New dawn or more of the same? Opinion on the latest round of insolvency regime changes in the financial institutions sector

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Executive summary

The Payment and Electronic Money Institution Insolvency (England and Wales) Rules 2021 (SI 2021/1178) (the **Rules**) were made on 21 October 2021 and came into effect on 12 November 2021, following a long line of consultations and regulations in the area. The Rules outline the procedure for the Payment and Electronic Money Institution Special Administration process established in The Payment and Electronic Money Institution Insolvency Regulations 2021 (the **Regulations**), which came into force on 8 July 2021. Together, the Rules and the Regulations establish a new special administration regime in the financial institutions sector, along similar lines to the Special Administration Regime for Investment Banks (**IBSAR**). Given the ever-developing electronic and paperless banking world that we now inhabit, it is a sensible step to provide specific legislative provisions that should result in speedier and more efficient return of customers' money in the event of insolvency.
Neil Griffiths, Head of the Restructuring and Insolvency Group in the UK: "In the ever-changing landscape of the financial technology and payments sector, the Rules and Regulations that introduce the new special administration regime are a welcome addition. As the prospect of insolvencies in this sector increase, the clarity and efficiency that should come with implementation of the new regime will undoubtedly prove a positive thing to insolvency professionals and, critically, customers."

This article highlights the key provisions of the new regime, which contains an expanded toolkit and sets out three key objectives for the appointed special administrator to look to achieve.

Why now?

Since the Global Financial Crisis enveloped the world in 2008, taking down many financial institutions with it, there has been increasing regulation of the sector. It has remained a hot topic on the political agenda ever since and ensuring stability across financial markets is an essential mandate of the government. The legislature and industry bodies (such as the FSA, as it then was) moved quickly to introduce wide-ranging changes and new laws that would address what to many were seen as significant shortcomings in the legislation at that time. The Banking Act 2009, and associated legislation, introduced the concept of special insolvency regimes, including the IBSAR. The UK was also subject to European Union legislation, which had direct effect and was implemented within domestic law.

The primary objective of the special insolvency regimes for financial institutions was to protect customer funds held by these institutions. This objective differed from the ordinary administration primary objective to rescue the company as a going concern. The special regimes recognised the often complex, heavily regulated and multi-faceted nature of the financial institutions, which had to consider their own customers, additional counterparties and general creditors if they approached the zone of insolvency. A common factor of the special regimes has been the FCA's monitoring, notification and consent requirements to ensure the regulator is directly involved in the process. In reality, there have been relatively few special insolvencies of financial institutions in the last 10 years.

With that said, the world has been turned on its head following the COVID-19 pandemic. Sectors that were once thought to be robust have come under the spotlight like never before, noting the leisure, retail and aviation industries in particular. Without the government's significant financial intervention, it is very likely that insolvencies (both corporate and personal) would have reached eye-watering levels in the last 18 months. The tsunami that insolvency professionals expected to hit has not materialised, but the expectation remains that as financial support and other protective measures are withdrawn there will be a notable uptick in insolvencies. Domestically, there has been a raft of new legislation in the insolvency and restructuring sphere, notably in the form of the Corporate Insolvency and Governance Act 2020 (CIGA), but also in the many statutory instruments that have amended and developed legislation (both on a temporary and permanent basis) since the start of the pandemic. The landscape therefore seemed ripe for further development and certainty around the potential insolvencies of payment institutions and electronic money institutions, particularly as the payments and financial technology sector in the UK has seen rapid development and expansion in recent years.

The Rules and the Regulations

The Rules provide detailed operating provisions to support a special administration specifically designed for insolvent non-bank institutions whose business was to facilitate the transfer or storage of money through card, mobile and electronic wallet systems. The new regime, which has been available since July 2021, was set down in the Regulations. The primary aim is to preserve continuity for consumers and to improve the efficiency of the insolvency process in general. Given the complex nature of the institutions in this sector, historic insolvencies with these entities have taken a long time to complete, resulting in higher costs for the proceedings and delays (and reductions) in the return of money to customers.

The general view from those professionals and stakeholders concerned with the introduction of the Rules and the Regulations (including the FCA, HM Treasury and the Insolvency Service) has been positive. The new regime gives insolvency practitioners an extended insolvency toolkit to deal with the collapse of such institutions. It is intended to reduce the need for administrators to seek court directions, helping to limit the time delays and inherent costs that come with court applications, and to expedite the return of funds to customers.

As indicated, the Regulations were introduced to help address the long insolvencies in this sector that had seen customers missing out on their money after the costs of distribution had been deducted from the insolvency estate. Often, these entities have large numbers of disparate creditors. Insolvency practitioners using the ordinary administration procedure had difficulties efficiently winding- down the businesses and returning money to customers and other creditors. Of the six payment institutions and electronic money institutions that entered insolvency in the last three years, only one process has returned money to customers. By comparison, the existing IBSAR has largely been successful in returning client assets more quickly and at reduced cost. Consequently, the new regime is based on the IBSAR and using the IBSAR as a template seemed an appropriate and effective way of bringing special measures into the ever-developing world of e-payments, digitisation and financial technology.

