DECEMBER 2007

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 118 – BUILDING SOCIETY AND INCORPORATED FRIENDLY SOCIETY SET-OFF

Proposal for a Mandatory Insolvency Set-Off Rule applicable to Building Societies and Incorporated Friendly Societies

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FINANCIAL MARKETS LAW COMMITTEE

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1. Introduction and Executive Summary

1.1 The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. This paper is intended to address an apparently inadvertent, but potentially serious, lacuna in the law of insolvency set-off as it relates to building societies and incorporated friendly societies (collectively "Societies").

1.2 Insolvency set-off as it applies to companies is governed by the Insolvency Rules 1986 ("Insolvency Rules" or "Rules"). Those Rules do not, however, apply to Societies. The result is that the mandatory insolvency set-off rules contained within those Rules do not apply in situations where Societies collapse. No analogous rules have been enacted in order to cover Societies and this introduces uncertainty to financial markets, in that participants in those markets are unable accurately to analyse fully the credit risk when dealing with Societies as counterparties.

1.3 As far as the FMLC can determine, the lack of a complete statutory framework for set-off in relation to the winding up of Societies is a mere oversight. This paper concludes that there are real reasons for correcting this oversight. It further contends that such correction can and should be achieved without recourse to primary legislation.

1.4 As set out in sections 5 and 6, below, the FMLC is of the view that the rule-making powers granted by Schedule 15 para 58(1) of the Building Societies Act 1986 (the "BSA") and Schedule 10 para 69(1) of the Friendly Societies Act 1992 (the "FSA 1992") ought to be exercised in order to put in place a set-off provision analogous to that set out in rule 4.90 of the Insolvency Rules, but applicable to Societies.[1] Various other mechanisms that the FMLC considers

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[1] The set-off provisions contained in rule 2.85 of the Insolvency Rules are not directly relevant in the context of this paper, as the administration of a building society would be conducted under the pre-Enterprise Act administration regime (see section 249 of the Enterprise Act 2002) and therefore rule 2.85 would not apply. In the case of friendly societies, for which administration is not available, rule 2.85 would similarly not apply.

ought to be introduced into the insolvency regime for Societies, in order to ensure that such set-off provisions operate effectively, are also discussed.

2. Background – Building Societies and Friendly Societies

Building Societies

2.1 The term "building society" first arose in the 19th century from working men's co-operative savings groups: by pooling savings, members could buy or build their own homes. Most of the original building societies were fully terminating, in that they would be dissolved when all members had a house.[2] In the 1830s and 1840s, there began to emerge permanent building societies that were continued on a rolling basis, taking on new members as earlier ones completed purchases.

2.2 In the 1980s, UK banking laws were amended so as to allow building societies to offer banking services equivalent to banks. Modern building societies are incorporated (or deemed incorporated) and registered under the BSA, which regulates their operation. The Financial Services and Markets Act 2000 ("FSMA") conferred responsibility for the regulation and supervision of building societies upon the Financial Services Authority (the "FSA"). Many building societies are authorised to conduct financial services business under FSMA and their details are included on the FSA Register.[3]

2.3 Building societies are, these days, complex institutions which, amongst other things, engage in complex financial markets transactions. They are major financial players. For example, the 59 UK building societies hold total assets of £315bn,[4] and include such major institutions as Nationwide and Britannia. Those 59 societies hold £215bn of mortgage assets[5] and, in 2006, were responsible for 18.5% of net mortgage lending in the UK.[6] Their importance to the UK banking sector is illustrated by the participation by many of the larger

[2] The last of the fully terminating building societies was wound up in 1980
[3] The FSA Register is a public record of financial services firms, individuals and other bodies which fall or have come under the FSA's regulatory jurisdiction as defined in FSMA.
[4] Source: Building Societies Association
[5] Source: Building Societies Association
[6] FSA Building Societies Statistics 2007

building societies in the Reserves Scheme and Standing Facilities operated by the Bank of England as part of its Sterling money market operations.[7]

Friendly Societies

2.4 A friendly society is a voluntary organisation comprised of people who have joined together for a common financial or social purpose. Friendly societies are typically authorised to provide their members with a wide range of savings and investment services as well as carrying out contracts of insurance. There is suggestion that friendly societies may have their origins in Roman times.[8] Friendly societies flourished in the time before the Welfare State and modern forms of insurance. They grew as a form of collective responsibility and as a solution to the financial problems faced when breadwinners became ill or died, leaving bereaved families with few resources. Members of friendly societies contributed a small monthly sum which was collected and invested or saved. The friendly society would then pay out money to its members in certain circumstances, for example, upon suffering from sickness, becoming unemployed and upon death (for funeral expenses).

