authorities have proposed the introduction of a special resolution regime (SRR).

SPECIAL RESOLUTION REGIME

4.2 As set out in the January consultation, recent events have demonstrated the effects that a bank experiencing significant difficulties can have on consumer confidence, with the potential to create wider instability. The January consultation also identified that the Authorities need broader powers to deal with those rare situations, and to handle failing banks effectively. Current insolvency procedures, in particular, are not specifically tailored for dealing with a bank failure for a variety of reasons, including:

- depositors might be deprived of access to their accounts at very short notice;
- no objectives exist around fast payout for depositors;
- likely destruction of any residual franchise value, which significantly reduces any chance of a rescue or turnaround of the firm; and
- the risk of contagion to other banks.

4.3 As Box 4.1 sets out, many other countries have a special regime for dealing with failing banks. In the UK no such regime exists and the Authorities' powers are limited. Additional powers are therefore needed to secure broader public interests in:

- managing the risks to financial stability;
- protecting the public finances;
- protecting depositors; and
- ensuring continuity of key banking and payment arrangements

in situations where voluntary action by the firm and regulatory options are judged insufficient.

4.4 Therefore, as proposed in the January consultation document, **the Government intends to legislate to introduce a "special resolution regime"**. The following paragraphs summarise how it is proposed that such a regime would work, in the light of consultation responses and further analysis conducted over recent months. The proposed SRR would complement the enhanced preventative measures set out in Chapter 3, providing the Authorities with the tools to take greater control of a failing bank in those rare cases where voluntary remedial action by the bank in question and regulatory interventions by the FSA are judged unlikely to bring the firm into line with the Threshold Conditions. It is envisaged that the existence of powers under the SRR will strengthen the Authorities' ability to achieve an earlier resolution on a voluntary basis, without the need to formally deploy them. The regime would also sit alongside the improved compensation arrangements outlined in Chapter 5.

4.5 Draft clauses and a detailed explanatory narrative of the SRR powers and the safeguards that would apply to their use will be published for consultation before the summer Parliamentary recess in July. This consultation document provides an overview of the SRR and seeks views on the roles of the Authorities in the triggering and operation of the SRR.

Consultation responses

4.6 The January consultation proposed that a SRR be established and set out the tools that might be included in such a regime. The majority of respondents agreed that a special resolution regime for banks would be appropriate. Annex B sets out in more detail respondents' views on the SRR proposals in the January consultation document.

Banking (Special Provisions) Act 2008

4.7 In February, Parliament enacted the Banking (Special Provisions) Act 2008. This Act provides the Government with a range of temporary powers, which were used to take Northern Rock plc into temporary public sector ownership. The key securities and property transfer powers provided by the Act lapse in February 2009, a year after the Act came into force. While the powers the Government will consult upon may in some instances be similar to the Special Provisions Act 2008, the forthcoming legislation will provide the Authorities with permanent powers to resolve any failing bank in an orderly manner in the future.

International regimes

4.8 In putting together these proposals the Authorities have looked to learn from the experiences of other countries. The following box summarises the approach that other countries have taken to resolving failing banks.

Box 4.1 (i): International experiences of resolution regimes

Many countries – including most G10 countries – have special arrangements in place for dealing with a failing bank, rather than relying on normal corporate insolvency laws. The exact form of each regime differs from one country to another. These differences reflect a number of factors – including different legal regimes, regulatory arrangements and banking industry structures. Of the international regimes considered, there are also a number of common themes:

Objectives

The objectives of resolution intervention by the relevant authorities in different countries are expressed in terms of one or more of:

- the stability of the financial system;
- protection of depositors; and
- ensuring continuity of banking business.

Some countries' bank resolution arrangements also require their authorities explicitly to pursue a least-cost resolution, unless financial stability is threatened.

Institutional arrangements

Combinations of some or all of the relevant financial authorities – banking supervisors, central banks, deposit insurers and ministries of finance – are responsible for various aspects of such regimes in other countries. For example, in the US and Japan, all four authorities are involved; elsewhere there is no formal role for the deposit insurer (for example in Belgium, the Netherlands) or the central bank (for example in Canada).

Box 4.1 (ii): International experiences of resolution regimes

Triggers for taking action

A key feature of resolution regimes is that they allow the authorities to take action to deal with any bank that is failing regulatory thresholds but before it reaches formal insolvency.

Some countries are prescriptive about the triggers for taking such pre-insolvency action; others are more flexible. For those countries that publish details of what would prompt them to put a failing bank into their special resolution regime (including the United States, Canada, Switzerland, Italy, Norway), the triggers relate to factors including whether:

- the bank in question is adequately capitalised;
- its liquidity is sufficient to allow it to meet its financial obligations on an on-going basis; and / or
- its management is competent.

Under their Prompt Corrective Action regimes, the United States and Japan explicitly publish details of quantitative capital triggers (the points at which various prescribed actions by the authorities are strongly presumed to occur); Korea, Mexico and Norway also have quantitative triggers as part of their special resolution regimes.

Tools and supporting measures

Once a bank enters the resolution regime, the authorities in various countries have one or more tools available to them to resolve the failed bank, including the ability:

- to appoint an expert special administrator to carry out the resolution (working to meet the authorities' objectives) – this is the case in many countries, including Italy, Switzerland and Norway;
- to direct a transfer of all or part of the failed bank's business to another private sector bank (via a purchase and assumption, or merger and acquisition);
- to transfer some or all of the failed bank's business to a "bridge bank" (in the United States and Japan), which allows potential purchasers of the failed bank to undertake due diligence, before bidding for some or all of the failed bank's business; and
- to close the failed bank, paying out to insured depositors.

Further measures are available in some countries to support these resolution tools. For instance, by allowing the use of a pre-funded deposit insurance scheme to support resolution options other than liquidation and prompt pay-out to insured depositors, where doing so would be lower cost to the contributors to that insurance scheme.

For many countries, provided it meets the objectives of their special resolution regimes, and where it is one of the tools available to them, the preferred method of resolving a bank is to effect a sale of all or part of the failed bank to a healthy bank (through a private sector solution), as this tends to be the least costly approach.

Overview of SRR model

Scope **4.9** In essence, the special resolution regime comprises a set of tools that will allow the Authorities to take control of a situation in which a bank is determined to be failing. As with such arrangements in other countries, this regime would be focused on UK-incorporated deposit-taking banks. As set out in Chapter 2, the Authorities continue to work with their international counterparts to put in place arrangements to deal more effectively with difficulties in banks operating across borders and different legal jurisdictions.

Application to group companies **4.10** The Authorities recognise that many of the deposit-taking firms that are incorporated in the UK are part of large, cross-border groups. The resolution tools discussed in this document are intended to be applied to the particular legal entity that accepts deposits. The Authorities have considered the position of deposit-takers in larger groups, particularly if the group is organised along business rather than legal entity lines or the deposit- taker is heavily dependent on other group companies to carry out key functions.

4.11 The Authorities' present thinking is not to extend the scope of the resolution tools directly to the holding companies or sister companies of deposit-takers. However, in order to ensure that the directed transfer, bridge bank and temporary public sector ownership tools can be as effective as possible, the Authorities are considering including powers to create, alter or nullify contracts between group companies. The Authorities believe that this power concerning intra-group arrangements could be an effective and proportionate approach to ensuring continuity of banking services. The Authorities will provide further detail on dealing with group companies and arrangements between companies in complex groups in the draft clauses and explanatory narrative document.

Investment firms **4.12** There are a number of other types of bank that play a key role in the financial market and whose disruption could have a significant impact on the stability of the financial system. The most obvious of these are investment banks – as highlighted in March 2008 by the collapse of Bear Stearns and its subsequent sale to JP Morgan.

4.13 The protection of retail depositors is generally not directly relevant in this case. Investment banks do not tend to interact directly with the general public – the counterparties they deal with are usually other firms, or occasionally sophisticated private investors, who are unlikely to rely on the services of only one investment bank or broker. Additionally the most significant legal entities in investment banks operating in the UK are not deposit-takers, so they do not have any eligible depositors to protect.

4.14 However, investment banks provide many key services to the financial community and are key components of the modern financial system and are, therefore, important to financial stability.

> 4.1) The Authorities would welcome views on the most appropriate ways to deal with other relevant entities in investment banking groups with the aim of helping to maintain financial stability

Authorities' Roles **4.15** The January consultation proposed that the decision to subject a failing bank to the application of the tools in the SRR should be based on regulatory triggers, and that as such the FSA would take the decision after consultation with the Bank of England and the Treasury. Views were also sought on the appropriate authority to determine the use of the SRR tools, and to implement the regime once invoked. Respondents generally agreed that it would be appropriate for the FSA to determine when the SRR should be initiated, given that the decisions would be made on the basis of a regulatory judgement. The majority of respondents argued that the Bank of England would be the most appropriate authority to implement the SRR. Respondents also agreed that the Treasury's approval would be required for decisions relating to the use of public money.

4.16 In practice, any decision to trigger the special resolution regime, and to deploy one or more of the tools within it, would only be taken following intensive discussion and consultation between the Treasury, the Bank of England, and the FSA through the Standing Committee at each stage of the decision-making process. Nevertheless, for reasons of accountability, it is important to clarify the lead responsibility of each institution based on their mandate and expertise:

- the FSA for supervisory decisions and regulatory actions, including the ongoing supervision of any firm while it continues to operate in the SRR;
- the Bank of England for liquidity support and, in line with the new proposals outlined below, operation of the special resolution regime; and
- the Treasury for public finances and the overall public interest.

4.17 The Financial Services Compensation Scheme (FSCS) which delivers the payment of compensation, will also need to be involved in the assessment of the readiness of a bank for payout of its depositors.

Tools

4.18 The Government intends to legislate so that the tools will include:

- a transfer of part or all of the failing bank to a private-sector third party;
- a transfer of part or all of the failing bank to a publicly-controlled bridge bank;
- a new bank insolvency procedure; and
- the power to take a bank into temporary public sector ownership.

4.19 Use of these tools would be supported by the option, already available to the Government, to provide financial support to a failing bank through funding or the provision of guarantees, subject to legal and other constraints.

Triggering the regime

4.20 As acknowledged in the January consultation, any decision to use such tools in the case of a specific institution would be a significant step, and the way in which these tools are deployed will therefore need to be considered very carefully. These points have come through strongly in the responses to the consultation, and are reflected in the following proposals.

4.21 **The Government proposes that initiation of the regime would be subject to an assessment by the FSA, as the firm's supervisor, that the firm had failed (or was likely imminently to fail) to meet its Threshold Conditions,** and that the alternative options to remedy the situation through voluntary actions and regulatory intervention were unlikely to be sufficient to bring the firm into compliance with the Threshold Conditions in the near future. The FSA would be required to consult the Bank of England and the Treasury in reaching this assessment. The Bank of England would be able to make recommendations to the FSA regarding this assessment.

Operation of the regime

4.22 **The Government proposes that the operation of the SRR and the resolution tools within it will be the responsibility of the Bank of England**. It proposes that the

Bank of England will, in consultation with the FSA and the Treasury, be responsible for the decision on which special resolution tool (or tools) to use and the operation of these tools, subject to the requirements that:

- **any decision requiring the use of funds for which the Chancellor of the Exchequer is responsible, or with implications for the public finances, would require the authorisation of the Chancellor of the Exchequer**. Examples could include cases in which significant public support was required to effect resolution successfully, or in which it was determined that there was a significant risk that compensation would be required to shareholders or other owners or creditors;

- **the Chancellor of the Exchequer will remain responsible for ensuring compliance with the UK's international obligations**, for example, EU State aid rules; and

- **any decision involving the temporary public ownership of an institution will be for the Chancellor of the Exchequer**, in particular given the potential implications for the public finances.

4.23 The FSA would also be able to make recommendations to the Bank of England regarding the choice of tools. However, in line with responses received during the consultation, the Authorities are agreed that the FSA should not be directly responsible for the SRR, in order to avoid any conflict with its regulatory responsibilities.

4.24 As set out in Chapter 6 it is expected that the Financial Stability Committee would play a key role within the Bank of England in overseeing the Bank of England's actions under the special resolution regime for a failing bank.

4.25 The January consultation document proposed that the SRR tools will include a new bank insolvency procedure. The bank insolvency procedure will ensure that, in cases where closure of the failing bank and payout of depositors was the most appropriate option, there was a specifically tailored insolvency vehicle for achieving this aim. The Government proposes that the decision to use the new insolvency procedure within the SRR would be taken by the Bank of England, and implemented through an application to the Court. As the body responsible for paying compensation to customers of the bank once it has been placed into the new insolvency procedure, the FSCS will also need to be involved, including in providing an assessment of the readiness of the failing bank's systems to support prompt payments to protected depositors.

4.26 Insofar as supervision of an entity (for example, a bridge bank) in the special resolution regime is required, the FSA will exercise this responsibility, as it does for all other banks.

Objectives of the regime

4.27 The objectives of the Bank of England, in operating the regime, will be to protect the financial stability of the United Kingdom; to protect public finances; to protect depositors; and to ensure continuity of key banking services.

4.28 These objectives will need to be balanced against the need to ensure sufficient protection for property rights, and the rights of creditors and counterparties of the failing banks. It is proposed that the operation of the special resolution tools by the Bank of England would be required to follow criteria set out in the legislation, and would also be subject to a set of safeguards, both of which will be set out in detail and subject to consultation. In particular, since the tools potentially involve disruption to property rights, the legislation will need to provide for the possibility of compensation.

4.29 It may be necessary to modify the operation of existing legislation and other ancillary provisions to ensure that these tools can be used effectively and without hindrance. Such modifications would be defined in legislation and would apply only in respect of the failing firm. It is also possible, however, that additional unforeseen modifications of legislative provisions might be required to give effect to one or more of the tools in specific circumstances. The Government will therefore ensure that it has power to amend the legislation making such provisions at short notice, to facilitate the use of these tools in particular cases not already covered by it.

> 4.2) Do you agree with the roles for the Authorities for the triggering and operation of the special resolution regime?

Practical considerations in developing a SRR

4.30 As part of developing the proposals in this document, the Authorities have been alert to the need to consider the practical issues and constraints that are involved in dealing with a failing bank. It is recognised that, in practice, there are limits to what can be achieved through the resolution tools alone, given the range of situations in which a firm could find itself; and that the tools will apply to firms ranging from small building societies up to large and complex banking groups with significant overseas presence. The Authorities will continue to work with their international counterparts to put in place arrangements to deal more effectively with difficulties in banks operating across borders and different legal jurisdictions.

4.31 For instance, the Authorities need to manage the conflict between seeking private-sector solutions and the risk of these discussions becoming public prematurely in ways that lead to market and depositor actions exacerbating the failing bank's weaknesses. The way in which a bank’s position deteriorates will also be a key factor: a situation in which a problem is identified at an early stage is likely to enable greater preparatory work for any eventual use of a resolution tool. But the speed of decline in the bank's position may be so rapid that there is only limited time to prepare for resolution.

4.32 Similarly, the Authorities maintain important relationships with regulators from the European Economic Area and around the world where there are shared interests in particular banking groups. If there is a rapid deterioration of a bank's situation then the scope to engage other regulators may be limited.

4.33 Finally, the Authorities recognise the practical need for the SRR to be governed by a streamlined and clear decision-making processes if the resolution is to be effective. The current model sets out responsibilities for each of the tripartite Authorities in this regime, consistent with their areas of expertise and authority.

> 4.3) Respondents’ views are sought on the practical considerations involved in developing an SRR.

RESOLUTION OF BUILDING SOCIETIES AND OTHER MUTUALS

4.34 Those respondents who commented were supportive of the idea that building societies should be placed on a similar footing to banks and be subject to the special resolution regime, if there was one for banks. Therefore, **the Government intends to legislate so that building societies are subject to a special resolution regime, similar to that for banks.** Further detail on how the tools will apply to building societies will accompany the draft clauses to be published shortly. Any differences in the regimes will be to reflect the differing legal basis under which banks and building societies are established – not to achieve any difference in functionality or the intended outcomes of the tools.

4.35 In addition, as set out in the January consultation, and supported by respondents' views, **the Government intends to bring forward an Order so that on winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and the society's members.**

4.36 The Treasury is currently undertaking a review of credit union and cooperative legislation. As a result any changes in relation to the special resolution regime and credit unions will be considered following that review and its recommendations.

FUNDING THE SRR

4.37 Following consultation on the issue in the January consultation, **the Government intends to bring forward legislation so that, in addition to its role in ensuring payout to depositors in the event of the failure of a deposit-taking firm, the FSCS can also be called on to contribute to costs arising from the use of resolution tools**. Such a contribution, which (as with depositor payout) would be met from industry levies collected by the FSCS, would be assessed and made after resolution had concluded, and would be subject to a cap of the net amount which the FSCS would otherwise have been required to pay in compensation to eligible depositors in the event of the failure of the firm. Given these conditions, levy payers would pay no more, and most probably less, to a non-payout resolution than they would have done if the bank had been liquidated and eligible depositors paid out.

4.38 The Government believes that it is appropriate for the financial services industry to contribute to the cost of resolution. This is because:

- where intervention is necessary to prevent the cost to the wider economy of the failure of a bank, there is a strong argument for banks to contribute to the cost. Banks, and the financial services sector more widely, also benefit from the improved financial stability that results; and
- but for the use of another resolution tool, the FSCS would have to pay compensation to depositors.

Principles

4.39 The extension of the role of the FSCS in this way would be underpinned by four main principles:

- the FSCS would only contribute up to the potential net cost of depositor compensation payments (that is, after allowing for recoveries from winding-up);

- the FSCS would only contribute after resolution is complete and any shortfall in recoveries against costs of intervention can be calculated accurately;

- should resolution result in a winding-up and compensation payments to depositors, the FSCS would not be called on to contribute to the costs of any other resolution tools; and

- there would be an independent process for assessing the cost of resolution.

Cost of resolution

4.40 The Government intends to set out in secondary legislation a framework for considering the types of resolution cost towards which it would be appropriate for the FSCS to contribute. These could include, for example, the market value of any guarantees provided by Government to the creditors of the bank in the SRR, or financial assistance from the Authorities to facilitate a transfer to the private sector. Further detail on this issue will be provided in the forthcoming detailed document on the SRR.

4.41 The FSCS would be responsible for calculating the hypothetical net cost of compensation. This would require the FSCS to calculate, at the point of entry into resolution, the level of protected deposits in the firm, and then apply an estimate for the rate of recoveries in insolvency, either on a case-by-case basis, or by applying a formula, which would apply in the case of any failure. This would have the advantage of simplicity, but it may be difficult to find a formula that would be fair in all circumstances. The Government is seeking views as to which of these methods would be more appropriate, or for any alternatives.

4.42 Any contribution would be raised from FSCS levy payers in the usual way. If, in future, pre-funding of the FSCS is introduced, the Authorities would consider whether and how such a fund would contribute to the cost of resolution.

> 4.4) What would be the best way to calculate the hypothetical net cost of depositor compensation payments, including the estimation of the recovery rate?

Agency Banks

4.43 **The FSA intends to work further with banks to ensure that indirect members of payment systems have contingency plans in place, in the event their sponsor bank fails.**

FINANCIAL COLLATERAL ARRANGEMENTS

4.44 As proposed in the January consultation document, **the Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.**

4.45 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. The January consultation paper proposed taking a power to strengthen the Government's ability to make secondary legislation in this area. Robust collateral arrangements for banks to manage their credit risk against counterparties such as other banks play a key part in reducing the impact of the failure of a bank. The EU directives already provide a robust level of coverage and did not present specific problems in the recent turmoil but we feel it would be helpful to take this opportunity to introduce flexibility, including to improve UK protections. Respondents generally supported this. Some respondents suggested issues they would wish future legislation to address – these focussed on UK legal structures that are not adequately covered by the existing EU regime and so do not currently receive full protection. We have noted these.

4.46 The Government will consult on any future regulations made using the power which strengthen the protections available to financial collateral arrangements.

5 Effective compensation arrangements for depositors

As the January consultation document made clear, effective and credible compensation arrangements are an essential part of any system for protecting depositors and also contribute to confidence in the financial system as a whole. While the proposals brought forward elsewhere in this document are designed to reduce the likelihood that the Financial Services Compensation Scheme (FSCS) is called on to compensate depositors, there may be circumstances when compensation does need to be paid. There are a number of challenges in designing an effective model, including setting compensation at an appropriate level, making consumers aware of the scheme, and importantly ensuring that arrangements are in place to facilitate quick and efficient payment in practice.

This chapter:

- seeks to address these challenges, and sets out the Authorities' thinking and proposals in a number of areas:
  - the level of compensation;
  - ways to facilitate fast pay out from the compensation scheme;
  - funding and the provision of liquidity to the scheme - including enabling the FSCS to borrow from the Government and the possible introduction of an element of pre-funding;
  - management and operations of the compensation scheme;
  - bringing the treatment of Scottish cheques into line with the treatment of cheques in the rest of the United Kingdom;
  - protection for holders of banknotes issued by commercial banks in Scotland and Northern Ireland; and
- summarises respondents' views to the January consultation, and seeks further views on specific issues.

5.1 As set out in Chapter 3, the Authorities recognise the importance of preventing banks from getting into financial difficulty, primarily through bank management's own actions, and reinforced through appropriate supervision, regulatory intervention and, where necessary, the provision of liquidity support.[1] The proposals in Chapter 4, particularly around the new special resolution regime (SRR), are intended to increase the range of tools available to the Authorities to reduce the impact, including on depositors, should a bank nevertheless get into trouble. However, it is also vital that effective compensation arrangements are put in place, so that depositors can be confident that in the rare cases in which a bank fails, their deposits (up to the FSCS compensation limit) will be protected, and they will be compensated quickly and efficiently.

