Note

PAYMENTS COUNCIL

7 December 2007

BANKING REFORM - PROTECTING DEPOSITORS

1. This consultation paper discusses two aspects of depositor protection at a time when normal banking business is disrupted, the FSCS and the concept of "critical banking functions". Payments Council's response focuses primarily on the latter, particularly from a payments perspective (for example operating ATMs, making direct debit payments and receiving direct credits). It identifies some key issues which we believe would need to be resolved before such a concept was introduced. It discusses the protections already in place to cope with serious disruption in the UK's systemic payments systems; what structural difficulties are perceived to be in the way of smooth resolution of the disruption; and it makes a brief comparison with experiences in the US with bridge banks.

   The paper is essentially about the practicalities of defining and running "critical banking services". It is less about the principle of whether their continuation is "a good thing". But we would note that the development of this concept has knock-on consequences for the concept of moral hazard and for the whole concept of how insolvency law applies to banks.

   As the overall acceptability and practicality of this approach will depend in some part on the detail, we are ready to work with the tripartite in the development of these proposals; it will not be straight-forward. We strongly urge that adequate time is allowed to consider all aspects of the proposals, including a careful review of their insolvency law implications.

2. The Payments Council is a body set up by the banking industry to consider, inter alia, issues to do with the integrity of the payments system as a whole. A fuller description of the Council's role is included at Annex 1. The Council has in place contracts with the main UK payment Schemes and they have been consulted in the development of this response.

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DRIVING CHANGE
IN UK PAYMENTS

3. Current Position

The payment Schemes place a number of obligations on their members – paramount among these is the ability to meet their settlement obligations as they fall due. In the event of failure to settle, the Schemes have in place arrangements to cover payments "in flight"[1] but these do not extend to future payments entering the system.

We believe that there are several key questions which need resolution.

4. For what purpose are critical banking functions being maintained?

Whilst depositors in a "failed bank" have access to payment systems, they are likely to use them to withdraw their cash and put it elsewhere. So a continuing ability to make payments would erode the deposit base of a bank and make the chances of its rescue less likely. It would, however, facilitate the orderly wind-down of a bank's business and may be desirable on those grounds. We believe that is the objective behind this concept of critical banking functions.

6 Scope

Are all deposit-taking institutions within the scope of these arrangements? Or is it intended that only institutions of a certain size or with a certain number of depositors will be covered?

7 Notification of Event

There must be a clear process whereby those involved in the payment system (as operators and as counterparties) are made aware that the CBF provisions have been invoked in respect of a particular institution. There has to be a clean trigger point and a clear means of communication. There should be a similar process in place should a bank come to exit this protection as the document envisages this to be temporary.

8 Indemnity

Any failure of a bank has the potential to lead to litigation at the time or post event. Payment Schemes and their members, including those acting on an agency basis for other banks, need to have absolute clarity as to their legal position and particularly the (additional) protection available to them during a period when the CBF provisions are invoked.

[1] For the purposes of this paper this means payments that have entered the central systems. Each system defines this "point of irrevocability" for itself.

9 Simplicity

It needs to be clear whether all accounts within a failed bank are allowed to perform critical banking functions or only a selection, for example those relating to consumers and small businesses. If the latter, thought will need to be given to how the eligible accounts are to be identified and "flagged" – the payment system will not be able to do this. The more comprehensive the cover, the more straightforward it is likely to be to administer – but more costly in terms of the value of funds covered by the CBF provisions.

10. Scope of Services

The document proposes those relating to a current account would be covered. These include the main types of payments through the payment Schemes. Would they also include the granting of overdraft facilities or the making of loans?

11. The rest of our response is in three parts: existing protections; the position for payments from and credits to existing accounts; and other outside influences. It considers BACS, C&CCC, Faster Payments ("FPS")[2] and LINK. It does not consider the position of credit cards because credit cards are not linked directly to current accounts.

12 Summary.

i) "In flight" payments are already protected in BACS, C&CCC and FPS by specific agreements between the settlement banks in those Schemes.

ii) Processes exist today to enable the public to open simple current accounts with another bank and to transfer standing instructions (for direct debits etc) in a few days. Clearly this timescale may be impacted by very large numbers of applicants.

iii) Within the current payments systems set-up it is unlikely that credit balances could be transferred quickly from a failed bank to another bank, even if those balances qualified for FSCS protection (see Para 15 in respect of opening new current accounts with an alternative institution).

13 Existing Protections

13.1 **"LFCA": BACS and C&CCC**. The Liquidity Funding and Collateralisation Agreement

[2] BACS: the UK's main automated bulk payments system; C&CCC: Great Britain's system for managing cheques and paper credits (ie excluding Northern Ireland); FPS: the near real time automated payments system due for launch in 2008.

("LFCA") provides for existing payments obligations of a failed bank in either of these Schemes to be settled in due time at the Bank of England, using funds called from the other BACS and C&CCC members. The Agreement does not differentiate between insolvency and a technical failure of systems. It is designed to meet the terms of Core Principle V[3] (that a multilateral net payment system should be capable of settling even if the largest payer cannot settle). It is limited, both as to absolute amount and as to the number of failures, but it covers the largest debit obligation across both BACS and C&CCC seen in the previous year. It is also limited to in flight payments (which, to repeat the point made in 3 above, has a relatively narrow scope). Associated agreements ("Settlement Agreements") for both BACS and C&CCC describe the rights and responsibilities of member banks of these Schemes. Currently a member bank for whom the LFCA has been activated is bound to prevent further payments entering the system. For **Faster Payments** there will be a similar protection agreement to the LFCA, so that existing payments obligations of a failed bank will be settled. Any change to these agreements will take time both to draft and to agree, as all members have to be in agreement.