2.5 Modern friendly societies can have memberships approaching 2m[9] and assets of almost £6.5bn.[10] Total net assets held by members of the Association of Friendly Societies on 31 December 2005 was £16bn.[11]

2.6 As with building societies, FSMA conferred responsibility for the regulation and supervision of friendly societies upon the FSA. The FSA defines friendly societies as *"a voluntary mutual organisation whose main purpose is to assist members (usually financially) during sickness, unemployment or retirement, and to provide life assurance"*.[12] Some friendly societies are authorised to conduct financial services business under FSMA and the details of these friendly societies are also included on the FSA Register, as referred to above.

[7] See http://www.bankofengland.co.uk/markets/money/reserves/index.htm and http://www.bankofengland.co.uk/markets/money/sf/index.htm

[8] Safety In Numbers by Tessa Morrison, credits the earliest recorded society as The Hornblowers a mutual club founded in 203 AD whose members were legionary officers of the Roman garrison. Monthly contributions were collected and payments were made on promotion, transfer, becoming a veteran and death. The Friendly Societies Commission Fact Sheet February 1999 states the origins of friendly societies date back to associations in the Roman Empire known as "*collegia*" which were formed for a variety of purposes including payment of member's burial expenses.

[9] Royal Liver Association has 1.9m members. Source: The Association of Friendly Societies

[10] Liverpool Victoria Friendly Society has assets of £6,477,600,000. Source: The Association of Friendly Societies

[11] Source: The Association of Friendly Societies

[12] http://www.fsa.gov.uk/Pages/Doing/small_firms/friendly/index.shtml

2.7 There exist a number of forms of friendly society:

(i) Unregistered friendly societies;

(ii) Registered friendly societies (registered under the Friendly Societies Act 1974); and

(iii) Incorporated friendly societies (incorporated under the FSA 1992).

While the legislative lacuna identified below exists in relation to all three forms of friendly society, incorporated friendly societies are the most important as far as the financial markets are concerned. They are entitled to undertake additional business over and above that permitted to the other forms of friendly society (such business including making loans out of a separate loan fund, setting up funds for the purpose of purchasing government securities, investing in housing associations etc. – see section 7 of and Schedule 5 to the FSA 1992). All of the top ten friendly societies (ranked by total net assets[13]) are incorporated under the FSA 1992. Furthermore, the FSA 1992 itself mandates that all new friendly societies be incorporated under that Act. For these reasons (and because the power to make insolvency rules provided by Schedule 10 para 69(1) of the FSA 1992 applies only in relation to incorporated friendly societies), the remainder of this paper addresses only incorporated friendly societies.

3. The legislative lacuna and its practical implications

The 'legislative lacuna'

3.1 The BSA provides a specific insolvency regime for building societies, which is set out in Part X of the BSA and in Schedules 15 and 15A to the BSA. Those provisions apply parts of the Insolvency Act 1986 (the "Insolvency Act") to building societies with certain modifications, and allow for the possibility of a voluntary winding up, winding up by the court, voluntary arrangement or administration of a building society.

[13] Source: The Association of Friendly Societies (statistics are for the year ended 31 December 2005).

3.2 Similarly, the FSA 1992 provides a specific regime for incorporated friendly societies, which is set out in Part II of and Schedule 10 to the 1992 Act. The relevant provisions apply parts of the Insolvency Act to incorporated friendly societies with certain modifications, and allow for the possibility of a voluntary winding up or a winding up by the court.