5.2 Designing a compensation system is a question of balance. If the system provides too little protection for depositors, they could face significant welfare losses in the event of bank failure. Such a situation could undermine confidence in the banking

[1] In this chapter, the term 'banks' includes building societies and other deposit-taking firms.

system, and exacerbate the risk that concerns about an individual bank lead to a run on banks generally. On the other hand, an excessively generous or otherwise poorly designed compensation system could impose excessive costs (through levy payments to the FSCS) on the financial services industry, harming its competitiveness, reducing consumer choice and increasing costs to consumers.

COMPENSATION LIMIT AND COVERAGE

Compensation limit

5.3 An important element of deposit protection arrangements is the limit to which deposits are protected in the event of a bank failure. As set out in the January consultation document, **the FSA intends to consult in autumn 2008 on changes to the FSCS compensation limits for all sectors and changes to other factors used in the FSCS compensation calculation.**

5.4 Respondents to the January consultation put forward a wide range of views on possible changes to compensation limits. Many respondents recognised that the existing limit already gave full protection to a very high proportion (around 97%) of accounts, and argued that a higher level of compensation would involve a disproportionate cost to FSCS levy payers. Other respondents took the view that an increase in the limit would increase consumer confidence, and would place the UK on a par with what were described as the best standards worldwide. Another view was that there should be no upper limit for compensation in respect of protected deposits, which would promote consumer confidence, as well as being simpler to operate and thereby speeding up payout. Some respondents thought a higher limit for deposits could distort the market for other kinds of savings products and lead consumers to make poor decisions with respect to saving and investment, although others thought consumers' perception of other products would not be affected.

5.5 It has also become clear that the precise way in which the FSCS's existing deposit protection arrangements operate is not well understood. The FSA has now published a statement on its website giving more details.[2] This statement explains how compensation payments are calculated under the current scheme, but also notes how this differs from the way that the former Deposit Protection Board (the predecessor to the FSCS in relation to deposits) operated, and outlines different ways in which the scheme could operate. The purpose of this statement is both to improve understanding of the current arrangements, and to facilitate comments on the consultation paper on limits that the FSA will, in due course, be publishing.

5.6 The January consultation explained that the compensation limit is currently set per person per bank and that the FSA considers that this approach should continue to apply.[3] A number of respondents proposed that the compensation limit should be set per person per brand. Some argued that it was difficult for consumers to understand the difference between a bank and the banking brands it used, and to be able to identify the banks to which different brands belonged. Other respondents thought that, as brands were the basis on which many banks organised their businesses, it would be easier for

2 http://www.fsa.gov.uk/pubs/other/Tripartite_feedback.pdf.

3 "Per bank" means per company or other entity which is a separate body authorised under FSMA so that a customer's compensation is calculated by reference to losses in respect of the total amount deposited in all their accounts with the same bank. "Per brand" means per business unit, division, branch or trade name under which the company operates or markets its products to customers. "Per account" means looking at each account a customer has with a bank separately.

them to organise their information about customers on this basis – see paragraphs 5.27 to 5.30 regarding the 'single customer view'.

5.7 The Authorities recognise that there may be benefits to paying compensation on a per person per brand basis, and will give the idea further consideration, working with the banking sector to see if the proposal is practical. However, there are some potentially difficult practical issues which will need to be overcome, including:

- the difficulty of defining the customer of a brand - brands have no legal basis and are defined by the bank (the authorised person) primarily for marketing purposes;
- the fact that per brand payment would not necessarily make it simpler for consumers to understand or manage their level of FSCS protection – products may be multi-branded or a bank could merge two of its brands, resulting in an unexpected reduction in cover for some customers; and
- whether there should be controls on the number of brands, or the use that banks made of brands – otherwise there might be no effective limit on compensation payable to an individual customer.

5.8 The FSA expects to publish its consultation paper on changes to the FSCS rules on compensation limits, and other factors used in the compensation calculations, this autumn. This will be a formal consultation in accordance with the requirements of section 155 of the Financial Services and Markets Act 2000 (FSMA) and will include a cost benefit analysis and draft rules.

5.9 The FSA is considering a broad range of options for possible change. At this stage, the consultation paper is expected to propose as the lead option an increase in the compensation limit for protected deposits to £50,000, on a per person per bank basis. Depending on the result of further work with the banks on per brand compensation, further consideration may also be given to paying compensation on this basis.

5.10 The FSA also expects that changes to the compensation limit for deposits will be accompanied by a change in the method of allocating recoveries from the assets of the failed bank between the FSCS and depositors with funds above the limit, towards what is described in the FSA statement referred to in paragraph 5.5 above as a "rateable" method. While an increase in the limit would increase the amount of levies that would be charged to firms to meet the cost of compensation following a failure, the move to a rateable system would tend to offset this, by increasing the recoveries retained by FSCS and set against future levies. Depositors with amounts below the limit would not be affected by this change of allocation method, and all depositors would of course benefit from any increase in the limit from £35,000.

Coverage of balances above the compensation limit

5.11 As set out in the January consultation document, **the FSA will explore with the financial sector ways for customers to cover amounts above the consultation limit (especially temporary high balances) and the appropriate coverage for client accounts and similar arrangements**.

5.12 There was not a great deal of comment from respondents on this issue, although there were concerns that it would be difficult to devise a workable and realistic system for providing special treatment for certain accounts. The Authorities recognise that this remains a difficult issue.

5.13 The FSA will undertake further work on this subject over the summer, and is planning to discuss possible approaches in its consultation paper on compensation limits. One approach which will be considered is how the issue might be addressed through market-led solutions, for example, involving insurance cover for account balances, or the provision of special accounts with deposits backed by assets pledged to the depositor. Such market-led solutions could be particularly attractive to solicitors, independent financial advisers, and other professional service providers, who often handle large amounts of money for limited periods of time on behalf of clients.

5.14 This topic illustrates the importance of ensuring that consumers are fully aware of what is and is not covered by the FSCS. Such awareness would put depositors in a better position to evaluate commercial options (whether provided directly to them or indirectly via the professional firm that holds the client's money) for protecting temporary high balances. The FSA and FSCS will be taking forward work to improve the level of consumer awareness and understanding in respect of the FSCS, and will continue to engage with consumer groups and industry stakeholders to ensure that this is achieved appropriately (see also paragraphs 5.46 to 5.48).

FASTER COMPENSATION PAYMENT

New process

5.15 The January consultation document indicated that the FSCS should aim to make compensation payments to eligible depositors within one week of a bank closing.

5.16 Respondents generally supported the aim, although some felt that a week was too long to expect depositors to wait for access to their funds. However, only a few of those who commented considered that a one week target would be achievable, and then only in cases involving the failure of a small institution. If a larger institution failed, the practical problems of processing compensation payments (for the FSCS and the liquidator of the failed bank), and opening new accounts (for the receiving banks, the depositors themselves and supporting infrastructure such as payment systems) would be considerable.

5.17 Nevertheless, having a process which ensures fast, reliable payout to the vast majority of protected depositors remains of critical importance to ensuring consumer confidence and financial stability. The Authorities therefore remain of the view that a demanding target for payout is essential.

5.18 As discussed below, a number of suggestions for developing new payout processes, which might provide depositors with fast access to liquid funds, possibly on an interim basis, came out of the last consultation. As part of work on developing these options, the question of establishing an appropriate and realistic target for final payout will continue to be considered. In the meantime, **the Authorities remain committed to a target of seven days for providing the depositors of a failed bank with access to at least a proportion of their funds, and the balance within the following few days, consistent with the aim of minimising disruption for depositors.**

5.19 A number of suggestions were made in response to the January consultation about methods to speed up pay out. These included making use of a failed institution's systems to enable customers to access their money through existing channels, and the possibility of making interim payments in advance of a full payout. The Authorities are considering these carefully and propose to continue discussions with all relevant parties with a view to achieving a practical solution that will deliver access to liquid funds to depositors quickly and effectively. This work needs to take account of the scale and complexity of the payments involved, as well as the logistical, operational and security issues for the FSCS, the liquidator of the failed bank, payment and other delivery systems, the receiving banks (who will have to open new accounts) and, not least, the depositors in the failed bank.

5.20 The Authorities also recognise that there is a possibility that a failed UK bank may have branches operating in other Member States of the European Economic Area (EEA). Under the EC Deposit Guarantee Schemes Directive[4] (DGSD), depositors with those branches will also be entitled to compensation from the FSCS. UK information-holding requirements will have to apply in relation to those branches, to ensure that the FSCS is able to pay compensation to their depositors in a similarly timely manner.

5.21 Depositors with UK branches of EEA banks may be entitled to compensation from the deposit guarantee scheme of the bank's home Member State, up to the limit of that scheme and, if the bank has also joined the FSCS under the "top-up" arrangements in the DGSD, depositors will also be entitled to top up compensation from the FSCS up to the UK limit. It is also recognised that the need to claim from the home country scheme could result in differences in the speed of payout for UK depositors at a UK incorporated bank and the UK branch of an EEA bank. The Government has raised these issues in ECOFIN.

Early access to information

5.22 An essential precondition for achieving faster payout – whether on an interim or final basis – is that the FSCS has sufficiently early access to reliable data on deposits with the failed bank, containing the key information needed to enable the right preparations for making prompt payment to be made.

5.23 As proposed in the January consultation, **the Government intends to legislate to enable the FSA to collect information from firms that the FSCS requires (and share this with the FSCS) before default, and ensure that the FSCS can require and obtain information directly from firms as soon as a firm is declared in default**.

5.24 Few respondents commented on these issues. The forthcoming legislation will extend FSA and FSCS powers in FSMA to ensure that:

- the FSA can obtain information needed by the FSCS and share it with them; and
- the FSCS can obtain information directly from firms after they have been declared in default but before any claims are made.

5.25 The information collected by the FSA for the FSCS, and by the FSCS directly, will need to be reviewed on an ongoing basis to confirm its accuracy and usefulness, that is to enable the FSCS to assess the practicality of payout and, if appropriate to pay out, to do so quickly and effectively. **The FSA will consult on how the information held by banks will be reviewed, including through options for the ongoing, routine involvement of the FSCS**

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

5.26 **The Government also intends to legislate to ensure that there are no barriers to the Bank of England, once resolution is invoked, being able to collect and share with the FSCS relevant information on the bank in question.**

Information holding requirements

5.27 As proposed in the January consultation document, **the FSA intends to consult on new rules requiring banks to have readily available information including balances, on the accounts held by depositors eligible for compensation from the FSCS**.

5.28 Respondents focusing on this issue were mainly banks, other deposit-taking firms and their representative bodies. Their responses emphasised the complexity and cost of installing systems which would deliver a reliable, consistent view of a bank's relationships on an aggregated basis with each depositor ("a single customer view"). Some respondents suggested that modifications to the eligibility criteria of depositors could make the information requirements less onerous, and as discussed above, that a single customer view might be more easily delivered for each banking brand rather than for a whole bank.

5.29 It cannot be emphasised too strongly how important adequate reliable data is to ensuring a rapid and accurate payout to depositors in a failed bank. It is essential, therefore, that the necessary information (including information which enables the accounts held by eligible claimants to be identified) is collected, held and kept up-to-date by the banks themselves in a consistent, standardised and appropriate format as part of everyday business activities while they are operating normally.

5.30 The FSA will be taking forward work to assess the feasibility of developing arrangements for providing a single customer view. This will include engaging external consultants to analyse the need for new systems and the cost implications, as well as the benefits, to the industry, consumers, the FSA, and the FSCS. The FSA will also continue to engage with stakeholders to review alternative proposals in greater depth. The FSA will report the results of this work in due course and will then consult on any policy proposals resulting from this. The FSA will carry out a cost benefit analysis as part of this process.

Eligibility

5.31 As indicated in the January consultation document, **the FSA is considering, and intends to consult on, the eligibility criteria for depositors to qualify for FSCS compensation payments**.

5.32 The January consultation indicated that the FSA intends to consult on new rules to reduce exclusions from the eligibility criteria for FSCS payments. The respondents who commented on this subject mainly commented on the relaxation of the eligibility criteria to enable the FSCS to cover large corporate or Government bodies. Generally, respondents were not in favour of this extension of eligibility, as it would increase the potential cost of the FSCS to the levy payers, and because it would effectively force all banks to be participants in the FSCS, including those banks who had chosen to specialise in areas without retail or small business customers.

5.33 The Authorities understand the arguments against changing eligibility criteria in this way. The principal policy intention in considering changes to eligibility is not to extend coverage significantly beyond what presently exists, but to ensure that the FSCS can immediately identify those individual customers who are eligible for compensation when an institution fails. Another way of achieving this would be to ensure that institutions have robust information systems that flag up those customers who are eligible in a way that would be immediately (and reliably) visible to the FSCS when required.

5.34 The FSA will consider further what changes may be needed to the eligibility criteria and whether it would be appropriate to place an identification "flag" on accounts. It will consult on any proposals in due course.

Gross payments

5.35 As proposed in the January consultation, **the FSA intends to consult on a move to gross payments of FSCS compensation.**[5] This may require amendments to the insolvency rules for the bank insolvency procedure, to ensure that making gross payments to eligible depositors gives a fair result for different customers and the FSCS.

5.36 Currently the FSCS operates on the basis that the depositor receives compensation up to the relevant limits solely in respect of the net balance (if any) of the amount owed to the depositor by the bank. The net balance is calculated by deducting any money owed to the bank by the depositor (for example a mortgage, loan or credit card debt) from the amount held on deposit for the depositor. There was widespread acceptance by respondents that the introduction of gross payment could help to speed up pay out and to ensure that depositors with loans outstanding would continue to have access to liquid funds. It was also accepted that where a depositor received a gross payment in respect of his or her deposits, there should continue to be an obligation to repay a loan owed to the failed institution in accordance with its original terms.

5.37 Moving to gross payment can be managed in a number of ways to ensure that depositors do not receive unwarranted benefits (for instance where they receive a FSCS pay out but also have set-off of the value of deposits against a mortgage). One possible way of doing this would be to impose a requirement for claimants to repay any compensation received which exceeds the net payment that would have been made if set off were still applied. Another approach would be to include provisions in the insolvency rules which would disapply set-off up to a limit (which could be as high as the FSCS compensation limit but need not be set at that level). A third way would be to make insolvency rules that provide for the breaking of mutuality of debt for depositors' claims assigned to the FSCS after the commencement of the banking insolvency procedure.[6] Changes to the well-established principles of set-off will be contentious and the Authorities are reviewing the most appropriate method. The FSA will consult on changes to the FSCS rules in due course, and there may be accompanying changes to the insolvency rules made under powers to be conferred in the forthcoming legislation.

> 5.1) The Authorities would welcome further views on the best way of introducing gross payout when there are mutual debts.

[5] With gross payments, a customer would be entitled to a compensation payment based on the amount of their deposits up to the FSCS limits without taking into account sums owed by the customer to the bank – e.g. in the form of a loan or mortgage. These latter sums would still have to be repaid by the customer.

[6] Mutuality of debt refers to the situation where there have been multiple dealings between the same two parties in the same capacity and that, as a result, there are sums due (either currently or in the future) both from party A to party B and from party B to party A.

Streamlined claims process

5.38 As indicated in the January consultation, **the Government intends to legislate to give the FSA the power to make new rules to specify the circumstances in which consumers need to make a formal claim to the FSCS before receiving a compensation payment and to allow for the automatic conferral of rights on the FSCS to make recoveries in place of claimants**.

5.39 Though there was support for this idea, the main concern expressed by respondents on this issue was that any process involving automatically making payments or sending cheques to persons who were thought to be eligible claimants without any formal claim would increase the risk of fraud and payments made in error.

5.40 The relevant clauses will be included in the forthcoming legislation. These clauses will amend FSMA to give the FSA the power to make rules which would allow claims to be deemed to be made in circumstances specified in the rules. The FSCS will not be required to deem claims to be made in cases where it would not be appropriate to do so, for instance in the case of dormant accounts.[7] The FSA will address the concerns raised by respondents as part of its consultation process on new rules for this area.

Opening new accounts

5.41 As proposed in the January consultation document, **the Authorities will work with banks and the appropriate trade associations to ensure that depositors can open up a new account quickly enough to facilitate fast compensation payments and minimise disruption.** The Authorities welcome the UK Payments Council's intention, expressed in the National Payments Plan, to analyse the problems that users encounter with payment formats, particularly non-standard account numbers.

5.42 Respondents noted the practical problems for banks in opening a very large number of new accounts in a short time, including capacity constraints in banks themselves, and in systems for transferring direct debits and standing orders, and the possibility of a reduced quality of service to other bank customers. There were also concerns about the requirements of anti-money laundering law and the ability of some customers, particularly vulnerable customers, to deal with their part of the process. Some respondents suggested that arrangements would be needed to give advice to bank customers generally, and support to those who particularly need it for account opening.

5.43 The Authorities will continue to work with trade associations, consumer groups and other appropriate bodies to remove unnecessary regulatory constraints on the ability of banks to process new account applications, possibly, for instance through the reliance on the 'know your customer' checks performed by the failed bank.

[7] Dormant accounts would still benefit from the protection of the FSCS where the dormant account is still held by the failed bank. However, it is neither feasible nor practical to automatically pay a claim on this account; by definition, the depositor is no longer contactable. If the depositor were to come forward, their claim would still exist. It would be necessary for dormant accounts to be immediately identifiable in bank systems.

FSCS management and operations

5.44 The January consultation explained that the Government proposed to include provision in the forthcoming legislation to ensure that the FSCS has the management flexibility it needs to manage a wide range of claim volumes. There were few comments on this issue but respondents agreed that the FSCS should have the management flexibility it needs.

5.45 After further work by the FSA and FSCS, the Government has concluded that no major legislative changes are needed to ensure that the FSCS has sufficient flexibility to enable it to process claims efficiently and cost effectively. The Government is considering including in the forthcoming legislation a number of minor changes to FSMA provisions relating to the handling of claims by the FSCS and the payment of compensation.

CONSUMER AWARENESS

5.46 As proposed in the January consultation document, **the FSA and FSCS intend to review how consumers can be better informed about the current compensation scheme**.

5.47 Respondents generally agreed that customers should be better informed and that banks should have a role in communicating information about the FSCS to their customers. A number of ideas have emerged from discussions with stakeholders which need to be taken further including notices in branches, information on statements and use of websites. But there were also concerns that too much emphasis on the FSCS could lead to unnecessary worry or confusion for depositors.

5.48 The FSA and FSCS will continue to discuss with relevant industry stakeholders and consumer bodies the best methods by which awareness and understanding of the FSCS can be raised. If appropriate the FSA may consult on rule changes to facilitate awareness of entitlement to compensation under the FSCS, alongside any industry led initiatives.

FSCS FUNDING AND LIQUIDITY

Borrowing from the public sector

5.49 As proposed in the January consultation, **the Government intends to ensure that the FSCS has access to immediate liquidity through borrowing from the public sector**.

5.50 There was widespread support among consultation responses for giving the FSCS the ability to borrow from Government or the Bank of England if it needed substantial immediate liquidity.

5.51 The Government will therefore include provision in the forthcoming legislation to allow the National Loans Fund to lend to the FSCS.[8] These loans will have to be repaid, with interest charged at appropriate market rates, out of future levies on the

[8] The National Loans Fund was established under the National Loans Act 1968. It is the fund, held in an account at the Bank of England, through which the majority of the Government's borrowing and lending transactions take place.

industry, as well as from the share of recoveries from the estate of the failed bank that accrue to the FSCS.

Pre-funding

5.52 The Authorities consulted in the January document on the question of whether, in addition to Government liquidity for depositor protection arrangements, there ought also to be an industry pre-funded pool of assets on which the FSCS could draw to finance compensation payments. There was a wide range of views.

5.53 Some respondents supported the introduction of pre-funding, often because it could facilitate the introduction of risk-based levies (see below). However, respondents from the deposit-taking sector were opposed to pre-funding. These respondents put forward a variety of arguments, including that accumulating a fund would increase pressure on bank capital and liquidity, that pre-funded schemes are not appropriate in concentrated banking systems like the UK, and that pre-funding is not necessary if the FSCS has access to liquidity from the Government or the Bank of England.

5.54 The Authorities continue to believe that there could be benefits from introducing pre-funding in a proportionate way. While borrowing from the National Loans Fund will allow the cash flow impact of payout on FSCS levy payers to be spread over a longer period of time following a failure, pre-funding would allow part of the impact to be spread over the period before any failure as well. This could reduce the pro-cyclicality of levy payments in the current arrangements – that is the imposition of levies on banks after another bank has failed, when confidence may be low and other banks may also be under financial stress. Pre-funding could also reduce the risk of contagion – the risk that levy demands could weaken the position of some other banks to such an extent that the probability of their failing was materially increased.

5.55 Pre-funding may allow the FSCS to pay compensation in the event of the failure of a smaller bank without recourse to borrowing from the National Loans Fund, or making a levy demand at the time of failure. The introduction of an element of pre-funding could therefore increase the credibility of the levy-based funding arrangements for the FSCS and provide a more even distribution of the costs of bank failure between bank customers, bank shareholders (including those of the failed bank) and the general body of taxpayers, at different points in time.

5.56 The Authorities nevertheless recognise the arguments against pre-funding raised by consultation respondents. Some of the issues raised could be addressed through careful design. The Authorities also recognise that the timing of the introduction of pre-funding, the size of the fund, and the speed at which it was built up, would need to be chosen after careful consideration, including of the cyclical position. In particular, pre-funding would need to be introduced at an appropriate time, when banks did not face further pressures and the fund would need to be:

- built up gradually over time, recognising that bank failures are rare events, and that calls on the fund may not be needed for a number of years;
- capped at a proportionate level, balancing the counter-cyclical benefits of pre-funding with the need to minimise cost; and
- complemented by the provision of public sector liquidity to the FSCS (by borrowing from the National Loans Fund) in the event of a significant bank failure.

5.57 The Authorities are not, therefore, proposing to introduce pre-funding immediately. They do, however, believe it is important to keep under review the introduction of pre-funding for the FSCS. **The Government therefore intends to include in the forthcoming legislation powers which would allow it to introduce pre-funding of the FSCS if it was considered appropriate to do so in the future.** The detail of any pre-funding arrangements would be set out in secondary legislation and consulted on in detail. The Authorities will continue to work with deposit-takers and other stakeholders on this issue.

