EXPLANATORY MEMORANDUM TO

THE BANK INSOLVENCY (SCOTLAND) RULES 2009

2009 No. 351

1. This explanatory memorandum has been prepared by Her Majesty's Treasury and is laid before Parliament by Command of Her Majesty. This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 The instrument introduces rules, in relation to Scotland, for the bank insolvency procedure set out in Part 2 of the Banking Act 2009 ("the Act").

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 Because of the unique circumstances surrounding the instrument, it has not in this case been possible to comply with the 21-day rule and the instrument will commence on 25 February.

3.2 The Act replaces the powers to resolve failing banks conferred by the Banking (Special Provisions) Act 2008. The operative provisions of that Act cease to be exercisable on 21 February 2009. Given the current financial instability, it is vital that powers to resolve failing banks and certain other financial institutions continue to be available and that there is no period of time where such powers cannot be exercised effectively.

3.3 The Banking Act 2009 received Royal Assent on 12 February 2009. It is necessary for this statutory instrument to be in force as soon as possible after 21 February (when the enabling power to make the rules comes into force) to enable Part 2 of the Act to be exercised in an effective manner, if required.

4. Legislative Context

4.1 The instrument is made by the Treasury under section 411(1A)(b) of the Insolvency Act 1986 as introduced by section 125 of the Act to make rules to give effect to the bank insolvency procedure.

4.2 Part 2 of the Act provides for a modified insolvency procedure for banks as defined in section 91 of that Act, which may be used as an alternative to the corporate insolvency processes set out in the Insolvency Act 1986.

4.3 The bank insolvency procedure is based, with modifications where required, on the provisions for winding up companies set out in Part 4 of the Insolvency Act 1986.

4.4 These rules give effect to that procedure and are based, with necessary modifications, on the rules set out in Part 4 of the Insolvency Rules 1986;. These rules largely follow the order of the Insolvency (Scotland) Rules 1986.

5. Territorial Extent and Application

5.1 This instrument applies to Scotland.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 Part 2 of the Act introduces a new insolvency procedure for banks as defined in section 91 of that Act. The procedure is based on the process of compulsory liquidation set out in Part 4 of the Insolvency Act 1986.

7.2 These rules will allow the bank insolvency procedure to work in practice in a similar way to which the rules in Part 4 of the Insolvency (Scotland) Rules 1986 give effect to the process of liquidation.

7.3 Many of the existing rules for the process of liquidation have been applied to the bank insolvency procedure with little or no modification; although because the process has certain unique features, particularly in the way that it is commenced, the role of the bank liquidator, and as a result of the specific objectives set out section in 99, new rules and changes have been introduced where required.

7.4 The principle policy aims of the bank insolvency procedure are to ensure that where a bank fails, insolvency proceedings can be commenced quickly, and the interests of depositors entitled to payments from the Financial Services Compensation Scheme ("FSCS") are protected. To facilitate this, the process can only be commenced by the court on an application by the Bank of England, the Financial Services Authority ("FSA") or the Secretary of State; only an insolvency practitioner can be appointed as bank liquidator and he or she will have unique statutory objectives.

7.5 In order to prevent a bank 'run' and to preserve the assets of a bank, the rules modify the process of applying for an insolvency order so that a court hearing can be held promptly.

7.6 In keeping with other special insolvency regimes, only a duly qualified insolvency practitioner (nominated by the applicant) may be appointed as bank liquidator since it is considered that only he or she will have the necessary skills and experience to wind up the affairs of a failed bank in the best interests of creditors.

7.7 The first objective of the procedure is for the bank liquidator to work with the FSCS to ensure that either the accounts of eligible depositors are transferred to another financial institution quickly or that prompt compensation payouts are made by the FSCS. To assist in achieving this, the Bank of England, the FSA and the FSCS must form an initial liquidation committee that will work with and oversee the bank liquidator.

7.8 Once the first objective has been achieved, it will be left to creditors to decide whether to continue with a liquidation committee and the winding up will continue in much the same way as an ordinary liquidation with the bank liquidator seeking to achieve the best result for its creditors.

