

HM Treasury's consultation "Special Resolution Regime: Safeguards for Partial Property Transfers" (Cm7497)

A Submission by the London Investment Banking Association

A. Introduction and main concerns

1. This submission focuses on our Members' views on the proposed Restriction of Partial Transfers Order – the Safeguards Order – although we also comment on the proposed "No Creditor Worse Off" Regulations and on the proposed Code of Practice. We have already made representations about our Members' views on the amendments that need to be made to the Banking Bill, including the continuing strong concerns about Clause 75, and we do not rehearse these arguments again here. We would flag again, though, that it is essential that if the Banking Bill is to be implemented as a whole, including the partial transfer powers, then the Safeguards Order must come into effect at the same time in order to avoid considerable – and very damaging – uncertainty about the implications of undertaking business with UK banks (we comment further on timing issues below).
2. A number of the issues we raise have already been covered in meetings of the Treasury's Expert Liaison Group, in which LIBA participates.
3. As early as the initial consultation on the possible introduction of a Special Resolution Regime for failing UK banks and building societies – in October 2007 – LIBA's Members have stressed the need to provide safeguards to ensure that the steps that wholesale creditors take to protect their interests in the case of counterparty's insolvency are not undermined. We therefore very much welcomed the inclusion of what has become Clause 48 in the Banking Bill, and we welcome the general approach that has been taken in the November consultation, which proposes special rules for protecting security arrangements in the case of a partial transfer of a bank's business. However, although the draft legislation has been designed to deal with the concerns that the market has raised about the potential impact of the provision within the SRR for partial property transfers on legal certainty for financial markets arrangements – paragraph 2.16 of the consultation states in terms that it is the "clear intention" to protect contracts relevant for regulatory capital purposes from the threat of disruption – the range of exclusions ("carve-outs") from the Safeguards Order's protections will prevent the objectives from being met. It is essential, if the competitive position of UK banks is not to be undermined, that the necessary amendments are made to ensure that clean legal opinions about the efficacy of netting and set-off arrangements can be maintained in order to prevent the capital position of a firm dealing with a British bank from having to be calculated on a gross basis (we comment further on this below).
4. In addition to the regulatory capital cost point, the loss of the ability to net will have a significant impact on the cost and availability of banking facilities for banks and non-financial companies where exposure across a number of accounts and facilities is calculated and controlled on a net basis. We would also raise separate, perhaps

more tangible, concerns on availability of intraday liquidity. A bank's relationship with another bank will usually involve many accounts in different currencies from which payments are made. In order to make sure that requested payments go out smoothly throughout the day, a net overall payment settlement limit (PSL) will be placed over the accounts. The effect of this will be that a payment can be made from an account which takes that specific account overdrawn provided that overall the net position (the rationale for which will be effective set off rights) is not breached. This intraday liquidity is essential intraday payments lubrication for a customer of any size because it is extremely difficult operationally to identify in advance every payment to go out on a day and ensure that at all times there are cleared credit funds available on the specific relevant account in advance to meet the payment. If PSLs are taken away by a counterparty as a result of concerns that a legal right of set-off across the accounts is not certain, that would force an institution into that much more difficult payments environment. The consequences would be that payments would not be made unless and until cleared funds were posted to the specific account. This will likely result in payments being delayed towards the end of the day while funds are moved to the right place (rather than this moving of funds being something that can be done after the event to correct the position). Amongst other things, the delays will make the fact that the institution's clearer is losing confidence in it visible to the market. Also payment defaults are rendered more likely due to failure to sort out appropriate postings of credit funds to the correct accounts in advance of payment system cut-offs.