Risk-based levies

5.58 The January consultation indicated that the FSA would be seeking views on the advantages and disadvantages of introducing risk-based levies or other ways of bringing behavioural factors into levy contributions.

5.59 Respondents' views on risk-based levies were mixed. While some saw advantages in risk-based levies in giving incentives to banks to improve risk management, there were concerns about maintaining the confidentiality of risk assessments, about possible duplication of arrangements for prudential regulation and about adverse effects on competition if risk-based levies inhibited the ability of smaller banks to compete.

5.60 The FSA will consider this issue further and consult on any changes to the criteria for calculating deposit contributions if appropriate in due course.

National Loans Fund borrowing and pre-funding: legal framework

5.61 Under the current provisions in FSMA (and FSA rules), the FSCS is responsible for deciding to collect a levy. As it operates on a pay-as-you-go basis, the FSCS calls for a levy only when it is satisfied that its resources are insufficient to meet its management expenses for the relevant financial year and the anticipated compensation costs for the 12 months following the relevant levy point. The FSA sets out in rules the maximum annual levies that can be collected from the financial services industry and the basis upon which levies can be collected.

5.62 However, the provision of a statutory borrowing facility from the National Loans Fund, and the possible introduction of a system of pre-funding to fund deposit compensation costs, would mean that the FSCS would no longer be operating solely on a pay-as-you go basis. From the perspective of public financial management, it is necessary, before the National Loans Fund can lend, to provide a suitable assurance that the borrowing will be repaid in full and to ensure that these financial arrangements would not involve any subsidy to the levy payers. Pre-funding would also raise the possibility of a significant gap between the collection of the levies and the costs being incurred.

5.63 **The Government therefore proposes to use the forthcoming legislation to ensure that borrowing from the National Loans Fund will be repaid and to enable the Treasury to make regulations, if necessary, regarding FSCS pre-funding**, including powers to regulate the building up and investment of funds (which it is intended would be deposited with the National Loans Fund), when funds would be used and the levy payers who would contribute. The regulations would be subject to Parliamentary approval under the affirmative resolution procedure.

5.64 The FSA would remain responsible for setting in its rules the more detailed and technical requirements relating to the setting and collection of levies. This could include the basis for the apportionment of a levy between firms in the same class and the circumstances in which particular firms would be exempt from the levy.

5.2) The Authorities would welcome further views on a possible move to pre-funding and on the proposed legal framework for pre-funding and FSCS borrowing from the National Loans Fund.

BANKNOTES AND CHEQUES IN SCOTLAND AND NORTHERN IRELAND

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

5.65 As stated in the January consultation, **the Government intends to legislate to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland.**

Current position

5.66 Under the Bank Notes (Scotland) Act 1845, the Bankers (Ireland) Act 1845 and the Bankers (Northern Ireland) Act 1928 (together, "the current legislation"), a limited number of commercial banks retain the right to issue their own banknotes in Scotland and Northern Ireland respectively.[9]

5.67 The current legislation requires commercial issuing banks to hold specified assets – Bank of England notes and current UK coin – equal to their notes in circulation, above a small absolute value. The value of these assets is reported by the issuing banks at the close of business on Saturdays to Her Majesty's Revenue and Customs. The current legislation does not provide for these assets to be specifically ring-fenced for the benefit of noteholders.

Consultation

5.68 The Government consulted on banknote issue arrangements in Scotland and Northern Ireland in 2005.[10] It proposed to enhance protection for commercial banknote holders 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.

5.69 All respondents supported the principle of noteholder protection, but a number claimed that the detail of the proposals went beyond what was necessary to protect noteholders. Some respondents felt that insufficient account had been taken of the costs associated with issuing banknotes and the social benefits supported by the income derived. It was argued that, without modification, the proposals could undermine the economic rationale for commercial bank note issuance and lead to

[9] The issuing banks are: Bank of Scotland; Clydesdale Bank; Royal Bank of Scotland; Bank of Ireland; First Trust Bank; Northern Bank and Ulster Bank.

[10] Banknote issue arrangements in Scotland and Northern Ireland, HM Treasury, July 2005.

some issuing banks withdrawing from this practice. A summary of the responses to the 2005 consultation can be found in Annex C.

Proposed framework

5.70 Following close dialogue with all the issuing banks, the Government intends to bring forward legislation which will provide enhanced protection for noteholders, while not seeking to discourage note issuing commercial banks from continuing to issue their own banknotes.

5.71 The key features of the framework are:

- the issuing banks will have to hold certain assets ("backing assets") to at least match the value of their banknotes in circulation at all times;
- no less than 60 per cent of the value of banknotes in circulation must be backed by Bank of England banknotes and/or current UK coin;
- the remaining value of banknotes in circulation and the value of banknotes with the potential to enter circulation (for example, in bank branch tills, ATMs and in transit) will be permitted to be backed wholly by way of an equivalent amount in a segregated interest-bearing account at the Bank of England, remunerated at Bank Rate;
- the minimum value of backing assets to be held must be reassessed each week, on the basis of the weekly peak level of banknotes; and
- backing assets will be legally ring-fenced for the benefit of noteholders in the event of an issuing bank failing.

5.72 The forthcoming legislation will mean that holders of Scottish and Northern Ireland banknotes will be afforded a similar level of protection to holders of Bank of England banknotes and, in the unlikely event of an issuing bank failing, can expect to obtain full face value for their banknotes.

5.73 Further details on the forthcoming legislation are set out below.

Non-legislative aspects

5.74 Maintaining confidence in the value and integrity of the currency is a prime objective of the Bank of England. Following consultation, the Government will work with industry to seek to develop workable and effective non-legislative proposals to better combat potential counterfeiting of Scottish and Northern Ireland banknotes.

Proposed legislative framework

Statutory framework

5.75 The forthcoming legislation will establish a new regime for the issuing of banknotes in Scotland and Northern Ireland. The framework of the regime will be established by primary legislation, with the details being set out in Treasury regulations and rules made by the Bank of England (hereafter referred to as the forthcoming legislation). The following section sets out the key components of the primary legislation and proposed regulations.

5.76 The current legislation governing the issuing of banknotes in Scotland and Northern Ireland will largely be repealed, in particular the provisions of the Bank Notes (Scotland) Act 1845 and the Bankers (Ireland) Act 1845 giving authorisation to issue banknotes. There will be consequential repeals to certain other provisions of those Acts, and of the Bank Charter Act 1844, the Currency and Bank Notes Act 1928 and the Bankers (Northern Ireland) Act 1928 (for example, removing the note-issue related administrative role of Her Majesty's Revenue and Customs).

Authority to issue

5.77 The forthcoming legislation will provide for a general prohibition of the issue of banknotes in Scotland and Northern Ireland, subject to an exemption for the Bank of England and for those banks which, immediately before the coming into force of the new provisions are authorised under the current legislation to issue banknotes in Scotland or Northern Ireland ("authorised banks"). These authorised banks will, therefore, be entitled to continue to issue banknotes. Any person who issues a banknote in breach of the prohibition will be guilty of an offence.

Approved agents

5.78 It is proposed that the forthcoming legislation will provide that any agency relationship between an authorised bank and a third party (for example, a non-issuing financial institution or a cash handler) must be approved by the Bank of England before notes held under that relationship can be treated as not being in circulation for backing purposes. It is envisaged that the provisions will provide that an "approved agent" is a person for the time being approved, in accordance with conditions determined by the Bank of England, to hold banknotes on behalf of an authorised bank otherwise than as bearer.

Backing Assets

5.79 The forthcoming legislation will require authorised banks to hold, at all times, backing assets to at least match the value of their banknotes in circulation and with the potential to enter circulation. It is intended to define backing assets as (a) banknotes issued by the Bank of England, (b) current UK coin and (c) funds held in a segregated interest-bearing account at the Bank of England.

5.80 The provisions will require that a minimum of 60 per cent of the peak value of notes in circulation over the course of a seven-day week be backed, throughout the week, by Bank of England banknotes and current UK coin. The remaining proportion of that peak level must also be backed, but can be in a segregated interest-bearing account at the Bank of England, which will be remunerated at Bank Rate.

5.81 Banknotes that have the potential to enter circulation (for example, notes held in ATMs, bank branch tills and in transit) will also have to be fully backed. The legislation will permit these notes to be backed by an equivalent value in a segregated interest-bearing account at the Bank of England, which will be remunerated at Bank Rate. Should a bank choose, it could back the banknotes with Bank of England banknotes and current UK coin, as long as the total value of banknotes with the potential to enter circulation is backed at all times.

5.82 It is expected that backing assets in the form of Bank of England notes will be held primarily at the Bank of England. However, the provisions will also permit backing assets in the form of Bank of England banknotes and current UK coin to be held at locations in Scotland and Northern Ireland that have been approved by the Bank of England for that purpose in accordance with conditions determined by the Bank, for the holding of specified backing assets. It is envisaged that some conditions will relate to the physical security of the site, while others will govern how Bank of England notes and current UK coin must be stored in order to qualify as backing assets.

Ring-fencing of backing assets

5.83 It is intended that the forthcoming legislation will provide for backing assets to be ring-fenced solely for the benefit of noteholders. Specifically, it is envisaged that in the event of an authorised bank failing, for a prescribed period, expected to be one year, affected noteholders will be able to exchange their notes for Bank of England notes or such other forms of payment as may be specified in, or in accordance with, the provisions. The backing assets cannot be treated as assets of the authorised bank during that period. At the end of the prescribed period, any surplus backing assets will be released for the benefit of other creditors.

Reports to the Bank of England

5.84 The forthcoming legislation will allow the Bank of England to require authorised banks to provide reports on the value of their banknotes in circulation, and with the potential to enter circulation. The provisions will also require authorised banks to provide reports on the value of backing assets held in approved locations. Provision may be made for reports to include both prior estimates and actual figures, along with the methods by which those figures have been arrived at.

5.85 The provisions will allow, at the expense of the authorised bank, for the Bank of England to require an authorised bank to appoint a person (typically the bank's external auditor, but possibly an independent expert) to provide assurance about the accuracy of figures reported and the adequacy of the methods used to obtain them.

Penalty regime

5.86 The forthcoming legislation will provide provisions to grant the Bank of England the power to impose a financial penalty on an authorised bank which fails to meet the backing requirements. Additionally, there will be a range of enforcement actions available to the Bank of England for breaches of note-issue related rules and conditions. Penalties may take into account size, severity and length of any breach.

Loss of issuing rights

5.87 The forthcoming legislation will provide that if an authorised bank ceases to issue banknotes it may not recommence doing so. This is consistent with the current legislation. The provisions will set out the procedures associated with voluntary cessation of note issuance, and will provide that certain elements of the new regime (in particular, the requirement to back notes) will continue to apply for a specified period.

5.88 It is proposed that the Treasury will have the power to determine that an authorised bank has failed to comply with the provisions to such an extent that it should forfeit the right to issue banknotes.

5.89 The forthcoming legislation will provide for certain circumstances to result in the automatic loss of note issuing rights. The provisions will focus on the circumstances in which an authorised bank is placed into the special resolution regime. It is envisaged that the provisions will set out that note issuing rights will be lost automatically if any of the following occurs:

- there is a directed transfer of all, or part of, the authorised bank's property to a third party (i.e. via a property transfer);
- a bridge bank is established in respect of all, or part of, the business of the authorised bank via a property transfer; or
- the authorised bank goes into insolvency procedures.

Scottish cheques

5.90 As stated in the January consultation, **the Government intends to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the UK**.

5.91 In Scots Law, under the funds attached rule, when a cheque is presented to a bank for payment the sum stated on the cheque is assigned to the payee of the cheque out of the funds held by the bank for the drawer of the cheque. Thereafter, neither the drawer nor the bank on their behalf may deal with that sum.

5.92 Problems arise in practice when there are insufficient funds to satisfy the cheque or multiple cheques presented simultaneously. In those circumstances, the bank makes no payment. Instead, the available funds are "attached" and placed in a suspense account. Therefore, no cheque can be paid, even though funds may be available to satisfy some of them.

5.93 This can cause considerable difficulty for the drawer of the cheques, for payees whose payment is delayed and for the bank concerned, which incurs the administrative cost.

Proposal **5.94** It is proposed to use the forthcoming legislation to abolish the funds attached rule in Scots Law, so far as it relates to cheques, and to make any necessary consequential changes to related legislation. Scots common law will still apply where there are insufficient funds available to satisfy a cheque presented for payment.

6 Strengthening the Bank of England and Tripartite coordination

In the January consultation, the Authorities set out proposals for strengthening the Bank of England's role in relation to financial stability, and for improving coordination between the Authorities including through the Standing Committee. This chapter:

- summarises the Authorities' proposals for strengthening the framework for financial stability, and setting out the objectives, roles and responsibilities of each of the Authorities. A key element of the reforms is to ensure that the Bank of England has the right statutory and operational framework to deliver against its core objective in financial stability. The Government will build upon the example of the monetary policy framework in bringing forward a number of measures to strengthen the financial stability role of the Bank of England by:
    - providing the Bank of England with a statutory responsibility for contributing to the maintenance of financial stability;
    - improving the policy instruments available to the Bank of England in support of financial stability, including through responsibility for the special resolution regime (SRR) for failing banks;
    - implementing new corporate governance structures within the Bank of England, including legislating for the creation of a Financial Stability Committee to support the Governor, drawing upon external expertise; and
    - modernising the Bank of England's Court, to reflect its enhanced role in financial stability.
- given the shared responsibilities for financial stability across the Bank of England, Treasury and Financial Services Authority[11] (FSA) the chapter summarises plans for strengthening coordination across the UK Authorities; and
- summarises respondents' views on the proposals in the January consultation.

STRENGTHENING THE ROLE OF THE BANK OF ENGLAND

Statutory objective for financial stability

6.1 The Bank of England plays a significant role in supporting the maintenance of financial stability, including through detecting and reducing threats to the financial system as a whole. This core purpose sits alongside the Bank of England's responsibility for monetary stability. Currently, responsibility for monetary policy is clearly set out in the Bank of England Act 1998, but there is no similar statutory description for its objective for financial stability. As proposed in the January consultation the Government intends to legislate, to provide the Bank of England with a statutory responsibility for contributing to the maintenance of financial stability.

[11] The FSA already has such a statutory responsibility. Under FSMA it has a statutory objective to maintain confidence in the financial system.

6.2 In response to the January consultation, respondents were generally supportive of highlighting and strengthening the Bank of England's responsibility for contributing to financial stability through a statutory objective, and indicated that they would support the Bank of England in increasing resources and introducing new accountability structures in support of financial stability.

6.3 The Bank of England will be given statutory responsibility for contributing to the maintenance of financial stability within the United Kingdom. This will be a high level objective, ensuring that the Bank of England has the flexibility it needs in meeting the objective. This approach recognises important differences between financial stability and monetary policy. Whereas monetary policy can be set out in clear operational terms through an inflation target, the requirements of financial stability are more context-specific, and liable to change as the operation of global financial markets changes. The Government will not set a financial stability target for the Bank of England.

Financial stability and policy instruments

6.4 For the Bank of England to fulfil its new statutory objective, it needs appropriate policy levers. Therefore, **the Government intends to improve the policy instruments available to the Bank of England in support of its responsibility for financial stability,** including:

- liquidity measures: the Bank of England has developed a number of money market operations to support its role in monetary policy and financial stability. In the area of financial stability it is particularly important that banks and other institutions can access liquidity without stigma. As set out in Chapter 3, further legislative changes are proposed that will clarify disclosure rules and strengthen the Bank of England's position as a creditor. In addition, the Bank of England is reviewing the Red Book with a view to introducing a new, permanent facility that learns from the experience of the Special Liquidity Scheme. The FSA will continue to be able to make recommendations to the Bank of England in relation to liquidity support.

- oversight of payment systems: the Bank of England sits at the heart of payment systems in the UK. Proposals to provide the Bank of England with statutory oversight, as set out in Chapter 3 will increase the ability to drive improvements to the robustness and resilience of payment systems that are fundamental to ensuring financial stability.

- information gathering: it is important that the Bank of England has access to and is able to obtain information to inform its analysis of the stability of the financial system as a whole. As set out in Chapter 3 the FSA will collect on behalf of, and share information with, the Bank of England in support of this role;

- prudential policy: the FSA and the Bank of England will continue to consult each other on all new proposals for prudential regulation with potential implications for financial stability or supervision. The Bank of England will continue to be able to make recommendations to the FSA in relation to its rules for prudential regulation; and

- implementing and overseeing the special resolution regime for banks: as set out in Chapter 4, the Bank of England will have responsibility for the operation of the special resolution regime and the resolution tools within it. This will include, in consultation with the FSA and the Treasury, responsibility for the decision on which special resolution tool to use.

Governance and accountability

6.5 To support the Governor and the Bank of England in discharging the enhanced responsibilities and policy tools that the Bank of England will have at its disposal, the Government proposes to bring forward changes to the financial stability governance and accountability structures.

Financial Stability Committee

6.6 The structures and decision-making processes that have proved successful in the area of monetary policy, and particularly in the role they play in strengthening accountability and the external credibility of the Bank of England provide a useful basis for new arrangements to strengthen the Bank of England's role in financial stability. **The Government intends to legislate for the creation of a Financial Stability Committee (FSC) to support the Governor and Bank of England, drawing upon external expertise.** This would be a sub-committee of Court and will comprise senior representatives from within the Bank of England as well as external experts (non executives drawn from Court) and be chaired by the Governor.

6.7 The FSC will bring valuable external expertise to bear on the Bank of England's decision-making in the area of financial stability and will ensure that the Bank of England commands authority and credibility in discharging its new financial stability objectives as it does on monetary policy. It is anticipated that the FSC will play an important role in overseeing the functions of the Bank of England in relation to financial stability. The Bank of England's executive will be accountable to the committee for its decisions and actions in financial stability, including, for example, market-wide operations and institution specific actions. It is also expected that the FSC will play a key role within the Bank of England in overseeing the Bank of England's actions under the new Special Resolution Regime for a failing bank. It will be important to manage any conflicts of interest that could potentially arise for Court and FSC members, and this may require amendments to the existing conflict of interest arrangements that are contained within the Bank of England Act 1998.

Role of Court

6.8 As set out in the January consultation document, **the Government plans to give the Court a formal role in overseeing the Bank of England's performance on financial stability.** The Bank of England Act will be amended to give Court a role in managing the performance of the Bank of England on financial stability. As part of this role, Court will be responsible for setting the precise remit of the FSC. In recognition of the wider importance of this and the shared responsibility for financial stability **the Government will bring forward legislation to require the Bank of England to consult with the Treasury, on a periodic basis, when setting the detailed financial stability objectives for the Bank of England and the remit for the FSC.**

Modernising Court

6.9 In support of the Court's enhanced role in overseeing the Bank of England's performance on financial stability and as proposed in the January consultation document the Bank of England intends to modernise the arrangements for meetings of the Court. To facilitate the decisions made by Court in this regard, **the Government will bring forward legislation to restrict the size of Court to a maximum of twelve members, including a majority of non-executives, one of whom will Chair Court as has been the case in practice since 2003**. Court will meet a minimum of seven times a year.

6.10 Court will also strengthen its capacity with regard to the skills and expertise related to financial stability. This is particularly important given the Financial Stability Committee will need to draw upon the non-executive expertise of the Court. It is important that there is a clear transition to the modernised Court. In line with the process that the Government undertook during the reforms to give the Bank of England operational independence in 1998, **the Government will legislate to facilitate the reduction in the size of Court by terminating the membership of all non-executive members when the measures come into force, allowing for their subsequent reappointment.**

Future appointments to the Bank of England and MPC

6.11 As well as its responsibility for contributing to financial stability, which will be strengthened, and given a statutory basis, the Bank of England also has a statutory responsibility for monetary policy. Alongside the changes discussed above, relating to financial stability, the Government is also committed to retaining the UK's monetary policy framework at the forefront of international best practice. The Chancellor of the Exchequer has confirmed a number of changes to the process of appointments to the Bank of England and the Monetary Policy Committee (MPC) that will inject more openness and transparency to the process, and further demonstrate commitment to this aim.

6.12 In future, **the Government will advertise vacancies for the Governor and Deputy Governors of the Bank of England and also for external members of the MPC, consistent with the principles of open competition.** The Governor has also agreed that the two Bank Executive Director posts that carry MPC membership will be advertised in the future.

6.13 From now on, all appointments made by the Government to the MPC will be for a maximum of two terms. This does not apply to the two Bank Executive Director posts on the Committee. Members of the MPC will be considered for re-appointment at the end of their first-term. Governor and Deputy Governors will serve a maximum of two five year terms in these posts with external members of the Committee limited to serving a maximum of two three year terms in these roles.

IMPROVING COORDINATION ACROSS THE UK AUTHORITIES

6.14 As proposed in the January consultation document the Authorities intend to apply some of the lessons from the operation of COBR to the working of the tripartite arrangements. The Authorities are implementing the measures contained in the January consultation.

6.15 In particular, the Authorities are focussing on the practical, as well as policy aspects of financial crisis management and contingency planning. Once decisions for dealing with a crisis have been taken, operational delivery becomes the key priority. Within this priority, effective and coordinated communication with consumers and markets, by the Authorities – and where issues around depositor protection are also involved, the FSCS – are recognised as being of particular importance.

Revising the MoU

6.16 As proposed in the January consultation document, **the Authorities will, in light of the new legislation, clarify responsibilities within the Memorandum of Understanding, setting out the roles and responsibilities of the Treasury, the FSA and the Bank of England with regard to financial stability, including the relevant roles and responsibilities in relation to the SRR.**

A IMPACT ASSESSMENT

Summary: Intervention & Options		
Department /Agency: HM Treasury	**Title:** Impact Assessment of the banking reform Bill	
Stage: Consultation stage	**Version:** CON/02	**Date: 01 July 2008**

Related Publications: Discussion Paper, Banking reform - protecting depositors; Consultation Document, Financial stability and depositor protection - proposals for a strengthened 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. Events in the financial sector since mid-2007 have highlighted a number of areas for improvement to the UK regime for 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 preceding consultation document.