3.3 Significantly, though, the Insolvency Rules do not apply to Societies, and therefore, the mandatory set-off provisions in rule 4.90 do not apply to those institutions. In relation to building societies, Schedule 15 para 58(1) to the BSA provides that *"[r]ules may be made under section 411 of the Insolvency Act [1986] for the purpose of giving effect, in relation to building societies, to the provisions of the applicable winding up legislation"*. In relation to incorporated friendly societies, Schedule 10 para 69(1) of the FSA 1992 provides that *""[r]ules may be made under ... section 411 of the Insolvency Act [1986] ... for the purpose of giving effect, in relation to incorporated friendly societies, to the provisions of the applicable winding up legislation"*.

3.4 It has been suggested to the FMLC that the principal reason for not applying the corporate Insolvency Rules to Societies was simply that the mutual nature of these organisations necessitated too many changes to those Rules and that self-standing appropriately adapted rules were considered preferable as a technical matter. However, no separate set of rules has been promulgated under either Schedule 15 para 59(1) to the BSA or Schedule 10 para 69(1) of the FSA 1992 and it is not clear why this is so.

3.5 Unfortunately, there is no general provision of the Insolvency Act that can be construed as applying insolvency set-off by implication. By way of contrast, the *pari passu* principle in the case of a compulsory winding up, which is set out in Rule 4.181 of the Insolvency Rules and therefore does not directly apply to Societies for the reason mentioned above, could be said nonetheless to apply by implication since it merely confirms the general position under section 143 of the Insolvency Act, which does directly apply to Societies.

3.6 The FMLC understands that, since 1986, some market participants have made regular periodic enquiries of the Lord Chancellor's Department (now the

Ministry of Justice), the Insolvency Rules Committee, the Building Societies Commission (now the FSA), the Department of Trade and Industry (now the Department for Business, Enterprise and Regulatory Reform) and the Insolvency Service (because of uncertainty as to where, as an administrative matter, responsibility for preparing these rules lay) as to the status of preparation of insolvency rules for building societies. Although little concrete information was yielded by these enquiries, market participants were apparently never told that there was no intention of introducing such rules. To the contrary, at least for the first few years after 1986, market participants were led to believe that such rules were at an early stage of preparation (generally, it was thought, initial responsibility rested with the DTI (as it was then called) or the Insolvency Service).

3.7 Prior to the repeal of the Building Societies Act 1962 by the BSA, insolvency set-off applied to the winding up of a building society by virtue of section 103 of the Building Societies Act 1962, which referred to the winding up of a building society under the Companies Act 1948, which itself incorporated a set-off provision by reference to the Bankruptcy Act 1914.[14] It seems a fair presumption, therefore, that had insolvency rules for building societies been introduced as contemplated by Schedule 15 para 59(1) to the BSA, they would have included an insolvency set-off rule comparable to rule 4.90 of the Insolvency Rules.

3.8 It may be that the lack of priority accorded to preparation of insolvency rules for Societies is attributable to the perception that the likelihood of a Society being allowed to fail is low. For instance, the most recent failure of a building society occurred in 1911.[15] In practice, a troubled Society may be absorbed by a healthy Society to avoid such a failure, as happened in 1978 in the case of the Grays Building Society. Various provisions of the BSA and the FSA 1992 are intended to facilitate such a result in those circumstances.

[14] See s.317 Companies Act 1948 and s.31 of Bankruptcy Act 1914. It is the combined effect of these two provisions that is now achieved (in respect of insolvent companies) by rule 4.90 of the Insolvency Rules (see, for instance, *Re Maxwell Communications Corp plc (No 2)* [1994] 1 All ER 737, 743).

[15] Birkbeck Building Society. Incidentally, that society was wound up under the Companies (Consolidation) Act 1908, s.207 of which was equivalent to s.317 Companies Act 1948. It follows that an insolvency set-off rule applied to building societies at the time.