7.9 Many of the new and amended rules for the bank insolvency procedure reflect the changes outlined above, in addition the rules provide for some amendments to the calculation of set-off in respect of the claims of eligible depositors only, although any changes will not come into effect until such time as the FSCS may move to gross compensation payments.

7.10 The FSA is currently consulting on changes to the financial compensation scheme to facilitate fast payments. At present the scheme operates on a net basis which means that any debts owed by a customer to a failed bank would be taken into consideration in calculating whether any compensation is due.

7.11 Under the Financial Services and Markets Act 2000, where the FSCS pays out on an insolvency, in stands in the shoes of the creditors it compensates and ranks as an unsecured creditor for dividend purposes alongside the claims of other such creditors.

7.12 Among other changes, the FSA is considering whether it would be more appropriate for the scheme to pay out on a gross basis. If this change is introduced, it would mean that any debts owed by a customer to a failed bank would be ignored for the purposes of calculating compensation; compensation would therefore be calculated only by reference to any positive balances held by a customer.

7.13 In Scotland, rights of set-off in an ordinary liquidation arise under common law and these will apply equally to bank insolvency.

7.14 In order to future-proof this instrument, if the FSA change their rules so that the FSCS pay out on a gross basis, rule 30 provides for a different way of determining set-off in respect of the claims of eligible depositors. In effect, set-off will not apply in the case of eligible depositors up to the limits of the compensation scheme. This will again ensure that the rules on bank insolvency and for the compensation scheme are similarly aligned to operate on a gross basis. Where an eligible depositor who also owes monies to a failed bank has an account balance (or balances) in excess of the limits of the compensation scheme, set-off will still apply as normal in respect of those amounts to determine whether that person is a net debtor or creditor in the bank insolvency.

7.15 These amendments will only apply to the determination of the claims of eligible depositors and will not apply in respect of the claims of other creditors to whom the existing rules on set-off will apply.

7.16 The instrument has been drafted based on the underlying format of relevant provisions of the Insolvency (Scotland) Rules 1986, in particular Part 4 of those Rules. It is acknowledged that the general format of the instrument is stylistically different to that taken for the Bank Administration (Scotland) Rules which are being introduced at the same time to give effect to the procedure of bank administration set out in Part 3 of the Act. The differences in style largely stem from the differences in the style of the underlying legislation of the Insolvency Act on which the two schemes are based - the compulsory liquidation provisions in the Insolvency Act 1986 versus the administration procedure set out in Schedule B1 to that Act, however it must be acknowledged that differences also arise from the reduced timescales that have been available to put the necessary Rules in place from the commencement of Parts 2 and 3 of the Act. These differences do not alter the legal effect of these rules.

8. Consultation outcome

8.1 Due to the need to implement this instrument promptly to coincide with the coming into effect of the Act on the expiry of the expiry of the Banking (Special Provisions) Act 2008, no public consultation was carried out; though drafts of the instrument were consulted on with Lord President's Office.

9. Guidance

9.1 No guidance is being issued on the instrument since it is largely based on existing insolvency rules and practice which will be familiar to insolvency practitioners and their advisers.

10. Impact

10.1 The bank insolvency procedure set out in Part 2 of the Act may only be instituted against a bank as defined in section 91 of the Act so it cannot be used in relation to other businesses, charities or voluntary bodies.

10.2 The Financial Services Authority are currently consulting on possible changes to the financial compensation scheme including the possibility of moving to gross payout.

10.3 The Bank of England and the Financial Services Authority will have an important role in the initial stages of a bank insolvency. Part 2 of the Act and these Rules have been developed in consultation with those bodies.

10.4 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

11.1 The bank insolvency procedure set out in Part 2 of the Act may only be instituted against a bank as defined in section 91 of the Act.

12. Monitoring & review

12.1 The bank insolvency procedure to which this instrument gives effect, is part of the new special resolution regime for banks introduced by Part 1 of the Act. The Banking Liaison Panel created in accordance with section 10 of the Act will monitor the impact of the special resolution regime.

13. Contact

Lucy French at HM Treasury, Tel: 020 7270 4479 or email: lucy.french@hm-treasury.x.gsi.gov.uk, can answer any queries regarding the instrument.