TEN YEARS ON FROM THE GLOBAL FINANCIAL CRISIS – A REFLECTION ON THE TREATMENT OF INSOLVENT FINANCIAL INSTITUTIONS IN THE UK AND EU

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Before I begin, I would like to thank ProfessorGhazinyan, Dean of the Faculty of Law at Yerevan State University for the great honour of being invited to speak on this wonderful occasion to celebrate 100 years of the success of this eminent institution.

Introduction

My theme for today is to reflect upon the work that has been undertaken in the UK and the EU in relation to the treatment of insolvent financial institutions in the aftermath of the global financial crisis that was still at its height a decade ago, in 2009.

Since this is a vast topic and, I appreciate, a highly specialist one in the context of this conference, this paper can only provide a brief introduction. I hope, however, that it will provide a starting point for any student interested in furthering their understanding of this fascinating area of law.

As a framework for this reflection, I will begin with a consideration of the financial sector safety net as it was in the UK in the period before the financial crisis and, using the failure of Northern Rock bank as an example, demonstrate how it has changed, both through UK "home grown" legislation as well as through EU legislation.[1]

I will then reflect upon whether it is likely that, as Mark Carney, Governor of the Bank of England and then Chair of the Financial Stability Board stated in November 2014:

> "Globally systemic banks that fail will in future be resolved without recourse to the taxpayer and without jeopardising financial stability".[2]

I ask this question conscious that, since 2009, much has changed in the world of finance with the development of digital (often called disruptive) technologies: cryptocurrencies such as Bitcoin and payment platforms such as Ap-

[1] EU Regulations are directly incorporated into the law of the EU Member States once published in the Official Journal. Directives are implemented by Member States through their own local, legislation. After Brexit, unless adopted by the UK as a matter of UK law, EU Regulations will no longer apply.

[2] **Mark Carney**, The future of financial reform, 17 November 2014. Available at www.bankofengland.co.uk/publications (accessed 17 June 2015).

ple Pay are now being perceived as "mainstream". In addition, the global consensus that existed in the post-crisis era[3] seems less assured as (most notably) the US and the UK appear to be pursuing more nationalistic or populist approaches to government. At the time of writing, if UK Prime Minister Boris Johnson is to be believed, the UK will be leaving the EU, with or without a deal, in a matter of weeks.

But first, some definitions.

In the context of this paper, "banks" means commercial banks; that is, deposit-taking institutions rather than investment banks.[4] The reason why I am talking about deposit-taking institutions is because between 2007 and 2009, the UK commercial banking sector was taken to the brink of insolvency and helped to spread financial instability across the global financial system. In addition, I think that this is a more relevant discussion for you here in Armenia, as my understanding is that the investment banking market is currently limited.

The second thing to say is that when I am talking about the financial sector safety net, I am talking about the following four aspects.[5] First, prudential regulation. This is the oversight of banks by a regulator whose job is (broadly) to ensure that they are sufficiently capitalised and fit for the highly responsible activity of lending money and taking deposits from customers. Second, the lender of last resort function of a central bank whereby emergency liquidity is provided to a bank in what are understood to be short-term financial difficulties. Third, depositor protection, whereby depositors are in receipt of a government guarantee that if a bank fails, their deposits will be guaranteed up to a specified amount. Fourth, that there is an insolvency regime in place that can be applied to a failing bank.

Northern Rock

Prior to the financial crisis, the UK's financial sector safety did not include a special bank insolvency regime. Cranston commented that:

> "The policy of not having a separate regime is, no doubt, that matters can be handled speedily under the general insolvency laws… systemic risk is

[3] As, for example, demonstrated at the April 2009 G20 summit in London.

[4] According to the Banking Act 2009, section 2 'Bank' means a United Kingdom institution which has permission under Part 4A of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits (within the meaning of section 22 of that Act, taken with Schedule 2 and any order under section 22). Within the EU, a deposit-taking bank is a "credit institution" under Article 4(1) of Council Regulation EU/575/2013on prudential requirements for credit institutions and investment firms (the 'Capital Requirements Regulation') [2013] OJ L176/1 ("CRR"), but excluding those entities referred to in Article 2(5) of Council Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms ('Capital Requirements Directive') 2013/36/EU) ("CRD IV") or an investment firm (as defined in Article 4(1) of the CRR).