The Rules have been through some iterations and are the result of a number of consultations and engagement with key industry stakeholders. Although based on the IBSAR, the new regime does contain a number of relevant differences, which tailor it to the very specific area of payment institutions and electronic money institutions. The final version of the Rules were refined to, among other things:

- requiring insolvency practitioners to provide a reasonable notice period before a claims bar date comes into effect;

- clarifying the full hierarchy of expenses;
- requiring notice of a bar date to be given to all persons whom the administrator believes to have a right to assert a security interest or other entitlement over the relevant funds; and
- requiring the special administrator to engage closely with payment systems operators during the special administration.

How does the new regime operate?

Payment institutions and electronic money institutions that are insolvent can enter into a special administration regime by court order and the grounds for applying for such an order depend on the type of creditor making the application. The application must establish that the entity is unable to pay its debts, or there must be a compelling fairness / public interest justification for putting the entity into special administration. If the application satisfies the court, upon the special administrator's appointment, he or she must seek to achieve one of three new objectives. The special administrator is also able to utilise an expanded toolkit of powers that are intended to facilitate them in keeping an insolvent institution operational for as long as possible with a view to ensuring continuity for consumers and prioritising the return of their funds.

The special administrators have a duty to achieve one of the following three new objectives:

Objective 1: to ensure the return of relevant funds as soon as is reasonably practicable.

Objective 2: to ensure timely engagement with payment system operators, the Payment Systems Regulator, the Bank of England, HM Treasury and the Financial Conduct Authority.

Objective 3: to either rescue the institution as a going concern, or to wind it up in the best interests of creditors.

The appointment taker may, at their discretion, choose to prioritise any of the three objectives, although the FCA does have power under the Regulations to direct the special administrator to focus on achieving a particular objective if it considers that will protect the stability of the financial sector and public confidence therein.

The Rules provide that the special administrator's proposals must specify the priority to be given to the three objectives. A meeting of customers and creditors (or, in applicable circumstances, the FCA) must approve the statement of proposals. Customers must be given notice of meetings in the same way as creditors and claims must be submitted to the special administrators for admission or rejection. If desirable, a creditors' committee can be appointed at the meeting. The Rules also go some way at trying to minimise the costs borne by the insolvent estate for "failure-related costs", which are incurred when the insolvent institution fails to safeguard relevant funds. Note that the Financial Services Compensation Scheme (**FSCS**) does not cover customers of payment institutions and electronic money institutions. The Rules allow the special administrator discretion (subject to approval) as to what funds realised in the course of the administration process can be distributed, and at what stage. The Rules provide details for setting bar dates to claims, notification and notice requirements, approval of a distribution plan, dealing with late-filed claims and an appeals process.

Notably for insolvency practitioners, it is not obligatory for insolvent payment institutions and electronic money institutions to enter the special administration regime. These institutions can still choose to go into ordinary administration under Schedule B1 to the Insolvency Act 1986, rather than adopt the new regime. Additionally, it is notable that the Regulations appear to introduce the option of a Schedule B1 administration proceeding without FCA consent if it has not responded to notice of the proposed administrator's appointment within two weeks (Regulation 11). The Regulations still need to be read subject to section 362A of the Financial Services and Markets Act 2000

(**FSMA**), which requires FCA consent.

Who will be interested in the new regime?

As digitisation and technology in financial institutions continues to develop and our day-to-day reliance on payment institutions and electronic money institutions increases, it is probable that this area of the industry will experience more insolvencies. Consequently, anyone who may be exposed to these insolvencies, including the following, will be interested:

- derivatives counterparties and those financial institutions providing cash pooling and other banking services; and
- customers, whose monies are not protected by the FSCS.

Where to next? Insurers

In May 2021, there was a consultation on amendments to the insolvency arrangements for insurers that apply under the FSMA.

The consultation sought to amend the current insurer insolvency arrangements to ensure they remain up to date and consistent with best practice, in particular those brought into effect by CIGA. Alongside broader changes to relevant legislation, the Prudential Regulation Authority (**PRA**) was to be given powers to, at its discretion, amend the compensation rules to make FSCS protection available to protected policyholders whose contracts are written down. The aim is to ensure that the PRA and FCA have the tools to manage the failure of an insurer in an orderly way and, in doing so, provide protection to policyholders. As well as providing continuity of cover for policyholders by allowing earlier intervention by the regulatory authorities when an insurer suffers financial distress, the new provisions are also intended to help mitigate business disruption and losses for insurers in distress. The proposals will be of interest to both insurers and their counterparties. The consultation on the proposals around a new regime for insurers has received a number of notable challenges. We will revisit the proposed new regime when the government provides a further update on next steps.

Conclusions

The introduction of the Rules will provide clarity and certainty for those dealing with, and suffering from, insolvent payment institutions and electronic money institutions. The Rules provide special administrators with specific tools to facilitate their mandate to achieve one of the three objectives of the new regime. This should not only make the office holder's job more cost-effective and efficient, but should also offer some comfort to customers who will feel more confident that they may recover part of their money otherwise lost in the insolvency.

Your Key Contacts

Neil Griffiths
Partner, London
D +44 20 7320 6822
neil.griffiths@dentons.com

Mark Price
Senior Associate, London
D +44 20 7246 7271
mark.price@dentons.com