5. A related point is the need to ensure that the underlying primary legislation is drafted correctly and that the Safeguards Order dovetails properly with it: the City of London Law Society has already written to the Treasury on this aspect and our Members support their representations (see, in particular, their proposals for amendments to Clauses 22/38 and 48).
6. In addition, Article 6 – which deals with the case where a partial property transfer has been made which fails to comply with the Safeguards Order – provides only that the Bank of England has to consider whether it agrees that a provision has been breached (and no appeal mechanism is provided). In order for the legislation in this area to provide the necessary certainty about its effects, it is essential that the Safeguards Order provides in terms that the right to netting or set off is protected from the effect of a partial property transfer.
7. Finally, there are two timing issues that must be addressed urgently. The counterparties of UK banks and building societies – including UK firms – will need to start to take steps to protect their position without delay if there is any doubt about their security rights under the SRR being less than under the current framework. The Government should clarify the policy on this as soon as possible once the consultation period has come to a close even if the detailed drafting cannot be delivered overnight. Second, our Members are beginning to consider again the possibility that finalising the secondary legislation before the powers in the Banking (Special Provisions) Act lapse next month will not prove to be possible: in this context it has been suggested that it will be necessary to extend the life of the Northern Rock legislation by, say, three months in order to ensure that the new regime cannot be brought to bear until the required certainty about the full enforceability of netting, set off, security and other credit risk mitigation techniques has been achieved. Such a deferral, though, would require the law firms to confirm that the current clean legal opinions about the efficacy of security arrangements

with UK banks could be maintained (and we understand that some of the law firms have started to consider this question).

B. The draft Safeguards Order, in particular proposed carve-outs

8. The general approach proposed in the consultation is to provide general exclusions for certain kinds of security – financial collateral and secured liabilities, as well as netting and set-off arrangements – from Special Resolution partial property transfers, an approach that our Members very much welcome.
9. However, certain carve-outs are also proposed and, as noted above, these would have the effect of preventing the Treasury’s general objective – as referred to in point 2.16 of the consultation – from being met. We explain our concerns about the implications of each of the proposed carve-outs below, but the key point to appreciate is that the greater the number of carve-outs from the basic netting and set-off safeguard, the greater the room for uncertainty as to whether certain arrangements are excluded or not. One way of addressing this problem would be to limit the carve-outs to retail business only, so that all wholesale business would fall within the protection of the safeguards (but there could be definitional – and therefore practical – problems with this approach). Another possibility that our Members are considering is whether the effects of the carve-outs could be limited by including an additional provision under which a counterparty, any of whose rights against or liabilities to a failed bank were transferred, to make an election – promptly after the partial transfer order – requiring such rights or liabilities to be transferred back to the failed bank. (Thus, for example, a counterparty would be able to keep a wholesale deposit and loan together with the same entity to preserve a position that was treated net for regulatory capital purposes if they wished to do so.) This additional element, it is thought, could enable clean legal opinions to be maintained – although the law firms will need to confirm that they agree with this analysis, and the practical implications would also need to be thought through. (It would be necessary as well, of course, to ensure that the reverse transfer powers in the primary legislation would permit such an approach.)

Set-off and netting

10. Although we are still considering the implications of the foreign property definition in Clause 39(2) of the Bill, the apparent effect of the foreign property carve-out in paragraph 3(3) would be to prevent a “clean” legal opinion being provided in the case of a netting agreement involving foreign rights and/or liabilities. This is important in market terms since arrangements involving foreign property are widespread, and will typically include repurchase and stocklending arrangements (where the securities sold or lent are held with a foreign depository or custodian), prime brokerage agreements and exchange-traded derivatives clearing agreements.
11. Moreover, many foreign property arrangements will be with foreign counterparties. In an international financial centre, any suggestion that foreign counterparties would suffer worse consequences than domestic ones seems highly unpalatable (and possibly in breach of our European obligations).
12. Given the jurisdictional limits of UK law, we appreciate that the issues raised by foreign property can be intractable; but this does not justify the blanket approach proposed and it may be that the only way to leave the UK banking industry

competitive in the international markets is to exclude all netting arrangements involving foreign property from the partial transfer powers. Alternatively, and given Clause 39(3) of the Bill, it may be that the difficulties of securing recognition in other jurisdictions of the effectiveness of a transfer are less insurmountable than feared, in which case there would be no need to maintain paragraph 3(3). This is an approach that has been discussed in the FMLC. (In this regard it should also be noted that Article 2 would disapply the entire Order – with the exception of Article 4¹ – where the only property, rights or liabilities which are not transferred are foreign property.)

