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Payment systems and collateral: regulatory overkill or panacea?

HM Treasury, the Financial Services Authority and the Bank of England published on 30 January 2008 a consultation paper with their proposals to strengthen UK financial stability and depositor protection. These include statements of intent regarding the introduction of a power enabling the Government to legislate in relation to financial collateral arrangements and future legislation for the oversight of payment systems. With the payment services sector already burdened by a plethora of EU laws and further clarification still being sought in respect of financial collateral legislation introduced some years ago, is further regulation in both areas strictly necessary?

Key Issues

2008 financial stability and depositor protection consultation proposes new oversight of payment systems and financial collateral legislation

Payment services sector already dealing with plethora of and interplay between EU regulation and schemes

Financial collateral area still endeavouring to clarify existing regulation and awaiting European Commission proposals relating to credit claims and netting

Reducing the likelihood and impact of bank failure

Recent financial turbulence has caused the UK Government, the Financial Services Authority (FSA) and the Bank of England to search hard for an adequate response. Following on from their consultation "Banking Reform - Protecting Depositors: a discussion paper" published in October 2007 and "The run on the Rock" issued by the House of Commons Treasury Committee in January 2008, the tripartite authorities are proposing to bring forward legislation with the aim of strengthening the financial system and reducing the likelihood and impact of bank failure.

Among their proposals, set out in their January 2008 consultation paper "Financial stability and depositor protection: strengthening the framework", for minimising the impact of a failing bank on its depositors and the UK economy, they have mentioned the Government's intention to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements. This is said to be in order to ensure that banks have in place arrangements which would lessen the impact of their failure, should it occur.

The tripartite authorities' 2008 consultation also lists, among other proposals with the dual objectives of reducing the likelihood of bank failure and strengthening the regulatory and supervisory framework, a proposal for "more formal oversight" of payment systems.

"The Government proposes legislation to provide for a new and flexible framework for oversight of payment systems. The Authorities intend to consult further on the detail of the regime to be implemented under this framework..."

The tripartite authorities point out in their 2008 consultation that payment systems, which they envisage as comprising networks which link key financial firms to customers, play a crucial role in the banking system, the functioning of financial markets and in maintaining consumer access to financial services. They explain that they are setting out the case for the formal regulation of UK payment systems because access to payment systems provides bank accounts with their functionality and customers would find their ability to manage their finances significantly impaired if their bank were to be excluded from payment

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systems - yet under payment system membership rules, a default event such as insolvency can mean exclusion from a payment system.

The consultation distinguishes between problems in retail systems and those in wholesale systems (which are said to threaten financial stability due to their potential for causing liquidity difficulties for banks and spreading contagion). An internal Bank of England review of payments responsibilities in the first half of 2007 apparently concluded that, while responsibility for oversight of high-value wholesale systems may sit well with the Bank of England's responsibilities for monetary policy and financial stability, oversight of significant retail systems might be better undertaken by the FSA.

Flexible oversight framework?

The tripartite authorities do not enlighten us in their 2008 consultation as to the precise nature of the oversight framework they are considering, nor do they give details of exactly which "payment systems" they intend to fall under its aegis. The Payment Services Directive has a very wide definition of "payment system" - if this were adopted a very wide range of "private" systems could be within the scope of these proposals. All they tell us is that the framework needs to be clearer and more robust than current arrangements, that it will be sufficiently flexible to be able to respond to the evolution of payment systems over time, that they are working together to analyse its objectives and assess current oversight arrangements and will propose any necessary changes in a separate consultation on the details of the new regime. They ask for feedback on how its scope should be defined and on which elements should be effected through statutory powers. The Government is proposing at the very least to take a power to enable it to assign oversight responsibilities to the appropriate authority. The exclusion of failed banks from payment systems of which they have been members is also clearly a concern which will be dealt with.

In addition, in order to ensure that payment services are not unduly affected by bank failure, the FSA is also said to intend to work with banks to ensure that those which are not members of payment systems such as BACS have contingency plans for the event that their arrangements with a payment system member (known as a sponsor bank) are disrupted by sponsor bank failure, so that the failure of one settlement bank does not automatically undermine the ability of other banks to make payments.

Payment systems oversight authority split between Bank of England and FSA?

The paper highlights the Bank of England's current role in contributing to the maintenance of financial system stability by overseeing payment system infrastructures which are systemically significant to the UK and its responsibility to advise the Chancellor on any major payment systems problem. It notes that the Bank of England's non-statutory responsibility in this regard derives from the 2006 Tripartite Memorandum of Understanding (MoU), while the FSA is responsible for the regulation of payment system members and other elements of market infrastructure such as clearing and settlement systems in which payment systems may be embedded.

