Considering the continuity of payments for customers in a bank’s recovery or resolution

By Emma Carter of the Bank’s Customer Banking Division. (1)

The robustness of payments infrastructure, and the associated ability of payments to flow seamlessly, is an important contributor to financial stability. The United Kingdom’s payments infrastructure has historically proved to be efficient and robust. But, in a situation where a bank is in difficulty or fails, the need to ensure that customers can continue to make and receive payments may become challenging. This article draws together and discusses some of the issues in the way that UK payments and payment schemes work in stressed scenarios. It highlights some possible enhancements which could help to achieve minimal disruption to payment flows in the event that a bank gets into difficulty or fails — a subject the authorities, payment schemes and banks have been addressing in recent months. It looks at elements of recovery and resolution planning from the specific perspective of retail payments. (2)

Introduction

A payment is the transfer of money from one individual or business to another. Payments are crucial to the efficient functioning of the economy. They are essential for individuals to receive their salary and pay their bills, for businesses to buy and sell goods and services, and for the Government to receive taxes and make welfare payments.

The systems that facilitate payments (3) are a key component of the United Kingdom’s financial infrastructure, ensuring that bank (4) customers’ payment instructions result in payments reaching the intended destination on time. They are therefore important to maintaining financial stability and confidence in the banking system. Payment schemes, such as Bacs and Cheque & Credit Clearing Company (C&CCC), are responsible for system governance and rules for participation.

When banks are operating under normal financial conditions, payments flow seamlessly between participants in the banking system. But when a bank is recovering from a period of stress it may need to take specific actions to retain access to the payment schemes while it recovers (so that its customers can continue to make and receive payments). A recovering bank may be able to take these actions itself. But when a bank fails, and is taken into ‘resolution’, it is the authorities (5) that will take action to ensure the failed bank’s customers can continue, or resume, their payments activity with minimal disruption.

This is critical to support financial stability because if a failed bank’s customers were unable to receive their salaries and pay their bills for a prolonged period of time, this could impact the wider economy and cause a loss in confidence in the banking system. The Bank of England is the resolution authority (6) and as such leads and manages the resolution process for such firms (see the box on page 151) including aspects on payments.

Bank recovery and resolution methods used in the past have resulted in little or no disruption to payments. But the landscape for bank recovery and resolutions is evolving and it is important that in future these processes do not result in undue disruption to payments. Following the publication of the Financial Stability Board’s (7) (2011) ‘Key attributes of effective resolution regimes for financial institutions’, the authorities will be thinking about developments to the United Kingdom’s resolution planning which could potentially impact plans for payment operations in resolution scenarios.

(1) The author would like to thank Andrew Forrest for his help in producing this article.
(2) It is not intended to represent in any way a comprehensive analysis or assessment of any other aspect of recovery and resolution plans or resolution planning.
(3) Interbank payment systems are arrangements designed to facilitate or control the transfer of money between financial institutions who participate in the arrangements.
(4) This article refers to all credit institutions as banks.
(5) In this article ‘authorities’ refers to one or more of HM Treasury, the Financial Services Authority and the Bank of England.
(6) See Davies and Dobler (2011).
(7) The Financial Stability Board was established to co-ordinate internationally the work of national authorities and international standard setters and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability.
And as part of banks’ own recovery and resolution plans(1) (RRPs) (which will be required by the Financial Services Authority (FSA) under forthcoming rules)(2) they will have to consider in detail their payment operations and interactions with the payment schemes. The authorities, payment schemes and banks should work jointly towards ensuring that payment operations do not act as an undue constraint on future recovery and resolution options.

This article focuses on payments-specific aspects of the United Kingdom’s work in relation to bank recovery and resolution. The article begins by explaining some of the payment schemes used by bank customers in the United Kingdom, and sets out how these are managed to ensure robustness and efficiency in their day-to-day processing of payments. The article goes on to outline how payments are settled and how this affects payments operations and interactions with the payment schemes. The authorities, payment schemes and banks should work jointly towards ensuring that payment operations do not act as an undue constraint on future recovery and resolution options.

