PARLIAMENTARY DEBATES

HOUSE OF COMMONS
OFFICIAL REPORT

Second Delegated Legislation Committee

DRAFT INVESTMENT BANK (AMENDMENT OF DEFINITION) AND SPECIAL ADMINISTRATION (AMENDMENT) REGULATIONS 2017

Tuesday 7 February 2017

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not later than

Saturday 11 February 2017

The Committee consisted of the following Members:

Chair: Mrs Madeleine Moon

† Barclay, Stephen *(Lord Commissioner of Her Majesty's Treasury)*
† Blackman, Kirsty *(Aberdeen North)* (SNP)
† Burns, Sir Simon *(Chelmsford)* (Con)
† Costa, Alberto *(South Leicestershire)* (Con)
† Field, Mark *(Cities of London and Westminster)* (Con)
† Ghani, Nusrat *(Wealden)* (Con)
† Graham, Richard *(Gloucester)* (Con)
Kendall, Liz *(Leicester West)* (Lab)
Kerevan, George *(East Lothian)* (SNP)
† Kirby, Simon *(Economic Secretary to the Treasury)*
Lammy, Mr David *(Tottenham)* (Lab)
Leslie, Charlotte *(Bristol North West)* (Con)
McFadden, Mr Pat *(Wolverhampton South East)* (Lab)
Reeves, Rachel *(Leeds West)* (Lab)
† Reynolds, Jonathan *(Stalybridge and Hyde)* (Lab/Co-op)
† Smith, Jeff *(Manchester, Withington)* (Lab)
† Sunak, Rishi *(Richmond (Yorks))* (Con)
† Williams, Craig *(Cardiff North)* (Con)

Danielle Nash, Eliot Barrass, *Committee Clerks*

† attended the Committee

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[Mrs Madeleine Moon *in the Chair*]

Draft Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017

8.55 am

The Economic Secretary to the Treasury (Simon Kirby): I beg to move,

That the Committee has considered the draft Investment Bank (Amendment of Definition) and Special Administration (Amendment) Regulations 2017.

May I say, Mrs Moon, what a pleasure it is to serve under your chairmanship?

The investment bank special administration regime was introduced in 2011 following the failure of Lehman Brothers. It is a modified insolvency procedure for investment banks that sought to protect more adequately the interests of clients and those engaging in financial transactions.

Two years after the special administration regime came into force, the Treasury appointed Mr Peter Bloxham to carry out a comprehensive review of it. The review was published in 2014 and recommended a set of reforms to strengthen the regime. The draft regulations will implement the recommendations that fall within the Treasury's remit. They are part of a wider insolvency regime, and should be considered alongside the work of the Financial Conduct Authority to improve client protections.

The draft regulations will improve the speed with which assets can be returned to clients and ensure that the administration process operates more efficiently and more effectively. They have been subject to widespread consultation with the different parts of the market that would be affected by the failure of an investment bank, including the creditors and clients of such banks as well as insolvency practitioners. We also took advice from the banking liaison panel on specific aspects of the regime, in particular to ensure that appropriate safeguards are in place.

I am happy to answer any questions that the Committee might have on the detail of the draft regulations but, in the interests of not detaining Members for much longer, I will do so in my closing remarks.

8.57 am

Jonathan Reynolds (Stalybridge and Hyde) (Lab/Co-op): May I, too, say what a pleasure it is to be here under your chairmanship, Mrs Moon, bright and early after such a late sitting in the House last night?

I thank the Minister for his speech. He and I have now discussed several pieces of legislation to improve the oversight and regulation of the financial system following the financial crisis, and the amendments in the draft regulations are clearly another part of that.

It is well documented that even before Northern Rock crashed many people had expressed concerns that the standard insolvency legal procedures did not work for banks. Providing a regime that is fit for purpose must therefore be a priority, so this is a particularly important and interesting area of legislation and, although we do not oppose the draft regulations, I have a number of questions on which I am seeking clarity.

I have two general questions. First, why did more than two years elapse between the January 2014 publication of the Bloxham review and the March 2016 launch of the consultation? That seems to be an abnormally elongated procedure. Secondly, it would be interesting to know why the measures to require certain third parties to co-operate with the administrator, which were considered in the consultation last year, will not be implemented under the draft regulations. Why did the Government feel it was unnecessary to proceed?

On the specific content of the provisions, I have a number of further questions. I appreciate that this area of law is fairly detailed and not especially accessible, but because of its importance I feel the level of scrutiny in Committee must be fairly thorough. I take advice from a number of sources of expertise in the City when preparing remarks such as these for the simple reason that I would never wish someone to read our exchanges following a subsequent financial crisis and find that we had not dealt with any measures with sufficient rigour. I am happy to receive answers from the Minister either today or in writing later.

