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.

Banking Reform consultation responses
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19th September 2008

Dear Sir / Madam

Response of the Financial 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)

Information about the City of London Law Society and the Committee appears at the end of this paper.

General Comments

We are concerned that the SRR in the form proposed raises issues which potentially are highly prejudicial to the international capital markets and particularly prejudicial to UK Banks and to London as a centre of banking business. It does not appear that any economic impact assessment addressing these concerns has been carried out and it would not, therefore, accord with good legislative practice as we understand it to adopt the proposed legislation in the timescale proposed. We believe that a full economic impact assessment on the Special Resolution Regime (SRR) as presently proposed would indicate that the primary aim of protecting depositors could be achieved without need for legislation in the proposed form and that the proposals would not be helpful to achieving financial stability in the markets in normal conditions, or in the more difficult circumstances in which they might be used.

This is not to distract from the valuable work of the Treasury, the Bank of England and the FSA to improve financial stability and depositor protection, but as regards the proposed SRR we believe that to proceed to legislation at this stage would be counter productive. Our concerns are:

- The fact that the SRR has at its core the potential for interference in existing contractual relations on a vast scale would itself be a source of systemic risk. This is because financial institutions currently are regulated and assess risk on the basis of net exposures. The proposed SRR process creates more uncertainty than does the long-established US system on which it is based.

- If financial institutions and regulators continue to use the existing basis of risk assessment, then they would suffer erratic exposures to any institution to which the SRR was applied as a result of the "cherry-picking" of assets (leaving behind liabilities) which is permitted by the proposed legislation (except for a very limited class of "Qualifying Financial Contracts"). Exposures could become gross as a result of this process and in any event are made unpredictable. This unpredictability affects all financial institutions which are potentially subject to the SRR process, even though they may be in good financial health, since that situation may change.

- If prudential provision or regulation were to be changed to reflect the impact of the proposed legislation, then exposures would be measured to a large extent on a gross basis. In that event, the availability of funds in the interbank markets may become limited and the cost of funds for affected institutions could rise. There is even a risk that this could affect the attractiveness of London as a financial centre, if other regulatory regimes and legal systems are comparatively more predictable.

- The proposals on SRR do not necessarily contribute to furtherance of the aim of protecting depositors and therefore should only be adopted if they have been fully demonstrated to be beneficial to financial stability.

- In addition, as drafted, the proposed SRR regime does not fully respect the requirements of European Community Law as regards financial collateral, market charges and system charges, all of which are intended to protect financial stability and which the UK is bound to comply with.

We see two possible ways forward, which are not mutually exclusive:

- Concentration on improvement in the protections for depositors as to amount and time of payment and the ways in which this could be funded within the existing regime. This is the recommendation of the Insolvency Law Committee of the City of London Law Society, whose submission we have read in draft, and we agree with the general position taken in that paper. We too would recommend further consideration of the possibility of achieving the principle objectives of reform with a more limited adjustment to the depositor protection arrangements thereby reducing the impact of such a potentially destabilising change being introduced at haste without sufficient consideration by all affected parties. This work can proceed whether or not the proposed SRR regime is taken forward.

- Taking the time to amend the proposed SRR regime in such a way that it avoids the extreme level of uncertainty of the present proposals, provides a legal framework which is in accord with net exposure regulation, allows parties to predict their exposure and accords with legal requirements on financial collateral, market charges and system charges. The aim should be to provide more, not less, certainty for market participants than does the comparable US regime. The amended proposals should be subject to consultation on their economic impact to confirm that they do not have adverse effects or disproportionate costs for market participants.

We would not recommend adoption of the SRR legislation in the form proposed.

Legal Analysis Overview

The potential upsetting of property rights and of parties' freely negotiated contractual positions means that persons entering into agreements with banks will not be confident that their assessment of risks or remedies should those risks materialize can be relied upon.