**UK payment schemes**

In the United Kingdom there are a variety of payment schemes, each providing a different service. Both wholesale and retail payments are used by individuals and businesses in the United Kingdom, but this article will focus on retail payments which individuals primarily use in their day-to-day activities. Some examples of payment schemes are given in Table A.

Payment schemes can be accessed by banks either directly as scheme members, or indirectly using payment services provided by a direct member. For example, there are only 16 direct members of Bacs, but many more banks are able to provide Bacs payments to their customers via indirect participation.

Payment schemes in the United Kingdom have proved efficient and robust in handling their day-to-day business. The major payment schemes adhere to international standards(3) to ensure that risks within the systems are identified and minimised, and that the schemes can withstand periods of financial stress. Examples of these standards include: settlement being conducted in central bank money where practical and available (see the box on the Bank of England’s role in payments on page 149); payment schemes having objective, risk-based and publicly disclosed criteria for participation; and payment schemes having clearly defined rules and procedures to manage the default of one of their members, so that losses and liquidity pressures are contained, and payments can continue to function smoothly. The payments infrastructure worked well during the recent financial crisis and the rules and operations of the core payment systems did not amplify shocks.

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1. The recovery plans will reduce the likelihood of failure by requiring banks to identify options for regaining financial strength in the event that they get into difficulty. The resolution plans will show how a bank will wind down if it fails, and thereby enable an assessment of the potential effect on financial stability and identification of any significant barriers to resolution.
2. See Financial Services Authority (2012).

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### Table A  Examples of UK payment schemes

<table>
<thead>
<tr>
<th>Name of payment scheme</th>
<th>Types of payments offered</th>
<th>Key information</th>
<th>Daily average volume of payments in 2011</th>
<th>Daily average total value of payments in 2011 (£ millions)</th>
</tr>
</thead>
</table>
| Bacs Payment Schemes Limited (Bacs) | • Direct debits (eg mobile phone and utility bills).  
  • Direct credits (eg salary and pension payments).  
  • Three working day clearing cycle.  
  • Deferred multilateral net settlement. | | 22,776,896 | 17,383 |
| Faster Payments Service (FPS) | • Internet and telephone banking payments (eg person-to-person).  
  • Standing orders (eg rent payments).  
  • Same-day payment usually credited within a few hours.  
  • Deferred multilateral net settlement three times daily. | | 2,092,931 | 936 |
| Cheque & Credit Clearing Company (C&CCC) | • Cheques (eg person-to-person and paying small businesses).  
  • Bankers’ drafts (eg car purchases).  
  • Three working day clearing cycle.  
  • Deferred multilateral net settlement. | | 2,932,339 | 2,804 |
| CHAPS Clearing Company Limited (CHAPS) | • CHAPS payments (eg business-to-business transactions and house purchases).  
  • Used by individuals for high-value payments.  
  • Real-time gross settlement. | | 135,550 | 254,489 |
| LINK | • ATM withdrawals (eg for cash purchases).  
  • Deferred multilateral net settlement the following day. | | 11,450,199 | 762 |

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(a) In a deferred multilateral net settlement system, details of payments are released to the receiving bank prior to the members settling their payment obligations. Settlement is achieved when net obligations are posted to accounts at the settlement agent bank (see the box on page 149 for more details). This requires members to generate less liquidity than would be required in a gross settlement system.

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The Bank of England’s role in payments

The Bank has a variety of roles in relation to payments largely stemming from its objective to support financial stability:

- The Bank acts as settlement agent for members of CHAPS, Bacs, Faster Payments, LINK(1) and C&CCC. This means that it provides accounts to payment scheme members to enable them to settle their payment obligations between one another. These accounts are held in the Bank’s real-time gross settlement system (which provides for the immediate settlement of payments with finality). Settling using money held at the central bank is less risky than settling using money held at a commercial bank as central bank money is the ultimate risk-free settlement asset.

- The Bank oversees systemically important payment systems(2) under the statutory framework set out in Part 5 of the Banking Act 2009.(3) It assesses the risks that each system could pose to financial stability and identifies areas where action should be taken to reduce risks (for further details see Bank of England (2012), Payment Systems Oversight Report 2011).

