**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.**

The City of London Law Society

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

# Response to consultation document dated July 2008 entitled "Financial Stability and Depositor Protection: Special Resolution Regime"

The City of London Law Society (**CLLS**) represents over 13,000 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, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to Government consultations on issues of importance to its members. The CLLS Insolvency Law Committee, made up of solicitors who are expert in their field, have prepared the comments below in response to the proposals regarding the implementation of a special resolution regime (the SRR) for a failing UK bank or building society contained in the **consultation document dated July 2008 entitled "Financial Stability and Depositor Protection: Special Resolution Regime"**.

By email to: banking.reform@hm-treasury.gov.uk

Banking Reform consultation responses
Banking Reform Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

17 September 2008

Dear Sir / Madam

**Response of the Insolvency 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)**

**Introduction**

1 The City of London Law Society (**CLLS**) represents over 13,000 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, often in relation to complex, multi-jurisdictional legal issues.

2 The CLLS responds to Government consultations on issues of importance to its members. The CLLS Insolvency Law Committee, made up of solicitors who are expert in their field, have prepared the comments below in response to the proposals regarding the implementation of a special resolution regime (the **SRR**) for a failing UK bank or building society[1] contained in the SRR Consultation Paper. Members of the working party listed in Schedule 2 to this letter will be glad to amplify any comments if requested.

3 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 our First Response has been published on the HM Treasury website[2]. In our First Response, we queried the need for a special

[1] We have referred elsewhere in this letter to a failing bank but similar concerns apply in relation to a failing building society subject to the special issues discussed below in response to questions 5.1 to 5.9 of the SRR Consultation Paper.

[2] ILC-CLLS Insolvency Law Committee of the City of London Law Society.

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. We also expressed serious concerns regarding the impact that such special procedures could have on legal certainty, investor confidence and the international arena. We note that our comments (and the comments of many other respondents to the January Consultation Paper) appear not to have been taken into account in the further consultations. The concerns we expressed in our First Response still stand and this letter should be read in conjunction with them.

4 We believe that there is still an important debate to be had as to the balance to be struck between the protection of depositors and the existence of wide-ranging powers and flexible procedures to avoid the insolvency, and to rescue the "good" business, of a failing bank on the one hand and the erosion of the rights of stakeholders (with potential implications for the cost of lending, UK competitiveness and ultimately financial stability) on the other. In light of this, we do not believe that it is sensible or valuable at this stage to comment on the drafting of the proposed legislation. Instead we have set out below our main concerns arising from the SRR Consultation Paper followed by (in Schedule 1) our detailed responses to those questions which are relevant in the context of our overall approach.

5 We also remain of the view that the timetable proposed in the SRR Consultation Paper is too ambitious for a debate of this magnitude and we would strongly encourage the Banking Reform Team to extend the period for resolving some of the difficult issues that arise. There is a danger here that the Government will "legislate in haste and repent at leisure". Although we are aware that the provisions of the Banking (Special Provisions) Act 2008 expire in February 2009 and that this is (in part) what is driving the proposed timetable, it would always be open to Government to extend the duration of this temporary legislation in order to consult properly on the issues that arise.

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

**Principal concerns regarding the SRR**

7 Any debate concerning the SRR should involve a balancing exercise between the advantages (to the UK financial system and stakeholders including depositors) of giving the Authorities flexible and wide-ranging powers to avoid an insolvency, and to rescue the profitable parts of the business, of a failing bank on the one hand and the impact that such powers will have on legal certainty, stakeholder rights and ultimately investor confidence on the other. In our view, the focus to date has been too much on the

former and insufficient thought has been given to the consequences of the SRR on the latter.

*Impact on legal certainty*

8 Legal certainty and transparency is essential in a distressed situation. Counterparties dealing with a UK bank experiencing financial difficulties will want clear advice about their rights, powers and remedies in an insolvency or pre-insolvency scenario (including the impact of any special regime on contractual rights, security interests, rights of set-off and ranking in any insolvency process). Such advice will not only inform the decision as to whether that counterparty chooses to deal with the UK bank in the first place (rather than, say, a German bank) but will also affect the pricing of the particular transaction in question. The legal advice given to rating agencies regarding the impact of a UK bank insolvency on, for example, a securitisation or structured finance transaction may well affect the rating of that transaction (and hence the price at which the UK bank can raise funds through such transaction) and the legal advice given to the FSA in respect of netting or security arrangements can affect the amount of regulatory capital that a UK bank is required to carry.

9 Our principal concern regarding the proposals for the SRR is that it will be extremely difficult to give counterparties clear and definitive advice regarding their rights, powers and remedies in such a scenario. This is in large part because of the proposals regarding partial transfers (discussed further below); a counterparty will have no way of knowing in advance whether its liabilities will be transferred across to the bridge bank or private sector company or whether it will be left behind with the underperforming assets. Further uncertainty arises from the fact that it is proposed that: (a) any safeguards for stakeholders be contained in a Code of Practice (the legal status of which is uncertain and the details of which we have not yet seen); and (b) the Treasury should have the power by secondary legislation to make further provision as to the nature and effect of the property transfer powers (paragraph 3.11 of the SRR Consultation Paper).