3.9 Nonetheless, the market is still left with the statutory "gap" that there is currently no mandatory insolvency set-off rule for Societies, in contrast to the position for companies generally (even an unregistered company - for example, a statutory corporation - wound up under section 221 of the Insolvency Act would be subject to mandatory insolvency set-off as the Insolvency Rules would apply in those circumstances). Given the importance of set-off in English insolvency law, both practically and as a matter of policy,[16] this is considered to be an unsatisfactory state of affairs, especially in light of the recent financial crisis and the near failure of the ex-building society, Northern Rock plc.

Practical Implications for the financial markets

3.10 Societies are active in the wholesale financial markets and hold mutual debts with banks. Further, they issue a significant amount of debt under MTN programmes and more structured products. It is not unusual for investors who are “negatively exposed” to a Society (that is, who owe money to the Society under a loan or are “out of the money” on a net basis under a financial market master netting agreement with the Society) to buy the debt of the Society as a liability hedge.

3.11 In practice, in financial market master netting agreements with Societies, the absence of a mandatory insolvency set-off rule for those entities is addressed by a combination of flawed asset and contractual set-off provisions. In fact, such provisions are also used by market participants when dealing with banks and other companies, so in that sense market documentation practice is not disturbed by the lack of an insolvency set-off provision.

3.12 Nonetheless, while there is relatively robust judicial support for the flawed asset approach, market participants draw substantial additional comfort, when dealing with Companies Act companies, for example, from the additional buttress of mandatory set-off under rule 4.90.

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[16] The importance of set-off is illustrated by *In re Bank of Credit and Commerce International S.A. (No.10)* [1997] Ch. 213, where Sir Richard Scott V.C. observed (at page 246) that rule 4.90 of the Insolvency Rules was a substantive rule of English law and not merely a procedural matter. The Vice-Chancellor made directions in that case that ensured English creditors continued to benefit from the set-off provisions of rule 4.90 in a cross-border insolvency.

3.13 Where a transaction entered into with a Society is a "financial collateral arrangement" within the terms of the Financial Collateral Arrangements (No.2) Regulations 2003 ("the Regulations"), the provisions for close-out netting in the transaction will be protected by Regulation 12 of the Regulations.

3.14 For banks and other financial institutions supervised by the FSA, an additional practical issue, of course, is the availability of regulatory capital relief as a result of the recognition of close-out netting under the regulatory capital rules of the FSA Handbook. Such relief is only available, in relation to the regulatory capital that a bank must allocate to its exposure to a specific market counterparty, where there is adequate comfort in the form of a robust legal opinion that close-out netting is effective against that market counterparty.

3.15 In the case of a Companies Act company, market participants are able to rely on legal opinions that rely on both the flawed asset and insolvency set-off "pillars" while, in the case of a building society, such opinions generally rely on the flawed asset analysis alone.

3.16 While there are other forms of set-off available under English law, in particular, equitable set-off and procedural set-off, these forms of set-off are too narrow to form a sufficient basis for a close-out netting or financial collateral arrangement. The fact that rule 4.90[17] is available in the event of the insolvency of a bank, but not in the event of the insolvency of a Society, is anomalous.

3.17 The FMLC acknowledges that the failure of a major Society is unlikely to occur. However, it should be acknowledged that such a failure in the context of the current legal framework could have a host of unforeseen consequences. Furthermore, the uncertainty surrounding the insolvency regime as it relates to Societies would encourage applicants to waste court time and costs by making what turn out to be unmeritorious and legally unfounded applications (see, for instance, paragraph 4.7 below).

[17] For an example of a recent case where the availability of such a right was relied upon in relation to an insolvent bank (albeit unsuccessfully on the facts), see *Re Bank of Credit and Commerce International SA* (No 8) [1997] 4 All ER 568

3.18 Even if no failure actually occurs, the financial markets are impacted negatively by the current state of the law because participants in those markets are unable to analyse accurately and fully their credit risk when dealing with Societies as counterparties.

3.19 Finally, a further practical impact of the lacuna is that depositors who owed money to a failing Society would, absent contractual or some other form of set-off, be required to pay this amount to the liquidator/administrator and would be, as against sums that they had deposited, unable to exercise insolvency set-off in relation to this amount. This is clearly an unfair result and is one that would surely elicit a surprised reaction from most Society depositors.