Proposed new regulations 10A and 10B, on page three, specify how the client assets that the investment bank is required to hold on trust for its clients—money that does not belong to the bank, but which it holds beneficially for clients—are to be dealt with. Basically, the bank needs to confer with the Financial Services Compensation Scheme about such assets. The client asset regulations, which were overseen by the FCA, have been shown to be defective in a fairly recent Supreme Court case. In Lehman Brothers *v.* CRC Credit Fund Ltd and others in 2012, it emerged that they failed to specify how the trust arrangement worked. The courts held there must be a trust but that the regulations did not make clear how that trust worked. It was unclear whether the trust failed, in that case, because Lehman Brothers had failed to separate each client's assets into a separate trust account or whether all assets held for clients should be treated as being held on the terms of one enormous trust. The Supreme Court held by majority that there should be held to be one enormous trust, so that clients could be protected.

That creates a certain degree of confusion. Can the Minister say how conferral with the Financial Services Compensation Scheme will solve the chaos, after a bank goes into insolvency, of identifying which assets are held on trust and are, therefore, ring-fenced from insolvency proceedings and which assets are to be divided up among the unsecured creditors?

Several investment banks have been fined by the old FSA and now the new FCA for failing to organise their clients' assets into trusts in compliance with those regulations. What do the Government propose to do to ensure that banks operating in the UK do not indulge in what might be a criminal practice of treating assets that should be held on trust for their clients as though they belong beneficially to the bank?

In the Supreme Court, in Lehman Brothers *v.* CRC, Lord Walker commentated that, as a result of that case, in his view investment banking can be

"more of a lottery than even its fiercest critics have supposed."

He had some very strong words about regulatory non-compliance. His particular focus was on the failures of the system for protecting client assets in times of bank insolvency and that litigation is important in relation to the regulations being analysed today. The case shows that senior employees at Lehman Brothers had known the bank was failing to protect its clients' assets for several years and had knowingly used those assets for its own purposes.

Mark Field (Cities of London and Westminster) (Con): The hon. Gentleman makes a good case, and he will appreciate that this is pretty complex. There is an assumption that there are very easily defined pots of money that can be assigned to a particular client, which clearly is not the case. Does he not recognise that the nub of the problem, and the main issue with Lehman's, was that it was an issue of liquidity rather than solvency? As it happens, it has been able to give more than 100p in the pound, albeit many years on. Therefore, we have learned quite a few lessons from Lehman. The Bloxham review has made an important contribution in trying to clarify these issues, but we should not think it is going to be entirely simplistic to have a template in place that does not lend itself, in part at least, to some of the commercial realities on the ground in the investment banking world.

Jonathan Reynolds: I absolutely recognise that and I certainly agree this is a far from simplistic area to get right. It is our role as a Committee to probe the Government on how the regime would operate in the event of that lack of liquidity that we all seek to avoid in future. What are the Government doing to confront this failure on the part of banks, regulators and the FCA regulation in that eventuality? How do the regulations confront those issues?

How does proposed new regulation 10B(12) confront the issue of knowing which assets are to be held beneficially for the bank and which assets are to be held beneficially for the clients? In the interest of certainty, would it not be preferable to require banks to segregate each client's assets into a distinct account and stop the practice referred to in that Supreme Court decision of bundling all those assets into one large account, perhaps making it easier to misappropriate them owing to the size of the account? Does new regulation 10B perpetuate the confusion identified by Lord Walker in the Supreme Court case?

The second point made by the right hon. Member for Cities of London and Westminster moves me on to new regulation 10D on page five. The regulations appear to bundle together too many things that are not the same. Regulation 10D(2) refers to set-off agreements, netting agreements and title transfer arrangements and seems to be based on the assumption that those agreements are similar. That was not my understanding when the regulations were explained to me. Consequently, would it not be preferable for the regulations to separate more clearly the different types of agreement and arrangement so that no confusion is caused by treating them as though they were functionally identical?

As we all remember from 2007 and 2008, it is fairly chaotic when banks go into insolvency. Any uncertainty about the types or nature of assets that parties have will only add to the confusion. The regulations need to ensure that they deal with the different types of right with sufficient clarity to guide the authorities and the insolvent bank's administrators through a future crisis.

Thirdly and finally, new regulation 10E refers to the Prudential Regulation Authority, which the Government are changing to the new prudential regulation committee. The reference to "security interests" in the title of the measure is unclear and perpetuates the problems of uncertainty in previous provisions. The term "security interest" does not describe any specific legal position, but tends to be a catch-all term that commercial lawyers use to describe a right that they hope will protect their clients if the counterparties go into insolvency. A security interest could be a trust, mortgage, charge and so on, and it would be preferable if the legislation were clearer about the rights involved. The regulations attempt to bundle the rights together, therefore leaving it to general law to sort out the problems of detail that the rights may create in future. However, that does not seem optimal when as much certainty as possible is required.