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: 01 July 2008

Summary: Intervention & Options

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

ANNUAL COSTS		Description and scale of **key monetised costs**	
One-off (Transition)	**Yrs**	One-off costs relate to streamlining the FSCS claims process; ongoing costs reflect costs to the FSCS of processing information. The proposals include taking a power in the forthcoming legislation which would allow the introduction of pre-funding into the FSCS. If pre-funding were introduced then costs to deposit-takers would significantly increase. (However, there would be lower costs at a later date if a bank failed. So this is a purely contingent cost.) To give an indicative scale, the annual and ongoing costs to the FSCS levy payers could be in the region of £300m. Further details on pre-funding are set out in the evidence base.	
£ 1.5m – 3.0m	1		
Average Annual Cost (excluding one-off)			
£ 0.0m – 0.1m		**Total Cost** (PV)	£ 2.2m – 4.5m

Other **key non-monetised costs** Many costs are non-monetised. This is because they will only be incurred in particular cases 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 firm, the financial climate, the Authorities' response etc.

ANNUAL BENEFITS		Description and scale of **key monetised benefits**	
One-off	**Yrs**	Ongoing benefits solely relate to Scottish cheques.	
£ 0.0m	1		
Average Annual Benefit (excluding one-off)			
£ 0.3m – 0.4m		**Total Benefit** (PV)	£ 3.6m – 5.1m

Other **key non-monetised benefits** 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 unpredictable and infrequent events. They will vary by firm, the financial climate, the Authorities' response etc.

Key Assumptions/Sensitivities/Risks The real discount rate used is 3.5%

Price Base Year 2007	Time Period Years 20	**Net Benefit Range** (NPV) **£ - 0.8m**	**NET BENEFIT** (NPV Best estimate) **£ 2.8m**

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?	£
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 of	£ Negligible	**Net Impact**	**£**

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

Specific Impact Tests: Checklist

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

Assessing the impact of the consultation proposals

A.1 The consultation document discussed the proposed banking reforms of the 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 proposals that are being considered, and an analysis of the benefits, costs and likely impact of the proposed reforms.

A.2 This consultation stage impact assessment follows from the consultation stage impact assessment published alongside the January consultation document. The analysis has been updated where relevant.

Stakeholder views

A.3 The January impact assessment asked three consultation questions. Responses to these questions are set out in the summary of consultation responses annex of this document.

Process going forward

A.4 An updated version of the impact assessment for the special resolution regime will be published alongside the detailed policy narrative and draft clauses. The Authorities will publish this before the summer Parliamentary recess.

A.5 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.6 Accordingly, contributions are now sought that may improve the analysis of the benefits, costs and risks arising from these reforms.

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

Scope

A.7 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 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.

Structure of this consultation stage impact assessment

Relationship with the consultation document

A.8 The impact analysis for each proposal is set out in the final section of this impact assessment. The numeric totals in the template reflect the sum of the benefits and costs for each policy. In line with impact assessment guidance, the template only contains benefits and costs associated with the banking reform Bill. Where there are a number of options put forward the benefits and costs are not included in the template; these are instead presented alongside the analysis of the proposal.

Terminology

A.9 Benefits and costs are split in two ways: firstly, between direct and indirect; and secondly, by quantifiable and non-quantifiable.

Direct versus **indirect** – Direct benefits and costs are those that will be incurred regardless of circumstances of financial instability or bank failure. These are distinct from indirect benefits and costs which arise only in these instances. Thus direct benefits and costs are non-contingent; indirect ones are contingent.

Quantifiable versus **unquantifiable** – Quantifiable benefits and costs are those for which the Authorities are currently in a position to estimate. These are clearly set out in each part of the impact assessment and summed to produce the totals presented in the impact assessment template. However, many benefits and costs are unquantifiable. In these cases indications are made to their scale, and the Authorities will continue to attempt to estimate them, where feasible, over the course of the consultation period.

Structure

A.10 This impact assessment annex is structured as follows:

1. the case for Government intervention and regulation;
2. what policy options have been considered?;
3. costs of financial instability and bank failure;
4. sectors and groups affected;
5. small firms impact assessment; and
6. analysis of proposals.

CASE FOR INTERVENTION AND REGULATION IN THE FINANCIAL SECTOR AND JUSTIFICATION FOR INTERVENTION

Importance of banks

A.11 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 the stability of the financial sector is paramount.

A.12 This is especially the case because of the interrelationships between firms in the sector. The banking sector may be unusually vulnerable to losses of confidence through the risk of contagion. As banks have substantial lending and other exposures to each other and because of the informational symmetry between banks and their customers, many bank investors and depositors could infer problems for the sector as a whole from bad news at a few banks.

A.13 Banks, building societies and other deposit-taking firms (for simplicity referred to as 'banks' unless otherwise specified) provide the bulk of the immediately available liquidity for UK households and non-financial business. They are key participants in the payment systems and are a key source of finance for households and businesses, especially those that do not have access to capital markets. Banks can have these roles because they are 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. Banks liabilities are liquid only because (except in the case of a bank run) banks have the 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, when these risks cease to be independently distributed and become highly correlated, which may lead to bank runs and wider systemic consequences.

Cost of failure

A.14 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 a bank of sufficient size is likely to have significant economic costs, which will fall on the customers of the particular bank and also on the wider economy. These are discussed in more detail in the section, 'Costs of financial instability and bank failure'.

A.15 Major banking failures are rare in the UK. However, the consequences of banking failure (and therefore banking crises) are likely to be extremely serious. Box A.1 discusses the aggregate costs of financial crises that have previously occurred in other countries. Furthermore, as consolidation in the financial sector has increased, and may continue to increase, so the impact that a failure of a bank would potentially have increases too.[1]

Rationale for regulation

A.16 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 little 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 shareholders' rights. The bank's management (or shareholders) 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. There are negative externalities attached to this as the actions of a bank's management may go on to affect a wider range of stakeholders through the various transmission mechanisms of the financial sector. These issues give grounds for Government intervention and regulation.

Responding to market failure

A.17 The problems faced by Northern Rock plc in 2007 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 problems 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.18 In order to rectify the issues outlined above, the Authorities proposed a package of reforms in the consultation document published in January. This second consultation sets out an updated analysis of the Authorities' proposals.

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

A.19 The Authorities believe that the policy measures proposed in this consultation document will successfully take steps towards solving the market failures discussed above. Moreover, the Authorities have assessed that the package of proposals is a proportionate response to the events of 2007.

WHAT POLICY OPTIONS HAVE BEEN CONSIDERED?

A.20 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.

A.21 The emerging conclusions were set out in a consultation document published in January 2008, *Financial stability and depositor protection: strengthening the framework*. A consultation stage impact assessment was published alongside the document.

A.22 This second consultation stage impact assessment updates the analysis presented in January. It evaluates each proposal in turn (including policy options, where applicable) against the alternative of no Government intervention.

COSTS OF FINANCIAL INSTABILITY AND BANK FAILURE

A.23 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 instability and bank failure under the current framework and discusses their implications for the economy and financial instability more broadly.

A.24 Costs are broken down between:

- depositors;
- borrowers;
- the Exchequer; and
- the economy as a whole.

Costs to depositors

A.25 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 more pronounced if the bank has a significant geographic or sectoral concentration of business.

A.26 In the UK, approximately 90 per cent of the population have a current account.[2] 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

[2] Family Resources Survey, 2005-06

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

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 a large numbers of individuals, households and businesses.

A.27 Under current arrangements, if a bank were to fail, depositors would suffer through loss of:

- liquidity, due to the nature of sight accounts (current accounts and instant access savings accounts) as immediate sources of cash;
- of access to payments systems, due to the transactional role of current accounts; and
- wealth, where current and savings accounts (including notice accounts) are used as a form of investment (to the extent that the depositor's balance exceeds the FSCS compensation limit and the depositor does not recover these additional funds through the insolvency process).

Loss of liquidity

A.28 Economic literature and experience of past failures document that a major 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. To the extent that this undermined confidence in the banking system more generally, this could, in turn, increase the probability of a run developing at other, healthy banks.

A.29 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 instant access 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.30 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. There may have to be some substitution by firms and individuals to other methods of payments (for example, debit card transactions or cheques).

Loss of access to payment systems

A.31 Payment systems are important for the functioning of the financial markets and the economy, therefore robust and effective payment systems are important for almost every economic transaction that takes place. The inter-linkages between payment systems, banks and other financial intermediaries means that problems have the

[4] Department for Work and Pensions

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

[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.

potential to spread through the financial system, which can ultimately affect business and consumers.

Loss of wealth

A.32 Should a bank fail and the FSCS pays out compensation, a small portion (data suggests that the current compensation limit of £35,000 covers approximately 97 per cent of all UK depositors) 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 compensation limit. However, this is not necessarily wholly a welfare cost. If depositors are fully informed about the compensation limit, then the investment decision may be viewed as the outcome of a maximising portfolio choice problem (in which the investor has invested above the compensation limit in order to trade-off greater risk for greater expected return). Thus it may be optimal to accept some of the risk. 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.33 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 are unable to easily signal their creditworthiness as borrowers to another lender. In this case, the long-term relationship between the borrower and their bank has value as it enables the bank to evaluate the borrower more effectively.

A.34 This asymmetric information problem is most commonly associated with small firms, for whom the costs of signalling their credit-worthiness through the production of credible public information (for example, agency ratings or detailed financial statements) are too high, or firms in specialised industries where lending decisions require detailed knowledge of individual projects.

A.35 Even if firms are able to find another lender, they may face higher borrowing costs (or credit rationing) 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.[7]

Costs to the Exchequer

A.36 The government may incur costs if it chooses to intervene in an attempt to resolve or alleviate the crisis. Unless these costs are offset by proceeds from the resolution (for example the sale of a state-owned bank) or recharged to another party (for example, FSCS levy payers), this loss will, ultimately, be borne by the taxpayer. Fiscal outlay may arise through a number of different means such as:

[7] 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)

- liquidity support, for example a central bank providing liquidity support;
- recapitalisation of failing banks;
- liability guarantees of wholesale and consumer liabilities (technically a contingent cost unless the guarantees are 'called'); and
- other interventions, for example bulk-buying of bad debts.

A.37 While these are likely to be short-term one-off costs, they may alter perceptions of how governments will react to crises in the future. If the public policy response does not contain a suitable punishment for those responsible, then the financial sector may realise that it has less of an incentive to properly manage risk. This is the problem of moral hazard. However, there will be some situations in which the costs to the economy of not intervening are significantly greater than the fiscal costs of taking action, hence intervention may be an optimal response.

Costs to the economy

Financial sector

A.38 The cost of funding the FSCS is covered by the UK financial sector in the event that the eventual recoveries from a failed bank were 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 US shows that the rough cost (to the FDIC) of resolving failing financial firms was around 14 per cent of the total deposits of firms that failed 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.39 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.40 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.

Wider economy

A.41 All of the types of cost discussed above – costs to depositors, borrowers, the Exchequer and the financial sector – will feed through in some form to the wider economy. This will be through a range of transmission mechanisms. In general, the academic literature on these costs is clear that in the event of a systemic banking crisis there may be a significant impact on the income and wealth of the economy as a whole. Box A.1 provides a brief summary of this literature.

Box A.1: Aggregate costs of financial crises

The previous section describes the effects of the failure of an individual bank on its customers. However, if multiple banks, representing a significant part of the banking sector, fail or become severely weakened at the same time, there will be additional effects on the economy.

If the banking sector lacks capital, and is unable or unwilling to raise more, it may choose to cut back on lending to firms and households in order to rebuild capital ratios. Similar cutbacks may follow if deposits and other lending to banks are withdrawn due to a loss of confidence in the banking system. Such a loss of confidence is also likely to make it harder for banks to raise additional capital, and may affect even banks with little exposure to the original cause of the crisis if they are unable to prove their soundness to investors.

These reductions in bank lending in turn may affect the economy by limiting the ability of firms and households to make new investments, or smooth shocks to their income and consumption.

Alternatively, capital constrained banks may seek to avoid recognising losses; for instance ensuring that troubled borrowers can continue to service loans by extending them new credit. If such 'evergreening', or similar practices, becomes widespread it can lead to an inefficient allocation of investment in the economy.

The effect on output of these and other costs can be very large. One estimate[8] puts the average cumulative output loss (relative to trend) in a sample of 47 banking crises at 15-20% of GDP (depending on the measurement method), and found that crises in developed countries are as severe as those in developing countries. Crises can also be long-lasting: in the same study the average length of crises in developed countries was 5.5 years.

These costs are not shared equally across the economy. There is evidence[9] that industrial sectors which have more small firms, or which are more dependent on external financing, are more severely affected by crises. One study[10] finds that the bulk of the fall in output in the first two years of a crisis is accounted for by a fall in investment, although consumption and inventories also fall, offset by a rise in net exports.

SECTORS AND GROUPS AFFECTED

A.42 The proposals presented in the consultation document will affect (either directly or indirectly) 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 protected deposits market is estimated at £950 billion.[12]
- **Banks** – There are 154 banks incorporated in the UK.[13]
- **Building societies** – There are 59 building societies in the UK.[14]

[8] "Costs of banking system instability: some empirical evidence"; G. Hoggarth, R. Reis and V. Saporta; Bank of England Working Paper 144

[9] "The Real Effect of Banking Crises"; G. Dell'Arriccia, E. Detragiache, R.Rajan; IMF Working Paper 05/63

[10] "Corporate financial structure and financial stability"; E. P. Davis and M.R. Stone; Journal of Financial Stability 1 (2004) pp65-91

[11] Family Resources Survey 2005-06

[12] FSA data.

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

- **Credit unions** – There are 559 registered credit unions in the UK.[15]
- **Authorities** – The Treasury, the Bank of England and the FSA, and in some instances, the FSCS.
- **Non-financial industry** – Non-bank stakeholders may be indirectly impacted, for instance through changes in bank behaviour, lending or investment policy.

IMPACT ON SMALL FIRMS

A.43 The previous impact assessment considered small firms in two ways:

1. As a consumer of banking services, a depositor or a borrower; and
2. As a provider of banking services, a bank. It is likely that for these small firms, the proposals relating to compensation in Chapter 5 will be the most important.

Stakeholder views

A.44 The previous impact assessment asked respondents whether they thought small businesses would be affected by the proposals in a different way to other consumers. There were no strong views expressed on this question. Of those who did respond, most did not believe that small business stood to be adversely affected by any of the proposals.

Small firms as consumers

A.45 None of the proposals 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.

Small firms as providers

A.46 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.47 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 from specific requirements.

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

[15] FSA, 2006 Annual Statistics, February 2007

ANALYSIS OF POLICY OPTIONS

A.48 The following section sets out an analysis of each of the policy options proposed by the Authorities.

REDUCING THE LIKELIHOOD OF A BANK FAILING

A.49 This section discusses legislative proposals included in chapter three of the consultation document.

Consultation proposal: Information sharing between the Authorities

Description **A.50** **The Government confirms its intention to legislate to facilitate the FSA obtaining and sharing information that the Bank of England and the Treasury require for purposes relating to financial stability.**

A.51 Currently, in the context of the Memorandum or Understanding, 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 the Treasury may require but which the FSA itself does not require.

A.52 To ensure each of the Authorities is able to carry out its role fully, 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 proposed financial stability statutory objective.

Benefits **A.53** 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. The proposed 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 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.54** Costs for supervised firms and the Authorities will depend on any increases in information requirements. The Authorities intend to codify arrangements in an agreement to ensure arrangements to collect and share information are as efficient as possible. In addition, the Authorities do not envisage that significant additional information (surplus to what is already provided to the FSA) will be required to be supplied to the Bank of England or the Treasury in times of financial stability.

Quantification: Contingent on any increases in ongoing data requirements. Likely to only be significant in rare circumstances, for example periods of financial instability.

Groups affected **A.55** Directly: the Authorities and supervised firms where additional reporting requirements are put in place.

Competition assessment **A.56** This measure should not have a significant impact on competition.

Risks **A.57** There is a risk that this proposal may increase the amount of information requested by the FSA from the firms it supervises, which may have cost implications for both firms and the Authorities requesting the information. To mitigate against this risk, as noted above the Authorities will codify arrangements to ensure the efficient collection of information in an agreement.

Consultation proposal: Bank of England statutory immunity

Description **A.58** **The Government intends to legislate to provide the Bank of England with statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and other central bank functions.**

A.59 Currently, both the FSA and FSCS have a statutory immunity in discharging their responsibilities. However, the Bank of England does not. The risk of litigation may therefore make it difficult for the Bank of England to discharge its responsibilities effectively and in full.

A.60 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 other central bank functions.

Benefits **A.61** This proposal ensures that the actions taken by the Bank of England in discharging its responsibilities in relation to financial stability and other central bank functions are protected from the threat of legal action seeking damages from the bank. Such litigation may have an adverse operational impact as it may restrict the Bank of England's actions in a time of financial instability. Removing these constraints stands to allow the Bank of England greater flexibility in its actions, and so may reduce the costs of financial instability and bank failure.

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 financial stability.

Costs **A.62** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected **A.63** Directly: the Bank of England. Indirectly: any firms that were affected by Bank of England actions that would not otherwise have occurred without statutory immunity. In addition, any party that would otherwise have taken legal action against the Bank of England.

Competition assessment **A.64** This proposal should not have a significant impact on competition.

Risks **A.65** To mitigate against the risks associated with this power, the Authorities propose 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, placing the Bank of England on a level of parity with the FSA and FSCS.

Consultation proposal: Floating-charges and building societies

Description **A.66** **The Government will bring forward legislation to ensure that floating charges may be granted by building societies in relation to the provision of liquidity support by central banks.**

A.67 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.68 The Government proposes modifying this restriction to allow building societies to grant floating charges to the Bank of England.

Benefits **A.69** There are no significant ongoing or one-off direct benefits associated with this measure.

Quantification: Negligible.

A.70 Liquidity assistance is an important tool available to the Authorities to assist an 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.71** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected **A.72** Directly: 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.73** This measure should have a positive impact on competition, as it levels the playing field between banks and building societies for receiving liquidity assistance from the Bank of England.

Risks **A.74** There is a risk that this proposal could be considered adversely to affect 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).

Consultation proposal: Contractual provisions

Overview **A.75** **The Government is seeking views on whether it should legislate to provide that restrictions on borrowing (including negative pledges) and other provisions having a similar effect are nullified to the extent that they would prevent financial assistance by the Authorities for the purposes of financial stability or are otherwise triggered by steps taken by the Authorities.**

A.76 There may be a number of contractual clauses that firms use to protect their position as lenders to and creditors of banks. For example, negative pledge clauses, where they are included in contracts, may specify that a borrower, having taken out a loan with a lender or issued debt securities to a bondholder, cannot subsequently grant security without consent of the lender or bondholder. The existence of such clauses could restrict or delay the Bank of England providing liquidity assistance to a bank in difficulties.

A.77 In addition, the presence of negative pledges could increase the level of risk that the Bank of England must absorb in relation to liquidity assistance through preventing it from taking security over the borrower's unencumbered assets. Similarly, contractual provisions which seek to give creditors rights to terminate financing agreements or otherwise modify agreements to the detriment of the borrower, specifically by reference to steps taken by the Authorities to reduce the likelihood or impact of an institution failing, may be counterproductive if they deter necessary actions either by the bank or the Authorities.

A.78 Two options for reform are presented in this consultation stage impact assessment. At present the Authorities do not have a preferred option.

Option one

Description **A.79** One solution would be to legislate to provide that restrictions on borrowing (including negative pledges) and other provisions of the kind described above are nullified to the extent that they would prevent financial assistance by the Authorities for the purposes of financial stability or are otherwise triggered by steps taken by the Authorities.

Benefits **A.80** A statutory override would enable the Authorities to take the appropriate action without the firm becoming liable for breach of contract. It would reduce legal risks both for the firm and the Authorities (who might, for example, be accused of inducing a breach of contract). In the case of liquidity assistance it would allow the Bank of England to reduce greatly the credit risk involved in the operation. It may also reduce the amount of support that was required.

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.81** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.82 The Government is seeking views on whether there are any indirect costs to this legislative solution. The final impact assessment will contain details of any costs that are identified during the consultation period.

> A.2) Do you think that there are any significant indirect costs associated with this proposal?

Groups affected

A.83 The FSA, the Bank of England and financial intermediaries who make use of these contractual provisions.

Competition assessment

A.84 At present the Authorities do not believe that this option would have a significant impact on competition, However, the Authorities will undertake further work over the consultation period to confirm that this is the case.

Risks

A.85 The Authorities are aware that a legislative solution may pose significant risks. For example, a legislative over-ride to contractual provisions, such as negative pledge clauses, events of default in connection with regulatory action and other restrictions on the terms of borrowing is likely to have costs for creditors, as the ability of such contractual clauses to mitigate the creditor's credit risk could be greatly reduced in circumstances where the firm was subject to actions by the Authorities. Lenders entering into these contractual restrictions following the introduction of a legislative override may seek to price the increased credit risk into the cost of borrowing. Over time markets may adjust and new contractual provisions to replace those that the Authorities may override are likely to emerge.

A.86 The benefits of creating a statutory override may be difficult to realise. In light of these risks, the Authorities are also seeking views on a non-legislative solution, which is set out below.

Option two

Description

A.87 An alternative to a statutory provision would be to discourage, or require through regulatory guidance or rules, firms from entering agreements which include the contractual provisions that may prevent the Authorities from taking appropriate actions to reduce the likelihood of a firm failing.

Benefits

A.88 The benefits expressed in the first option still stand. An additional benefit is that a non-legislative solution would allow firms and creditors to assess the risk of relevant clauses and alter their contracts accordingly.