In particular:

- the ability to force a transfer of a Bank's assets and liabilities to a successor entity means that counterparties who are subject to the transfer can have no certainty about the party with whom they are doing business. Counterparties must be free to rely on their contractual protection in that event;
- the position of counterparties who are left behind following a partial transfer when the good parts of the Bank are transferred away will be materially worse than it would be if no transfer occurs. Counterparties should be entitled to rely on their contractual rights in that event;
- any risk that set off and netting might be ineffective raises uncertainty. All set off and netting arrangements should be respected in respect of entire transactions and entire relationships (including with affiliates) for proper use of capital and economic efficiency.
- the ability to rewrite or ignore contractual provisions or to impose new ones means that new risks are introduced when providing capital or liquidity to a Bank.

We understand that the regime in the United States for dealing with a failing bank addresses these concerns by providing that there is no interference with contractual rights other than (i) a stay of action which may be as short as one day and (ii) the ability to repudiate contracts which are burdensome (but only with respect to all contracts with that counterparty (or its affiliate) and further providing that any transfer of contractual rights must extend to all contracts with that counterparty (or its affiliates). This "whole relationship" protection is central to the effectiveness of that regime.

We very strongly recommend that any new regime in United Kingdom respects contracts and relationships at least to a similar extent as in the United States. The public interest in a stable and efficient banking system is not promoted by legislation which increases risk and uncertainty. This legislation does that.

Failure to address this is likely to lead to increased cost of doing business, a worsening of the position of UK Banks, and a movement to deposit taking to more favourable regimes (relying on EU passport or the movement of operations to a non-UK subsidiary subject to a different lead regulator to continue to operate) thereby inflicting unnecessary damage and producing a result which cannot be in the interests of the public.

We have set out below some more specific comments on areas of particular concern regarding the proposed regime which we hope illustrate some of the practical aspects of risk associated with the proposed reform as they affect banking law and legal aspects of the operation of the banking markets.

Given the high level of these concerns we did not consider that it would helpful or meaningful to offer detailed comments on the drafting of the proposed clauses at this stage.

Specific Comments

In addition to the general comments made above we have a number of specific comments on the proposals.

1 Entry into SRR

The SRR gives the Authorities a very wide range of powers. It is important that the financial markets have confidence that those powers will only be exercised in circumstances where it is clearly in the public interest to do so. To better achieve this we suggest the following changes should be considered.

1.1 There should be a test at the time of entry that there is a likelihood that the use of the SRR is not only for a proper purpose but likely to be effective:

To commence the SRR it is only necessary that a (i) bank should be failing or likely to fail its Threshold Conditions; and (ii) it is not reasonably likely that, absent the use of the SRR, actions will be taken to enable the bank to satisfy the Threshold Conditions.

While the exercise of the power thereafter is subject to the conditions set out in Section 8, there is no test that the use of the SRR itself is likely to achieve its objectives. Given the extraordinary wide powers involved in the SRR there is a case for arguing that there needs to be a likely public benefit sufficient to justify the use of the SRR as a condition to it being invoked.

Accordingly, we suggest that there should be a further condition to triggering an SRR namely that the utilisation of the SRR is necessary either to (i) protect and enhance the stability of the financial systems of the United Kingdom; or (ii) to protect and enhance public confidence in the stability of the banking systems of the United Kingdom; and, (iii) in addition, that in either case the SRR can be expected to contribute to the achievement of that aim and to the protection of depositors.

This is in line with the objectives to be satisfied in the operation of the stabilisation tools (Para 2.16 and Section 7) but unless these are reasonably likely to be satisfied it is not clear why the SRR apply at all.

The conditions for triggering the SRR should not include all of the objectives. In particular Objective 4 – "to protect public funds" should not be a sufficient grounds to trigger the SRR: that would, in effect be give preference to public bodies over other creditors in every respect.

1.2 The reference to "failure to meet the Threshold Conditions" should make it clearer that it relates only to conditions 4 and 5 as none of the other conditions in Schedule 6 of FSMA are relevant.

1.3 The Specific Conditions as drafted raise a degree of uncertainty which may cause difficulty for the operation of the SRR.