10 Ultimately any uncertainty as to how the SRR will operate in practice and a lack of appropriate safeguards in respect of stakeholder rights could contribute to (rather than prevent) financial instability if it resulted in a loss of investor confidence in the UK banking system. Any legal uncertainty in this area could cause other banks to choose to invest elsewhere (rather than choosing to support a UK bank experiencing financial difficulties) or may, at the very least, raise the costs of funding for UK banks. If an investor discovers or anticipates that the rules of the game have changed or may change and that it may not form part of the orderly queue of creditors in an insolvency process (or that fewer assets might be left for creditors than would otherwise have been the case), that investor is likely to demand a larger risk premium. Increased risk

premia mean increased credit spreads and any measure that widens credit spreads on UK banks at this time would be unwelcome.

11 In our view, there is a risk that the SRR (as proposed) could result in a loss of competitive advantage for the UK banking system (within the EEA in particular) by encouraging investors to invest in non-UK banks rather than UK banks, or by encouraging non-EEA banks to establish EEA banking subsidiaries outside the UK, because of concerns regarding the lack of legal certainty of the proposed UK regime as highlighted above.

*Objectives of the SRR*

12 Throughout the consultation process, the emphasis of the Authorities has been on preventing systemic failure and protecting depositors. For the reasons given in our First Response, we consider that the second of these two objectives can be addressed through improvements to the FSCS. In relation to the first objective, we consider that any proposals which might ultimately discourage counterparties from dealing with a UK bank that is experiencing financial difficulties (because of a lack of legal certainty as to such counterparties' rights in an insolvency scenario) could be detrimental to the rescue of that bank and could thus (potentially) increase the chance of systemic failure. We do not consider that sufficient emphasis has been given, in the consultation process, to investor confidence and inter-bank lending through the wholesale market.

*Partial transfers*

13 We consider that partial transfers (either to a private sector purchaser or a State-owned bridge bank) and the corresponding impact on contractual rights, security interests, rights in an insolvency and (in practice) the ranking in an insolvency process are the most problematic aspect of the SRR Consultation Paper and we would strongly suggest that such proposals are not taken forward by the Authorities. While we acknowledge that partial transfer undoubtedly increases the chances of a successful operation and sale of a bridge bank and/or private sector purchase, the real question is one of the cost-benefit analysis – whether the ongoing costs to the industry in allowing partial transfer (in particular in the commercial ramifications for legal and contractual certainty) outweigh the benefits. We believe that the costs substantially outweigh the benefits. We are therefore of the view that the partial transfer power is so fundamentally inimical to the certainty which the markets require to operate efficiently as to be unjustifiable and counterproductive.

*International context and state aid issues*

14 The proposals need to be considered in an international context. It is not clear whether partial transfers or provisions nullifying or varying contractual rights would be recognised outside the UK or in respect of contracts governed by laws other than English law. It is also not clear whether the special administration regime or the modified liquidation regime referred to below would be recognised as "insolvency procedures" for the purposes of the Credit Institutions Winding-Up Directive so as to be recognised throughout the EEA. We suspect the modified liquidation procedure would be recognised but it is less clear that this would be the case in relation to the special administration regime for dealing with a residual company following a partial transfer to a bridge bank.

15 The potential state aid issues that arise in relation to partial transfers to bridge banks, public funding and the payment of fees by a bridge bank for the provision of services by the residual company through the special bank administration procedure have not been fully considered in the consultation papers.

16 Finally, we note that the proposed SRR seems to be heavily based on, and influenced by, the US model and the tools the Federal Deposit Insurance Corporation has at its disposal. The expertise of the working group does not extend to US law and we are not therefore able to comment on the relative merits or success of the US model. However, we would question whether the Federal Deposit Insurance Act (**FDIA**) is a good precedent for the UK given that: (a) it was created for small, local, deposit-taking banks and not the large, global, financially complex institutions we have in the UK; and (b) the European banking sector is markedly different to that in the US (where the banks' activities are limited by US law to engaging in specified activities such as deposit-taking, lending, custody and trust activities). We would also note that the FDIA has yet to be tested in a large-scale bank insolvency. It is not clear how successfully it would operate in the context of the failure of a systemically important bank.

