The City of London Law Society

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Response regarding Banking Bill: Impact on Cash Management Systems for Corporate Customers

1. It is not just financial institutions that rely on netting or set-off arrangements. Set-off lies at the heart of numerous cash management arrangements offered by banks to groups of companies. These are based on the standard forms of individual banks and are often not described as master agreements. There is no market standard form of agreement (comparable to the ISDA Master Agreement for derivative and other transactions) which is used for cash management purposes. As far as we are aware, there are no statistics publicly available as to the amount of money subject to such cash management systems but the total is certain to be huge.

2. Typical features of the above systems are that (i) the bank agrees, for the purposes of calculating interest, to deduct credit balances from debit balances on the current accounts of the group companies participating in the system, (ii) each participant authorises the bank (if it chooses) to set off money standing to its credit on a relevant account within the system against the indebtedness to the bank on the relevant accounts of the same or any other participant, (iii) each participant is permitted to utilise a group overdraft facility (up to a net limit) subject to guaranteeing, or being liable as a co-obligor for, the indebtedness to the bank of each other participant. Such systems offer improved risk management for banks and also offer corporate customers an important saving in interest charges and a reduction in credit risk in relation to the bank concerned.

3. If the contractual right of set-off is reciprocal, the group has the ability to achieve a net settlement under which a single net amount is payable to or from the bank. Even if the contractual right of set-off is not reciprocal, the group can, subject to certain exceptions, rely on automatic, self-executing, mandatory set-off under Rule 2.85 of the Insolvency Rules 1986 (if the bank enters into administration and the administrator decides to make a distribution to creditors) or under Rule 4.90 (if the bank enters into insolvent liquidation). If such set-off was disapplied or excluded, the insolvency representative of the bank could require payment of the debit balances owing to the bank by group companies whose accounts are overdrawn, while treating group companies with credit balances on their accounts as mere unsecured creditors of the bank for the amount of those credit balances. This could result in the financial position of the group itself being destabilised.

4. A reporting entity in a group of companies is permitted under International Accounting Standard (IAS) Number 32, paragraph 42, to offset a financial asset

against a financial liability and state the resulting net amount in its balance sheet when, and only when, that entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

5. Similarly, a bank is permitted to report to the FSA on a net basis in relation to debit and credit balances within such systems when, and only when, certain minimum criteria are fulfilled: see section 5.3 of the FSA's Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU). In particular:

(a) the on-balance sheet netting agreement must be legally effective and enforceable in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty;

(b) the reporting bank must be able to determine at any time those assets and liabilities that are subject to the on-balance sheet netting agreement;

(c) the reporting bank must monitor and control the risks associated with the termination of the credit protection; and

(d) the reporting bank must monitor and control the relevant exposures on a net basis.

6. It is essential that the changes contemplated in the Banking Bill and its related secondary legislation do not undermine the ability of corporate customers and banks to report on a net basis and, if the need arises, to effect a net settlement by operation of netting or set-off.

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 a variety of consultations on issues of importance to its members through its 17 specialist committees. This response to the consultation regarding the Impact on Cash Management Systems for Corporate Customers has been prepared by the CLLS Joint Working Party on the Banking Bill. The Working Party is comprised of representatives of the Financial Law, Insolvency Law and Regulatory Law Committees. The Committees are made up of a number of solicitors from City of London firms who specialise in these areas of law. The Committees' purpose is to represent the interests of those members of the CLLS involved in these respective areas.

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11th December 2008