4. The current regime governing Societies

The insolvency regime relating to Societies

4.1 The insolvency proceedings to which Societies may currently be subject are set out in Part X of, and Schedules 15 and 15A to, the BSA (building societies) and Part II of, and Schedule 10 to, the FSA 1992 (incorporated friendly societies). These apply parts of the Insolvency Act to Societies with certain modifications. The proceedings include the following:

(a) voluntary arrangements (building societies only);[18]

(b) receivership (building societies only);[19]

(c) administration (building societies only);[20]

(d) voluntary winding up; and

(e) compulsory winding up.

[18] Section 1(A) of the Insolvency Act (moratorium) does not apply to building societies.
[19] A building society cannot be subject to administrative receivership as section 9B(1) of the BSA prevents the creation of floating charges by building societies.
[20] Section 249 of the Enterprise Act 2002 preserves the application of the former (pre-15 September 2003) administration regime to building societies.

4.2 The better view is that schemes of arrangement under section 425 of the Companies Act 1985 (that are often used in the restructuring of insolvent companies) are not available to Societies.

4.3 In addition, there are certain provisions of English insolvency law that either do not apply or apply with certain modifications to Societies. The most significant of these are as follows:

(a) Section 74 of the Insolvency Act (Liability as contributories of present and past members) applies to Societies in determining the liability of members to contribute, but the reference to past members does not apply. The definition of 'contributory' in section 79 of the Insolvency Act does not apply, but this term is defined in Schedule 15 para 9(2) to the BSA (in relation to building societies) and Schedule 10 para 9(2) to the FSA 1992 (in relation to incorporated friendly societies);

(b) Section 423 (Transactions defrauding creditors) of the Insolvency Act does not apply to Societies;

(c) Section 426 (Co-operation between courts exercising jurisdiction in relation to insolvency) of the Insolvency Act does not apply to Societies;

(d) The Cross-Border Insolvency Regulations 2006 do not apply to Societies;[21] and

(e) As discussed above, the Insolvency Rules do not apply to Societies.

Set-off

4.4 As set out above, there is no express statutory provision for an automatic, mandatory insolvency set-off applicable to Societies. In the case of liquidation, rule 4.90 of the Insolvency Rules has no direct application because no

[21] In theory the Cross-Border Insolvency Regulations 2006 may apply where a friendly society does not have FSMA permission to carry out contracts of insurance, although this would be relatively unusual

provision of those Rules has been made to apply to Societies. In the case of administration of building societies, no provision for the Insolvency Rules to apply has been made, and even if there was such a provision, rule 2.85 of those Rules has no application because building societies are subject to the former (pre-15 September 2003) administration regime, the applicable rules for that regime having no equivalent of rule 2.85. There is no administration regime applicable to friendly societies.

4.5 In the absence of express statutory provisions for insolvency set-off, the following set-off mechanisms appear relevant to a Society insolvency:

(a) a 'close-out netting provision' within the Regulations will remain applicable after a Society insolvency;

(b) leaving aside the Regulations, it has been suggested that the following forms of set-off may apply:

(i) contractual set-off and equitable set-off will remain applicable after a Society insolvency, subject to a possible challenge under the principle against divestiture and section 127 of the Insolvency Act; or

(ii) after a Society liquidation, the court may apply by analogy the operation of rule 4.90 of the Insolvency Rules.

Missing insolvency rules

4.6 The fact that the powers to "make rules" under Schedule 15 para 58(1) of the BSA and Schedule 10 para 69(1) of the FSA 1992 have not been exercised causes a problem on two levels – first, the bespoke insolvency rules that were envisaged by the primary legislation have not been made. Second, the fact that bespoke rules were expressly envisaged casts doubt on how (or indeed whether) a court should infer that the general insolvency rules apply to a Society insolvency.

4.7 The above comment regarding the absence of insolvency set-off rules is only one aspect of the current deficiency. In many areas, there is significant uncertainty which is likely to result in multiple applications to court for directions. For example, without a court order, one does not know the definition of debts, debt-proving mechanisms, creditors' meetings and other procedural matters.