**The Insolvency Law Committee of the City of London Law Society**

**September 2008**

**Schedule 1 to the response of the CLLS Insolvency Law Committee**

**Responses to Specific Questions in the Second Consultation Paper**

<table>
<tr><th>Question</th><th>Response</th></tr>
<tr><td colspan="2">SRR objectives, roles and governance</td></tr>
<tr><td>2.1</td><td>We agree with the first objective namely protecting and enhancing the stability of the financial systems of the UK. However, for the reasons given in the main body of our response, we believe that investor confidence and legal certainty regarding stakeholder rights are essential aspects of such stability and we are not convinced that these aspects are sufficiently protected by the SRR proposals.<br><br>In relation to the second two objectives[3], we believe that the Authorities' focus on protecting depositors at the expense of, and potential detriment to, other stakeholders could cause long term damage not only to the stability of the UK financial markets but also to the attractiveness of those markets. If the aim of the legislation is to protect depositors, enhance consumer confidence and prevent a run on a bank then (in our view) this could be achieved by reforming the FSCS. Whilst we understand and appreciate the benefits associated with, and resulting from, the ability of the Authorities to exercise powers to rescue a bank pre-insolvency in terms of preventing the consequences of another Northern Rock, the Authorities must be careful that, in exercising these powers, they do not undermine market and inter-bank confidence. If the SRR proposals ultimately discourage other banks from lending to a UK bank facing financial difficulties (because of any uncertainties as to the rights and position of such lending banks in the event of the SRR being utilised), this could seriously jeopardise the rescue of that failing bank and thus potentially lead to the financial instability that the SRR is intended to prevent.<br><br>We consider that a new objective should be added, or the second objective should be amended, concerning investor and market confidence in the stability of the banking systems of the United Kingdom.</td></tr>
</table>

[3] In relation to objective 2, we note that the word "public" is not defined and could conceivably include wholesale investors as well as consumers. Similarly objective 3 could in theory include wholesale as well as retail depositors. However, in view of the emphasis on consumers and retail depositors elsewhere in the paper, we assume that these expressions are not intended to include commercial counterparties. This should clearly be clarified in the legislation.

| | |
|---|---|
| | In relation to both objective 3 and objective 4, we are concerned that such objectives could give rise to an inference that depositors and public funds are to be preferred over other creditors despite the Authorities' proposal that such parties should not be given statutory priority in the modified liquidation process. If the inclusion of objectives 3 and 4 were to lead to a partial transfer being used to transfer deposits and public funding liabilities to the new entity, while leaving other creditors behind with the residual bank, this would result (in practice) in the depositors and the Authorities being in a better position than other creditors.<br><br>We have no objections to objective 5 but it is unclear how this objective is to be reconciled with the others (and in particular 3 and 4). |
| 2.2 | Under the proposals, the FSA will be the gatekeeper to the SRR. The FSCS is under the auspices of, and is controlled by, the FSA. We would like to understand the Authorities' views on the proximity of this relationship. Any nexus between the two institutions necessarily raises questions regarding independence and autonomy. Do the proposals contained in the SRR Consultation Paper create potential grounds for conflict between the FSA and the FSCS in respect of their respective roles and duties in relation to the SRR? What safeguards will be put in place should conflicts arise? We consider that further details need to be provided in this regard. |
| 2.3 | In view of the expertise of the working group, we do not feel we are adequately experienced or qualified to comment on the suitability or adequacy of the proposed triggers to be used by the FSA in determining when (and if) to employ any of the SRR tools. However, we consider that any triggers must be clear, objective and transparent to all investors and market participants. |
| 2.4 – 2.5 | We have no comments regarding the proposed division of roles and duties between the Authorities as set out in the SRR Consultation Paper. We would, however, urge the Authorities to explore further the role the courts should play in reviewing not only the Authorities' decision-making process but also the implementation of any of the stabilisation tools so as to afford all stakeholders an extra level of comfort and protection. We believe that, given the inevitable interferences with contractual and property rights and any potential for contravention of the Human Rights Act which may result from implementation of |

| | |
|---|---|
| | any of the tools, it is imperative that all stakeholders should have recourse to the courts in order to be able to challenge the decisions of the Authorities.<br><br>We note that, unlike the January Consultation Paper, the SRR Consultation Paper does not refer to a Chief Restructuring Officer (or person of similar stature and responsibility). We presume that this is a deliberate omission and that the Authorities have decided against the creation of such a role. Although we acknowledged in our First Response that there would be difficulties in defining the duties and responsibilities of such a person, the proposal that an experienced restructuring officer be appointed did give us some comfort that the SRR would be well-managed and would not be subject to the vagaries and whims of political spin-doctors.<br><br>The SRR Consultation Paper proposes that the Bank of England would, in selecting which stabilisation tool to use, have regard to the "public interest". It is not clear what this expression is intended to mean (and we note that it is not defined in the draft legislation). Given the focus of the Authorities on protecting depositors, we are worried that "public interest" will be equated with depositor protection and that the stabilisation tool selected will be that which is most in the interests of depositors (rather than stakeholders generally). Maintaining investor and market confidence in the financial markets could also be said to be in the public interest and, in some instances, could be more important than protecting depositors who already have the benefit of the FSCS.<br><br>As a related point, we query whether the protection of depositors should be, of itself, sufficient to trigger implementation of one of the stabilisation tools (draft clause 8(2)(c)). If depositor confidence and protection are addressed through the reform of the FSCS then surely the protection of depositors should not on its own be a reason for putting a failing bank into the SRR?<br><br>Finally in this regard, we note that, as currently proposed, the Bank of England would dominate the discussion as to what stabilisation tool to implement and how such tool should be implemented (including, in the case of a partial transfer, the choice of the assets and liabilities to be transferred across or left behind). This puts a significant burden on the Bank of England which will undoubtedly face huge criticism and/or adverse publicity if (with the benefit of hindsight) the judgment calls exercised by it are called into question. |