Condition (A) (Clause 8 (2)) says that the exercise of the power is “necessary” but does not make it clear what is necessary for. We would suggest that the word “necessary” would be interpreted to mean “an essential condition for the achievement of a purpose or objective”. If that is correct then presumably the purposes are those set out in (a) –(c). In which case the use of the language “having regard to the public interest” raises a question – is it a qualifier to the word “necessary” or is it an additional test that there must be some public interest in the outcome?

It is also not clear as to the status of purpose (c) “the protection of depositors”. Is that a separate purpose so that even if the matter does not affect public confidence on financial stability then the SRR can still be utilised? By definition there is no public interest in that result. We fail to see why the powers of the SRR should be utilised in such a case and would assume a Bank Insolvency would be appropriate.

We do not consider that it should be a separate purpose and the word "or" should not be used at the end of Clause 8 (b). It should be made clear that it is an additional condition for the SRR to apply amended as suggested at 1.1 above.

2. Governance of the SRR

It is not clear what role, if any, the courts will have in the governance of the SRR. Of course speed in the initial use of the SRR may be critical to its success and it is understandable that the initial implementation of the SRR should not be made subject to unnecessary delay or uncertainty. However, after the initial phase there may be a prolonged period where rights of many persons could be affected or subject to indefinite moratoria and where it seems that decisions will be made by the Bank of England without supervision of either a creditors committee or the court. There may well be issues arising in the conduct of the SRR where there is at least a risk of perception of conflict of interest between the authorities and other stakeholders and the absence of a role for the courts leaves the authorities open to claims of abuse. This is particularly the case in dealing with the affairs of the residual bank after a partial transfer to a third party or a bridge bank.

It is suggested that the operation of the SRR as it affects the affairs of a residual bank in the Special Bank Administration Procedure (BAP) should be subject to the supervision of the courts and we agree that the Special Bank Administrator should be an officer of the court (question 3.30). Creditors and stakeholders would have access to the courts even if there is no creditor committee. Setting out a clear role for the courts will reduce the risk of successful challenge through judicial review.

This is not intended to remove the ability of the Bank of England to control the affairs of the residual bank but would provide a degree of independent scrutiny in the absence of a creditor committee.

The Bank Insolvency Procedure (BIP) is operated through the courts so it would seem consistent for the BAP Regime to operate similarly.

3. Partial Transfers

It is understood that the SRR may require a partial transfer leaving some of the assets of a bank behind in the residual bank. Further, in order to induce a purchaser to take on liabilities of the failing bank (in particular the liabilities to depositors) it may be necessary to transfer across the better quality assets with those liabilities leaving the residual bank with a worse position than before transfer occurred. Whilst this enhances the prospects of the success of the SRR in achieving its primary objectives it leaves creditors and stakeholders of the residual bank potentially in a worse position.

It is in particular in the area of partial transfers that the greatest difficulties arise and the most careful consideration is required (see FMLC Issue 133 Legal Assessment of the Safeguards that are Necessary for a Special Resolution Regime – 30 July 2008 available at *www.**fmlc**.org*).

Key issues are:

3.1 What types of SRR can a partial transfer apply to? Is it restricted only to a transfer to a bridge bank and not to a share or asset transfer to a third party? Could it also apply to a situation where a bank is subject to temporary public ownership? As Residual Company Creditor Compensation is only available for a sale of a bridge bank (or possibly for on sale of a bank subject to temporary public ownership) it would seem that partial transfers should be restricted only to transfers to a bridge bank as there may never be an on sale for a nationalised bank.

3.2 The ability to move assets and liabilities post creation of a bridge bank raises the possibility that the residual bank's position may be worsened (by moving assets to the bridge bank). This creates ongoing and potentially unlimited uncertainty for the residual bank and its creditors and stakeholders. Consideration should be given to limiting the circumstances in which these transfer can occur, specifying the purposes for which they can be made, imposing a final cut off date beyond which they cannot be made and establishing fair value for the transfer.