[5] Financial Stability Board 2012 Thematic Review on Deposit Insurance Systems, 8: "A financial safety net typically consists of prudential regulation and supervision, an emergency lender of last resort, problem bank insolvency frameworks and deposit insurance".

> addressed by lender-of-last resort facilities and measures of prudential regulation… [and] deposit insurance is now mandatory…[and] satisfies claims independently of the insolvency laws."[6]

Whether this policy was correct was put to the test when UK bank Northern Rock experienced financial difficulties as the financial crisis began to unfold.

Northern Rock was a building society which became a bank.[7] As a building society, Northern Rock could only really deal in residential mortgages backed by deposits; as a bank, it had the freedom to undertake more creative ways of financing mortgages through securitisations and inter-bank lending arrangements.[8] And therein lay its downfall. When the interbank lending market dried up in 2007 as the problem of the US sub-prime mortgages began to emerge, Northern Rock was faced with severe liquidity problems: it was struggling to meet its own payment obligations and was not able to access funds on the interbank market to do so. When it became public that Northern Rock had sought emergency liquidity from the UK's central bank, the Bank of England, depositors began to withdraw their deposits, worried that they would lose them.[9] And the reason that depositors were worried that they would lose them was either because they were unaware that there was a depositor protection scheme in place, or, if they were aware that there was a depositor protection scheme in place, they realised that it was a system of co-insurance and they would not get back the full amount of their deposit if the bank collapsed.[10]

The government recognised both the importance of keeping the bank open so that depositors could access their funds, and the danger of allowing the run to continue. The longer the run continued, the greater the reduction in the bank's capital assets - as they were converted to cash to pay customers - and the more damaging the situation for any remaining depositors. To address this, the government issued an emergency guarantee of all deposits to stop the run.[11]

In the immediate aftermath, the government struggled to find a way of dealing with Northern Rock. In the absence of a buyer for the bank, the government was ultimately forced to take it into "temporary public ownership" (otherwise known as nationalisation) under emergency legislation.[12]

The lessons learned

So what had gone wrong? Let us deal first with the question of prudential regulation. Clearly, at some level there had been a failure of prudential regulation: although Northern Rock was acclaimed at the time as a highly successful bank, the light touch regulatory approach in place– which was a deliberate policy

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[6] **Ross Cranston**, Principles of Banking Law, Second Edition (2002) OUP, 18.
[7] Northern Rock Annual Report 1998, 25.
[8] House of Commons Treasury Committee Report, The Run on the Rock, Fifth Report of Session 2007-2008 Vol 1, 12 -13.
[9] House of Commons (n 8)5.
[10] Ibid, Chapter 6.
[11] Ibid, 126.
[12] The Banking (Special Provisions) Act 2008.

to enable banks to get on with running their business and not be held back by red tape - had left depositors exposed.[13] What was also notable was that the capital adequacy rules of Basel II had proved insufficient protection for the bank and it became clear that more work needed to be done on liquidity risk.

The result of this in the UK was that there was a change of regulator. Prudential oversight was taken away from the Financial Services Authority and transferred to the Bank of Englandviaa newly established subsidiary, the Prudential Regulation Authority.The Financial Services Authority was abolished and conduct of business regulation passed to the Financial Conduct Authority.[14]

In addition, at a supra-national level, the Basel Committee introduced Basel III, which included new rules on capital and liquidity requirements, and this was implemented across the EU in the Capital Requirements Regulation and the Capital Requirements Directive.[15]

Let us move on to consider the lender of last resort facilities. Northern Rock had approached the Bank of England for emergency liquidity and it was this request becoming public that acted as the trigger for the bank's failure.[16]For the public, it would have been difficult to distinguish between a short-term liquidity problem due to lack of liquidity in the market place generally and a fully-fledged insolvency of a particular institution. The received wisdom now is that there must be no guarantee that such assistance will be provided.