Payment systems: critical banking functions

The tripartite authorities' October 2007 discussion paper highlighted payment systems as constituting "critical banking functions" which need preservation in the event of bank distress or failure. It asked for views on how long they would need to be maintained (and under which circumstances this period might vary) in order to protect consumers, maintain consumer confidence and ensure an orderly transfer of services.

It referred to direct debit and automated payments as "payment systems" and also listed current accounts, direct debits and credits, ATMs and debit cards, with access to current accounts considered a critical function. Because of the lack of a clear dividing line between current accounts, saving accounts and products such as offset mortgages, with many instant access savings accounts providing payment functions such as payment cards, cheque books and direct debit facilities, the authorities felt that it was arguable that access to a wider range of accounts should be preserved in the event of bank failure. It was also noted that continuity of bank access to payment systems linked to bank accounts might be desirable, instead of the automatic suspension from payment systems for any member bank which enters into insolvency proceedings.

The authorities are mulling over splitting the proposed oversight of payment systems between the Bank of England (with responsibility for wholesale) and the FSA (regulating systems used wholly or mainly for retail payments). Their feeling is that a separate retail oversight role may fit more naturally with the FSA, while the Bank of England's current responsibilities, together with its operational role as a central bank, entail its involvement in the design, management and operation of high-value wholesale inter-bank payment systems and give it the necessary leverage to ensure their effective functioning. The paper notes, however, that the central bank's leverage is limited due to its lack of formal powers, which means that it is either reliant on transparency, persuasion and shared interests (in relation to systems in which it has significant operational involvement) or (where its involvement is more limited) on formal dialogue with management and its published assessments of compliance with international standards in its annual Payment Systems Oversight Report.

The authorities consider that a power could be taken which would enable oversight responsibilities to be assigned to the appropriate authority. It would also give the latter powers and duties depending on the nature and characteristics of the payment systems which it supervises.

Oversight powers and duties?

It is easy to see that granting and apportioning regulatory oversight of payment systems could be viewed by the tripartite authorities as a panacea for their perceived lack of regulatory leverage and also for the lack of a statutory platform for ensuring the smooth functioning of payment systems in the event of bank failure. It is difficult to envisage, however, how the "wholesale" and "retail" oversight roles would be split in practice. The consultation seems to assume a financial threshold (using the terminology "high-value" wholesale inter-bank systems), but oversight for inter-bank systems dealing with large volume payments for non-bank payment originators or payees may be difficult to allocate. In a post Payment Services Directive era (the PSD is due to be implemented by November 2009) where payment services providers will include licensed non-bank payment institutions which will be allowed access to what are currently inter-bank payment systems, it is not clear precisely how this oversight allocation would work.

Furthermore, any powers and duties granted to the oversight authority would need to take into account the significant compliance risk management and regulatory burden currently faced by payment systems and their members, deriving from a plethora of EU initiatives impacting on the payments sector such as the PSD itself, the Consumer Credit Directive, the Third Money Laundering Directive, Regulation 2560/2001/EC on cross-border payments in euro (which the European Commission is currently considering extending), Regulation (EC) 1781/2006 on information on the payer accompanying transfers of funds, the E-commerce Directive (2000/31), the Distance Selling Directive (97/7/EC), the Distance Marketing of Financial Services Directive (2002/65/EC), Directive 2004/39/EC on Markets in Financial Instruments (MiFID), EC Directive 93/13 on Unfair Contract Terms and the Unfair Commercial Practices Directive (2005/29/EC). The confusing interplay between these regulatory initiatives covers areas such as territorial scope, type of payments and businesses caught and home-host supervision. Payment system processes are also being overhauled in light of the proposed Single Euro

Payment systems: speedy release of funds upon bank failure

The Treasury Committee noted in their report on Northern Rock that consumer confidence depended upon the speedy release of funds to depositors of a failed institution, who face significant delays under the UK's existing arrangements. They took on board the response of the British Bankers' Association (BBA) to the tripartite authorities' 2007 discussion paper, to the effect that it was not feasible to expect customer account data to be exported from one institution to another in the case of a failed bank due to the diversity and complexity of the systems used by different banks.

The BBA considered that speedy payout was best achieved through existing bank channels (cheques, cash or electronic) and facilitated by arrangements enabling bank staff (or a special administrator) to take over and operate the payment systems of a distressed bank. The Committee recommended in its conclusions that "the relevant authority must ensure that banks' information systems and procedures are capable of such a speedy release of funds". It also noted that any disruption to direct debits, standing orders, ATM availability and other banking services would cause profound problems for the banking system as a whole and that if a bank were to fail, a smooth transition to a bridge bank or third party bank would be essential. It recommended that the Government address the issue of how essential banking services would be maintained.