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.89 A non-legislative option may impose fewer costs on banks as they would be able to price the risk of their contracts appropriately. A non-legislative option may have costs for depositors, creditors and shareholders if the Authorities are hindered, delayed or unable to take action to reduce the likelihood of failure of a firm due to the presence of certain contractual provisions.

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

Groups affected

A.90 The FSA, the Bank of England and financial intermediaries who make use of these contractual provisions.

Competition assessment **A.91** As noted above, the Authorities do not expect this proposal to have a significant impact on competition.

Risks **A.92** Firms may not assess the level of risk accurately and contracts and agreements may continue to contain provisions that could hinder, delay or prevent the Authorities from taking appropriate action.

Consultation proposal: Bank of England weekly returns

Description **A.93** **The Bank of England has been consulting further on whether or not to continue publication of the weekly return.**

A.94 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 set out explicitly the amount of emergency lending operations, significant liquidity support activity is likely to cause noticeable movements in the balance sheet.

A.95 It may not be in the best interests of financial stability for liquidity support to be disclosed immediately and in this fashion. Therefore the Government is considering legislation that would enable the Bank of England to stop publishing weekly returns.

Benefits **A.96** There will be an ongoing cost saving to the Bank of England (and the Treasury, as it pays for their publication in the London Gazette) by not publishing the returns. However, this benefit is not estimated to be material.

Quantification: Negligible

A.97 In the event that the Bank of England has given liquidity support, the Authorities may judge that the objective of maintaining financial stability is best served by delaying disclosures of information relating to emergency lending operations 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 statutes and statutory instruments to remove the obligation to disclose such information or to grant the Authorities the right 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.98** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.99 It is not yet clear whether the current users of the weekly return would incur costs if it were not published. While respondents to the January consultation did not express strong views on this issue the Authorities will continue to explore whether there are costs associated with this proposal.

Groups affected **A.100** Directly: the Bank of England and users of the weekly bank return. Indirectly: banks receiving liquidity support which is otherwise undisclosed apart from through means of the weekly return.

Competition assessment

A.101 This measure should not have a direct impact on competition, given that the weekly return is freely available. However, there may be an indirect benefit to any bank receiving liquidity support from the Bank of England not having to publish these returns (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 adversely impacts on the rest of the financial sector are minimised.

Risks

A.102 The risk of this proposal is that it causes a reduction in transparency for the markets and consumers. To mitigate the risks, the Bank of England will undertake further consultation before deciding whether to continue with publication of the weekly return.

Consultation proposal: Registration of charges

Description

A.103 **The Government intends to legislate so that any charges granted to a central bank in connection with its functions as a central bank will be exempt from registration.**

A.104 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.105 Removing the requirement on banks to register charges over certain assets would mean that liquidity assistance could not be identified from their own register or the register at Companies House.

Benefits

A.106 There are no significant one-off or ongoing direct benefits associated with this measure. While there may be some administrative savings for banks that would otherwise register charges, these are unlikely to be material.

Quantification: Negligible.

A.107 In the event that the Bank of England has given liquidity assistance, 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 it from the Bank of England may harm consumer confidence and cause the type of problems that the lending operation 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 financial instability.

Costs

A.108 There are no significant one-off or ongoing direct costs associated with this measure.

Quantification: Negligible.

A.109 Exempting charges that are granted to a central bank in connection with its central bank functions may impose a cost on shareholders and creditors of a borrower who wish to investigate the extent to which the borrower has created charges over its assets. The Companies House register provides information – albeit in general terms – relating to when the charge was created, which persons are entitled to the benefit of the charge, the amount that has been secured and the property that has been charged. This information is sought routinely in connection with legal transactions (such as mergers and acquisitions, leases, property sales, etc.). However, fixed charges over most types of assets (other than land) are not required to be registered at Companies House nor is it common practice for creditors to investigate the company's own register. Title transfer collateral arrangements, which are increasingly the favoured form of taking collateral for many financial institutions, also fall outside any registration regime. Accordingly, creditors wishing to obtain a fuller picture of a borrower's secured assets are already required to make enquiries to the borrower directly.

Quantification: For the reasons outlined above, the Authorities do not expect these costs to be material.

Groups affected

A.110 Directly: any bank receiving liquidity support from the Bank of England that registers a charge against its assets. Indirectly: depositors and other creditors of the bank, who may benefit if such liquidity support prevents a failure. It would also affect future creditors of the bank, who would be extending credit to the bank, unaware of the liquidity support.

Competition assessment

A.111 This measure should not have a direct effect on competition. However, there may be an indirect benefit to any bank receiving liquidity support 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.112 Any removal of the current registration requirement delays the discovery by the financial sector that a firm has received liquidity support from the Bank of England. This reduces transparency.

Consultation proposal: Regulation of the UK payment systems

Description

A.113 **The Government intends to legislate to formalise the Bank of England's role in the oversight of payment systems to ensure the robustness or payment systems which, if a disruption in the operation of the system were to occur, would be likely to lead to systemic and system-wide consequences.**

A.114 The Bank of England currently undertakes oversight of payment systems on a non-statutory basis under the tripartite Memorandum of Understanding. The FSA has statutory responsibility for the regulation of Recognised Clearing Houses (which contain embedded payment systems). The Office of Fair Trading has statutory responsibility for issues relating to competition and access.

A.115 Following the January consultation, the Authorities propose to provide the Bank of England, as the sole regulator of payment systems, with a statutory backing. In effect, this formalises the Bank of England's existing responsibilities of ensuring that payment systems are robust and effective. The Bank of England's oversight will be restricted to those systems whose disruption or failure could have systemic or system-wide consequences.

A.116 The Authorities do not envisage that this proposal will amount to a substantial change in practice.

Benefits

A.117 The primary benefit of giving the oversight of payment systems a statutory basis is that it provides the Bank of England with the necessary powers to take action (should informal actions fail in the first instance). In addition, it will give greater clarity for payment systems stakeholders (principally the operators and members). As such, the Authorities believe that the legislative framework for oversight should improve the robustness of payment systems whose failure may have systemic or system-wide consequences.

Quantification: It is not feasible to quantify the benefits of more robust and efficient payment systems, as the resulting benefits are the prevention of any failure. However, payment systems are crucial to the smooth running of the financial sector and their robustness is important to the financial system.

A.118 The tighter scope of oversight to focus on systems with systemic or system-wide consequences could reduce the number of systems overseen (that is, not the card schemes) and hence eliminate some costs.

Quantification: It is not possible to quantify this impact until the Treasury has recognised payment systems which are systemic or of system-wide importance.

Costs

A.119 The proposed approach formalises the current informal arrangement between the Bank of England and payment systems. Under the existing arrangements the Bank of England meets with most of the key UK payment systems on a quarterly basis. It also requests information from these systems in order to undertake risk assessment. The Bank of England does not envisage any significant change to this approach under the statutory regime.

A.120 As such, there should be no significant impact on the costs incurred by the payment systems which will be overseen. However, the Authorities recognise that there may be a small increase in costs to the payment systems should they wish to change the way they engage with the Bank of England under a statutory regime.

Quantification: At this stage, the Authorities believe these costs to be negligible.

A.121 The legislation also gives Bank of England the power to charge fees for oversight. If they seek to exercise these powers there would be an additional burden on recognised payment systems. At this stage the Authorities do not expect that fees charged (if any) will be significant in size. In any case, the legislation provides that the level of any fees be capped by Treasury regulations which will be consulted on in due course.

Quantification: At this stage, negligible.

A.122 The Bank of England is likely to incur a small cost in establishing formal oversight and an ongoing increase in personnel costs to carry out the statutory functions. Any additional costs will be funded from existing resources.

Quantification: It is not expected to be to be more than three full-time equivalent officials.

Groups affected

A.123 The Bank of England, payments systems whose disruption may lead to systemic or system-wide consequences and a small number of infrastructure providers.

Competition Assessment **A.124** This measure should not have a significant impact on competition. Competition issues relating to payment systems will remain the responsibility of the Office of Fair Trading.

Risks **A.125** There is a risk that some costs may be incurred by non-recognised systems if they are asked to provide information to the Bank of England. The Authorities will use this consultation to assess how many systems this could affect.

REDUCING THE IMPACT OF A FAILING BANK

A.126 This section discusses legislative proposals included in chapter four of the consultation document.

Consultation proposal: Special resolution regime

Overview **A.127** **The Government intends to legislate to introduce a "special resolution regime".**

A.128 This part of the impact assessment covers the special resolution regime as whole and does not cover the specific tools of the regime. This is consistent with the treatment in Chapter 4. Analysis will be extended to encompass the tools in the next consultation document (which will comprise of draft clauses and associated policy narrative for the special resolution regime), to be published before the summer parliamentary recess.

Description **A.129** The SRR is, in effect, a set of tools to enable the Authorities to resolve failing banks. These tools will be used in limited circumstances: as acknowledged in the January consultation, any decision to use such tools in the case of a specific firm would be a significant step, and the way in which these tools are deployed will therefore need to be considered very carefully.

A.130 Given this, and the fact that the regime does not impose particular requirements on banks outside of its operation, there are few direct benefits and costs associated with it. It is important to distinguish between benefits and costs arising from the existence of the SRR and benefits and costs arising from its usage. Costs and benefits will in the main be incurred when a failing bank has entered the regime and in these cases will be determined by the particular tool chosen by the Bank of England. These benefits and costs, which are contingent on the powers of the regime being used, need to be separated from any direct benefits and costs.

A.131 The regime does, however, regardless of whether it is invoked or not, carry risks. Some of these risks could have a significant impact. These are discussed in detail below. The Authorities believe, though, that the benefits of the special resolution regime outweigh these risks and that appropriate safeguards can help to mitigate such risks.

Direct benefits **A.132** There are no one-off or ongoing quantifiable direct benefits associated with the SRR.

A.133 There should, however, be some non-quantifiable direct benefits, primarily in the form of confidence in the financial system. Establishing a regime is likely to increase confidence – both at a consumer and wholesale level – in the banking industry. The new tools give bank stakeholders increased certainty that the Authorities will be able to successfully and optimally resolve a bank in severe difficulties.

Indirect benefits

A.134 The two most significant benefits of the special resolution regime are that it reduces the likelihood and the impact of a failing bank. These two benefits, in particular the latter, mean that the overall costs of bank failure should be reduced with the regime in place.

A.135 Reducing the impact of bank failure affects a number of groups:

- **Depositors** – the SRR tools (other than the bank insolvency procedure) provide for the continuation of banking services, ensuring customers retain access to their deposits, preserving liquidity. In the case of the bank insolvency procedure, depositor payout is the priority.
- **Authorities** – the fiscal impact of a bank failure should be reduced as the Authorities have better means to pursue a private-sector solution.
- **Financial services sector and the wider economy** – by isolating bank failure and reducing the risk of contagion, the special resolution regime will benefit economic sectors closely linked to the banking sector.

Quantification: It is not feasible to quantify these benefits because they will vary on a case-by-case basis. However, the 'Costs of financial instability and bank failure' section sets out the benefits of preserving financial stability and preventing bank failure.

Direct costs

A.136 At this stage there are no quantifiable direct costs associated with the special resolution regime.

A.137 There may be some unquantifiable (at this stage) direct costs associated with the costs of implementation to the Authorities. It is likely that the Bank of England, given its central role in the SRR, may need to invest in additional resources to enable it to carry out its functions. There may need to be various 'on call' contracts with appropriately qualified experts who may be called in at short notice to assist in the resolution and advise the Authorities.

Quantification: The Bank of England will work over the consultation period to estimate the one-off and ongoing administrative costs of the SRR. At present it is not possible to quantify these costs. In general, it is not anticipated that there will be significant ongoing costs; most costs will be incurred only when the Bank of England is involved in a bank resolution.

Indirect costs

A.138 The indirect costs of the SRR may be defined as the costs incurred as part of any resolution of a failing bank. These costs could include:

- an injection of liquidity, that is a special loan to a bank;
- a public sector liability guarantee;
- additional administrative expenses to the Authorities of appropriate advisers (legal and financial); and
- compensation costs.

A.139 To protect the public interest the Authorities would seek to recover as many of these costs as possible. However, it should be noted that the creation of the SRR should reduce these costs overall from what they otherwise would have been if the Authorities did not have the new tools.

Compensation costs

A.140 The powers of the regime may remove or adversely affect property rights, employment and other private law rights. This would need to be justified in relation to the European Convention on Human Rights (ECHR) and be compatible with Community law obligations. The Authorities believe that such intervention will be justified by the strong public interest grounds set out in Chapter 4, further any legislation will provide a quick and effective mechanism for assessing such compensation as may be payable.

A.141 In some cases compensation may be due for property rights that have been overridden (where required to render the interference proportionate, under Article 1 of the First Protocol to the ECHR). These costs – to be determined by independent valuation – will vary on a case-by-case basis.

Competition assessment

A.142 The Authorities do not believe that the SRR will have a significant impact on competition. However, there may be competition issues in relation to the some of the tools of the SRR. These will be discussed in the next consultation document when the detailed narrative of the SRR tools will be set out.

Risks

A.143 As discussed above, there are certain risks, some significant, to the creation of an SRR for failing banks. A number of these risks would cause costs to the economy, especially the financial services sector, if they fully crystallised. Others could reduce the effectiveness of the regime. To mitigate these risks the Government will consult on a range of safeguards in the next consultation document, to be published before the summer Parliamentary recess.

A.144 However, it should be noted that regimes similar to the SRR exist in other countries. Indeed, most G10 countries have special arrangements for dealing with a failing bank, rather than relying on normal corporate insolvency laws. Box 4.1 sets out international experiences of resolution regimes in more detail. The operation and existence of these regimes suggests that any adverse impact on the financial markets is modest, whilst accepting that the risks of an SRR regime have to be assessed in the particular context of this country and its financial markets.

A.145 Perhaps the greatest risk attached to the introduction of the SRR is that, without appropriate safeguards, giving the Authorities broad powers to resolve failing banks could increase the costs of capital and funding for banks. In broad terms, this could occur if counterparties perceive there to be an increased risk that their property rights will be interfered with. This may induce them to either take additional security or increase the price of their lending. In the context of the banking sector the cost of funding relates to the price of borrowing and is one function of banks' cost of business. It is likely that at least a portion of any increase would be passed on to consumers, either through higher costs of banking services or increased charges on borrowing. If this occurred across the banking sector, aggregate consumption and investment could be affected, although effects would be constrained by overseas competition. There is little evidence, however, that the existence of special regimes in other countries has raised the costs of capital and funding for banks. Offsetting this risk is the potential benefit that the legislation could bring to make financial markets work more efficiently and reduce the systemic risk attached to the sector.

A.146 If risks relating to the cost of funding for banks crystallised then it is possible that the attractiveness of London, compared to other financial centres of business, would be reduced. London, and the UK more widely, is generally considered an attractive location to do business. English law is widely acknowledged to be an attractive legal form in which to agree financial transactions.

A.147 There is also a risk that if the powers of the special resolutions regime do not fully extend to group entities (that is, beyond the company that is the deposit-taker) that the directed transfer, bridge bank and temporary public ownership tools will be less effective. This could occur if it was impossible to operate the deposit-taker in isolation to the rest of the group. The Authorities are seeking to mitigate this risk by considering including powers to provide compulsory 'contracts' between any bank in the SRR and entities to which it has a business relationship. These will be set out in further detail in the subsequent consultation document.

A.148 There is a risk that the use of the SRR tools would become an event of default in commercial documents and arrangements and counterparties could choose to exercise their rights to default. The Government will be consulting on appropriate safeguards in draft clauses and accompanying narrative to be published before recess to help ensure the success of the SRR tools.

Consultation proposal: Resolution of building societies and other mutuals

Overview

A.149 **The Government intends to legislate so that building societies are subject to a special resolution regime similar to that for banks.**

A.150 The previous consultation stage impact assessment asked respondents whether the impact on building societies of the special resolution regime tools would be different to that on banks. In general, stakeholders responded that they did not believe there were any noteworthy differences.

A.151 An impact assessment of the tools of the special resolution regime will be published in the next consultation document.

Consultation proposal: Funding the special resolution regime

Description

A.152 **The Government intends to legislate to bring forward legislation so that, in addition to its role in ensuring payout to depositors in the event of the failure of a deposit-taking firm, the FSCS can also be called on to contribute to costs arising from the use of resolution tools.**

A.153 Currently, the costs of bank failure are only borne by financial services providers (in their capacity as levy payers to the FSCS) at the point at which the FSCS is engaged to pay depositors.

A.154 As an alternative, the Government is proposing legislation to provide the FSCS with responsibility for contributing to the cost of using SRR tools, where this would better protect the interests of depositors, and would be no more costly for the FSCS than paying compensation.

Benefits

A.155 The use of pre-insolvency SRR tools to resolve a failing bank would be undertaken on the grounds of a number of public interest considerations, including the need to preserve financial stability, to protect the public finances, to protect depositors, and maintain the availability of key banking services for consumers. These considerations, as discussed above, point to significant benefits resulting from the use of the SRR to the economy as a whole.

A.156 In the case of levy payers, the direct benefit of the use of pre-insolvency SRR tools in the absence of any contribution towards the cost, would be the hypothetical cost of compensation had the SRR not been available and the failing bank been put into insolvency (with depositors paid out through the FSCS). It is anticipated that the proposal to require the levy payers to contribute to the cost of resolution will have two effects:

- firstly, it will transfer some of the direct benefits described above from levy payers to the Authorities; and
- secondly, the total benefit may increase, as it is anticipated that the cost of resolution through pre-insolvency tools may be significantly below the cost of payout in most cases. Therefore there would still be some direct benefit to the levy payers. The position of levy payers would be protected, furthermore, by the provision that their contribution to the resolution would be capped at the level of the hypothetical cost of compensation. So in the worst-case scenario, the benefit would be nil, rather than negative (that is, a cost).

Quantification: It is not feasible to quantify these benefits: they will vary from circumstance to circumstance.

Costs

A.157 There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

A.158 As discussed above, this measure should not increase the costs of resolving a failing bank, indeed it is more likely to decrease them. The transfer of benefits from levy payers to the Authorities will, however, be a cost for the levy payers in instances where the Authorities choose to intervene instead of allowing a bank to go into insolvency.

Quantification: It is not feasible to quantify these costs: they will vary from circumstance to circumstance.

Groups affected

A.159 Directly: the FSCS, the failing bank, and the FSCS levy payers.

Competition assessment

A.160 The operation of the SRR may give rise to some competition and EC State aid issues. As discussed above, these will be discussed in the detailed consultation on SRR tools and draft legislative clauses. The use of funds from the financial services industry to support these tools may give rise to additional competition issues, which will also be considered. The SRR tools, and their funding, will clearly need to be made compatible with all relevant aspects of competition law.

Risks

A.161 There is a risk that the Authorities may not estimate correctly either the costs of the SRR tools or of the hypothetical cost of compensation to eligible depositors had the bank failed. Therefore, both of these measures will be subject to independent assessment.

Consultation proposal: Financial collateral arrangements

Description

A.162 **The Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.**

A.163 The Government will consult on the scope of any future regulations to strengthen the protections available to financial collateral arrangements.

Benefits **A.164** 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.

Quantification: Negligible

Costs **A.165** 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.166** 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 affect individual consumers.

Competition assessment **A.167** 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.168** The power has no direct impact and hence no direct risks. The future use of this power will be subject to the usual better regulation checks and balances.

CONSUMER CONFIDENCE AND COMPENSATION ARRANGEMENTS

A.169 This section discusses individual proposals included in Chapter 5 of the consultation document to confer new powers on the Treasury to make regulations or to confer new powers on the FSA to make rules.

FSA consultation **A.170** Other compensation-related proposals discussed in Chapter 5 can be implemented in rules made by the FSA under existing FSMA powers and FSMA requirements relating to consultation and cost-benefit analysis will apply. This consultation stage impact assessment does not, therefore, include discussion of the following proposals:

- changes to the FSCS compensation limits and other factors used in compensation calculations;
- requirements for banks to have readily available information on the accounts held by depositors eligible for compensation from the FSCS (including single customer view);
- changes to eligibility criteria for depositors to qualify for FSCS compensation payments; and
- gross payments of FSCS compensation

A.171 The Chapter 5 proposals relating to compensation discussed here are:

- enabling the FSA to collect information on behalf of the FSCS before the default of a firm;
- enabling the FSCS to obtain information from firms after the default of a firm but before a claim has been made;
- for streamlining the FSCS claims process;

- ensuring the FSCS has access to immediate liquidity through borrowing from the Government;
- pre-funding; and
- ensuring the FSCS has the management flexibility it needs to manage a wide range of claim volumes.

Consultation proposal: FSA to have the power to collect information on behalf of the FSCS

Description

A.172 The Government intends to legislate to enable the FSA to collect information from firms that the FSCS requires (and share this with the FSCS) before default.

A.173 Currently, the FSA cannot obtain information not directly required for its own regulatory functions. Additionally, the FSCS does not have the power to obtain information from firms before claims for compensation have been made.

A.174 This proposed power would enable the FSA to obtain information that the FSCS needs. This information would be primarily used for the purposes of assessing the adequacy of the bank's systems to provide the Authorities with the information needed to assess whether payout is practical, and when necessary to prepare for compensation payments to be made, should a bank fail.

A.175 The FSA will carry out a cost-benefit analysis as part of the process of making rules under new powers conferred by the legislation.

Benefits

A.176 In the event of a bank getting into difficulties, this measure allows the FSCS to be better prepared to process payments quickly, should compensation be 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.177 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. This has been estimated at less than £100,000 per year.

A.178 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.179 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.180 This measure should not have a significant impact on competition.

Risks

A.181 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 Authorities taking actions to ensure that such information requests do not become public and in any event may become routine.

A.182 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 preparatory information is set too early, or any routine steps are too burdensome.

> **Consultation proposal:** Allowing the FSCS to obtain information from firms at an earlier stage

Description

A.183 **The Government intends to legislate to ensure that the FSCS can require and obtain information directly from firms as soon as a firm is declared in default.**

A.184 Currently, the FSCS can only obtain information directly from a firm once a compensation claim has been made.