The United Kingdom’s existing payment schemes were not built with bank recovery and resolution scenarios in mind. Therefore, schemes and banks may like to consider the impact that these challenging scenarios may have on their operations. The ultimate goal is that disruption to payments is minimised during a bank’s recovery or resolution process, and that payments infrastructure and operations do not present barriers to the execution of any bank resolution method.

Considering retail payments in past bank resolutions

During a bank resolution, the ability of customers to continue, or resume, making and receiving payments is important to maintaining financial stability (this includes retaining access to their insured deposits).(1) The Bank has been involved in a number of resolutions in recent years, both before and after the creation of the Special Resolution Regime (SRR) in 2009.

In all past resolutions the authorities have worked towards there being little or no disruption to the payment activities of the failed banks’ retail customers. One way that continuity of payments was achieved was by keeping the whole of a bank running as one entity. For example, in the case of Northern Rock, HM Treasury took the bank into temporary public ownership in February 2008. It remained solvent and could continue to meet its payment obligations. It could therefore continue to provide banking services, including payments, to its customers in exactly the same way as it did before. From a payments perspective, a resolution method which keeps a bank together as one whole entity is the least complicated option. This is still an option within the SRR. For example, by taking a whole bank into temporary public ownership, although this exposes public funds to the greatest risk, and therefore the failure of a bank would need to pose a serious threat to financial stability in order for this option to be selected. Alternatively, a whole bank could be transferred to a private sector purchaser or to a bridge bank.(2)

In the case of Northern Rock, the bank was subsequently split in January 2010 into two entities: Northern Rock plc (a savings and mortgage bank) and Northern Rock (Asset Management) plc (an asset management vehicle providing for the orderly wind-down of the remaining business). Following this split, Northern Rock plc was able to continue to provide payment services to its customers as it acquired the ‘old’ Northern Rock’s payment scheme membership and indirect participation relationships via a statutory Transfer Order,(3) which stated the terms for separation. One of the payment

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(1) Not all LINK members are able to hold a settlement account at the Bank as some are not banks.
(2) Currently these are CHAPS, Bacs, Faster Payments and others outside the remit of this article (CLS, payments arrangements embedded in CREST, LCH.Clearnet and ICE Clear Europe).
(4) With the exception of taking a bank into temporary public ownership which is the decision of HM Treasury.
scheme memberships that it acquired was for Bacs, which would normally require an entity to have a minimum credit rating history in order to be eligible. As a new entity, Northern Rock plc did not have any credit rating history and so the Transfer Order included a temporary waiver of Bacs’ minimum credit rating membership criterion.

Another example of a successful resolution during which disruption for customers was closely managed was that of Southsea Mortgage and Investment Company Limited in June 2011. In this instance, the Bank Insolvency Procedure (BIP) was used since it was judged that the failure of the bank would not have a systemic impact on the financial system. Southsea customers were paid their insured deposits (up to £85,000) automatically by the Financial Services Compensation Scheme (FSCS) via cheque soon after the resolution. They could then pay this into an alternative bank account, or open another account for this purpose. It was appropriate to use the BIP tool in the case of Southsea as it was a small bank which was not in the business of providing current accounts, meaning that the remaining industry players could easily absorb its customers, and there was not a large number of people needing to contact their employers and service providers to change their payment instructions. Disruption for Southsea’s customers was thus effectively managed and the impact on the wider economy was contained.

A resolution can become more complicated when the SRR transfer tools are used to transfer part of a bank to a private sector purchaser or bridge bank (see the box on page 151). When using the transfer tools to conduct a partial bank transfer it is still a priority to ensure the continuity of payments for customers. In the case of the Dunfermline Building Society resolution in March 2009, a private sector purchaser, Nationwide Building Society, acquired core parts of the business. A further portion was transferred to a small Bank of England bridge bank (this was later sold to Nationwide in July 2009) and the remainder of Dunfermline’s business was placed into the Building Society Special Administration Procedure. Nationwide acquired Dunfermline’s infrastructure and staff needed to run the business it had taken on, by virtue of the Bank’s property transfer instrument. Nationwide could then manage its newly acquired bank accounts using Dunfermline’s existing banking platform, meaning that banking services continued to operate normally for customers. Some payment services required by the bridge bank were also provided by Nationwide so that customers of the bridge bank received continuity of service also.