13. The liabilities-only transfer carve-out provision in paragraph 3(4) would give rise to similar legal opinion difficulties as it would give the Authorities the power to transfer the liabilities owed to any of a bank’s counterparties regardless of the terms of a netting agreement. Such a transfer could be desirable to the counterparty of the failing bank at that time but the existence of the power would render all nettable arrangements ineffective for regulatory capital purposes, with significant negative consequences for regulated counterparties. The carve-out should also be deleted, therefore (and also see our comments at paragraph 9 above).
14. Paragraph 3(6)(a) carves out deposits as defined – very broadly – in the RAO. It is understood why the Authorities might wish to carve out retail deposits – this is conceptually in line with the carve-out for regulated mortgage contracts in subparagraph (b) – but as drafted the provision allows for the carve out of *all* deposits. This would cast doubt on the enforceability of on-balance sheet netting agreements for counterparties, and any set-off/netting agreements which included deposits would therefore not be eligible for net regulatory capital treatment in the hands of a regulated counterparty. Clearly this would not be an acceptable outcome but we do understand why for policy reasons the Authorities might wish to maintain a carve-out not limited to retail deposits: it was their consideration of this issue that prompted our Members to consider the alternative approaches outlined in paragraph 9 above. Paragraph 3(6)(b) carves out *regulated* mortgage contracts. We have some sympathy with the policy of carving out regulated mortgage contracts (as they are exposures to *retail* counterparties) but are not sure what impact this excluded right carve-out might have on offset mortgages and similar arrangements. We believe that a wider carve-out applying to all retail exposures – i.e. all rights and liabilities (including under regulated mortgage contracts) in respect of a retail counterparty – would be wider and give the Authorities greater flexibility.
15. Paragraph 3(6)(c) carves out “non-banking” exposures. Although we think that we understand the policy grounds for this proposal, it would inevitably give rise to problems on identifying the border between the banking and non-banking business of an institution. We believe that the provision should be deleted or amended to confirm that the definition of the business of banking is widely defined. Perhaps paragraph (7) was drafted with this in mind, and we wonder whether the position could be clarified by adding the following words after the section in parentheses: “where the supplier is acting principally in their capacity as a supplier of such goods and services and irrespective of any other relationship the supplier may have with the banking institution...”.
16. Paragraph 3(6)(d) carves out securities issued by the banking institution. We do not understand the policy grounds for carving out exposures relating to self-issued

¹ We also wonder whether Article 2 should make reference to Article 6 as well as to Article 4.

exposures. It is suggested in the consultation paper that this is aimed at subordinated securities but such securities are unlikely to be available for set-off in any event. The carve-out would also render nettable arrangements involving self-issued securities ineffective for regulatory capital purposes, with significant negative consequences for regulated counterparties. The effect would be that banks would be unable to use self-issued securities as collateral for repurchase or stock lending arrangements (other than where those arrangements fell under the Financial Collateral Directive). In the broad terms currently drafted, this carve-out seems to serve no specific purpose and should be deleted. If the Authorities do have specific concerns about subordinated securities, the carve-out should directly reflect such concerns and should not extend to all self-issued securities.

17. In response to our question at the last ELG meeting, the Treasury confirmed that there are no plans to include additional carve-outs (paragraph 3(6)(e)).
19. We would note, finally, that our Members have raised some concerns about the proposal not to define "excluded liabilities" in terms (the final part of paragraph 3(6) proposes that they should be defined simply by reference to "excluded rights").

Financial collateral

20. Although our Members very much welcome this exclusion, they believe that it should refer to the UK regulatory protections which extend beyond the EU requirements.
21. The purpose of sub-paragraph 4(3) of the Order is unclear, and its application could lead to uncertainty: is there any need for it?
22. Paragraph 4(1)(b) refers to "financial institution".

Secured liabilities

23. Our Members very much welcome this comprehensive exclusion, but some concerns have been raised by the use of the term "title transfer security" arrangements in the carve-out at the end of the opening part of paragraph 5(1). We understand that the Financial Markets Law Committee's response to the consultation will address this issue.
24. As regards the treatment of structured finance arrangements, our Members *do* consider that an explicit safeguard will be needed, and we are considering the extent to which the provisions on the appointment of Administrative Receivers in the Enterprise Act form a useful precedent (we also understand that Allen & Overy are writing to you separately on this aspect).
25. It is important to preserve the certainty of contractual arrangements and ensure that there is no impairment/delay of the perfection of legal title to the underlying assets where the assets remain with the originating bank (until the occurrence of certain events).