| | |
|---|---|
| 2.6 – 2.7 | As a means of indicating how the Authorities will deal with the run-up to, and the implementation of, the SRR, we consider that a code of practice may have some value. However, for purposes of legal certainty (and in particular when providing safeguards around the property or contractual rights that can be disturbed by the operation of the SRR), non-binding guidance in relation to the exercise of powers by the Authorities is valueless (particularly in the absence of any precedent). These matters should, instead, be set out in the legislation itself.<br><br>The legal status of the code of practice as proposed by the SRR Consultation Paper is uncertain. The Authorities seem to envisage that such a code will be given a statutory footing (paragraph 2.28). We agree with this approach and think that any code of practice must be enshrined in legislation. Given the potential importance of the code to counterparty confidence and legal certainty, we believe that it should be publicly consulted on before implementation; accordingly we would be grateful to be given the opportunity to review and comment on the draft legislation. Any amendments to and updating of the code should also be the subject of consultation.<br><br>It is also essential that any code of practice is brought into force at the same time as the rest of the legislation regarding the SRR. In relation to the special railway administration regime that was introduced by the Railways Act 2003, the detailed rules concerning the procedure were not made available until after Railtrack plc (the first company to use the regime) had gone into railway administration. We are keen to ensure that such a situation is not repeated in the case of the SRR. |
| **SRR tools: stabilisation powers and compensation** | |
| 3.1 | For the reasons given above, we have not reviewed in detail draft clauses 14 to 23 and our views set out below on the property transfer powers are of a general nature.<br><br>It is in the interests of legal certainty that a party to a contract or other legal |

| | |
|---|---|
| | instrument can take clear advice as to its rights and obligations. In principle, a transfer of all the business of a bank to a bridge bank or private sector purchaser could be thought to be relatively uncontroversial. However, the proposed property transfer powers go wider than the mere transfer of contractual and property rights: they also enable the Authorities to vary the rights of third parties. In particular, clause 19 of the proposed draft legislation empowers the Authorities to override termination or close-out rights under instruments which are transferred. The consultation and the draft legislation leave unanswered the question of whether termination rights which may arise by virtue of events related to the transfer, rather than by virtue of the transfer itself (such as the substitution of a new counterparty to the transaction or the exposures of the bank / transferee to the counterparty exceeding a certain limit) could also be overridden. This will be a question of key importance to counterparties whose rights are transferred as the loss of the right to close out or terminate on a property transfer (or certain related events) will be of commercial value to them. If left as they stand, the property transfer powers will give rise to qualified enforceability opinions.<br><br>The SRR Consultation Paper (and the earlier July consultation paper) propose that the Authorities be able to vary, nullify or create contracts (a statutory override) in two other circumstances. These are where contractual or other provisions present a barrier to the Bank of England lending or taking action under the SRR (for example negative pledges), or where a bank which is in the SRR relies on members of its group for services (such as employees, systems, payroll provision etc). The possibility of a statutory creation, alteration or nullification of a contract negotiated on arms' length terms is an extremely worrying development from a legal standpoint. These proposals would effectively negate counterparty rights and/or subordinate the rights of market participants to those of the Authorities. We consider that this would be fundamentally prejudicial to counterparties and group members, give rise to legal uncertainty and raise the costs of funding for UK banks as a result.<br><br>We also query how the property transfer powers are to be used where assets are located overseas. Although clause 20 purports to apply such powers to foreign property, it is not clear whether such powers would be recognised in a jurisdiction outside the UK in which property is located or whose law governs the contract in question. It is also unclear how clause 20(4) is intended to operate. As a matter of English law, is such property held on trust for the transferee (and if so should clause 20(4) not make this clear) and how does this work if the jurisdiction in |

| | |
|---|---|
| | which the property is located does not recognise a trust?<br><br>We are particularly concerned regarding the proposal in paragraph 3.11 of the SRR Consultation Paper that the Treasury be able, by secondary legislation, to make further provision regarding the nature and effect of the property transfer powers. This would result in further legal uncertainty for counterparties and we do not see why all necessary provisions could not be included in the primary legislation. |
| 3.2 | We consider that the share transfer powers are generally acceptable (subject to appropriate compensation provisions for existing shareholders) and, in practice, we think that this is the most likely tool to be used to transfer the business of a failing bank. However, we consider that there should be further consultation on the proposed powers to modify the nature and terms of the securities being transferred as, again, this leads to legal uncertainty on the part of the investor. It is currently unclear as to when (and why) it is proposed that such a power would be used. |
| 3.3 | We agree that a company limited by shares is the most appropriate legal form for a bridge bank (although this may not be the case in relation to a transfer of the business of a building society for the reasons given below). It is not clear, however, how such a bank would be capitalised. Would such capital be provided by the Bank of England and, if so, what return on capital (if any) would the Bank of England anticipate and how would this: (i) rank relative to the interests of disenfranchised stakeholders in the failing bank; and (ii) interrelate with payment for the SRR by the FSCS? Would the bridge bank need to comply with the regulatory capital requirements applicable to banks at inception or would there be special rules for such a bank? More detail is needed on these points.<br><br>It is also not clear who would be appointed as directors of the bridge bank. Paragraph 3.31 suggests that the directors may be selected by the Bank of England from amongst the existing directors of the failing bank (but excluding senior members of management who had contributed to the failure of the original bank) but there is clearly a question as to whether such directors would be willing to take on the corporate governance of the bridge bank. The SRR Consultation Paper does not specify whether the directors of the bridge bank would owe the usual fiduciary duties and be subject to the usual wrongful / fraudulent trading |