The third element for consideration is the inadequacy of the UK's deposit guarantee scheme in place at the time. The UK scheme at the time Northern Rock failed was a system of co-insurance, which had been implemented on the basis that an individual depositor "accepted" the risk of depositing their money with a bank on the basis that they might not get it all back.[17]Information asymmetries between depositors and banks made such an argument untenable. Depositors expect banks to look after their money properly and to have 100% of their deposit returned, not merely 100% of the first £2,000 and a percentage of the balance.In the short term, the UKgovernment's emergency guarantee stopped the run on the bank, but subsequently, the EU's deposit guarantee scheme was overhauled.[18]

The final point for consideration was the insolvency regime. In the aftermath of the Northern Rock crisis, there was a political argument made that banks were different to other non-financial companies and needed to have special rules on insolvency.[19] The core bank functions of enabling customers to withdraw deposits and make payments, were seen as being as critical to the

[13] House of Commons (n 8) 34.
[14] Financial Services Act 2012, amending the Financial Services and Markets Act 2000.
[15] EU/575/2013 Capital Requirements Regulation [2013] OJ L176/1 and 2013/36/EU Capital Requirements Directive [2013] OJ L176/388 (CRD IV).
[16] House of Commons (n 8) 5.
[17] Ibid, 89.
[18] 2009/14/EC Deposit Guarantee Scheme Directive [2009] OJ L68/3.
[19] Ibid, 73.

functioning of society as ensuring the water or electricity supply.

Those advocating a special regime for banks cited the benefits of the US Federal Deposit Insurance Corporation (FDIC) model that had been adopted in the US in the aftermath of the Great Depression. The FDIC approach enables early intervention and swift action to be taken in the event of bank failure to ensure that payment services and cash flows and the lives of human beings are not destabilised; this is achieved by transferring – generally, over a weekend – the services of the failing bank to another bank which continues those activities without interruption.[20]

These discussions fed into the development of the UK's Banking Act 2009 and the EU's Bank Recovery and Resolution Directive (the BRRD)[21] which applied to all EU Member States and the Single Resolution Mechanism Regulation (SRM) which only applied to Eurozone countries.[22] The BRRD was important because it set out comprehensive arrangements for banks to provide information to the regulator and to other banks within banking groups, particularly where they operated across borders. Harmonisation within the EU was essential to avoid regulatory arbitrage across Member States, with different regimes being applied in different countries. The enhanced regulatory oversight was designed to enable financial problems to be identified at an early stage so that, if necessary, the regulator could intervene and act before a bank's insolvency became an inevitability.

It is beyond the scope of this paper to discuss the BRRD in detail, but the ambition of the legislation is evident in the following extracts from the Recitals:

> "Whereas:
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> … The financial crisis has shown that there is a significant lack of adequate tools at Union level to deal effectively with unsound or failing credit institutions …. Such tools are needed, in particular, to prevent insolvency or, when insolvency occurs, to minimise negative repercussions by preserving the systemically important functions of the institution concerned. During the crisis, those challenges were a major factor that forced Member States to save institutions using taxpayers' money. The objective of a credible recovery and resolution framework is to obviate the need for such action to the greatest extent possible…"[23]
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> "Effective resolution of institutions or group entities operating across the

[20] For a discussion of the FDIC, see Campbell A and Moffatt P, Protecting Bank Depositors After Cyprus1 NIBLeJ 4.

[21] 2014/59/EU Bank Recovery and Resolution Directive [2014] OJ 2 173/190, now consolidated in: Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/ECPE/48/2019/REV/1 [2019] OJ L150/296.

[22] EU/806/2014 Single Resolution Mechanism [2014] OJ 2 225/1.

[23] BRRD (n 21) Recital 1.