3.3 The possibilities that the effect of cherry-picking would have a domino effect on counterparties facing unexpectedly high exposures must be assessed, given that prudential regulation currently proceeds on the basis of net exposures. Alternatively, the cost of a move to assessing risk on the basis of gross exposures should be assessed, both as regards availability of funds and cost of funds.

We also note the suggestion that guidelines could be used to provide greater clarity in this area. Such guidelines would not be legally binding and also would be subject to change by relatively easy process. This would not provide the sort of certainty which would be needed for banks or regulators. Nor would it be possible to give firm legal opinions on the likely position in the event that the SRR was applied on the basis of non-binding guidelines.

4 Residual Creditor Compensation:

It is not clear which creditors of the residual company will participate in the Bank Resolution Fund – is it the creditors at the time of the initial transfer based on their exposures at that time or is it the creditors in the subsequent insolvent liquidation of the residual bank based on the claims admitted into the insolvency? What will happen to any surplus in the Bank Resolution Fund – will this be available to subordinated creditors and shareholders in the residual bank as proceeds of liquidation available for distribution? Para 3.134 seems to indicate that this would be the case but clarification would be helpful. Costs of resolution would be a matter which the creditors may have an interest in (particularly if the costs of advisor services procured by the authorities are to be borne by the creditors and not the authorities (Para 3.137). There is no reason why the creditors committee or the court should not have a role in approving these. There is no reason why the bank resolution fund should not be available where there has been temporary public ownership but costs may include cost of equity provide from the public purse.

5. Set Off and Netting:

The correct treatment of set off and netting for credit exposure and capital adequacy purposes is essential. This means that legitimate expectations that set off and netting will be available must be upheld. The current proposals to address this are inadequate and create expense and uncertainty and disregard the regulatory importance of these arrangements.

It is proposed that a list of Qualifying Financial Contracts (QFCs) be created and updated which would qualify for protection from cherry picking. It is very likely that such a regime will result in legal advisors being asked to opine frequently on any transaction where set off and netting may be relevant to the parties expectations as to whether the particular transaction is a QFC and that transactions which are not clearly QFCs will become impossible to do except at additional cost. This creates an additional business expense and limits creativity as new transactions or structures cannot be economically implemented until they are added to the QFC list. This also disregards the importance of set off and netting more generally and in particular its importance in the operation of capital adequacy measurement. It is suggested that a better approach would be either (i) to require that the entirety of a banking relationship be transferred without cherry picking where it is subject to a financial market master agreement (see FMLC paper at para 4.14). We understand that this would also reflect the position in the United States which are generally considered to be sufficiently widely drafted so as to prevent cherry picking in virtually all commercially arrangements which are subject to set off and netting on close out under a master netting agreement (see section 1821(e)(9)(a) of the US Federal Deposit Insurance Act) or (ii) irrespective of whether or not an arrangement is a defined QFC to provide that where the regulatory authorities of the relevant counterparty allow the position to be reported on a net basis then the authorities cannot cherry pick the arrangements so as to interfere with that netting. This would at least ensure that the regulatory authorities are supervising the counterparties to the bank on a correct basis. This would also address the structured finance concerned raised in Para 3.76.

The consultation paper at para 3.74 very significantly understates the importance of this issue to third parties dealing with a bank. The fear expressed by the authorities of manipulation by counterparties to fall within the protection against cherry picking is not proportionate to the economic consequence of potential disruption to the ability of banks to contract with those counterparties on economically efficient terms.

There is reference in the Consultation paper to the operation of the QFC concept in the United States. It should be borne in mind that the overall result in the USA is effectively the same as our proposals for change given above.

We would also point out that in the consultation papers issued in connection with the proposals relating to Market Contracts under part 7 of the Companies Act 1989 there is a discussion of the definition of “non-eligible investment products” whuich expressly recognizes that a definition based on a list is inappropriate "*as such a list could become out of date quite rapidly and potentially stifle market innovation. We expect the FSA would consider such matters as part of its usual ongoing supervision.*" Exactly the same argument applies to any attempt to create a specific list of QFCs.