Reflecting on use of the SRR

Although resolutions to date have been successfully conducted with minimal impact on the continuity of customer payments, these experiences can still be useful when considering improvements and how to deal with more complicated scenarios in the future.

There are a number of variables which could increase the complexity and risk involved in the continuity of payments in a future bank resolution. Some examples of these are:

- When using the transfer tools it may not always be possible to find a sole private sector purchaser willing to buy the majority of the business. A bank may therefore need to be split up into multiple parts for sale.
- A private sector purchaser may not always be a bank that has existing access to the payment schemes (for example, it may be an entity which did not previously provide a retail banking business).
- A failing bank may be a direct member in the payment schemes providing payment services to indirect participant banks that are not scheme members themselves. These indirect participants may depend upon the failing bank to make their customers’ payments and therefore there would also be an impact on these indirect participant banks (and their customers) in the event of the direct member’s failure.
- It may not be possible to use the BIP tool on a large bank. Challenges to banking continuity may arise as there would be more customers requiring FSCS payout and potentially requiring new bank accounts to be opened. This could lead to capacity constraints on the FSCS and the remaining banks absorbing the failed bank’s customers. The decision to use the BIP tool would depend on the ability to pay out and for customers to resume their banking activities within a reasonable amount of time.

Factors such as these may make a resolution more complex, and the provision of payments with minimal disruption more difficult to achieve. It is therefore important that banks, payment schemes and authorities are well prepared for all eventualities in advance.

Preparing for future bank recovery and resolution scenarios

In 2011, the Bank led a Financial Stability Board (FSB) workstream looking at barriers to recovery and resolution in payment operations. The Bank consulted with banks and payment schemes in the United Kingdom in order to understand the issues from various perspectives. Discussions highlighted some areas for further work and put forward some suggestions for improvements in order to overcome existing

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(1) A property transfer instrument is a legal instrument made by the Bank of England under the Banking Act 2009, and has the legal effect of transferring property, rights or liabilities of a failed bank to another entity.
The Special Resolution Regime objectives and tools

Following the financial crisis of 2008, the Banking Act 2009 created the Special Resolution Regime (SRR) which gave the authorities a permanent framework for dealing with distressed banks. The SRR has a number of objectives:

- to protect and enhance the stability of the financial systems of the United Kingdom;
- to protect and enhance public confidence in the stability of the banking systems of the United Kingdom;
- to protect depositors;
- to protect public funds; and
- to avoid interfering with property rights in contravention of a Convention Right (within the meaning of the Human Rights Act 1998).(1)

Achieving the continuity of customer payments soon after resolution is necessary in order to meet the SRR objectives for all banks providing a current account service.

The SRR created a set of statutory resolution tools. The use of these tools will be triggered following a decision by the FSA that certain conditions are met. These conditions are, broadly, that:

i. the bank is failing, or is likely to fail, to satisfy the threshold conditions for authorisation; and
ii. having regard to timing and other relevant circumstances, it is not reasonably likely that action will be taken that will enable the bank to satisfy threshold conditions.

It is the Bank’s responsibility to select from the SRR tools available. The tools allow the authorities to:

- apply to place a bank into the Bank Insolvency Procedure (BIP) which is designed to allow rapid payout to customers who are insured by the Financial Services Compensation Scheme, or to facilitate the transfer of eligible accounts to another bank;
- transfer all or part of a bank to a private sector purchaser;
- transfer all or part of a bank to a bridge bank, pending a future sale;
- apply for the use of the Bank Administration Procedure to deal with a part of a bank that is not transferred. This differs from a BIP as the bank administrator is obliged to ensure that the residual bank continues to provide services to the private sector purchaser and/or bridge bank until new arrangements are in place; and
- place a bank into temporary public ownership if it is HM Treasury’s decision to do so. This is not the first tool considered for use as it uses taxpayer funds to recapitalise the bank.

