c/o Bank of England
Threadneedle Street
London
EC2R 8AH

Fax: (+44) (0)20 7601 5226

Email: fmlc@bankofengland.co.uk

Website: www.fmlc.org

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Desmond Flynn
Inspector General and Agency Chief Executive
The Insolvency Service
21 Bloomsbury Street
London
WC1B 3QW

Dear Mr Flynn

FMLC ISSUE 118: INSOLVENCY SET-OFF AND BUILDING SOCIETIES

I write on behalf of the Financial Markets Law Committee regarding the current lack of a statutory insolvency set-off rule for building societies. This issue has been brought to our attention by financial market participants who are concerned by the legal uncertainty that this creates as they attempt to analyse their credit risk when dealing with building society counterparties. The issue, and its practical implications, are described below. I am writing to you so that the Insolvency Service, as the government agency responsible for this area, may consider how this should be addressed.

The Issue

Building societies are incorporated (or deemed incorporated) and registered under the Building Societies Act 1986 (the "BSA"). 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 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.

Significantly, though, the Insolvency Rules 1986 do not apply to building societies, and therefore the mandatory set-off provisions in Rule 2.85 (in the event of a distribution during an administration) and Rule 4.90 (in the event of a winding up) do not apply to building societies. Instead, paragraph 58(1) of Schedule 15 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." However, no such rules have been made.

It is not clear why this is so. It has been suggested to the FMLC that the principal reason was simply that the mutual nature of a building society necessitated too many changes to the Insolvency Rules 1986 and that a self-standing set of appropriately adapted rules was considered preferable as a technical matter.

Unfortunately, there is no general provision of the Insolvency Act 1986 which 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 1986 and therefore does not directly apply to building 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 1986, which does directly apply to building societies by virtue of the insolvency provisions of the BSA mentioned above.

We understand that, since 1986, some market participants have made regular periodic enquiries of the Lord Chancellor's Department (now the Department of Constitutional Affairs), the Insolvency Rules Committee, the Building Societies Commission (now the Financial Services Authority), the Department of Trade and Industry 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 or the Insolvency Service).

Prior to the repeal of the Building Societies Act 1962 by the BSA, insolvency set-off applied in the winding up of a building society by virtue of section 103 of the Building Societies Act 1962, under which a building society could be wound up under relevant provisions of the Companies Act 1948, including the insolvency set-off provision in that Act. It seems a fair presumption therefore that had insolvency rules for building societies been introduced as contemplated by paragraph 58(1) of Schedule 15 to the BSA, they would have included an insolvency set-off rule comparable to Rule 4.90 of the Insolvency Rules 1986.

It may be that the lack of priority accorded to preparation of insolvency rules for building societies is attributable to the perception that the likelihood of a building society being allowed to fail is low. The last such failures occurred in 1892 and 1911. In practice, a troubled building society will be absorbed by a healthy building society to avoid such a failure, as happened in 1978 in the case of the Grays Building Society. Various provisions of the BSA are intended to facilitate such a result in those circumstances.

Nonetheless, the market is still left with the statutory "gap" that there is currently no mandatory insolvency set-off rule for building 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 1986 would be subject to mandatory insolvency set-off as the Insolvency Rules 1986 would apply in those circumstances). Given the importance of set-off in English insolvency law, both practically and as a matter of policy, this is an unsatisfactory state of affairs.

Practical implications

In practice, in financial market master netting agreements with building societies, the absence of a mandatory insolvency set-off rule for building societies 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 for building societies.

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 (or Rule 2.85, as the case may be). It would be helpful to establish a level playing field by remedying the lack of an insolvency set-off rule for building societies.

Where a transaction entered into with a building 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.

For banks and other financial institutions supervised by the Financial Services Authority 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.

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.

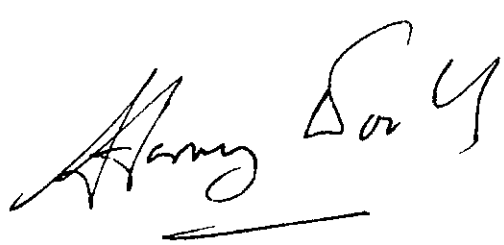
While there are other forms of set-off available under English law, in particular, equitable set-off and set-off under the Civil Procedure Rules (derived from the Statutes of Set-off), these forms of set-off are too narrow to form a sufficient basis for a close-out netting or financial collateral arrangement.

Conclusion

Notwithstanding that the absence of mandatory insolvency set-off rules applicable to building societies may be mitigated in practice in the manner described above, financial market participants would welcome the closing of the current statutory gap, which would promote legal certainty in this area. Perhaps it would be worth exploring whether paragraph 58(1) of Schedule 15 to the BSA would provide a sufficient basis for a limited rather than fully comprehensive set of insolvency rules for building societies which would, at a minimum, encompass insolvency set-off.

The FMLC would welcome the opportunity to discuss these issues further with you if that would be helpful.

Yours sincerely



Lord Woolf

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