4.8 Further, not only does the absence of insolvency rules render the insolvency proceedings uncertain, it also throws into doubt how one commences the insolvency proceedings in first place. For example, a creditor intending to make a winding-up petition will not know what rules he has to comply with, such as the form and content of the petition and the advertisement requirements.

4.9 There is a risk that the uncertainty is so significant that it would require rapid secondary legislation to fill the gap.

4.10 In the absence of legislation, it is likely that the Court would need to resolve the various questions that would arise in relation to the insolvency of a Society, such as how one commences the insolvency proceedings in the first place, by giving directions. These directions would be expected to follow closely the provisions of the Insolvency Rules and might include a direction equivalent to rule 4.90. However, such a makeshift solution may not be able to resolve all the potential issues in relation to set-off, to the extent providing for set-off may be characterised as affecting substantive rights of creditors as opposed to merely a procedural process relating to the calculation of a creditor's claim in the estate of an insolvent Society.

5. Machinery required for the operation of a set-off provision applicable to Societies

Why additional provisions are required

5.1 The statutory provisions relating to set-off for companies contained in the Insolvency Rules sit with a number of other provisions that lay down a machinery for the proof of a creditor's claim in the insolvency of the company, together with rules for the quantification of the creditor's claim. Should it be decided, as the FMLC considers it should, that a set-off provision is to be enacted for Societies, it will also be necessary to consider what additional machinery for proof and quantification of debts should go alongside such a provision to ensure that it works in practice.

5.2 At the outset, it should be noted that this additional machinery is very important in the context of the conduct of an insolvency more generally. It provides for a clear and certain regime for creditors to establish what they are owed by the insolvent debtor. Therefore, although such provisions may be thought of as merely rules of evidence or calculation rather than fundamental statements of parties' rights (unlike set-off), they are nevertheless crucial provisions and as such would be needed in some form or other in the insolvency of a Society. If they were not provided for in a statutory context, it would be necessary to have reference to such rules in some other way.

5.3 In addition to their utility in the insolvency of a Society generally, reference to the concepts contained in such provisions would also be necessary to make a set-off provision work. Particularly in a financial markets context, currency conversion and discounting of future debts would be crucial. For a set-off provision to operate effectively, quantification of a debt taking into account these factors is necessary. Set-off can then be applied to the mutual credits properly valued according to certain and easily ascertainable rules.

Summary of the relevant provisions

5.4 In the context of a liquidation, the relevant provisions that sit alongside the provision for set-off can be found in Chapter 9 of Part 4 of the Insolvency

Rules, which lays out the procedure for proving a debt in a liquidation and the quantification of a claim. These provisions are briefly summarised below.

5.5 In relation to the procedure for proving a debt, broadly the provisions address the following areas:

1. the procedure for lodging proofs, including a provision in relation to the meaning of "prove";
2. the cost of proving;
3. the duties of liquidators in relation to proofs; and
4. decisions in relation to proofs.

5.6 In relation to the quantification of a claim, in addition to set-off, the provisions address the following areas:

1. a permission for the liquidator to estimate debts subject to a contingency or that do not bear a certain value;
2. the treatment of secured creditors;
3. the treatment of debts in a foreign currency;
4. the treatment of periodic payments;
5. the treatment of interest; and
6. the treatment of debts payable at a future time.

Proving for a debt

5.7 Rule 4.73 of the Insolvency Rules sets out the meaning of "prove"; the rule requires a creditor to submit his claim in writing to the liquidator and states that a creditor who claims is referred to as "proving" for his debt. The concept of proving for a debt that is established in this provision is then used throughout this section of the Insolvency Rules, including in relation to the provision for set-off.

5.8 Although the concept of proving for a debt is an important one in the context of an insolvency, the FMLC does not consider it is necessary to introduce this concept (together with the other rules relating to proving for a debt) alongside a provision for set-off for Societies. Instead, the FMLC considers that reliance can be placed instead on common concepts of when a debt is claimed from or established or accepted as owing by a person. In light of this, it is not necessary for additional machinery in relation to the proof of a debt to be included with a set-off provision.