| | |
|---|---|
| | liabilities in the event of an insolvency of the bridge bank and further clarification is needed in this area. In particular, to whom would they owe their duty of care – the Authorities or the failing bank's creditors? There is a scope for conflict if the directors' roles and duties are not clearly defined.<br><br>We would also welcome further clarification regarding what a bridge bank will be able to do in terms of banking functions. Is it envisaged that it will be able to accept new deposits or to accept new business? There is a real risk that allowing it to carry out traditional banking activities could distort the inter-bank market. There is an argument that, because of the bridge bank's healthy and attractive balance sheet and because it is in effect supported by the Authorities, there is the chance that it will have a competitive edge over other banks. Have the Authorities considered these concerns? |
| 3.4 – 3.5 | We agree that it is not appropriate to have a bridge bank with an indefinite lifespan. However, we consider that a fixed term of 12 months is too inflexible. Imposing any inflexible and rigid limits on the life of a bridge bank could affect whether or not the optimum price is obtained for the assets in any onward sale to a third party purchaser. For example, if a potential purchaser is aware that the bridge bank has been in existence for 11 months, it may offer less for the assets knowing that the Authorities have limited time in which to achieve a sale. This may be an inevitable consequence of any time period chosen in respect of the lifespan of the bridge bank. However, this potential for distortion and loss of value could be lessened by building into the regime an option for the Authorities to apply to the court to extend the life of the bridge bank (if, for example, the initial time period is close to expiring and negotiations for a sale are at an advanced stage but have not yet concluded). As the continuation of the bridge bank could affect the compensation rights of creditors of the original bank, we consider that such creditors should have the right to be heard by the court that considers the application to extend the life of the bridge bank (unless there is a compelling reason why such an application should be heard *ex parte*). |
| *Partial transfers* | |
| 3.6– 3.10 | We have grave reservations regarding the desirability and effectiveness of partial transfers of assets either to a private sector purchaser or to a bridge bank. We have set these out below. As a result of these concerns, we do not support the |

| | |
|---|---|
| | Authorities' proposals to introduce partial transfers as one of their stabilisation tools.<br><br>*Preference of particular creditors*<br><br>In practice, partial transfers will almost inevitably be a form of statutory preference. Counterparties whose liabilities are transferred to the private sector purchaser or the bridge bank with the valuable assets will be in a better position than those counterparties whose liabilities are left behind with the residual bank. This will occur not least because of the over-collateralisation of assets relative to liabilities on transfer to ensure continued compliance with capital adequacy requirements – this is indicated in paragraph 3.50 of the consultation.<br><br>The SRR Consultation Paper suggests that the most likely scenario for a partial transfer is for the deposit book to be transferred to a private sector purchaser (paragraph 3.43) indicating, once again, that the main emphasis of the consultation process is on depositor rights. For the reasons given in our First Response, we query whether a partial transfer (and the detrimental effect that this would have on legal certainty) can be justified on the grounds of retail depositor protection and whether it is necessary in light of the suggested improvements to the FSCS. We would also question the practicalities of being able to transfer the deposit book as an isolated business. A bank's business is complex and it is not clear that the deposit book could always be neatly and cleanly severed from the rest of the bank's activities.<br><br>We note the statement, in paragraph 4.22 of the SRR Consultation Paper, that no changes are proposed to the current statutory order of priority of creditors for distribution purposes in the modified liquidation regime. However, as a result of the partial transfer provisions and the objectives of protecting depositors and public funds, we consider that, in practice, depositors and the Authorities (as the providers of public funding) may well achieve a better result through the SRR than other creditors. This is clearly a policy decision but, if this is the intention, we consider that it should be acknowledged in the consultation process.<br><br>*Legal and commercial certainty* |

The partial transfer provisions create legal uncertainty including the effect of the transfer on (a) contractual rights and obligations (see in particular our comment on question 3.1 above) and (b) security interests and close-out netting (see below).

Partial transfers will also affect commercial certainty as a creditor of a bank will not know whether, in the event the bank is put into the SRR, its entitlement will be transferred or left in the residual bank. Because the powers place no limit on the Authorities' ability to effect a partial transfer, a creditor may suffer no loss following the implementation of the SRR (if the debt is transferred to the bridge bank or private sector purchaser), the creditor may recover nothing (if all the assets are transferred out of the residual bank, the debt is left behind and the bank resolution fund does not generate a return) or its recoveries may be somewhere between those extremes. Hence it will be difficult to advise a counterparty as to its position in the SRR.