In conclusion, to move away from the specifics of the regulations, the Minister knows that many of our fellow citizens feel that despite changes for the better, the UK banking system somehow remains a liability rather than a strength. That worries me and should worry us all because, as we initiate Brexit, financial services are clearly fundamental to the UK economy, and we have to make sure the public understand that. In responding to those points, I hope that the Minister will provide reassurance that the lessons of the financial crisis are being learned and that steps are being put in place to ensure that our regulatory regime is fit for purpose.

9.6 am

Kirsty Blackman (Aberdeen North) (SNP): As the two hon. Gentlemen said, it is a pleasure to serve under your chairmanship, Mrs Moon.

I have two questions—the Minister will be pleased to know that they are brief. First, the hon. Member for Stalybridge and Hyde talked about the duty to co-operate. In the guidance that was mentioned, it is not clear whether the Government plan to implement the duty in future. It would be useful to know whether they are planning to look at the duty to co-operate as regards supplying documents to the administrator, when they can see a clear mechanism for doing that. That would be useful to know.

Secondly, the guidance says that the Treasury does not plan to issue guidance. Will the Minister let me know what the process is for ensuring that all organisations can comply with the new rules as they come through? There is no point in having sensible legislation if nobody knows about it, so it would be useful to know what the process is.

9.7 am

Simon Kirby: I welcome the contributions made by both hon. Members during today's discussion. It is right that we consider whether the special administration regime meets the aims set out for it in the legislation. Indeed, we rightly have a statutory obligation to do so

[Simon Kirby]

under the Banking Act 2009, and that is why Mr Peter Bloxham was appointed to carry out a comprehensive review of the original regime. His recommendations have informed the reforms that we are discussing, and at this juncture I would like to pay tribute to Mr Bloxham's hard work and tenacity in compiling such a constructive report.

The reforms seek to strengthen the administration process in three ways: by making it easier for client assets to be transferred, by simplifying the procedure for assets to be returned to clients and by providing increased legal certainty. It is important to note how far we have come since the special administration regulations were introduced in 2011. We have learnt lessons from the banks that have been put into the special administration regime, and in designing these reforms we have worked closely with regulators, the Financial Conduct Authority, and the Bank of England, as well as with expert administrators and lawyers. These regulations represent an important step forward as we continue to strengthen the UK's important financial services sector, not only to ensure this country's financial stability, but to help cement further our position as a world-leading financial centre.

Some important points have been raised today that I would like to address. First, the hon. Member for Stalybridge and Hyde asked why it has taken so long for these reforms to be implemented. We carefully considered the Bloxham review's 72 recommendations, which were broadly technical in nature, and worked closely with regulators and expert insolvency practitioners to develop draft legislation. We consulted on those changes in 2016; over the consultation period, the Treasury engaged with representatives of firms, clients and insolvency practitioners. We tested the proposals with the banking liaison panel and participated in industry forums organised by the FCA. We also met representatives from most of the organisations that submitted formal consultation responses. That work was essential. Developing policies that will make a substantive difference was time well spent.

The hon. Gentleman asked why we are not implementing all the Bloxham recommendations. We have implemented the majority of them, and we consulted on our proposed approach in 2016, setting out our rationale as regards the recommendations that have not been adopted. In some cases, there are very good technical reasons for that; for example, the Treasury does not have the power to extend the use of schemes of arrangement. In other cases, our discussions with industry indicated that the reforms in question, such as the recommendation to limit the liability of administrators, would not be beneficial. He also asked about client money held on trust. The FCA is currently seeking feedback on proposed changes to the CASS—client asset sourcebook—rules on the return of client assets against the backdrop of amendments to the special administration regime regulations. He asked about banks' duties and I am confident that the existing duties are effective in ensuring that clients can access their assets quickly and efficiently. It has become clear that that could not be done in a proportionate way. A specific duty would be disproportionate given the existing statutory duties on banks, custodians and counterparties. As for his very technical questions about regulations 10B, 10D and 10E, I will, with the Committee's permission, write to him about them in some detail.

Finally, the hon. Gentleman asked about distinguishing assets held for the bank from assets held for clients. Since the financial crisis, the FCA has taken a number of steps to improve firms' record keeping. These reforms have been extensively consulted on with practitioners who have experience in dealing with pooled accounts.

I will also write to the hon. Member for—for?

Kirsty Blackman: Aberdeen North.

Simon Kirby: Aberdeen North. I apologise—it is a very long way from Brighton.

In conclusion, the regulations make important reforms to implement Mr Bloxham's recommendations and strengthen the regime that covers the administration of investment banks. The reforms they contain should be seen as part of the wider efforts that the Government and financial authorities are making to enhance the regulatory environment and protect financial stability, such as ring-fencing banks' investment banking activities from their retail operations, and the forthcoming updates to the FCA's client asset protection rules. Collectively, such measures represent important steps forward to address the problems of the past and strengthen financial stability. I hope that the Committee has found this morning's sitting interesting and informative and that it will join me in supporting both our efforts and the regulations.

Question put and agreed to.

9.14 am

Committee rose.