A.185 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.186 There are no significant ongoing or one-off direct benefits associated with this measure.

Quantification: Negligible.

A.187 This proposal would allow the FSCS to begin processing compensation payments earlier. (This would also be a benefit of the proposal to allow claims to be deemed to be made – see Streamlining the FSCS claims process below.) 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.188 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.189 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.190 This measure should not have a significant impact on competition.

Risks

A.191 None identified at this stage.

> **Consultation proposal:** Streamlining the FSCS claims process

Description

A.192 **The Government intends to legislate to give the FSA the power to make new rules to specify the circumstances in which consumers need to make a formal claim to the FSCS before receiving a compensation payment and to allow for the automatic conferral of rights on the FSCS to make recoveries in place of claimants.**

A.193 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.194 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 payment, there would be an automatic conferral on FSCS of rights of recovery.

Benefits

A.195 There are no significant ongoing or one-off benefits associated with this measure.

Quantification: Negligible.

A.196 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.197 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 for claims and less paperwork for individual claims to establish eligibility.

Costs

A.198 No significant ongoing costs associated with this measure are envisaged. However, the FSCS is likely to have to review claims in more detail after they have been paid and to recover overpayments in appropriate cases. It is likely that the FSCS will have to invest in its technology systems, in order to facilitate this proposal and may have to incur some higher running costs.

Quantification: At this stage, the capital investment (one-off) for this measure is estimated at between £1.5 million and £3.0 million. Additional running costs cannot be quantified at this stage.

Groups affected

A.199 Directly: the FSCS. Indirectly: depositors eligible for compensation in the event of a bank failure.

Competition assessment

A.200 This measure should not have a significant impact on competition.

Risks

A.201 There is a greater risk of claims being paid in error. This measure also carries greater risks that cheques will be intercepted and fraudulently encashed or of other forms of fraud.

A.202 The FSA will carry out a cost-benefit analysis as part of the process of making any rules and it will be able to explore the risks of fraud and other forms of loss and the costs of measures to control these risks, in more depth when considering whether and in what way to exercise the powers conferred by the legislation.

Consultation proposal: FSCS access to liquidity for compensation payments

Overview **A.203** In the January consultation the Government sought views on ways to ensure that the FSCS could obtain access to immediate liquidity (including, potentially, through the introduction of an element of pre-funding, or through borrowing from the public sector). Following consultation the Government intends to:

- **ensure the FSCS has access to immediate liquidity through borrowing from the public sector**; and
- **include in the forthcoming legislation powers which would allow it to introduce pre-funding of the FSCS if it was considered appropriate to do so in the future.**

A.204 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, and has a unified funding model, which has been recently reviewed by the FSA after extensive consultation and which came into force 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.205 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.

Borrowing from the Government

Description **A.206** The Government intends to legislate to enable the FSCS to borrow from the National Loans Fund. The Government would become a creditor of the FSCS in the ordinary way – exactly as if the FSCS had borrowed from a commercial lender. These loans will have to be repaid with interest (charged at the appropriate market rates) out of future levies on the industry.

Benefits **A.207** 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.208** There are no significant ongoing or one-off direct costs associated with this measure.

Quantification: Negligible.

Groups affected **A.209** Directly: the FSCS, the Government. Indirectly: eligible depositors of a failed bank who may benefit from quicker compensation payments.

Competition assessment **A.210** 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.211** None identified at this stage.

Pre-funding

Description **A.212** The Government intends to legislate to take powers to make regulations to introduce pre-funding into the FSCS. There will be further consultation before any regulations are made.

Benefits **A.213** Pre-funding would reduce the need for the FSCS to meet its immediate funding needs by borrowing from the market or public sector. It means that contributions are required at less stressed times. (However, 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.

Costs **A.214** The numbers expressed in the following section are for illustrative purposes only. No decision has been taken about how a pre-funded scheme would operate or what the detailed specifications (including the amounts to be levied and the target size of fund) of the scheme would be. The aim of this section is simply to provide an indication of the scale of costs that pre-funding would involve. As noted above, there will be further consultation before any regulations are made.

A.215 The Government now proposes that the funds should be deposited in the National Loans Fund. The FSCS should not therefore incur significant costs in managing and operating any fund, as was anticipated in the January consultation document.

Quantification: In January the Authorities estimated that the administrative and asset management costs could be in the region of between £0.5 million and £1 million (assuming the fund is passively managed). This estimate has now been revised to be significantly less than £0.5 million.

A.216 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 the National Loans Fund 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 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 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. Some 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.217 Directly: FSCS levy payers and the FSCS.

Competition assessment

A.218 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.219 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. This may deter entry into the sector.

Risks

A.220 There is a risk that pre-funding could encourage banks to switch subsidiaries from the UK to other Member States.

Consultation proposal: FSCS management flexibility

Description

A.221 The Government is considering a number of minor provisions relating to the handling of claims by the FSCS and the payment of compensation.

A.222 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. Following further work by the FSA and FSCS, the Government has concluded that major legislative changes are not needed to ensure that the FSCS has the management flexibility it needs.

Benefits

A.223 Any benefits are likely to be reflected in slightly faster or more efficient pay out by the FSCS. 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.224 There are no significant one-off or ongoing direct costs associated with this measure.

Quantification: Negligible

Groups affected

A.225 Directly: the FSCS. Indirectly: any bank whose FSCS levies are affected by this measure.

Competition assessment

A.226 This measure should not have a significant impact on competition.

Risks

A.227 None identified at this stage.

Consultation proposal: Scottish and Northern Ireland banknotes

Description **A.228 The Government intends to legislate to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland.**

2005 consultation **A.229** In 2005 the Government stated its intent to enhance commercial banknote-holder protection by seeking to:

- require all issuing banks to hold sufficient and appropriate note-covering assets at all times, thereby creating a level playing field for all institutions with respect to banknote supply;
- strengthen the regulatory framework, including the transfer of current administrative responsibilities from Her Majesty's Revenue and Customs to the Bank of England; and
- ensure that noteholders, as creditors, can obtain value for their notes.

January consultation **A.230** In the January consultation, the Government restated its intent to legislate to strengthen arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland. In doing so the Government's two main priorities were to ensure that noteholders would be appropriately protected in the event of a banknote-issuing bank becoming insolvent and banknote issuance does not distort competition.

Changes to proposals **A.231** The detail of the proposals has changed in a number of respects since 2005. Principally, the measures now:

- allow issuing banks to back their banknotes with a mixture of interest-bearing and non-interest bearing assets;
- permit backing assets in the form of Bank of England banknotes and current UK coin to be held in locations outside the Bank of England, subject to certain conditions; and
- include a non-legislative approach to combating potential counterfeiting of Scottish and Northern Ireland banknotes. This is subject to agreement between the Government and industry on workable and effective anti-counterfeiting measures.

A.232 On the basis of the previous proposals, the January consultation envisaged an income transfer of £100million per year from the issuing banks (collectively) to the Exchequer. This estimated cost to the issuing banks and corresponding gain to the Exchequer arose from the original proposal that Bank of England banknotes should be the sole backing asset at all times.

A.233 Following consultation, the original proposal has been refined to allow backing assets to be a mixture of Bank of England banknotes and current UK coin and a segregated interest bearing account at the Bank of England. The impact is that there is now no net income transfer from issuing banks to the Exchequer.

A.234 The refinements outlined above reflect consultation responses, which confirmed that there were no concerns about there being a lack of a level playing field between issuing and non-issuing commercial banks. Further, the Treasury also better understand the costs associated with note-issuance, including the nature of commercial and agency relationships, which exist with non-issuing banks. It also recognises the potential additional costs to the Exchequer where a note-issuing bank cease to issue.

A.235 These proposals also incorporate a level of cover above that which was initially envisaged. This is because the issuing banks will be backing at the peak value of notes in circulation throughout the course of a seven-day week.

A.236 It remains the Treasury's intention not to discourage note-issuing commercial banks from continuing to issue their own banknotes. The Government believes that the proposals will provide greater confidence to noteholders and should support the continuation of the long-standing tradition in Scotland and Northern Ireland of banknote issuance.

Benefits

A.237 Implementation of the current proposals will have the following benefits:

- There will be enhanced protection for holders of Scottish and Northern Ireland banknotes in the event of an issuing bank getting into financial difficulties;
- the Bank of England, in line with its expertise in banknote issuance, will assume regulatory responsibility. There will be a small resource saving for Her Majesty's Revenue and Customs, whose historical administrative function in relation to commercial banknote issuance is no longer core to its objectives; and
- the framework does not discourage note-issuing commercial banks from continuing to issue their own banknote.

Quantification: There are no quantifiable benefits (aside from the administrative savings to HMRC, which are negligible).

Costs

A.238 There will be additional resource costs to the issuing banks, arising from complying with the new regulatory framework. However, the Authorities do not believe these will be significant.

Quantification: Further work will be undertaken to estimate these costs over the course of the consultation.

A.239 The Bank of England will incur costs in performing its regulatory role. However, the Authorities do not believe these will be significant.

Quantification: Further work will be undertaken to estimate these costs over the course of the consultation.

Groups affected

A.240 The reforms will affect the seven commercial banks which issue banknotes in Scotland or Northern Ireland. The position of holders of Scottish and Northern Ireland banknotes, as creditors, will be affected in insolvency. The transfer of regulatory responsibility will affect Her Majesty's Revenue and Customs and the Bank of England.

Competition assessment

A.241 The Authorities do not believe that these changes will have a detrimental impact on competition.

Risks

A.242 Should an issuing bank decide to cease issuing its own banknotes, there could be an additional cost to the Bank of England from increasing its distribution of banknotes. This assumes the bank concerned does not seek to dispense the notes of another commercial issuing bank.

Consultation proposal: Scottish cheques

Description **A.243** **The Government intends to legislate to bring the law in Scotland relating to the treatment of cheques in line with that in the rest of the United Kingdom.**

A.244 In Scots Law, under the funds attached rule, when a cheque is presented to a bank for payment the sum stated on the cheque is assigned to the holder of the cheque out of the funds held by the bank for the drawer of the cheque. Therefore, neither the drawer nor the bank (on the drawer's behalf) may deal with that sum. Problems arise in practice when there are insufficient funds to satisfy the cheque or multiple cheques are presented simultaneously. In those circumstances, the bank makes no payment.

Benefit **A.245** Abolition of the funds attached rule in Scots Law, insofar as it relates to cheques, removes an administrative cost for clearing banks in Scotland and reduces associated expense and inconvenience for the banks' customers.

Quantification: The abolition of the funds attached rule would remove an administrative cost for clearing banks in Scotland estimated to be approximately £300,000 per year.

Costs **A.246** The Government does not believe that this measure will lead to costs for any of the affected parties.

Quantification: Nil.

Groups affected **A.247** Abolition of the funds attached rule will benefit the four clearing banks in Scotland. Drawers and payees of cheques in Scotland will also benefit from this reform.

Competition assessment **A.248** Implementation of the cheques reform will 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.249** None identified at this stage.

COORDINATED ACTION

A.250 This section discusses legislative proposals included in chapter six of the consultation document.

Consultation proposal: Statutory changes to the Bank of England

Description **A.251** The Government intends to legislate for a number of changes to strengthen the Bank of England. Full details of these measures is set out in Chapter 6 of the consultation document.

A.252 Currently, the Bank of England does not have a statutory obligation for 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.253 The Authorities therefore propose to formalise the Bank of England's role in the area of financial stability through legislation, to create a Financial Stability Committee that would be a sub-committee of the Court and to bring the structure of Court further in line with corporate governance best practice.

Benefits

A.254 These changes should improve accountability and 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.255 There are no significant one-off or ongoing direct costs associated with this measure as the FSC will be drawn from members of Court.

Quantification: Negligible.

Groups affected

A.256 Directly: the Bank of England.

Competition assessment

A.257 This measure should not have a significant impact on competition.

Risks

A.258 None identified at this stage.

B SUMMARY OF CONSULTATION RESPONSES

INTRODUCTION

B.1 *Financial stability and depositor protection: strengthening the framework* was published on 30 January 2008. Comments were requested by 23 April 2008. During the consultation period, Treasury Ministers, the Governor of the Bank of England, the Chairman of the FSA, and their officials met with a wide range of stakeholders to discuss the proposals. A number of policy-themed workshops, bilateral meetings and discussions with international counterparts were also held.

B.2 Written responses, where confidentiality was not requested, can be found on the Treasury website at the following address: In total 114 responses were received.

B.3 The Authorities have considered all the responses to the consultation in developing the analysis and proposals set out in this document. The Authorities have also taken account of the recommendations made by the Treasury Select Committee in their two recent reports, The Run on the Rock, and Financial Stability and Transparency.

B.4 The section below contains a summary of the responses received to the questions posed in the January consultation.

SUMMARY OF RESPONSES

General issues

> 1.1) Please provide detail if you think that any of the proposals in this document:
>
> 1. are necessary and proportionate;
> 2. raise significant concerns; or
> 3. could be improved?

B.5 Most respondents supported the objectives for reform and many of the proposals put forward in the January consultation to achieve them. In considering the balance across the proposals as a whole, a number of respondents commented that there should have been more emphasis placed on reducing the likelihood of bank failure and greater recognition that improving the execution of the FSA's existing regulatory powers should be an important part of any enhanced regime.

B.6 Following on from this point, although many saw the special resolution regime as necessary some felt too much emphasis had been placed on proposals focused on reducing the impact of potential bank failure, particularly the special resolution regime. While many respondents saw this as a necessary addition, they also made the point that it should only be activated on very rare occasions.

B.7 A number of respondents noted that the effective operation of the Authorities, and clarity about each of their roles and responsibilities was also key to delivering financial stability in the UK.

B.8 Many respondents, particularly academics and policy-makers supported the case for introducing an element of pre-funding for the FSCS. However those in the deposit-taking sector argued that the case in favour of pre-funding the FSCS was not sufficiently strong to recommend its introduction.

B.9 Most respondents agreed with the goal of delivering a much quicker FSCS pay out, but many also identified severe practical difficulties which would arise from this aim and the associated proposals to achieve that.

B.10 Given the importance and complexity of a number of aspects of the reform, the speed at which the Authorities intend to implement change was a matter of concern to many respondents. More time has been given for discussion and consideration of the proposals by the moving the introduction of the proposed legislation to later in 2008. This has allowed for publication of this further consultation, followed by publication of some draft clauses and more detailed policy narrative and further stakeholder engagement.

> 1.2) To what extent are the proposals in this document mutually reinforcing?

B.11 Those who commented on this question generally expressed the view that many of the proposals in the document are mutually reinforcing. Some commented that the proposals around reducing the likelihood and impact of bank failure could be thought of as occupying a continuum of intervention, while noting that it is important to delineate between the various stages. A number commented on the importance of making sure that existing tools, including the FSA's regulatory powers and the provision of liquidity assistance to the market are fully utilised, and that the proposals to 'reduce the impact of failure' should only be implemented once there is no prospect of reversing the fortunes of an ailing firm.

B.12 A number of respondents pointed out that the more significant proposals, for example those relating to the special resolution regime need to be carefully worked through, in order to avoid unintended consequences, which might undermine the objectives for reform and affect the competitiveness of the UK financial markets.

> 1.3) The proposals in this consultation document, unless specified, are intended to be implemented for banks, building societies and other deposit-taking firms. Please provide details where this is not appropriate.

B.13 The majority of respondents who commented on this question agreed that all institutions that take deposits should be subject to the same or equivalent provisions.

B.14 Some concerns were expressed about the disproportionate costs which small credit unions might face in terms of meeting the information requirements needed to deliver the improvements to the speed of FSCS payout. It was noted that a review of mutuals legislation (including that covering credit unions) is currently being undertaken by Treasury, and that this would be a good opportunity to look further at the sustainability of credit unions.

Chapter 2 – Stability and resilience of the financial system

Stress testing

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

B.15 Those who responded to this question generally agreed that the Authorities are taking the right steps to improve stress testing by banks. They supported both the FSA's proportionate approach, and its strengthening. Some commented that it is important to develop stress testing appropriate to the size, nature and complexity of each firm, rather than establish a pre-determined set of scenarios.

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

B.16 Respondents generally agreed the Authorities have correctly identified the work at international level, and supported work being taken forward on this basis. There was support for persuading international partners to focus their stress-testing at the group level, to allow for a more complete understanding of future capital and liquidity requirements. Some stressed the importance of the Authorities coordinating with international counterparts to ensure that the UK's stress testing requirements do not place UK banks at a disadvantage internationally.

Liquidity regulation

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

B.17 There was general agreement that the Authorities have identified the right issues, and support for the proposed activities in relation to liquidity regulation. It was noted by some that, given the work that was taking place internationally to seek consensus on quantitative liquidity requirements, the FSA should not bring forward its own proposals on this issue, but instead focus on qualitative elements, including stress testing and contingency planning.

Accounting and valuation

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?

B.18 The majority of respondents who answered these questions agreed that there should be enhanced disclosure requirements.

B.19 Some noted that speedy international implementation of the Basel II requirements would help better align regulatory capital with risk, and should be encouraged.

B.20 Many also noted, agreeing with the Authorities' view, that all concerned are still in the process of learning the long-term lessons of recent events for accounting standards. As such, although greater transparency and consistency in valuation methodologies may be appropriate, it is important not to rush into new regulation in this area.

Credit Rating Agencies

2.6) Have the authorities correctly identified the issues on which international work on credit rating agencies (CRAs) 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?

B.21 There was general agreement that the Authorities have correctly identified the issues on which international work on credit ratings agencies should focus, and that the proposals for improving the information content of CRAs are appropriate. Many agreed that this work should proceed on an international basis.

B.22 Most who responded support the use of the IOSCO Code of Conduct as a way to deliver improvements to CRAs, though noting that if this approach does not work, further action might be necessary.

Exposure to off-balance sheet vehicles

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

B.23 Those who commented generally agreed that the authorities are right to focus on the reputational risks relating to off- balance sheet vehicles for capital charges, liquidity requirements and consolidation decisions.

Chapter 3 – Reducing the likelihood of a bank failing

Regulatory powers and supervisory information

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?

B.24 Most respondents thought that the FSA already had extensive powers that are clear and appropriate but that the FSA needs to focus on using these powers effectively. A key element was considered to be the FSA having the skills and experience necessary to use the powers and the calibre, size and experience of supervisory teams. The one exception identified was in the case of a major fraud where it was noted the FSA may not have sufficient time to intervene. Respondents mentioned the need to not restrict the regulatory focus to larger groups only and to balance regulation between capital, liquidity and consumer protection. Additionally the FSA's appetite to use its existing powers is not always clear and could be better communicated.

> 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?

B.25 Most respondents felt unable to answer this section in detail due to the lack of specific information. Most expressed the view that no case has been made for additional information and that the Authorities can already ask for and receive whatever information they require under existing powers. Respondents were concerned about competition effects and most were insistent that any new information requirements, particularly data specified in advance, must be risk based and proportionate and not duplicative.

B.26 Many cautioned that information provision has a very high cost of infrastructure, a cost potentially underestimated by the Authorities, although other respondents felt that the firm's senior management would want similar information in a crisis and therefore the additional costs would need to be met by the firm anyway. Additionally many respondents considered that having a very short time requirement increases costs and threatens accuracy, potentially leading to decisions being made on unverified data.

> 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?

B.27 Those respondents who commented on this question generally considered that the Authorities should be able to share information although each new requirement to obtain information should be assessed on its own merit. Many were concerned that the information being transferred would be very sensitive and confidential in nature and that appropriate consideration needs to be given to the practicalities of transfer and data security both between and within each of the Tripartite organisations. Some respondents mentioned the issue of cross border information sharing although acknowledged this could not be fully dealt with in national law.

> **Payment systems**
>
> 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?

B.28 Responses were received from banks, trade bodies and a number of scheme providers. Many respondents including most scheme providers expressed the view that the current regime, where the Bank of England has informal oversight, had worked well to date. One respondent noted that the current regulatory boundaries between the FSA and that Bank of England are not as clear as they could be.

B.29 Some respondents expressed concerns that the January consultation set out the potential benefits of regulation, but did not provide a justification for the regulation in the first place. However, respondents were consistently of the view that given that the Authorities are seeking to put this oversight onto a statutory footing, the legislation should aim to regularise the current role and functions of the Bank of England in the oversight of payment systems.

B.30 As such, there was a strong message from respondents that if statutory oversight of payment systems is to be introduced, it should be undertaken by a single body, preferably the Bank of England. Several respondents suggested that the splitting of statutory oversight would lead to duplication and confusion.

B.31 It was also noted that it is important for the Bank of England to have statutory oversight of payment systems to allow it to discharge its responsibility in relation to its proposed financial stability objective.

Liquidity assistance

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?

B.32 Few gave detailed responses to this proposal. Where comments were made they were generally supportive of introducing some kind of exemption, although views differed on the detail. Some argued that collateral given in return for all lending by the Bank of England should be exempt from registration. Others favoured a wider exemption for all financial collateral. There was little or no support for extending the 21-day period.

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

B.33 Few responded to this proposal. Of those that did, most supported removal of the weekly return requirement, and proposed it be replaced a by a monthly report by the Bank of England.

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?

B.34 Among those who responded to this question, there was unanimous support in favour of providing the Bank with statutory immunity.

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?

B.35 Subject to further detail respondents thought that the proposal to ensure that the Bank of England could rely on its security was sensible.

B.36 Respondents also supported the other proposals.

Chapter 4 – Reducing the impact of a failing bank

Special resolution regime

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?

B.37 The majority of respondents agreed that there is a need for a form of special resolution regime, and was positively received by international respondents. Others queried whether a form of administration specific to banks would be sufficient.

B.38 Respondents also noted that further detail would be needed before final assessments of the benefits and risks could be made. Respondents requested that draft clauses be made available to help the consultation process.

