Minutes of the Banking Liaison Panel 4 September 2012

Attendees and Apologies

1. David Lunn (HM Treasury) chaired the meeting. Others attending were Jayne Breckon, Philip Hammond, Cameron Drysdale, Leo Hodes and Rob Elliot (HM Treasury), as well as Michael McKersie (Association of British Insurers), Roger Brown and Rob Beattie (British Bankers' Association), Sarah McShane (Financial Services Compensation Scheme), Dorothy Livingston (City of London Law Society), Peter Brierley and Lauren Anderson (Bank of England), Paul Mayo (Insolvency Service), Richard Heis (Association of Business Recovery Professionals), Michael Percival (Association of Financial Markets in Europe), Kate Sumpter (International Swaps and Derivatives Association), and Roland Susman (Financial Markets Law Committee).

2. Apologies were received from Stephen Drayson (Financial Services Authority), Ed Murray and Peter Werner (International Swaps and Derivatives Association), Jeremy Palmer (Building Societies Association) and James Darbyshire and Alex Kuczynski (Financial Services Compensation Scheme).

Minutes from the previous meeting

3. The minutes of previous Banking Liaison Panel meeting held on 17 July 2012 were approved with some minor amendments.

Financial Sector Resolution: Broadening the Regime

4. HM Treasury gave the Panel an overview of its public consultation document that it published in August 2012 in relation to broadening resolution options for the financial sector. In particular it focuses on investment firms, insurance companies, central counterparties (CCPs), and other financial market infrastructures (FMIs). Its objective is to enhance the mechanisms available to Government to preserve financial stability for dealing with the failure of systemically important non-banks. HM Treasury also invited Panel members to provide formal written feedback on the consultation and offered bilateral discussions for interested parties.

Insurance firms

5. After an initial discussion of proposals relating to insurers, the Banking Liaison Panel invited members' views on the issue. Members broadly agreed with the objectives to protect policy holders and maintain financial stability but made the point that insurance firms and banks were quite different for resolution purposes. The discussion focused on the systemicity of insurance firms, noting the past failure of large insurance firms that had varying impacts on the financial sector and the real economy.

6. There was some discussion of the merits of existing techniques to deal with distressed insurers, notably run-off. Members raised concerns around the issue of time subordination that is noted in the consultation document. In a run-off, nearer term policy holders may be paid off to the detriment of longer term policy holders if a solvent insurer in run-off subsequently becomes insolvent. As the firm's liabilities wouldn't crystalise for a long period

of time, any present valuation for the purpose of addressing the time subordination issue would be difficult.

Financial Market Infrastructures – Non CCPs

7. The Panel sought views in this area focusing on whether a full resolution regime was needed, and if so, in what form? It was discussed that it may not be appropriate for an administrator to be appointed in order to continue to operate the financial infrastructure in question as they would not engender the confidence of market participants to be able ensure the continuity of the service. This could lead to a dysfunctional system where market participants may be reluctant to settle payments with an insolvent FMI. It was also noted that administrators may be reluctant to take on the risk involved. These were arguments for a resolution regime.

8. Members questioned the assumptions that the failure of an FMI would be related to financial issues as opposed to operational issues. In the scenario of an operational failure, the intervention of authorities would not necessarily address the issue. It was suggested by some members that a focus should be placed on developing recovery and business continuity plans to mitigate against operational failures as opposed to concentrating on resolution options. Others argued that both recovery plans and resolution tools were needed, given that implementation of a recovery plan might not restore the FMI's fortunes.

9. Members were conscious of the additional impact of introducing wide ranging powers for authorities on the cost of doing business for firms that could potentially be covered by a new resolution regime.

Investment Firms

10. The Panel discussed the proposed measures relating to the resolution of investment firms and welcomed members' views on the issue. The first issue raised by members was the scope and broad definition of 'investment firms' that is currently proposed. It was suggested that the threshold used by the European Commission may be a useful benchmark to begin with, but overall that the definition should be narrower than currently defined to ensure that non-systemic investment firms have certainty that they would not be subject to the proposed resolution stabilisation tools.

11. Members also suggested that developing Recovery and Resolution Plans (RRPs) for investment firms, similar to the process undertaken by retail banks, may help address some of the concerns raised in relation to whether a firm would be subject to the stabilisation tools of the proposed special resolution regime.

12. Some members were also concerned that the additional resolution powers granted to Government would raise the regulatory costs for all investment firms and increase their overall cost of capital. In addition, members questioned whether these powers should pre-empt European directives that will cover the same ground, potentially creating a multiplicity of legislation, on the basis that it may disadvantage the UK financial sector. It was recognised that moving first to introduce these powers may shape the implementation of any proposed future European directive.

13. Members opined that the objective set out in the consultation document regarding the protection of ‘client assets’ raises wider issues around the definition of ‘client assets’. Given the lack of regulatory record keeping and separation of client and firm assets, it may be difficult in a resolution scenario to determine the assets that are client owned. It was proposed that a pass/fail test would be required to overcome this issue, which in turn would require improvements in the record keeping of assets designated to clients. The FSA is due to publish a consultation document regarding client assets, which may address some of these issues. In general, members agreed with the proposed objective to protect ‘client assets’ subject to the wider concerns raised.

14. The issue of parent holding companies was discussed, in particular where the parent company is not a financial institution, and the resolution powers that would be open to the Government to use on the parent. It was again suggested that these additional powers would raise the regulatory costs as well as the cost of funding for the parent company. However it was noted that an intermediate financial holding company (IFHC) that would separate the bank and non-bank elements of a corporate group could mitigate against these potential negative effects, provided that the legislation around this issue was clear. If all financial parts of a group were under the IFHC, the resolution powers might be applied to the IFHC but not to a non-financial parent.

Central Counterparties

15. Members discussed various aspects of the proposed options for resolution of CCPs, highlighting the issue of uncapped liabilities of owners and members of clearing houses. It was suggested that loss allocation rules already set out by CCPs may provide a more efficient means of absorbing potential losses. It was acknowledged that this is an area that requires further work.

Any Other Business

16. Members agreed that the current format of the Banking Liaison Panel would benefit from being expanded or modified in order to discuss wider issues in the financial sector. Details of any proposed modifications will be discussed at future meetings.