Union requires cooperation among competent authorities and resolution authorities within supervisory and resolution colleges at all the stages covered by this Directive, from the preparation of recovery and resolution plans to the actual resolution of an institution…"[24]

"It is essential that institutions prepare and regularly update recovery plans that set out measures to be taken by those institutions for the restoration of their financial position following a significant deterioration. Such plans should be detailed and based on realistic assumptions applicable in a range of robust and severe scenarios…"[25]

The focus of the new EU legislation was thus on ensuring financial stability and preserving functions, something that had, in fact, been discussed in the period before the failure of Northern Rock.[26]

From this, it can be seen that many lessons were learned from the financial crisis. The following key themes have now been acknowledged and addressed through legislation in the EU and the UK:

- First, the essential requirement of maintainingfinancial stability across the global financial system;
- Second, the preservation of bank functions – the form of an institution is not the critical factor– failing banks could and should go out of business: no bank should be too big to fail. Nevertheless, core banking services, such as payment, settlement and clearing functions must be maintained;
- Third, the importance of early intervention in the event that a bank's financial position begins to deteriorate;
- Fourth, the importance of bank regulators having a clear understanding of the capital and liquidity position of the banks they regulate through enhanced monitoring;and
- Fifth, that taxpayers should not subsidise banks through bail outs.

The table annexed to this papersummarises some of the most important legislative changes that have been made to improve the financial sector safety net since Northern Rock failed and serves to illustrate just how much work has been done in the UK and the EU to prevent future crises.[27]

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[24] BRRD (n 21) Recital 17.

[25] BRRD (n 21) Recital 21.

[26] **Eva Hupkes** Protect Functions, Not Institutions (2004) 9 Financial Regulator 43; 'Form follows function – a new architecture for regulating and resolving global financial institutions', European Business Organization Law Review Vol 10 Issue 3 Sept 2009, 369.

[27] As has already been mentioned, it is beyond the scope of this paper to provide anything other than an overview of this vast topic on which much ink has been spilt. There are some excellent texts providing an in depth consideration of the legislative changes that have taken place post-crisis including (from a UK perspective) *Principles of Banking Law*by Ross Cranston and others, OUP(2017), *Debt Restructuring*by Olivares-Caminal, R., Douglas, J., Guynn, R., Kornberg, A., Paterson, S. and Singh, D., 2nd Ed OUP (2016) (which considers the restructuring of companies, financial institutions and sovereign entities from a UK, EU and US perspective); and *EU Banking and Insurance Insolvency,*.Eds Moss, G., Wessels, B. and Haentjens, M., 2nd Ed

Where are we now?

At the beginning of this paper, I said that I would examine Mark Carney's comment from 2014in which he suggested that, in future, "Globally systemic banks that fail will … be resolved without recourse to the taxpayer and without jeopardising financial stability".[28]

A critical factor here is that Mark Carney referred to *globally* systemic banks – whether the same can be said for *national* banks, remains to be seen.[29]

As Professor Campbell and I recently observed, this statement was put to the test in 2016, when the Italian Bank Monte deiPaschi di Siena was given €5 million by the Italian government to prevent its failure.[30]So bail outs have not gone away.

Having said that, the stress tests that have been conducted in the UK by the Bank of England and by the EU all indicate that UK and EU banks are much better placed to face the next financial crisis than they were when the last one came along.

The 2018 Bank of England stress test results have specifically modelled the "Resilience of the UK financial system to Brexit" and the Financial Policy Committee has concluded that:

> "the UK banking system is strong enough to continue to serve UK households and businesses even in the event of a disorderly [i.e. no deal] Brexit".[31]

Similarly, the European Banking Authority is positive:

> "The aggregate capital ratio at the starting point of the 2018 stress test is notably above the aggregate capital ratio reported by banks at the beginning of previous EU-wide exercises, an evolution that reflects a continuous and significant strengthening of the capital position by major EU banks since the end of 2010". [32]

But is this legislation future proof?

Nevertheless, as I said at the beginning of this lecture, the world in 2019 is a very different place from ten years ago. And, as Professor Ghazinyan said at the beginning of this conference, one of the things we are doing today is asking questions that we are not necessarily going to answer! So here are some of mine.