B.39 A significant number of respondents requested that safeguards be put in place to protect creditors and netting arrangements. They noted that if such safeguards were not put in place there could be adverse consequences for the wider UK financial services market. Additional safeguards mentioned were: a role for the court; clear triggers for the regime; and judicial review and appropriate appeals mechanisms.

B.40 The majority of respondents agreed that the trigger for the special resolution regime should be regulatory, and exercised by the FSA. They also supported the proposal that the trigger be linked to regulatory guidance material. Respondents were divided between the potentially conflicting needs to have firm prescriptive triggers while retaining a degree of flexibility.

B.41 While the majority or respondents agreed that the potential abridgement of shareholders' property rights could be justified with a suitable public interest test, some disagreed that this is the case for counterparties' contracts and netting arrangements. Some respondents noted that careful consideration should be given to employees of any institution being placed in the special resolution regime.

Directed transfers

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?

B.42 The majority of respondents agreed that the timeliness needed for action within a special resolution regime means that the Authorities should have a power to direct a sale of a bank

B.43 Respondents' views were mixed on the role of judicial review and the Financial Services Tribunal, and requested more detail on how this would be expected to work in practice.

Bridge bank

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?

B.44 The majority of respondents made clear that they believe a private-sector solution (perhaps making use of the directed transfer tool) would be preferable to transferring some or all of a bank's business to a publicly controlled bridge bank. However, stakeholders also noted that there may be circumstances in which an immediate sale to the private sector may not be feasible. As such respondents accepted that the bridge bank tool could be useful in some situations. Respondents stressed that there would need to be a clear and overwhelming public interest if shareholder and creditor rights were to be removed.

B.45 Some respondents questioned whether the Authorities could use other means to obtain the necessary control over a failing bank. In addition, some also suggested that temporary public ownership could be a more suitable tool in many situations.

B.46 Many respondents expressed serious concerns about powers to transfer part of a bank. Respondents were concerned that any splitting process would disturb property rights, creditor rankings and collateral, set-off and netting arrangements. While these matters were raised in relation to the special resolution regime as a whole, stakeholders were especially concerned about partial transfers. Respondents also sought further detail from the Authorities on how the partial transfers would work in practice and on what safeguards would be put in place to avoid the problems they might raise.

B.47 Perhaps the single greatest issue presented in response to the proposal concerned legal certainty. Respondents expressed the view that, without strong safeguards, counterparties would not be able to know in advance whether contractual relationships would be subject to the transfer, and might therefore reflect such issues in their pricing and risk management arrangements. Stakeholders believed these uncertainties would make a counterparty's risk profile difficult to assess in the context of a bank resolution.

Bank insolvency procedure

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?

4.18) 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?

B.48 The majority of respondents suggested that wholesale changes to current insolvency provisions were not required to ensure rapid payments to eligible FSCS claimants. In addition, most suggested that any changes to insolvency law would need to be carefully considered and should be subject to a fuller, more detailed, consultation.

B.49 Many also suggested that while provision for continued trading might be useful, in practice it would be highly unlikely that a bank could continue to trade effectively on insolvency. There were therefore suggestions from several parties that any new procedure should be closer to liquidation than administration, proceedings; and that the existing duties and powers of a liquidator, with some minor modifications, should be sufficient to achieve the Authorities' objectives.

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?

B.50 There were divergent views on what the objectives of a bank liquidator should be, with several respondents suggesting that no changes to current insolvency provisions were necessary. It was also suggested that changes to the rules of the FSCS alone would be sufficient to achieve the Authorities' objectives. On the other hand, other respondents agreed that a modified form of liquidation focussing on effecting rapid payments to eligible FSCS depositors would be desirable, provided that this was not at the expense of other creditors generally.

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

B.51 Many respondents suggested that overall supervision of any new procedure should remain with the Court. Several respondents could see some continued role for FSA supervision within the procedure, and it was also suggested that there could be some role for the Bank of England and HMT.

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

B.52 Views on this question were mixed. Several respondents suggested that, in the interests of creditors generally, it should fall to the FSCS to cover any additional costs associated with rapid payments to eligible depositors. It was also suggested by some that the proposed new regime should be cost neutral. However, a majority of respondents argued that the FSCS should not cover such costs, and that these should be borne generally by the insolvent estate rather than levy-payers

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

B.53 There was generally little support for a new insolvency regime providing for depositor preference, and it was generally agreed that the current priority of creditors on insolvency should remain unchanged.

> 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?

B.54 While it was acknowledged that this was consistent with other special insolvency regimes, there was some concern about the idea of a 14-day moratorium, during which period a run on the bank could occur. A number of respondents therefore suggested that a shorter time period might be more appropriate. Others pointed out that the Authorities should be aware that a bank is in difficulty and be prepared to take prompt and appropriate action in such cases. There were again comments that responsibility for the overall control of any new insolvency procedure should lie with the Courts.

> **SRR Governance**
>
> 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?

B.55 The majority of respondents argued that the Bank of England should oversee the SRR, but some argued that the FSA or the Courts should oversee a bank within the SRR.

B.56 The majority of respondents believed that a restructuring officer should oversee the running of a bridge bank.

B.57 There were few comments on the specific implications for shareholders, creditors and directors, beyond those already noted on the regime in general and specific tools.

Temporary public ownership

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?

B.58 The majority of respondents supported the view that the Government, as a last resort, should have the power to take temporary ownership of a failing bank.

B.59 Some respondents noted that this may, in a number of cases, be the most useful tool available to the Authorities.

Application to mutuals

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?

B.60 In line with the view that, so far as possible, all deposit-taking institutions should be subject to the same or equivalent provisions, those who commented on these questions agreed that if an SRR is introduced for banks, the same tools should be available for building societies.

B.61 Some considered it unlikely that an SRR would need to be invoked for deposit-taking mutuals other than building societies (e.g. credit unions or industrial and provident societies). It was also noted that credit unions would be disadvantaged if the SRR is not applied to them and the FSCS contributed to the funding of the SRR, because they would contribute to the costs of the SRR but would not receive any benefit.

B.62 It was noted that a review of credit union and cooperative legislation is currently underway at the Treasury and that this would be a good opportunity to look further at the sustainability of credit unions.

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?

B.63 Those who commented strongly supported the making of this Order.

> **Funding for the SRR**
>
> 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?

B.64 The majority of respondents argued that the industry should not contribute to the cost of resolution. They suggested that if the firm continued in business as a going concern or is sold, either the firm itself or the acquirer should pay for any costs incurred. If the firm goes into insolvency, the costs should be met by the insolvent estate. Others suggested that the costs should fall on the public purse.

B.65 Reasons given for this position included the fact that the industry already funds the FSA and the Bank of England (in addition to paying general contributions to the Exchequer through corporation and other taxes), that it would remove accountability and responsibility from the failed bank's directors and shareholders, and that the industry would have no control over the level of costs incurred during resolution.

B.66 Some responses supported the proposal that the industry contribute to the cost of resolution. Arguments cited included the consideration that the key purposes of a special resolution regime would be to maintain financial stability, which is in the industry's interests as a whole, and that the SRR would reduce the chance of the industry being called on for depositor compensation payments.

B.67 Other responses argued that if this is taken forward, it should be only the deposit-taking class of the FSCS that contributes, and that small firms should not contribute given that the tools in the SRR are unlikely to be used on them. An alternative put forward was that there should be a wider review of the FSCS' funding structure.

B.68 Views varied as to whether the FSCS should be the body which facilitates industry funding of resolution of the SRR. FSCS was acknowledged to have specialist skills as a compensation provider, but some suggest that, as an industry wide body, such a role would focus too much on banks. Others suggested that FSCS would be the most appropriate methods, with a role to ensure that the costs are proportionate and appropriate.

> **Requirements on banks**
>
> 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?

B.69 Some respondents, particularly from the banking industry, expressed concerns that it would be costly and inefficient to put in place back-up settlement arrangements.

B.70 One suggestion was for some form of 'special administration regime' for payment systems, to help maintain access to banking services.

> 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?

B.71 Most who commented supported the view that banks should have contingency plans to switch payments providers and systems.

> 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?

B.72 There was a range of views on this proposal with some respondents commenting that they would appreciate more information on what was being proposed. Others said they considered it an appropriate time to strengthen the Government's powers to make regulation in the area of protections available to financial collateral arrangements. Some commented on the importance of ensuring there was a substantive consultation on the scope and use of any powers.

B.73 On the question of future revisions, there were few comments other than noting that UK arrangements should be consistent with measures resulting from the EU revision of the Financial Collateral Directive.

Chapter 5 – Consumer confidence and compensation arrangements

> **Compensation limits and coverage**
>
> 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?

B.74 Most of the respondents who commented considered that higher limits would not necessarily have a material effect on consumer confidence and did not consider that a higher compensation limit would affect the responsibility consumers have for their financial choices. It was considered that consumers generally were not aware of the coverage that the FSCS provided and lacked the information to evaluate the relative riskiness of different banks (which limited the extent to which consumers could be expected to choose between different banks).

B.75 Respondents put forward a wide range of views regarding compensation limits, ranging from no change to very substantial increases in the existing £35,000 limit. Many respondents recognised that the existing limit already gives full protection to a very high proportion of depositors and thought that a higher level of compensation would involve a disproportionate cost to FSCS levy payers and increase the risk of moral hazard. Other respondents took the view that an increase in the limit would increase consumer confidence and would place the UK on a par with what were described as the best standards worldwide.

B.76 Some thought that the compensation limit should be per person per brand, not per person per bank as it is currently1. Another view was that there should be no upper limit for deposits, which would promote consumer confidence, be simpler, and reduce calculation costs for the FSCS. Some respondents thought a higher limit for deposits could distort the market for other kinds of investments, leading consumers to make poor investment decisions; others argued that consumers' perception of other products would not be affected.

> **Coverage of balances above the compensation limit**
>
> 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?

B.77 There was not a great deal of comment from respondents on these issues. Many of those who responded commented that this was an issue that required further consideration, and expressed concerns that it may be difficult to devise a workable and realistic system for providing special treatment for certain accounts. One view was that privately provided insurance might be available at reasonable cost but there was no strong support for any one approach.

B.78 Some respondents thought that the problem could be addressed by not having an upper limit for deposit compensation. Others commented that deposits above the compensation limit should not be protected in any circumstances, as it should be left to depositors to take a degree of responsibility for their deposits.

> **Faster compensation payment**
>
> 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?

B.79 Respondents generally supported the aim of faster payout but only a minority of those who commented considered that a target of one week would be achievable because of the practical barriers to fast depositor payout for institutions and the size of the retail depositor base of many UK banks or building societies. Practical problems include processing compensation payments (for the FSCS and the liquidator of the failed bank) and opening new accounts (for the receiving banks, the depositors themselves and supporting infrastructure such as payment systems). Those who expressed a view thought that the one week target could probably only be achieved in the event of the default of the smallest institutions.

[1] For an explanation of per brand and per bank, see Chapter 5, footnote 2.

> 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?

B.80 A number of methods to speed up FSCS pay out were suggested. These included making use of a failed institution's existing IT systems to enable customers to access money through the ATM or branch networks, or through online channels, and the possibility of making interim payments in advance of a full payout. Other approaches included arrangements in which the depositor is notified by the FSCS of his entitlement (on the basis of information held by the failed bank), has to establish his identity with a new bank which is able to use online information to verify entitlements and recover initial payments it makes.

B.81 Those who commented noted that interim payments could be helpful in mitigating depositors' short-term hardship but considered that interim payments might not be enough to ensure consumer confidence.

> 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?

B.82 The respondents who focused on this issue were mainly banks and other deposit-taking firms and their representative bodies. Their responses emphasised the considerable complexity and cost of installing systems which would deliver a reliable, consistent view of all a bank's relationships with each individual customer on an aggregated basis ("a single customer view"). Most of those who expressed a view considered that complexity would depend on the type of institution but the cost would be high and that a single customer view could take over 24 months to complete. It was thought that imposing common data formats could increase firms' costs unnecessarily and restrict systems development.

B.83 Some respondents suggested that modifications to the eligibility criteria and compensation limits could make the information requirements less onerous. They also suggested that introducing a single customer view might be less complex and costly if compensation was to be paid on a per person per brand basis, since a single customer view would only be required for each banking brand rather than each bank.

> 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?

B.84 The respondents who commented on this generally thought that it would be difficult to place flags on ineligible account, although it would depend on the complexity of exclusions. They argued against the extension of eligibility criteria, because the consequence would be to cover large corporate or Government bodies, thus increasing the potential cost of the FSCS to the levy payers. There were also concerns that extending eligibility to these bodies would effectively force all banks to be participants in the FSCS, including those banks who had chosen to specialise in areas without retail or small business customers and who would, therefore, not currently need to participate in the scheme.

> 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?

B.85 There was widespread acceptance by respondents that the introduction of gross payment is desirable both to speed up pay out and to ensure that depositors with loans outstanding would continue to have access to liquid funds. It was also accepted that where a depositor receives a gross payment in respect of their deposits they should continue to have the obligation to repay a loan in accordance with its original terms. There was strong general support for set-off as an important feature of insolvency law.

> 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?

B.86 The main concern expressed by respondents on this issue was that any process which involved automatically making payments or sending cheques to persons who were thought to be eligible claimants without any formal claim would increase the risk of fraud.

> **FSCS funding and liquidity**
>
> 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?

B.87 Some respondents – particularly academics– supported the introduction of pre-funding, for a variety of reasons, including because it could facilitate the introduction of risk-based levies and because it could increase consumer confidence. However, respondents from the deposit-taking industry were opposed to pre-funding. These respondents put forward a variety of arguments, including: that the assets held in any fund could be more efficiently deployed by the banking sector than by the managers of the fund; that accumulating a fund would increase pressure on bank capital and liquidity; that pre-funded schemes are not appropriate in concentrated banking systems like the UK; and that pre-funding is not necessary if the FSCS has access to liquidity from the public sector. A small number of respondents commented that, if pre-funding was introduced, it should be restricted to deposit-taking.

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

B.88 There was widespread support for giving the FSCS the ability to borrow from Government or the Bank of England in the event of its needing substantial immediate liquidity.

> **Opening new accounts**
>
> 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?

B.89 Respondents noted the practical problems for banks in opening a very large number of new accounts in a short time, including: capacity constraints in banks themselves and payment systems; and the possibility of a reduced quality of service to other bank customers. Some also distinguished between opening accounts (which could happen relatively quickly) and adding the full functionality of current accounts would add to the problems of the capacity constraints on branches. There were also concerns about: the requirements of anti-money laundering law for banks to be able to properly identify their customers; the extent to which receiving banks could rely (as they may under anti-money laundering law) on checks carried out by the failed bank; and the ability of some customers, particularly vulnerable customers, to deal with their part of the process. Some respondents suggested that arrangements would be needed to give advice to bank customers generally and support to those who particularly needed it for account opening.

> 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?

B.90 It was generally recognised that customers should be better informed and that banks could have a role in communicating information about the FSCS to their customers. Respondents suggested a range of routes including notices in branches, information on statements and use of websites. Other suggestions included that branches should carry 'kite' marks and/or that notification should be in plain sight in branches. General view that awareness should be increased. But there were also concerns that too much emphasis on the FSCS could lead to unnecessary worry or confusion for depositors.

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?

B.91 Few respondents commented but suggestions included using Post Office card accounts, pre-paid plastic cards and vouchers which could be used at supermarkets.

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?

B.92 There were few comments on this issue but respondents agreed that the FSCS should have the management flexibility it needs.

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?

B.93 Respondents' views on risk-based levies were mixed. Some saw advantages in risk-based levies, while others were opposed. There were concerns about maintaining the confidentiality of risk assessments, about possible duplication of existing arrangements for prudential regulation and about possible adverse effects on competition if risk-based levies became a barrier to entry or inhibited the ability of smaller banks to compete with larger firms.

Chapter 6 – Strengthening the Bank of England

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?

B.94 Respondents were generally supportive of providing the Bank of England with a statutory responsibility for financial stability and indicated that the key benefit of a formal role would be to give the issue greater prominence. A small number of respondents thought that it would be difficult to define financial stability for the purposes outlined in the document. The proposed reforms to Court, including the responsibility for Court to oversee the Bank of England's performance on financial stability were welcomed.

Chapter 7 – Effective Coordination

Tripartite coordination

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

B.95 Those who commented agreed that recent events did not demonstrate fundamental flaws in the design of the Tripartite, and the proposals to enhance the operation of arrangements, particularly in a crisis were welcomed. [Some commented that they did not wish to see the politicisation of crisis situations and thought the plan to learn lessons from the COBR model might not deliver in that respect]. There was significant support for ensuring strong external communication and clear leadership in a crisis.

B.96 Respondents generally welcomed the publication of a revised Memorandum of Understanding and the enhanced clarity of roles and responsibilities of each of the Authorities it was designed to deliver.

International coordination

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?

B.97 There was agreement that given the global nature of financial markets it was right that issues be considered at an international level. Some noted that since the January consultation was published the Financial Stability Forum (FSF) had reported to the G7 finance Ministers and were keen to understand the UK Authorities' views on those proposals.

B.98 Those who responded generally supported the moves to increase cooperation between the IMF and FSF, including the development of an early warning system to complement existing national systems.

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

B.99 Respondents generally agreed that the proposals would help in managing international financial crises. Many noted that the international nature of financial markets and increasing amount of cross-border activity means that policy development led by authoritative international bodies such as the Bank for International Settlements was the right way to proceed.

Impact assessment

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

B.100 Very few responses commented on the impact assessment that was published alongside the January consultation document.

B.101 The most common remark was a criticism that the impact assessment had not analysed the costs to banks of investing in single customer view (SCV) systems. Respondents argued that these costs would be significant. However, it should be noted that such a measure, requiring SCV for all banks would be a change in FSA rules, not primary legislation, and so the analysis was not presented in the January impact assessment. The FSA would be required to conduct a full consultation and cost-benefit analysis for such a change to its rules, in the normal way.

B.102 In addition, some stakeholders requested that the Authorities investigate the risks associated with the special resolution regime more closely. They commented that such an investigation should include an assessment of whether the regime might increase the banking sector's cost of funding and reduce the incentive for creditors to lend to banks incorporated in the United Kingdom. These risks are discussed in the impact assessment sections of chapter four in this consultation document.

> 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?

B.103 There were no strong views on this question. When answered, respondents believed that there would be no significant differences in impact.

> A.3) Do you agree that small businesses would not be affected by these proposals in a different way to other consumers?

B.104 There were no strong views expressed on this question. Of those who did respond, most did not believe that small business stood to be adversely affected by any of the proposals.

C BANKNOTES – SUMMARY OF CONSULTATION RESPONSES

SUMMARY OF 2005 CONSULTATION RESPONSES

C.1 There were over 30 responses to the 2005 consultation with the overwhelming majority supporting the principle of noteholder protection. However, some respondents claimed that the proposals in the consultation document went beyond what was necessary either to protect noteholders or to create a level playing field for all institutions with respect to note supply. A number of respondents said the proposals failed to take account of the costs associated with issuing banknotes and the benefits supported by the income derived and, without modification, could undermine the economic rationale for commercial banknote issuance and lead to some issuing banks withdrawing.

C.2 Other respondents viewed the present arrangements as providing inadequate protection for noteholders who, in these respondents' view, appeared to bear the risk while issuing banks' shareholders profited.

> Q1. Do you agree that the note-covering assets used to back the note issue should be earmarked specifically for the benefit of noteholders?
>
> Q2. What impact would earmarking the note-covering assets for the benefit of noteholders have on (i) the issuing banks; and (ii) other creditors, including depositors, of the issuing banks?

C.3 The overwhelming majority of respondents accepted the principle of providing sufficient protection for noteholders, although some claimed that existing regulatory frameworks and the role they play in maintaining the soundness of financial institutions provides adequate protection.

C.4 Several respondents suggested that earmarking note-covering assets for the benefit of noteholders would limit the sums available to distribute to other creditors in the event of the insolvency of an issuing bank. An alternate view expressed was that the impact on other creditors would be negligible. Some respondents considered that the proposals might encourage hoarding of notes instead of payment of them into a bank account.

C.5 Some respondents supported the proposals that sufficient and appropriate note-covering assets should be maintained at all times, and that note-covering assets should be earmarked specifically for the benefit of noteholders. However, others expressed views that no change was required to note cover arrangements and that noteholders should not receive, what was viewed as preferential treatment, by having notes earmarked.

Q3. Do you foresee issues with the issuing banks or the Bank holding the note-covering assets for noteholder s on trust or under a statutory scheme, for example in accounting procedures, or the impact on regulatory capital or liquidity requirements?

Q4. In the event of insolvency, should the issuing bank or the Bank have statutory responsibility for providing noteholder s with value for their notes from the note-covering assets?

Q5. Would the proposed arrangement be compatible with existing insolvency and trust laws or would existing insolvency and trust laws need to be amended?

C.6 A number of respondents emphasised the complexity of trust and insolvency laws, and expressed concern about the legal and administrative costs of establishing and managing a trust or statutory scheme for the holding of note-covering assets. Questions were also raised about the jurisdiction under which any trusts would be constituted; it was noted that any trust documentation would need to be sufficiently tightly worded to prevent challenge by an insolvency office holder. A few respondents stated that it would be preferable for the note-covering assets to be held under a statutory scheme which set out the primacy of the scheme in relation to accounting procedures and regulatory capital or liquidity requirements.

C.7 A few respondents indicated that they did not foresee a significant impact on regulatory capital requirements but thought there might be an impact on liquidity requirements. Some also suggested that direction was needed from the FSA as to the treatment of note-covering assets in relation to liquidity requirements.

C.8 Most respondents agreed that, if the Bank of England were to hold the note-covering assets, it would make sense for it to be responsible for providing noteholders with value – though a better understanding was sought of the practicalities. Other suggestions included the use of agents (such as UK clearing banks) to act on the Bank's behalf or, alternatively, that redemption responsibility should fall on the insolvency office holder.