*Impact on set-off and netting*

Partial transfer could also have a significant impact on set-off and netting. Banks currently manage credit risk on a net basis in reliance on the legal enforceability of set-off and close-out netting arrangements. Without appropriate protections, partial transfer powers could override netting arrangements (for example if "in-the-money" positions were transferred to the transferee but "out-of-the-money" positions were left with the bank) effectively leaving counterparties exposed on a gross basis to a bank in SRR. Although it is proposed that netting be addressed by providing for a carve-out for "qualifying financial contracts", this is not without its difficulties (see our response to questions 3.15 – 3.18 below).

*Impact on collateral and security interests*

A related risk is the destruction of certainty as to rights in collateral: the partial transfer powers would enable the Authorities to disassociate secured obligations from the collateral which secures them, effectively leaving counterparties unsecured. Although it is proposed that there be some carve-outs in this regard, the consultation does not go into any detail as to how this would work.

*Due diligence in relation to partial transfers*

To ensure that a proper price is paid and maximum value obtained, any partial transfer would require a thorough due diligence exercise in order to ascertain what are the healthy, good assets and liabilities that can be transferred to either a bridge bank or a private sector purchaser and what are the bad, worthless ones that will be left in the residual bank. Moreover, if the qualifying financial contracts or structured finance safe-harbours are introduced, a thorough and accurate due diligence exercise would also be necessary to ensure that no connected or inter-related contracts are inadvertently split up in the transfer process. There is little detail in the SRR Consultation Paper as to how, when and by whom such a due diligence exercise would be carried out. We note that the Authorities state that they will rely on the failing bank's records and regulatory documentation to make a quick and informed assessment regarding what assets should be transferred across and what assets should be left behind. Whilst in theory this works, it relies on the failing bank having adequate and accurate records. If a bank's failings are a result of poor management, it is unlikely that its records will have been well-maintained. The quickness and accuracy of the due diligence exercise may well impact on the price obtained for the assets and the value (if any) of the residual bank and therefore we would suggest that this aspect of the partial transfer proposals requires further consultation.

*Safeguards for creditors*

Critically, none of the consultation papers has set out any statutory protections for stakeholders in relation to the issues referred to above. Given the ramifications of partial transfer for stakeholders, such protections are essential; otherwise the loss of certainty as to counterparties' legal rights will damage confidence in the UK banking sector. That could result in increased, rather than reduced, financial instability.

In particular, it is not clear what mechanisms and procedures there will be for stakeholders to challenge the transfer process, the asset selection process and the valuation of those assets and liabilities. What if stakeholders consider that the price obtained for the partial transfer was not the best one available? Will the remedy be for such stakeholders to bring an action against the Authorities for their role in implementing the SRR (in the same way as a disgruntled creditor

| | |
|---|---|
| | might bring an action in negligence against an administrator who sold the assets of a company through a pre-packaged administration at less than their true value) or are the Authorities to have immunity from suit? Clearly it would have a detrimental effect on any transfer to a private sector purchaser if the stakeholders could overturn the transfer itself and so an action against the Authorities may be the only practical alternative.<br><br>The necessary safeguards to mitigate the concerns raised in this letter must be enshrined in law and not in guidance.<br><br>*Conclusions regarding partial transfers*<br><br>For all of the reasons given above, we do not consider that the advantages of a partial transfer (in relation to providing greater flexibility when seeking to rescue a failing bank) can be justified in light of the potential cost in terms of legal and commercial certainty. We are aware that, in some special administration procedures (for example, for protected railway companies or PPP companies), the legislation allows for partial transfers of assets. However, in the few cases in which such special administration procedures have been used, the administrators attempted to achieve a transfer of the business as a whole possibly because of the difficulties that a partial transfer would have raised. |
| 3.11 – 3.13 | Given our grave reservations as to the desirability of partial transfers, we do not propose to comment on the subsequent transfer proposals but instead would simply note that any subsequent transfer power could again impact on creditors' rights. For example, there may have been secondary trading in the residual bank's debt and any subsequent transfer of assets may upset that position. |
| 3.14 | We consider that there is insufficient detail in the SRR Consultation Paper for us to be able to comment in relation to this question. We note, however, that it is assumed by the Authorities that a sale of the bridge bank to a purchaser in due course will generate proceeds of sale in excess of the costs of the resolution (so that the circumstances in which the creditors who are left behind with the residual bank will be worse off as a result of a partial transfer will be limited). In our view, |