13.2 **Central suspension**. Generally, the more automated the system the quicker payments drawn on or due to the failed bank can be rejected centrally after the point of failure. C&CCC can instruct its central systems to suspend a bank but the process is not immediate and because of the nature of the paper-based system it will require significant intervention at bank branch level (. for example counter staff not accepting cheques drawn on a failed bank), particularly in the early stages. The central systems of BACS and FPS can be instructed to suspend a bank at any time but because FPS is a "near real time" system the effect of suspension will be felt more quickly than in BACS.

13.3 **LINK**. In the event of a bank failure LINK would suspend the failing card issuer from the LINK network once it is reasonably determined that the issuer is unable to pay its debts to any person as they fall due. There will usually be a certain volume of unsettled transactions and, if that settlement fails, the multilateral settlement will be recalculated excluding the failed issuer, with each ATM operator left with a bilateral claim on the card issuer.

13.4 The protections built around payment Schemes generally relate to full members. But a large number of banks have access to the clearings through an agency

[3] Core Principles for Systemically Important Payment Systems published by the BIS, January 2001

agreement with a member of the clearing. Any new arrangements must take into account the position of agency banks, as well as full members. Banks may also sponsor corporates as direct in-putters into certain of the clearings. This does not imply that the bank itself has any added financial exposure to either the corporate or the relevant clearing scheme but any changes to legislation should not inadvertently affect this sponsorship.

14. Re-enabling a failed bank

14.1 When a bank is suspended in the central payments systems its identity is recognised by its sort code or a similar bank identifier. As discussed above, and depending on the system, the suspension mechanism is designed to act more or less quickly and to take effect on the entire bank, not just some parts of it; the system acts on the bank, as opposed to a division or branch, identifier. Agency banks would be caught by this, until their business could be moved to another sponsor.

14.2 If it was decided that there should be a focused response with only selected parts of a bank's activity allowed to participate in the payment system, then re-enabling certain parts (e.g. selected branches) would in principle be possible for the electronic systems (but not for C&CCC). Normal sort code data (the ISCD) maintenance takes place over a weekend, so that a mechanism is in place to manage re-enabling a bank or certain Codes weekly (or possibly more frequently in exceptional circumstances). But control over individual accounts has to be managed internally and banks' internal systems are not at present geared to fine-tuning control over very large numbers of current accounts at short notice. This reinforces our plea for simplicity.

14.3 In general, banks have greater control over payments out of an individual account than credits to it, although some controls are manually intensive (e.g. returning cheques).. Payments to an enabled account would need to be controlled by the account holder by identifying that account to the payer. Management of accounts in this way and on this scale would be likely to be complex and time consuming to establish. Again this encourages us to press for a simple approach to the problem.

14.4 As far as the ATM network is concerned**, LINK** could reconnect a whole bank quickly. It would be possible to reconnect as a whole and suspend payments from individual accounts but it is unlikely this can be done in bulk efficiently.

14.5 The ability of a failed bank to continue to make and receive payments would depend also on the Bank of England keeping its settlement account open. Final settlement of payments between the settlement banks in BACS, C&CCC, FPS and LINK takes place across the settlement accounts at the Bank which are also used to settle other real time payments (principally CHAPS and CREST).

15 Basic bank accounts

15.1 It is open to account holders at the failed bank to apply to open accounts with other banks. Assuming the customer had the right identification papers a **basic bank account** could be set up quickly, subject to the logistics of potentially large numbers of applicants. Banks would be expected to manage the KYC/money laundering checks (albeit that these might be amended or relaxed in exceptional circumstances), but there would be no need for credit checks if overdraft facilities are not offered. A basic bank account would give the account holder access to a current account through the debit card system as long as the account is in credit. Larger volumes following a bank failure will lengthen this timescale further. Assuming no objection from the failed bank administrator direct debit/standing order information could be accessed from the failed bank within days. The Banking Code has service levels for transfer of information and enabling the account to be operated in normal times although the logistics of large numbers of applicants is likely to affect banks' performance in this area. The transfer of existing balances would be subject to the constraints on payments mentioned above.

16 Business accounts.

16.1 Small businesses (i.e. those with up to £1m of turnover) are eligible for protection under the FSCS, so those in credit up to the FSCS limits are in the same position as personal account holders. For many small businesses, however, access to the bank account facilities may be critical to their day-to-day operations - any significant delay in obtaining an account from an alternative provider could have serious implications. Also many businesses rely on overdraft facilities. These businesses would potentially find it hard to transfer their bank accounts quickly since any new bank would wish to undertake credit and other due diligence checks which might take some weeks. So these accounts would need to be run as far as possible out of the failed bank for as long as it took to effect an orderly transfer. It is worth noting that many personal customers also run overdrafts and would be similarly affected.

17 Special purpose / Bridge banks.

17.1 The discussion paper considers the possibility of setting up a special purpose bank to handle normal banking functions, and mentions the practice in other countries e.g. the United States.

Whilst we are happy to discuss this issue further, our impression is that bridge banks are used in the US in different circumstances than would be likely to apply in the UK. For example, there are many more small regional banks in the US than here and it is unlikely that any other than the smallest UK building society and its customers could be treated in a similar way

18. Legal considerations

18.1 The Discussion Paper acknowledges that managing an insolvent bank so that critical banking functions can continue would require a change in current insolvency law. An administrator of a bank that is threatened with insolvency would need clarification of the law so that he could prioritise the interests of the stakeholders. And, as mentioned above, the existing agreements that govern settlement banks in the payments systems would need to be adapted to any new regime.