Q6. Should there be a time limit for noteholders to make a claim against the note-covering assets, or should the notes be treated like Bank of England notes and have an indefinite time period for redemption?

Q7. If a time limit were adopted, would one year be sufficient length of time for noteholder s to make a claim for their notes? Should there be flexibility for the Bank to be able to extend the one year time period, subject to Treasury approval?

C.9 There was support for a time limit for claiming against the note-covering assets. Respondents' views differed on length, varying from one year to 20 years, with no one view being overwhelmingly favoured. A small number of respondents, however, asserted that no limit should be set – on the grounds that Scottish and Northern Ireland notes, like Bank of England notes, should be redeemable forever.

C.10 A number of respondents were supportive of the idea that there should be flexibility to extend the period for claiming against the note-covering assets under certain circumstances, but highlighted a need for the process for extending the limit to be transparent.

Q8. What should happen to any note-covering assets remaining after all permitted claims on them by noteholders have been settled? Should they be held for the benefit of the issuing bank, so that they can be used to satisfy the claims of other creditors?

Q9. If the surplus note-covering assets were held for the benefit of the issuing bank, what implications would this have, if any, for the proposal to make the Bank hold the note-covering assets on trust for noteholders?

Q10. If there were insufficient note-covering assets, for example as a result of counterfeit notes being redeemed mistakenly, how should the claims of noteholders be treated?

Q11. If noteholder s claimed value for their notes after surplus note-covering assets had been paid out to other creditors, how should the claims of noteholders be treated?

C.11 Respondents generally agreed that any note-covering assets remaining after permitted claims by noteholders had been settled should be held for the benefit of the issuing bank, in order to meet claims of other creditors. It was suggested that the insolvency office holder should assume control of any surplus note-covering assets from the Bank of England after noteholders had been paid.

C.12 Some respondents thought a shortfall of note-covering assets was unlikely. They anticipated that the full note issue would not be redeemed and also expected controls surrounding the redemption of notes to be tight enough to identify counterfeits.

C.13 In the event that a shortfall did occur, some respondents suggested that remaining noteholders should continue to be treated as preferential creditors. Those who supported a perpetual right for noteholders to receive value for their notes considered that any shortfall or late claim should be met by the Bank of England. Most respondents, however, thought that remaining noteholders should be treated as ordinary unsecured creditors.

Q12. Do you agree with this proposal? [Provision for loss, or voluntary relinquishment, of issuing rights.]

C.14 Some respondents supported the proposal that an issuing bank which lost or voluntarily relinquished its right to issue notes should continue to hold note-covering assets for outstanding notes in circulation. However, several respondents opposed an automatic loss of issuing rights if an insolvent issuing bank were taken over or recapitalised, stating that this could place the newly recapitalised business at a commercial disadvantage. Reservations were also expressed about the permanent removal of issuing rights from an issuing bank that decides voluntarily to cease to issue its own notes. Concerns included that this could restrict future competition for note supply.

Q13. We would be interested to receive comments and views on these proposed changes (to modernise the note issue arrangements of note issuing banks in Scotland and Northern Ireland to ensure that the proposed trust arrangement for protection of noteholders can be made to work effectively and that there is a level playing field with respect to the supply of banknotes for all issuing and non-issuing institutions alike), in particular the likely costs and benefits they would have for the issuing banks and others.

C.15 A number of respondents considered that the modernisation proposals went beyond what was necessary to protect noteholders and to achieve a level playing field and, conversely, that they would put issuing banks at a disadvantage relative to non-issuing banks.

C.16 In particular, there was concern about requiring backing for notes with the potential to enter circulation (such as those in bank branch tills and ATMs). It was argued that the issuing banks had no liability for such notes, as there was no third party noteholder to protect in these circumstances, and that – in the event of an issuing bank becoming insolvent – measures to prevent further notes entering circulation could be introduced quickly.

C.17 A number of respondents wanted coin retained as a note-covering asset to avoid unintentional adverse implications for the cash handling industry. Without this, they considered that the costs would fall disproportionately on issuing banks.

C.18 A few respondents argued that backing should be via a mixture of interest-bearing and non-interest-bearing assets. In their view, this would preserve both noteholder protection and the commercial viability of note issuing. The proposals that note-covering assets should be held only at the Bank of England was questioned. It was argued that the location of the note-covering assets should be immaterial if there were adequate legal protection for noteholders.

C.19 There were calls for the fiduciary level to be retained. Some respondents suggested that it should be rebased to allow for the costs of note issue and/or to take account of old design notes that will probably never be presented for payment but which remain, notionally, in circulation.

C.20 Respondents largely supported the proposed transfer of the note issue-related functions of Her Majesty's Revenue and Customs (Stamp Taxes) to the Bank of England, but some questioned the need for the Bank of England to have additional powers.

> Q14. What other information should the Banknote Register hold? [Besides dimension, denomination, design, public security features etc]

C.21 There was general support for the concept of a Banknote Register but some respondents expressed concern about the practicalities. Since it has never been the practice of Scottish and Northern Ireland issuing banks to formally withdraw old design notes from circulation, the perceived implication was that every note ever issued would need to be registered, unless the register applied only to designs issued after an agreed implementation date. Additionally, a few respondents were uncomfortable with the notion of a register that was freely accessible to the public, on the grounds that the information held might facilitate the production of counterfeits.

C.22 In general, the registration information proposed in the consultation document was regarded as sufficient.

> Q15. What costs and benefits do you see these anti-counterfeiting arrangements generating? [Requirements related to security features, educational material, denominational values, design etc.]

C.23 The costs identified by respondents in relation to the proposed anti-counterfeiting measures included: higher note production costs arising from incorporating more expensive security features, the cost of providing additional educational material, and the potential reputational cost of being required by the Bank of England to withdraw from issue notes subject to major counterfeit attack. Doubt was expressed as to whether there would be a corresponding benefit in terms of a reduction in counterfeit notes in circulation, though there was some acknowledgement that appropriate educational material resulted in greater consumer awareness.

C.24 A collaborative approach was thought more appropriate than legislation, and suggestions for self-regulation included best practice guidelines and/or a code of conduct or 'Standards Board' under the auspices of the National Anti-Counterfeiting Forum (chaired by the Bank of England) or APACS.

C.25 A number of respondents considered that the Bank of England should not be able to impose on commercial issuing banks requirements it is not obliged to observe itself. However, the proposal to empower the Bank of England to require issuing banks to produce educational material about the security features of their notes was welcomed by some other respondents.

C.26 Granting the Bank of England control over denominational values was thought, by some, unlikely to have a significant influence on fraud risk. Several respondents also raised concerns about the proposal to allow only one note design per denomination at a given time, noting that this would effectively result in an end to commemorative notes. A few respondents supported the proposal and highlighted the disadvantages of having several different sets of notes.

> Q16. We would be interested to receive views and comments on whether the proposed legislation should permit the establishment of an arrangement similar to that for accounting for the value of Bank of England notes in issue instead of setting out in detail the note cover structure in the legislation itself.

C.27 A number of respondents recognised the benefits of additional flexibility in not specifying the precise note cover requirements in legislation, but were keen that there should be a statutory obligation on the Bank of England to consult widely before implementing any changes to the note cover structure and/or reporting arrangements.

> Q17. We would be interested to receive views on a suitable and appropriate penalty structure for failure to provide sufficient note cover.
>
> Q18. We would also be interested in views on a suitable and appropriate penalty structure for failure to provide the required information to the Bank on time.

C.28 Several respondents commented that any penalties should be proportionate to the level of non-compliance.

C.29 The proposal to move away from the existing penalty structure for failure to provide sufficient or appropriate note cover was welcomed by some respondents. Suggestions included a stepped approach, such as first offences being subject to making good the financial cost of any shortfall, proportionately higher penalties applying to subsequent offences, and the ultimate sanction being the loss of issuing rights.

C.30 Respondents agreed that penalties collected by the Bank of England should be paid to the Treasury. It was suggested, however, that the Bank of England should be able to recover its costs of regulating commercial bank note issuance from the penalty income and that only net proceeds should be paid to the Treasury.

Q19. What other information should issuing banks provide to the Bank and how often should this be provided? [Information besides note issue reports, counterfeits data and audit assurances.]

Q20. What costs and benefits do you see these information and auditing arrangements generating?

C.31 A number of respondents thought that no further information (beyond that proposed) needed to be provided to the Bank of England. It was considered that the level of information sought should be commensurate and proportionate, and should not give rise to unnecessary bureaucracy.

C.32 There were mixed views on the need for independent verification of note issue reports. While some respondents accepted the rationale for an external audit, others considered that it should be sufficient for reports to be signed by an appropriate officer of the issuing bank, in line with the manner in which other returns are submitted to regulatory authorities.

C.33 Assessment of the likely costs of the proposed information and auditing arrangements ranged from 'minimal' to 'substantial'. A number of respondents noted that the costs would represent an overhead that would not similarly be borne by non-issuing banks.

C.34 Some respondents regarded the principal benefit of the arrangements to be the added assurance provided to the public and the Bank of England (as regulator) that noteholders are adequately protected. The maintenance of a level playing field amongst issuing banks was also identified as a benefit.

Q21. What other information on the note issue arrangements of banks in Scotland and Northern Ireland should be published by the Bank? [Besides note issue/cover values, cost of regulation, penalties and counterfeit data.]

Q22. What costs and benefits do you see these publication arrangements generating?

C.35 Whilst recognising the principle of ensuring transparency of the note issue arrangements, a number of respondents thought that no further information (beyond that proposed) should be published by the Bank of England. A few respondents considered that some of the information planned to be made public should instead be subject to access restrictions and controls and used only for regulatory monitoring purposes.

C.36 Some respondents did not expect the proposed publication arrangements to generate either significant costs or significant benefits. However, the benefits of openness and transparency were referred to by a minority.

SUMMARY OF JANUARY CONSULTATION RESPONSES

C.37 15 respondents commented on the proposals in relation to the protection for holders of banknotes issued by commercial banks in Scotland and Northern Ireland (see paragraphs 5.73 – 5.77 of the January consultation document).

C.38 Most of the respondents confirmed that the views expressed in the 2005 consultation had not changed, and as such an overwhelming majority of respondents supported the notion of improving protection for the holders of Scottish and Northern Ireland banknote holders.

C.39 Several respondents indicated that they would oppose any proposal that removed the incentives for issuing banks to continue to issue commercial banknotes or create adverse unintended consequences.

C.40 A number of respondents noted that discussions were taking place between the issuing banks and Treasury and the Bank of England and that it was hoped that a suitable and sustainable framework could be developed. Some respondents noted that any new framework should be proportionate and that any changes should be motivated by consumer protection.

C.41 As part of the consultation responses, a detailed alternative proposal was received. The proposal included:

- Rebasing the certified (fiduciary) level of notes in circulation for each issuing bank from 1845 to current values (known as the 'fiduciary level');
- Full backing of the certified level at all times with a mix of interest-bearing and non-interest-bearing assets, in proportions consistent with preserving the existing economics of note issuance;
- Weekly re-calculation of the value of notes in circulation on the basis of the forecast peak day (of seven) level;
- Full backing at all times of notes in circulation above the certified level with a mix of interest-bearing and non-interest-bearing assets, in proportions reflecting both the costs of note issuance and over-backing resulting from the methodology proposed to define notes in circulation;
- No requirement to back notes in branch tills and ATMs on the basis that these notes were not inc circulation, but recognition that note-cover arrangements may need to be extended to cover the possibility of these notes entering circulation; in which case there should be no additional cost to the issuing banks;
- Transfer of oversight of the regulatory framework to the Bank of England and creation of a 'Technical Standards Board', comprising a cross-section of industry representatives, to oversee standards for note design, educational material etc; and
- Ring-fencing of note-covering assets for the benefit of note holders.

LIST OF CONSULTATION RESPONDENTS

Organisations

- APACS
- Association of Chief Police Officers in Scotland
- Bank of Ireland
- Bank of Scotland

- British Bankers' Association
- CBI Scotland
- Clydesdale Bank
- Committee of Scottish Clearing Bankers
- De La Rue
- Department of Trade and Industry (now Department for Business, Enterprise and Regulatory Reform)
- First Trust Bank
- General Consumer Council for Northern Ireland
- Insolvency Service
- KPMG
- Law Society of Scotland – Investor Protection Committee
- Law Society of Scotland – Banking Law Sub-Committee
- Lloyds TSB Scotland
- Northern Bank
- Northern Ireland Insolvency Service
- Office of the First Minister and Deputy First Minister of Northern Ireland
- Professional Oversight Board for Accountancy
- Royal Bank of Scotland Group (on behalf of RBS and Ulster Bank)
- Scottish Financial Enterprise
- Scottish National Party
- Small Business Service
- Superintendents' Association of Northern Ireland

Individuals

- Timothy Ferres
- David Gibson
- Peter Gray
- David Macintosh
- Alan Ritchie
- Matthew Ross
- Andrew Smart
- David Wallace

D Summary of proposals and consultation questions

D.1 This annex summarises the proposals made by the Authorities in this document, and highlights areas where further views are specifically requested. Views on all other relevant issues are also welcome.

Reducing the likelihood of a bank failing

D.2 The Government confirms its intention to legislate to facilitate the FSA obtaining and sharing information that the Bank of England and the Treasury require for purposes relating to financial stability.

D.3 The FSA will publish a consultation paper, setting out proposals on the provision of additional information by banks to demonstrate that they are meeting threshold conditions, on an ongoing and forward looking basis.

D.4 The Government will take the earliest opportunity to bring forward legislation to provide the FSA with additional powers.

D.5 The Government intends to legislate to provide the Bank of England with statutory immunity from liabilities in damages arising from acts or omissions in carrying out its responsibilities in relation to financial stability and other central bank functions.

D.6 The Government will introduce secondary legislation, consulting where appropriate, to amend the Settlement Finality Regulations 1999 to ensure that collateral provided to the central bank in connection with its functions may be realised more effectively.

D.7 The Building Societies (Financial Assistance) Order 2008 was debated and approved by Parliament in June of this year.

D.8 The Government will bring forward legislation to ensure that floating charges may be granted by building societies in relation to the provision of liquidity support by central banks.

D.9 The Bank of England has been consulting further on whether or not to continue publication of the weekly return.

D.10 The Government intends to legislate so that any charges granted to a central bank in connection with its functions as a central bank will be exempt from registration.

D.11 The FSA will consult on changes to the Disclosure and Transparency Rules to clarify that an issuer in receipt of liquidity support from a central bank may have a legitimate interest to delay disclosure of that fact.

D.12 The Government is seeking views on whether it should legislate to provide that restrictions on borrowing (including negative pledges) and other provisions having a similar effect are nullified to the extent that they would prevent financial assistance by the Authorities for the purposes of financial stability or are otherwise triggered by steps taken by the Authorities.

> 3.1) The Authorities are seeking views from respondents on the extent that contractual provisions, such as those set out above may prevent the Authorities from taking appropriate action; and the merits of the two approaches set out above.

D.13 The Government intends to legislate to formalise the Bank of England's role in the oversight of payment systems to ensure the robustness of payment systems which, if a disruption in the operation of the system were to occur, would be likely to lead to systemic and system-wide consequences.

> 3.2) Are the criteria as set out, the right criteria and will they provide sufficient flexibility as payment systems evolve overtime?
>
> 3.3) Is there a preferred method for recognising payment systems?
>
> 3.4 Do you agree that the indicative list in paragraph 3.47 includes all the relevant payment systems which are of systemic or system-wide importance?
>
> 3.5) Are the powers, as set out above, necessary and appropriately graduated?

Reducing the impact of a failing bank

D.14 The Government intends to legislate to introduce a "special resolution regime".

> 4.1) The Authorities would welcome views on the most appropriate ways to deal with other relevant entities in investment banking groups with the aim of helping to maintain financial stability.

D.15 The Government proposes that initiation of the regime would be subject to an assessment by the FSA, as the firm's supervisor, that the firm had failed (or was likely imminently to fail) to meet its Threshold Conditions.

D.16 The Government proposes that the operation of the SRR and the resolution tools within it will be the responsibility of the Bank of England.

D.17 Any decision requiring the use of funds for which the Chancellor of the Exchequer is responsible, or with implications for the public finances, would require the authorisation of the Chancellor of the Exchequer.

D.18 The Chancellor of the Exchequer will remain responsible for ensuring compliance with the UK's international obligations.

D.19 Any decision involving the temporary public ownership of an institution will be for the Chancellor of the Exchequer.

> 4.2) Do you agree with the roles for the Authorities for the triggering and operation of the Special Resolution Regime?
>
> 4.3) Respondents views are sought on the practical considerations involved in developing a SRR.

D.20 The Government intends to legislate so that building societies are subject to a special resolution regime, similar to that for banks.

D.21 The Government intends to bring forward an Order so that on winding up or dissolution of a building society, any assets available to satisfy the society's liabilities are applied equally to creditors and the society's members.

D.22 The Government intends to bring forward legislation so that, in addition to its role in ensuring payout of depositors in the event of the failure of a deposit-taking firm, the FSCS can also be called on to contribute to costs arising from the use of resolution tools.

> 4.4) What would be the best way to calculate the hypothetical net cost of depositor compensation payments, including the estimation of the recovery rate?

D.23 The FSA intends to work further with banks to ensure that indirect members of payment systems have contingency plans in place, in the event their sponsor bank fails.

D.24 The Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements.

Effective compensation arrangements for depositors

D.25 The FSA intends to consult in autumn 2008 on changes to the FSCS compensation limits for all sectors and changes to other factors used in the FSCS compensation calculation.

D.26 The FSA will explore with the financial sector ways for customers to cover amounts above the consultation limit (especially temporary high balances) and the appropriate coverage for client accounts and similar arrangements.

D.27 The Authorities remain committed to a target of seven days for providing the depositors of a failed bank with access to at least a proportion of their funds, and the balance within the following few days, consistent with the aim of minimising disruption for depositors.

D.28 The Government intends to legislate to enable the FSA to collect information from firms that the FSCS requires (and share this with the FSCS) before default, and ensure that the FSCS can require and obtain information directly from firms as soon as a firm is declared in default.

D.29 The FSA will consult on how the information held by banks will be reviewed, including through options for the ongoing, routine involvement of the FSCS.

D.30 The Government also intends to legislate to ensure that there are no barriers to the Bank of England, once resolution is invoked, being able to collect and share with the FSCS relevant information on the bank in question.

D.31 The FSA intends to consult on new rules requiring banks to have readily available information including balances, on the accounts held by depositors eligible for compensation from the FSCS.

D.32 The FSA is considering, and intends to consult on, the eligibility criteria for depositors to qualify for FSCS compensation payments.

D.33 The FSA intends to consult on a move to gross payments of FSCS compensation.

> 5.1) The Authorities would welcome further views on the best way of introducing gross payout when there are mutual debts.

D.34 The Government intends to legislate to give the FSA the power to make new rules to specify the circumstances in which consumers need to make a formal claim to the FSCS before receiving a compensation payment and to allow for the automatic conferral of rights on the FSCS to make recoveries in place of claimants.

D.35 The Authorities will work with banks and the appropriate trade associations to ensure that depositors can open up a new account quickly enough to facilitate fast compensation payments and minimise disruption.

D.36 The FSA and FSCS intend to review how consumers can be better informed about the current compensation scheme.

D.37 The Government intends to ensure that the FSCS has access to immediate liquidity through borrowing from the public sector.

D.38 The Government therefore intends to include in the forthcoming legislation powers which would allow it to introduce pre-funding of the FSCS if it was considered appropriate to do so in the future.

D.39 The Government therefore proposes to use the forthcoming legislation to ensure that borrowing from the National Loans Fund will be repaid and to enable the Treasury to make regulations, if necessary, regarding FSCS pre-funding.

> 5.2) The Authorities would welcome further views on a possible move to pre-funding and on the proposed legal framework for pre-funding and FSCS borrowing from the National Loans Fund.

D.40 The Government intends to legislate to strengthen the arrangements underpinning banknote issuance by commercial banks in Scotland and Northern Ireland.

D.41 The Government intends to bring the law in Scotland relating to the treatment of cheques into line with that in the rest of the United Kingdom.

Strengthening the Bank of England and tripartite coordination

D.42 The Government intends to legislate, to provide the Bank of England with a statutory responsibility for contributing to the maintenance of financial stability.

D.43 The Government intends to improve the policy instruments available to the Bank of England in support of its responsibility for financial stability.

D.44 The Government intends to legislate for the creation of a Financial Stability Committee (FSC) to support the Governor and Bank of England, drawing upon external expertise.

D.45 The Government plans to give the Court a formal role in overseeing the Bank of England's performance on financial stability.

D.46 The Government will bring forward legislation to require the Bank of England to consult with the Treasury, on a periodic basis, when setting the detailed financial stability objectives for the Bank of England and the remit for the FSC.

D.47 The Government will bring forward legislation to restrict the size of Court to a maximum of twelve members, including a majority of non-executives, one of whom will Chair Court as has been the case in practice since 2003.

D.48 The Government will legislate to facilitate the reduction in the size of Court by terminating the membership of all non-executive members on enactment, allowing for their subsequent reappointment.

D.49 The Government will advertise vacancies for the Governor and Deputy Governors of the Bank of England and also for external members of the MPC, consistent with the principles of open competition.

D.50 The Authorities will, in light of the new legislation, clarify responsibilities within the Memorandum of Understanding, setting out the roles and responsibilities of the Treasury, the FSA and the Bank of England with regard to financial stability, including the relevant roles and responsibilities in relation to the SRR.

Impact assessment

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

A.2) Do you think that there are any significant indirect costs associated with this proposal?

E How to respond

E.1 This consultation document is available on the 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 15 September 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 on 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 at least once during the development of the policy;
- be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses;
- ensure that your consultation is clear, concise and widely accessible;
- give feedback regarding the responses received and how the consultation process influenced the policy;
- monitor your Department's effectiveness at consultation, including through the use of a designated Consultation Co-ordinator; and
- ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

E.10 If you feel that this consultation does not fulfil these criteria, please contact:

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