6 Ipso Facto Clauses and rewriting of contractual terms

It is not clear if the legislation will purport to restrict clauses that will give rise to termination rights because of the failure of the bank or the change of identity of the counterparty. The draft legislation appears to restrict itself to preventing automatic termination clauses operating by reason of the transfer itself. It is suggested that there should be no restriction on counterparties being free to include effective clauses in their contracts permitting termination or other rights to arise by reference to facts relating to the credit or identity of their counterparty. There should be no restriction on those clauses being fully effective and enforceable (subject possibly to a short and specifically time limited stay). This would be comparable with the equivalent provisions in the United States. (US FDI Act sections 1821(d)(12), 1821(n)(4)(H) and 1823(c)(2)(C)).

7. Security Interests

It is suggested that the only security liable to be ignored on the SRR (but of course which would be recognised on any subsequent insolvency) would be a floating charge over all or substantially all of the assets of the bank (whether or not crystallized) where the assets in question were the subject of a transfer. In effect the bridge bank or purchaser would take free of the charge as if it had not crystallised and the disposal was made under the chargor’s license to deal free of the charge. The purchaser would not be bound by the charge. This would not prejudice a holder of a floating charge over all of the assets of a bank where the shares were transferred under the SRR.

It is important not to restrict the effectiveness of floating charges over specified pools of assets (e.g collateral for liquidity lines) which must remain effective and (if crystallised) would bind purchasers of assets from those pools. Counterparties must be confident that those pools and their security over them will at all times be recognized: the position of such floating charges should be clarified.

In addition, it must be stated that market charges, system charges and security protected by the financial collateral legislation will be protected. This accords with EU law. Many such charges take the form of floating or fixed charges over specified pools of assets. We have separately recommended that, because of the risks of recharacterisation of charges purported to be fixed but over substitutable assets, the protections afforded by the financial collateral legislation should be extended to cover floating charges over pools of assets in the nature of financial collateral.

8. SBAP

The main benefit of the SBAP is to ensure that there is a smooth transition across to the bridge bank by ensuring continuity of services to support the operations of the bridge bank and possibly to effect subsequent transfers where it subsequently becomes apparent that the assets (or liabilities) transferred are not all of that is required to achieve the objectives of the bridge bank. However the creditors of the SBAP also have a legitimate interest in its affairs and (subject to the overriding purpose of effecting the resolution) need their interests to be properly protected. The proposals as currently formulated do not do this adequately:

8.1 Whilst the paper suggest that there may be a number of secondary objectives (Para 3.91) it omits a key one which is to try to ensure that the bank becomes subject to a full winding up as soon as reasonably practicable and (subject to the proper operation of the SRR) to maximise the return to stakeholders on that winding up. This should be specified as an objective in itself.

8.2 The paper suggests that the appointment of a Special Bank Administrator be made by the court (Para 3.97) it therefore seems consistent to give the court an ongoing role in monitoring the activities of the Bank Administrator who should be an officer of the court. This is preferable to having the appointment made by the Bank of England with their overall direction and a reduced role for the court (ruling on disputes).

8.3 It is suggested that a moratorium be imposed in the SBAP. It is proposed that no enforcement of security may be made without consent of the Bank of England (Para 3.104). This is far more severe than the moratorium in a comparable US bank restructuring which can be as little as one day. At the very least this should be replaced with a provision that the consent of the court alone would be sufficient but of course the Bank of England would be able to make representations to the court. The residual bank has no long term future and is not a viable going concern so secured creditors should not lose their enforcement rights where a court consents.

8.4 The duration of any moratorium must be constrained. In an administration it is limited to 12 months (with an optional extension with the consent of the court for a further 6 months) there should be no reasons why a longer period is required in the SBAP and to be comparable to the USA regime it should be much shorter (45-90 days).

