It should be noted that, since this submission was submitted, the Banking Bill has been published and the areas of greatest concern are now to be dealt with by statutory instrument, which it is hoped will enable these concerns to be effectively addressed.

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19th September 2008

Dear Sir / Madam

Response of the Regulatory Law Committee of the City of London Law Society to the consultation document dated July 2008 entitled Financial Stability and Depositor Protection: Special Resolution Regime (the SRR Consultation Paper)

This response to the July 2008 Consultation on Financial Stability and Depositor Protection: Special Resolution Regime (**SRR**) is made by the Regulatory Law Committee of the City of London Law Society (**CLLS**). Our comments are limited in scope to those matters within the remit of the Regulatory Law Committee.

The City of London Law Society is the local Law Society of the City of London and represents City solicitors, who make up 15% of the profession in England and Wales. Members of the Regulatory Committee advise a wide range of firms in the financial markets including banks, brokers, investment advisors, investment managers, custodians, private equity and other specialist fund managers as well as market infrastructure providers such as the operators of trading, clearing and settlement systems.

Introduction

1. We refer you to our response (the **First Response**) to the January consultation paper entitled Financial Stability and Depositor Protection: Strengthening the Framework (the **January Consultation Paper**), a copy of which is enclosed with this letter for your convenience. In our First Response, we queried the need for a special resolution regime or special insolvency procedure to deal with a failing bank in light of the proposed changes to the Financial Services Compensation Scheme (the **FSCS**) which, in our view, would achieve many of the expressed objectives of protecting depositors and enhancing public confidence. The concerns we expressed in our First Response still stand and this letter should be read in conjunction with that one. We also note that the Insolvency Committee has written a separate response, which we endorse.

2. The expression "Authorities" when used in this letter means the Bank of England, HM Treasury and the Financial Services Authority (**FSA**).

Partial Transfers, Netting and Collateral

3. The primary regulatory concerns which the proposed SRR give rise to relate to the impact of the partial transfer options under the SRR. These give rise to potential uncertainty for the regulatory capital treatment of exposures to UK banks following the implementation of the regime. Netting and collateral arrangements are widely used and are a valid means of managing risk. Any effort to override some, but not all, netting arrangements would be a limitation on freedom of contract and would have significant consequences for market participants who use them.

4. Banks operate netting and collateral arrangements in order (*inter alia*) to mitigate their regulatory capital requirements. It is essential that these arrangements are enforceable in their entirety if they are to be used for regulatory capital purposes. Banks' ability to manage risk on a net (rather than gross) basis, taking into account the ability to realise collateral and undertake close-out netting is a key part of management of economic, as well as regulatory, capital.

5. The SRR as proposed will put limits on netting arrangements to only protect certain so-called qualified financial contracts (**QFC**). In addition, it is suggested that certain collateral arrangements may be overridden by the Authorities. It is feared these limits will create doubt as to the enforceability of existing and new netting and collateral arrangements as elements of the arrangements may or may not fall within the scope of the QFC and collateral safeguards.

6. The reason enforceability is key to netting and collateral arrangements is that banks can only manage their credit risk on a net basis if they can be certain of enforcing the arrangements in the event of a default or on insolvency, of the counterparty. Accordingly, there are detailed requirements of enforceability under Basel II (as implemented into EU law by the Directives 2006/48/EEC and 2006/49/EEC (together the Capital Requirements Directive (**CRD**)).

7. Netting is recognised in the CRD regime generally as a mitigant of credit risk. The CRD sets out detailed requirements for the recognition of netting and collateral.

8. Some of the examples where the requirements specifically provide for netting and collateral arrangements including:

- Off-balance sheet exposures - Part 7 of Annex III of Directive 2006/48/EEC provides that netting arrangements should only be recognised by competent authorities if there is a '*written and reasoned legal opinion to the effect that, in the event of a legal challenge the relevant courts and administrative authorities would find that the credit institution's claims and obligations would be limited to the net sum of their transactions and rights…'*.

- On balance sheet netting - Annex VIII Part 2 Point 3 of Directive 2006/48/EEC provides for on balance sheet netting to be recognised in respect of reciprocal cash balances between a bank and its counterparty, provided that (*inter alia*) the on-balance sheet netting agreement is "*legally enforceable and effective in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty*".

- Credit risk mitigation – Directive 2006/48/EEC provides conditions where collateral arrangements will only be recognised if they are legally enforceable (e.g. articles 92(1), 92(4), and 92(5)).

9. Failure to comply with these conditions results in the relevant protection not being recognised by the regulatory authorities. Any doubt as to enforceability will affect the certainty of counterparties to UK banks as to their rights on entry of a UK bank into the SRR.

10. If the SRR is to be implemented as proposed, it will have a significant effect on the regulatory capital requirements and the legal certainty of netting and collateral arrangements of UK banks. The banking market is a competitive one, for both financial services and in raising funds, and the new regime will certainly make credit relationships with UK banks less attractive, which will lead to the increased cost of those relationships whose enforceability is called into question. We believe that no limits should be placed on netting or collateral arrangements that UK banks may be party to. To the extent that the Authorities consider netting or collateral arrangements inappropriate for

UK banks, it would be more proportionate to regulate to prevent UK banks entering into such arrangements than to cast doubt on their enforceability.

11. We are also concerned that no cost-benefit analysis has been undertaken into the likely impact of these proposals.

Contractual overrides

12. A related area is the presence of possible overrides to contractual rights. These are found in a number of areas of the SRR proposals - including on transfer of part or all of a business, and in relation to group companies. We are concerned that these overrides currently remain ill-defined and potentially capable of creating or extending regulatory capital exposures which would otherwise terminate. An example is an undrawn liquidity facility in favour of a UK bank. The facility will typically provide that it may not be drawn on in the event of a default or insolvency of the UK bank. A lender will have a reasonable expectation that that provision will be effective. It will also expect that, following introduction of the SRR, it will also provide for the facility not to be capable of being drawn on on the bank entering into the SRR. If it is not made clear that such a provision will be binding on the Authorities, the lender will have to assume that, on the bank entering the SRR, it may be obliged to make payment under the facility. This would be likely to significantly affect the lender's willingness to enter into the facility. It will also be likely to affect the regulatory capital requirements of the lender (assuming it is regulated), as its exposure at default will be increased.

13. Similar concerns arise in relation to the general override suggested in the first July consultation (question 3.1) and the group override suggested in chapter 5 (question 5.9). It is essential that there be clarity on these points.

Large exposures

14. A related area is large exposures regulation. The prospect of transfer of shares, or of part or all of a business to a private sector purchaser raises the possibility of breaches of large exposures requirements of regulated counterparties through circumstances beyond their control. We believe that regulatory forbearance will be necessary on the part of the FSA and other regulators when dealing with such issues. The non-statutory Code should reflect this position.

Dual regulation

15. We would also raise a point around the importance of avoiding dual regulation. While we endorse the split in responsibilities as between the Authorities in the run-up to, and execution of, the SRR, there is a clear risk that as a bank goes through the close and continuous supervision process a bank will find that it is involved with both the Bank of England and the FSA. We believe that dual

regulation during the "amber" phase building up to the SRR would be unhelpful for banks: it would be potentially duplicative, and move resource away from the job of nursing the bank back to health. It should be made clear, both in the Code and as an operational matter between the Authorities, that firms should not have to deal with the Bank of England as well as the FSA in that period. If they do have to deal with both, there must be absolute clarity as to which entity has which authority and responsibility vis-à-vis the bank at that time.

The Regulatory Law Committee of the City of London Law Society

19 September 2008