The Bank has managed two resolutions under the SRR to date: Dunfermline Building Society in March 2009, using both the transfer tools and the Building Society Special Administration Procedure; and Southsea Mortgage and Investment Company Limited in June 2011, using the BIP tool. Since the introduction of the SRR, the high-level actions the authorities can take when resolving a bank have been refined and set out publicly so that all parties are able to plan for resolution more precisely.

The UK Government (alongside the other G20 governments) has signed up to the Financial Stability Board’s ‘Key attributes of effective resolution regimes for financial institutions’. The objective of these attributes is to allow the authorities to resolve banks in an orderly manner without taxpayer exposure to loss from solvency support. The implementation of these would include the introduction of a new resolution tool to ‘bail-in’ a failing bank — that is, to recapitalise it through subjecting creditors to loss and converting their debt claims to equity.


barriers to recovery and resolution stemming from payments. The group’s recommendations fed into the FSB report on ‘Key attributes of effective resolution regimes for financial institutions’.

The FSA’s future guidance and rules for RRPs will require banks to consider any payments issues that could hinder their ability to recover or be resolved in an orderly manner. This work will include thinking about how they access the payment schemes and what they would be able to do to ensure that this access is maintained without increasing risk for other payment scheme members, or any direct member providing them with payment services. It will also include, in a resolution context, considering the potential need to split up their business lines while avoiding severe disruption to payments. This will be particularly relevant for large banks which may have numerous business lines and legal entities sharing the same payment scheme membership and pools of liquidity. The remainder of this article sets out some of the issues and ideas that were discussed during the workstream and related consultations.

Retaining payment scheme membership

It is helpful for payment schemes to understand how their rules and processes may play out during the recovery or resolution of a member bank. For example, a minimum credit
rating criterion for payment scheme membership is a useful measure for judging and controlling the level of risk that a member may bring to the system. Nevertheless, if a member is financially stressed but still a potentially viable bank and is taking recovery actions, it would not be desirable for it to be mechanistically excluded from a payment scheme due to a credit rating downgrade.

Payment schemes have made progress in this area by considering ways that a member whose credit rating has been downgraded could retain access without increasing risk for other members. For example, by requiring an affected member to increase its provision of collateral to cover its net debit position (the amount it is in debt to other members at any time) in full, an arrangement that was implemented in Bacs in 2011. By clearly outlining such a requirement in scheme rules, members are able to plan in advance for their potential collateral requirements (and incorporate this into their RRs) so that they are best prepared to meet these additional requirements. Measures to allow a member in difficulty to minimise the additional risk that it could bring to the system supports the member’s recovery while containing the risk to other scheme members and hence reducing the chance of contagion.

**Acquiring payment scheme membership**

It might be necessary for a new entity to take on payment scheme membership quickly if it acquires part of a failing or failed bank, in order to ensure continuity of customer payments. This was necessary in the event of the partial transfer of Dunfermline’s business to Nationwide. However, the new entity could be a bridge bank or a private sector purchaser which for some reason does not immediately meet scheme membership eligibility requirements. In business as usual, payment schemes have robust application and checking processes for potential new members to protect the integrity of the scheme. These processes can be lengthy and could act as a barrier to the recovery or resolution of a member bank. It is for this reason that the Bank’s property transfer powers explicitly allow for a transferee to be treated ‘for any purpose, as the same person as the transferor’. Therefore, if the Bank transfers payment scheme membership to a bridge bank or private sector purchaser they would take on the failed bank’s existing payment scheme membership and would not need to apply as a new member. Such a transfer will not, of course, increase risk to the payment scheme or its members as the transferee will, in all cases, be an appropriately authorised entity, and the scheme’s existing protections and requirements will continue to apply to that transferee as scheme member, just as they applied to the failed bank as a member. The Banking Act ‘Code of Practice’ explicitly requires the authorities to seek to ensure that any transferee which takes on direct payment scheme membership is suitable to do so. By transferring payment scheme membership to an acquiring entity the acquirer has a grace period to allow it to obtain a credit rating or otherwise demonstrate to the scheme its creditworthiness.