| | |
|---|---|
| | it is by no means certain that this will be the case. We would expect management of the assets of the bridge bank to be challenging: existing management is likely to have failed and new management is unlikely to be familiar with the business. Management time will need to be given to the splitting of assets between the residual entity and the bridge bank and markets will be likely to move against the failing bank. For all of these reasons, we consider that there is a significant risk that the value of the bridge bank could fall rather than rise and hence we do not consider that the bank resolution fund should be the only avenue of compensation for a creditor of the residual bank.<br><br>Furthermore, it is not clear from the SRR Consultation Paper how the bank resolution fund (or equivalent compensation provisions) would work in the case of a partial transfer to a private sector purchaser. |
| 3.15 – 3.18 | We believe that statutory safeguards for set-off and netting are essential. The ability to set-off and net financial arrangements is of enormous importance in managing credit risk. Furthermore, we believe that there would be a high likelihood that limiting the scope of netting so as to put the scope of any currently enforceable netting arrangement in doubt would have adverse consequences for the UK financial markets, by driving business offshore and increasing the cost of funding for UK financial institutions (for example by requiring such institutions to hold regulatory capital on a gross rather than a net basis).<br><br>Introducing the concept of "qualifying financial contracts" will lead to carve-out complexity and is too arbitrary. We also query whether the legislation listing what types of contract are to be defined as "qualifying financial contracts" will be able to keep up with market developments and creativity. |
| 3.19 – 3.20 | Without appropriate safeguards, we consider that the SRR proposals could have a detrimental effect on structured finance arrangements because of the lack of legal certainty regarding the impact of the proposals on counterparty rights and therefore the difficulty that legal advisors will have in giving the necessary transaction opinions on which the rating agencies depend. However, it is difficult to see how an appropriate safeguard could be framed. Paragraph 3.76 suggests that this should protect "interconnecting parts of a structured finance arrangement from being separated in the course of a partial transfer". However, |

| | |
|---|---|
| | this could include a wide range of the failing bank's activities (for example if, in the context of a securitisation, the originator bank agrees to act as servicer of the loans). There is a danger that any carve-out wide enough to protect all structured finance transactions would effectively prevent partial transfers by requiring substantially all of the business to be kept together. |
| 3.21 – 3.22 | We agree that a safeguard to protect security interests could make a partial transfer more difficult. However, we do not consider that this difficulty justifies such security interests being overridden by the SRR. Holders of security have a legitimate interest in the realisation of that security. A loss of certainty as to a secured creditor's rights could have a damaging effect on confidence in secured financing arrangements and on the regulatory treatment of secured interbank lending. This is highly significant as banks engage in extensive secured credit relationships (particularly through repos, covered bonds and collateral under OTC derivatives). It is also not clear how any erosion of a secured creditor's rights in respect of financial collateral would sit with the UK's obligations in respect of the Financial Collateral Directive. |
| *Special bank administration regime* | |
| 3.23 – 3.41 | For the reasons given above, we do not consider that partial transfers should be allowed and therefore, in our view, there is no need for the special bank administration regime. We have therefore not considered in detail questions 3.23 to 3.37. However, we would make the following general points in relation to the proposed regime:<br><br>• As the residual bank would almost certainly be insolvent, it would be necessary for the directors to commence the special bank administration regime immediately to protect them against wrongful trading liabilities.<br><br>• We cannot see why the special procedure would be needed in the case of a partial transfer to a bridge bank but not in the case of a partial transfer to a private sector purchaser.<br><br>• It is not clear whether the special bank administration regime would be an "insolvency proceeding" for the purposes of the Credit Institutions Winding- |

Up Directive so as to be recognised throughout the EEA. As the primary purpose of the procedure is to support the bridge bank (rather than its being a collective procedure for the creditors), it is doubtful that the proceeding would be recognised.

- The concern for creditors in relation to the proposed purposes of the special bank administration regime is that they suffer a double hit. First they are left behind with the under-performing assets rather than being transferred to the bridge bank. Secondly, any (limited) resources or assets that the residual bank may still have are then to be utilised in order to support the bridge bank (rather than being realised in order to make a distribution to those creditors). Furthermore, the creditors will have little say in what are "non-essential" services and assets that the special bank administrator is able to realise in the interests of the remaining creditors.

- The role of the residual bank is primarily one of support to the new bridge bank. It is unclear how this support role would work in practice. Presumably there will need to be agreements between the two banks. This assumes that the residual bank has the ability to enter into any such agreements and to make such promises of continued support and service provision. What if, for example, the essential service relates to IT that is licensed to the residual bank or intellectual property that is not owned by the residual bank – can the Authorities force a third party that is outside the residual bank's group party to continue to provide services? The matter becomes more complicated if the third party is not subject to the jurisdiction of the UK court.

- We consider that the special administrator should be an officer of the court and the procedure should be commenced by order of the court in order to give creditors an opportunity to make representations as to who is appointed or to bring disputes before the court.