8.5 Unlike the proposal in Para 3.108 the Special Bank Administrator should be answerable to the court (not just the Bank of England) and it would not be appropriate for the Bank of England alone to modify the objectives without court supervision.

8.6 The suggestion that a special bank administrator may be able to disclaim onerous property outside of a liquidation (Para 3.111) would not be appropriate unless all of the protections affording in a liquidation to the affected third party were also available. Further such repudiation must be with respect to all contracts with that counterparty and its affiliates or they all must be left intact. (see US FDI section 1821 (e)(11) In the US the period for repudiation is limited to 180 days and damages must be paid by the FDIC for such repudiation (FDI section 1821(e)(3)).

8.7 It is suggested (Para 3.111) that there would be no creditors committee and that the Bank of England would fulfil that role. As the Bank of England has many different roles (including potentially as a creditor of the residual bank) this places the Bank in a position of perceived and possibly actual conflict. There is no reason why a creditors committee cannot be formed and if the court had overall supervision of the process the creditors would have standing. This would not diminish or restrict the Bank of England's position which would be given weight be the court particularly where the Bank of England was acting to promote the objectives the SBAP. The Bank could have a residual power to prevent to prevent disposals of essential assets without its consent.

8.8 In particular the creditors committee and the Bank of England should approve the special bank administrator's proposal.

8.9 The procedure should not be indefinite (Para 3.121). There should be a time limit which can be extended with leave of the courts. Creditors must have some process of bringing about an eventual liquidation.

9 Compensation Procedures:

The proposal of using an independent valuer (Para 3.141) is problematic. Unless he has a high degree of protection from the authorities it will be difficult to find any credible valuer to take on this task.

10. Groups

The SRR only applies to the deposit taking institution in a Group. Where that institution is part of a larger corporate group there may be complex inter group arrangements in place. Paras 5.38 and 5.39 are very unclear as to how the SRR would impact on the wider group. Whilst an obligation to continue to provide operational service (presumably at fair cost) is not in principle objectionable in practice imposing a mandatory supply contract may be quite impossible to achieve on anything other than a consensual basis and any wider power to alter or nullify inter group arrangements is likely to be wholly impracticable and effectively unenforceable.

Where the group is not UK incorporated or the underlying contracts are not governed by English law, there will be major difficulties under private international law which, in reality, cannot be overcome on anything other than a consensual basis.

Conclusion

In short, we do not consider the adoption of the proposed SRR legislation in current form as in the interests of the UK and recommend against proceeding with its adoption. We agree with the view expressed by the BBA in its letter to the Chancellor of 15th September 2008 that the proposed fast track timetable for legislation on the SRR carries unacceptable risks for banks and the UK economy generally. The legislation would require substantial amendment and rethinking to remove these uncertainties and to provide protection for security arrangements that are recognised in EU law as contributing to financial stability. Once that amendment had occurred, before being put to Parliament the complete draft, together with a legal analysis showing that its effects on legal certainty, would need to come satisfactorily through a full economic impact assessment of its effect on the cost and availability of funds to UK financial institutions to whom the SRR regime could apply. This should not prevent the adoption of measures to improve depositor protection, which we urge should be proceeded with independently of the SRR proposals.

The City of London Law Society and its Financial Law Committee

The City of London Law Society (**CLLS**) represents approximately 12,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments.

The CLLS responds to Government consultations on issues of importance to its members. The CLLS Financial Law Committee, made up of solicitors who are expert in their field, drawn from major firms operating in the City of London and in other jurisdictions, who advise leading financial institutions, exchanges and other financial market operators. Members of the Committee would be pleased to amplify any comments if this would be useful. Principal contact points for this matter are Dorothy Livingston (Herbert Smith, Committee Chairman dorothy.livingston@herbertsmith.com) and David Ereira (Linklaters, Working Party Chairman, david.ereira@linklaters.com). A full list of members of the Committee appears on the CLLS website (http://www.citysolicitors.org.uk).

Yours faithfully,