Payments Area (SEPA), an integrated payment services market for transactions in euros across the EEA and which, among other things, provides a framework for the clearing and settlement infrastructures which provide operational processing services for euro payments.

"The Government intends to introduce a power enabling it to make secondary legislation in relation to financial collateral arrangements..."

The tripartite authorities' 2008 consultation contemplates giving the Government the power to make secondary legislation with the aim of giving legal certainty to secured creditors who lend against financial collateral in relation to the realisation of their security "quickly and simply" upon the obligor's failure. Their objective is to protect lenders (including derivatives counterparties, corporates, pension funds and insurers) who use financial collateral as a credit risk management tool and thus "to strengthen the robustness of the financial markets". The paper notes that the "recent loss of confidence in the credit markets has reinforced the importance of legal protections when firms lend to each other". Statistics published by ISDA in relation to the derivatives industry are cited as evidence for the importance of financial collateral in the financial markets as a whole. The authorities are also asking for more general suggestions for future revisions to the financial collateral regime which stakeholders feel should be considered.

Financial collateral

The consultation refers to the Financial Collateral Arrangements (No. 2) Regulations 2003, which implemented the EU Financial Collateral Directive (2002/47/EC). This required member states to remove certain formalities and other procedural and legal obstacles which hindered the use of collateral arrangements involving cash or securities in the financial markets. The paper notes, however, that "it has become increasingly clear that there are other uses of collateral in the financial markets which also merit protection".

"Financial collateral" is described as including cash or securities and while "financial collateral arrangements" are not defined (the paper refers simply to the use of different legal mechanisms for "taking collateral"), this would presumably include arrangements involving title transfer as well as those involving the taking of security, both of which are covered by the 2003 Regulations. "Failure" of an obligor is also not defined.

The European Commission issued a report in December 2006 recommending the extension of the Financial Collateral Directive to encompass "credit claims" (or bank loans) as a further type of financial collateral ripe for procedural simplification. If the tripartite consultation is referring to this proposal and views it as some kind of panacea to help secured creditors cope in turbulent markets, securitisation market participants may wish to point out that legal mechanisms already exist to protect and give legal certainty to secured creditors and transferees in relation to the monetisation and realisation of credit claims used as collateral - and that further legislation may not strictly be necessary.

While any attempt to ease the realisation of security would no doubt be welcome to secured creditors, there are particular

Impact of illiquid collateral

While the tripartite authorities' 2007 paper did not mention financial collateral at all, the Treasury Committee focused in their report on Northern Rock on the problems caused by illiquid collateral when the market for mortgage-backed securities dried up in August and September 2007.

Among their conclusions and recommendations, the Committee noted that the European Central Bank was happy to lend against a wide range of collateral, including relatively illiquid assets, throughout the period of recent market turmoil and that the Bank of England's subsequent decision to do the same was of great assistance to UK banks. The Committee concluded that the Bank of England should have broadened the range of collateral acceptable to it as security for bank borrowings under its standing facilities at an earlier stage.

In the 2008 consultation the Government is, accordingly, proposing:

- the enhancement of provisions implementing the EC Settlement Finality Directive which insulate collateral provided to the Bank of England from the effects of insolvency in order to ensure that realisation of the collateral provided to the Bank of England is fully effective whenever carried out; and

- legislation to allow building societies to grant floating charges to the Bank of England as security.

The Government is also seeking views on whether the statutory requirement for companies to register charges over their assets should not be applicable to banks in receipt of emergency liquidity support from the Bank of England, so that it would not quickly become public knowledge that a bank has received central bank emergency support. The paper acknowledges, however, that this would increase the risk of a third party lending to the bank while unaware of the security provided to the Bank of England and the possible implications for the repayment of its loan.

issues with the enforcement of financial collateral arrangements relating to credit claims. Other types of financial collateral can be sold or appropriated - but the lack of a liquid market for credit claims is problematic. How, apart from sale in administration or receivership, can these be liquidated? And just how easily can they be sold in an enforcement situation?

The tripartite authorities' consultation also comes while the European Commission is still evaluating feedback on its January 2006 consultation on the implementation and impact of the Financial Collateral Directive and those of the latter's provisions which are considered by some to need a little further clarification in order to be fully effective in furthering the Directive's aim of simplifying the taking and enforcement of financial collateral. English law issues raised during the consultation process included confusion relating to the application of certain provisions to floating charges and the disapplication of insolvency law to close-out netting. The Commission's response in December 2006 mentioned exploring further improvements in relation to netting and conflicts of law.

The financial markets will have to wait to learn the precise nature of the proposals before being able to determine what practical benefit, if any, they may have for secured creditors.