- As a general comment, we do not consider that the usual rights and powers of creditors should be transferred to the Bank of England. In circumstances where those creditors have already been prejudiced by being left behind with the residual bank, we consider that it is even more important that they have some say in how the residual bank is managed.

| | |
|---|---|
| 3.42 | We agree that it should. We note that nationalisation effectively involves state expropriation of shareholder rights. Share sales to a private sector purchaser have the same effect. The European Convention on Human Rights allows infringement of private law rights in this way only if appropriate compensation is provided. As discussed below, the quantification of compensation is a complex and controversial issue. |
| 3.46 – 3.50 | There should be adequate compensation for the infringement and erosion of private law rights but the quantification of such compensation is complex and gives rise to the following practical and legal difficulties:<br><br>• How should one quantify the value of shares in a failing bank which is supported by the State (typically a failing bank will have had recourse to the Bank of England as lender of last resort, without which it would have become insolvent earlier)?<br><br>• If there is shareholder value, how should one quantify loss to shareholders as a result of the operation of the relevant SRR tool?<br><br>• What rights of recourse should be available to shareholders for mismanagement by the Bank of England and should this Authority have statutory immunity for its role?<br><br>The concern with substituting shareholdings for unquantifiable compensation rights is that the consequent uncertainty could affect the ability of banks to raise capital in the markets – at a time when the banking industry is capital constrained.<br><br>It is imperative that stakeholders have a right to challenge the valuation (and the valuation process) after the event. A purchaser, however, will want certainty that the consideration paid by it will not be subject to subsequent query or challenge. At the very least, it will be necessary to ensure that, even if the value of the consideration is called in to question, this would not unwind the transfer nor affect the purchaser's title to the assets. It is arguable that, if it is the Authorities that |

| | |
|---|---|
| | have procured the transfer, then they should be the ones compensating stakeholders for any loss resulting from a flawed valuation. |
| 3.51-3.52 | This is a policy issue on which others (e.g. the BBA) will be more qualified to comment. We note, however, that requiring the FSCS to bear the cost of the SRR is expanding the responsibilities of the FSCS significantly. |
| **SRR tools: bank insolvency procedure** | |
| | As a general comment, we note that the Authorities have taken on board the comments of a number of respondents to the January Consultation Paper and have sought to avoid making wholesale changes to existing winding up provisions. We welcome this approach.<br><br>On this basis, we consider that the modified liquidation procedure is likely to be recognised as a collective insolvency proceeding for the purposes of the Credit Institutions Winding-up Directive although we would welcome the views of the Authorities in this regard. |
| 4.1 | These do not appear to be contentious. |
| 4.2 | The difficulty here for a liquidator will be in balancing the first objective (i.e. to engage with and assist the FSCS to ensure that depositors are paid out on a timely basis) with the second objective (i.e. winding up the affairs of the bank to achieve the best result for the bank's creditors as a whole). For example, it may be in the interests of the creditors as a whole to reduce costs by closing down the bank's operations and making the employees redundant, particularly in cases where there is no business to be saved. However, in order to assist the FSCS, the liquidator may be obliged to keep certain branches open and to retain certain staff for this purpose. As the first objective is to take precedence, it would appear that, in such circumstances, the liquidator would be obliged to keep the operations going even if this was not in the interests of the creditors as a whole. It is not clear why, from a public policy perspective, the rights of depositors should be more important in this respect than the rights of other creditors (including potentially employees and pensioners). |

| | |
|---|---|
| 4.3 | No comment. |
| 4.4 | As one of the main purposes of being on the liquidation committee is to be kept informed of the progress of the liquidation, we can see no reason why creditors other than (and in addition to) the FSA, the Bank of England and the FSCS should not be entitled to be appointed to the liquidation committee from day one. Such creditors have an interest in knowing what actions the liquidator is proposing to take to realise the first objective and what the costs of these actions are likely to be, particularly as such costs could have a direct impact on such creditors' recoveries (subject to the proposals that the FSCS would cover the costs of protecting eligible claimants[4]). |
| 4.5 | No comment. |
| **Building societies and other issues of scope** | |
| 5.1 – 5.8 | We think that it is right that the SRR should be applied to building societies as well as to banks. However, we would query what happens to the members of the failed building society. We presume that de-mutualisation would occur on the transfer of the undertakings to a bridge bank if such entity is a private company limited by shares but, in the case of a transfer to an existing building society, we think it would be useful if the legislation allowed a transfer of the memberships of the failing building society to the purchaser (as is the case pursuant to Building Society Act 1986).<br><br>We also wonder whether special issues arise in relation to the transfer of part of the building society's undertaking to a bridge bank or private sector purchaser. Clearly the existing members will be left owning the residual building society that will now contain the unattractive parts of the business. In view of the typical profile of a building society member, the Authorities may have concerns about this from a public policy perspective. |
| | |

[4] We find these proposals problematic as we are not convinced that a liquidator's costs will always be divisible between actions taken to protect depositors and actions taken to protect creditors more generally.

| | |
|---|---|
| 5.9 | The possibility of a statutory creation, alteration or nullification is very worrying from a legal standpoint. Although the scope of the provision is not clear, the effect could be to negate counterparty rights and/or to subordinate the rights of market participants to those of the Authorities. To do so would be fundamentally prejudicial to counterparties, give rise to legal uncertainty and raise the costs of funding for UK banks. |

**Schedule 2 to the response of the CLLS Insolvency Law Committee**

**Members of the CLLS Insolvency Law Committee's Working Group**

Hamish Anderson, Norton Rose LLP

Maureen Farrell, Herbert Smith LLP

Stephen Gale, Herbert Smith LLP

Ian Hodgson, Slaughter and May

Jennifer Marshall, Allen & Overy LLP