We have introduced banking regulation for a world in which intermediation is the norm and in which money flows through banks. But is this the reality of our future? Cryptocurrencies such as Bitcoin rely on block chain technology which directly connects users, so bypassing intermediaries. If financial transac-

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OUP (2017) (which considers the EU perspective).

[28] **Mark Carney**, "The future of financial reform", 17 November 2014. Available at www.bankofengland.co.uk/publications.

[29] As Sir John Vickers pointed out in his response to the House of Lords Economic Affairs Committee on 30 June 2015 at approximately 16.28.

[30] **Paula Moffatt** and **Andrew Campbell**, The introduction of ring-fencing in the UK: an example to be followed? // Journal of Business Law [2019] JBL, 241

[31] Bank of England Financial Stability Report November 2018 Issue 44, i.

[32] European Banking Authority 2018 EU-Wide Stress Test Results November 2018, p. 8.

tions are conducted through entities other than banks, then money flows are redirected through a system that is not regulated in the way that a deposit-taking bank is. This raises a whole number of questions not merely of financial regulation, but also of general regulation: the opportunities for the unscrupulous to separate ordinary citizens from their hard-earned cash become so much easier and the law has yet to catch up.[33]

And finally, much work has been done within the UK and the EU to ensure that, in the event of a cross-border crisis banks in different jurisdictions will co-operate with each other and with the relevant regulators to preserve financial stability and limit the damage to the financial system, to depositors and to the taxpayer. The aspiration to do the right thing and to work collaboratively is set out in the BRRD. But there is a political element to doing the right thing that depends upon consensus amongst leaders; if such consensus is absent, it will be much more difficult to deal effectively with a future financial crisis.

Key words: *financial crisis, insolvency, Northern Rock bank, financial stability*

ՊՈԼԱ ՄՈՖԱԹԹ – ***Համաշխարհային ֆինանսական ճգնաժամից տասը տարի անց. անվճարունակ ֆինանսական ինստիտուտների իրավական վիճակը Միացյալ Թագավորությունում և ԵՄ-ում*** – 2009 թ. միջազգային ֆինանսական ճգնաժամը հասավ իր գագաթնակետին: Միացյալ Թագավորությունում ծանր վիճակում հայտնվեց «Նորթերն Ռոկ բանկը»: Հիմք ընդունելով այդ բանկի օրինակը՝ հոդվածում քննարկման առարկա են դարձել ֆինանսական հատվածի անվտանգության խնդիրները և դրանց առնչությամբ առկա օրենսդրական կարգավորումները Միացյալ Թագավորությունում և ԵՄ-ում: Վերլուծվում են իրավական կարգավորման կառուցակարգի արդյունավետությունը, բանկերի առջև ծառացած մարտահրավերները, ինչպես նաև ապագայում դրանց անկումից ապահովագրված լինելու հարցը:

Բանալի բառեր – *ֆինանսական ճգնաժամ, անվճարունակություն, «Նորթերն Ռոկ բանկ», ֆինանսական կայունություն*

ПОЛА МОФФАТТ – *Десять лет глобального финансового кризиса: правовое положение неплатежеспособных финансовых институтов в Соединенном Королевстве и ЕС.* – 2009г. в мире финансовый кризис достиг своего пика. В Соединенном Королевстве лопнул банк Northern Rock, многие банки как в Соединенном Королевстве, так и ряде стран ЕС борются за выживание. На примере банка Northern Rock проанализированы проблемы безопасности финансового сектора и законодательные регулирования в Соединенном Королевстве и странах ЕС. В статье рассмотрены вопросы эффективности механизма правового регулирования, вызовы, стоящие перед банками, а также возможности гарантирования их финансовой безопасности в будущем.

Ключевые слова: *финансовый кризис, неплатежеспособность, банк Northern Rock, финансовая стабильность*

[33] For an excellent discussion of this, see PhilippPaech'The Governance of Blockchain Networks' LSE Law Society and Economy Working Papers 16/2017.