5.9 Since the concept of proving for a debt is used in other provisions of the Insolvency Rules, including the provision for set-off, it will be necessary to make textual adjustments to any rules based on those for company liquidations that are introduced for Societies. However, this could be simply done by replacing "prove" with "claim".

Quantification of a debt

5.10 Rule 4.90 specifically refers to a number of other provisions of the Insolvency Rules. These are:

1. Rule 4.86, which provides for a permission for the liquidator to estimate debts subject to a contingency or that do not bear a certain value;
2. Rule 4.91, which provides for the treatment of debts in a foreign currency;
3. Rule 4.92, which provides for the treatment of periodic payments;
4. Rule 4.93, which provides for the treatment of interest; and
5. Rule 11.13, which provides for the treatment of debts payable at a future time.

5.11 All these provisions are important and useful in order to establish the quantum of a debt. Therefore, the FMLC considers that they should be included with a set-off provision for Societies. There would thus exist clear machinery for establishing the amount of any claim on the Society, primarily to enable set-off to function effectively. However, such provisions could have the added benefit of being applicable to claims made on the Society more generally, and so would bring greater certainty to the valuation of all claims.

5.12 Without these provisions, some uncertainty would remain in the operation of a set-off provision in relation to Societies. Although counterparties may be able to manage and alleviate this uncertainty by deciding to adopt a pragmatic approach to the quantification of claims, such approach being informed by the provisions in the Insolvency Rules for companies in liquidation or administration, it would be preferable for the position to be made explicit by incorporating these limited rules for the quantification of claims in an instrument providing for set-off. Alternatively, although this is probably a less satisfactory approach, the necessary rules could be incorporated into the instrument by reference to the rules in the Insolvency Rules.

5.13 Regarding the other provisions in relation to quantification of a claim, namely those concerning the treatment of negotiable instruments, secured creditors and discounts, the FMLC considers that while they may be of some use, there is no particular need for them to be included with a set-off provision.

6. Conclusion

6.1 The legislative lacuna identified above appears to have resulted from an oversight and the FMLC is of the view that this oversight ought to be corrected. The absence of a mandatory insolvency set-off rule applicable to Societies may have real practical consequences for financial markets. While there is relatively robust judicial support for the flawed asset approach referred to above, market participants who deal with Societies as counterparties are unable to draw the additional comfort from rule 4.90 that they would be able to draw if they were dealing with companies. This impacts upon the ability of market participants' advisers to provide clean legal opinions in relation to transactions involving Societies and introduces an unnecessary friction into the operation of the wholesale financial markets. A further impact of the oversight is that depositors who also owed monies to their Societies would be impacted upon unfairly, as described above.

6.2 The problem is one that the FMLC considers can be easily addressed. As outlined above, in relation to building societies, Schedule 15 para 58(1) of the BSA provides a statutory power to make rules "*under section 411 of the Insolvency Act [1986] for the purpose of giving effect, in relation to building societies, to the provisions of the applicable winding up legislation*". Schedule 10 para 69(1) of the FSA 1992 provides a similar power in relation to incorporated friendly societies. It follows that the lacuna can be removed without recourse to primary legislation.[23]

6.3 As outlined above, the FMLC would suggest that some of the peripheral machinery provided for by the Insolvency Rules in relation to companies would also need to be incorporated into the new framework for Societies, in order to ensure that the set-off rule operates effectively. There are, however, no obvious bars to the incorporation of such machinery. Should a decision be taken to introduce rules as recommended above, the FMLC (and its Working Group devoted to this issue) would be happy to offer such assistance as may be desired during the drafting process.

[23] The FMLC recognises that the BSA and the FSA 1992 envisage complete sets of insolvency rules for both types of Society and that these sets of rules are missing in their entirety, whereas this paper addresses only one aspect of that absence (i.e. the absence of insolvency set-off rules relating to Societies). However, conscious that legislative resources are scarce, the Committee would argue that addressing the particular lacuna outlined above would be worthwhile on the basis of cost/benefit analysis, even if producing complete sets of insolvency rules for both building societies and friendly societies would not be.