**Ensuring continuity of indirect memberships**

Many banks will access payment schemes indirectly via a direct member providing payment services. Payment schemes and banks therefore need to be aware of these interlinkages during the recovery or resolution of either a direct or indirect member. Challenges may arise when an indirect participant gets into difficulty and the direct member providing it access takes unexpected action to protect itself, or when a direct member providing indirect participants with access goes into resolution. The former scenario was observed in the lead up to the failure of Lehman Brothers Holdings Inc. when its banks across the world became less willing to grant intraday liquidity with which to make its payments. The banks started to apply additional conditions to reduce their exposures, including requiring Lehman to lodge more collateral. Lehman was not prepared to meet this call for additional collateral, and the act of doing so was therefore a drain on its liquid asset pool. This contributed materially to the speed of its demise. Had Lehman been prepared for the actions these banks would take, it may have been better able to cope with the need to provide the additional collateral. Despite the somewhat different context of an investment bank using the wholesale markets to fund its activities, this case study demonstrates the scope for unexpected actions by payment counterparties to complicate a bank’s situation when it is in difficulty.

There are actions that can be considered by direct members and indirect participants to prepare for recovery and resolution scenarios. These might include:

- Indirect participants who are large (either by size or payment flows) could join the payment schemes directly. The Bank has been encouraging this in CHAPS.
- Smaller indirect members, for whom indirect participation is the only viable option, could ensure that the contracts that they have in place with the direct member provide them with assurance about the continuity of service that they will receive in response to certain events. This would include setting out the circumstances in which additional collateral might be requested from the indirect participant, and on what grounds the relationship could be terminated and with what notice period.
- Although the costs and benefits would have to be assessed, it might be useful for indirect participants to consider having a contingency arrangement in place for payment scheme access via an alternative direct member.

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(1) Section 36(1)(b) of the Banking Act 2009.
(3) See Ball et al (2011).
These relationships need to be carefully managed so that the level of risk is minimised for all parties involved.

**Banks’ internal management of information**

It would be beneficial for banks to be able to segregate FSCS-insured and uninsured deposits in the event of their resolution. This would go further than the single customer view that banks already have in place which provides a single aggregate overview of the compensation amount payable to each depositor in the event that a bank fails. Developing this would be helpful as it may in some instances enable a failed bank’s customers to access and make payments with their insured deposits sooner following resolution, while ensuring that uninsured deposits are not used. This could involve banks needing to do some developmental work on their own banking platforms in order that such segregation is achievable.

A bank’s management information on payment flows is critical in the event that it goes into recovery or resolution. For example, in resolution it would be important for a bridge bank or private sector purchaser acquiring part of a failing or failed bank’s business to understand the payments made and received by that part of the business so that it is able to quickly ascertain and fulfil its financial obligations in the payment schemes. Banks may be required to consider this as part of their RRPs.

**Conclusion**

Minimising disruption to payments during a bank’s recovery or resolution is critical to maintaining financial stability. Without payments, bank customers would not be able to carry out everyday financial transactions such as receiving their salary and paying their bills. This could cause a loss of confidence which could spread to the wider banking system. To ensure that disruption is minimised, the Bank has been working with the payment schemes and banks to consider the challenges associated with payment systems and operations when a bank is in a recovery or resolution process.

Some of the payment schemes have already implemented specific provisions enabling a member in recovery to retain scheme access without increasing the risk for other members. The Bank has also engaged in discussions with the schemes to explain the process for membership to transfer from a failed bank to an acquiring entity, if necessary, as part of a member’s resolution. Banks may also want to consider how they can segregate insured and uninsured deposits in the event of their resolution, and whether any improvements can be made to their management information on payment flows. Payment schemes and banks have both considered the implications of indirect participation in the payment schemes, and how the additional risks it might present in recovery and resolution scenarios could be minimised. Banks should ultimately be able to incorporate any specific actions into their RRPs.

With appropriate preparation, all parties should feel confident that there would be minimal disruption to payments in the event that a bank gets into difficulty or fails. This should be the case regardless of the nature of the bank, or the recovery or resolution actions taken.

**References**