Other issues

26. We are considering the provisions in the Bill on group contracts, for example how they might affect the position of servicing contracts in securitisation transactions.

C. The draft “No Creditor Worse Off” Regulation

27. Our Members welcome the Authorities’ recognition that a pre-insolvency partial transfer could disadvantage the creditors whose claims are not transferred but we would note, however, that we had suggested that the kind of approach envisaged in the NCWO Regulation should be applied at an earlier stage as one of the criteria for determining whether a partial transfer should be implemented. We are clear that there is insufficient certainty about how a NCWO claim would be valued to provide any comfort on the clean legal opinions front.

Our comments at this stage on the draft set out in Annex B of the consultation are set out below.

28. *Application of NCWOR*: Regulation 2 should state affirmatively that the NCWOR applies in all cases of partial transfer under the Bill. The exclusion in 2 of the NCWOR from its application where only UK property, rights and liabilities are transferred likely will have a negative impact on the willingness and ability of a global institution to provide credit to UK banks.
29. *Appointment of Independent Valuer*: Regulation 3 should clearly indicate who has the responsibility to appoint the independent valuer. It should provide for at least consultation on the appointment with creditors. The criteria for choosing the independent valuer should be stated: the person (i) should have demonstrated experience in valuations of the type at issue and with respect to similar types of institutions, (ii) should be a person of high reputation in the field and (iii) should have no existing commercial or advisory relationships with the UK government, its agencies or the relevant bank that could cause a conflict of interest.
30. *Mandatory Provisions – Assessment and Valuation Principle*: The independent valuer should be required (4(2)) to take into account the close-out rights of counterparties in determining what the value would have been had the contract not been transferred. The independent valuer also should be required (4(3)) to determine value based on the actual treatment a creditor receives, rather than speculation as to what a creditor is “likely to receive”.
31. *Optional Provisions*: The provisions of Regulation 7 should be deleted. These provisions set forth valuation bases that could undermine the level playing field concept of the credit protections provisions.
32. In addition, we understand that the CLLS have some drafting comments on the Regulation.

D. Initial draft of the Code of Practice

33. Our Members have not yet concluded their consideration of the *initial* draft of the Code. However, we continue to believe that the primary legislation should make provision for elements of the Code to be mandatory. If this proposal was accepted, we think that the provisions set out below should be the parts of the Code with which the Authorities would be required to comply.

Part 3: General and specific conditions and choosing the SRR tools

Clauses 24 -28 – Determining that the regulatory pre-conditions are satisfied

Reason: to ensure consistency and clarity in the evaluation and decision making process each time the use of a stabilisation power is contemplated.

Clauses 29-33 – Determining that the specific conditions for exercising the SRR tools are met.

Reason: to ensure consistency and clarity in the evaluation and decision making process each time the use of a stabilisation power is contemplated. Additionally, clauses 32 and 33 give important guidance on the matters the Bank should take into account.

Clauses 34-39 – determining which SRR tool to use

Reason: to ensure consistency and clarity in the evaluation and decision making process each time the use of a stabilisation power is contemplated.

Part 4: Bridge bank and TPO governance arrangements

Clause 60

Reason: It is vital that any Bridge bank has an appropriate governance structure and is handled on an arms length basis.

Clauses 63-67 – Directors

Reason: It is vital that any Bridge bank has an appropriate governance structure implemented as soon as possible.

Temporary Public Ownership

Clause 88

Reason: This is a very important concept as it is important that all banks in the UK market operate on a level playing field.

Clause 92

Reason: It is vital that any bank in TPO has an appropriate governance structure implemented as soon as possible.

Clauses 97-98

Reason: In order to ensure a consistent approach across the UK banking market any bank in TPO should be subject the same regulatory and reporting requirements.

Other issues/Drafting

34. We have already commented on areas of the Bill dealing with the Code that our Members believe should be amended.
35. As for the drafting, we understand that the CLLS has raised points as regards paragraphs 29, 36, 74 and 75 of the Code.

E. Conclusion

36. We would be pleased, of course, to discuss the issues covered in this submission with the Treasury or to provide further information about any of the matters which our Members have raised if that would be helpful.

**London Investment Banking Association
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