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Financial Stability Contingency Planning
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

By post and by email (non-bankresolution@hmtreasury.gsi.gov.uk)

28th September 2012

Dear Sir,

Re: Financial Sector Resolution: broadening the regime

The City of London Law Society ("CLLS") represents approximately 15,000 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 19 specialist committees. This response in respect of the consultation on *Financial Sector Resolution: broadening the regime* has been prepared by the CLLS Financial law Committee.

We are pleased to have the opportunity to respond to this consultation and very grateful for being allowed additional time to do so. We deal with each group of questions asked below. Our answers may not always address every question.

- ***Do you agree that the four types of non-bank identified above – investment firms and parent undertakings, CCPs, non-CCP FMIs and insurers – are those that are most likely to have the potential to be systemically important?***

- ***What other types of non-bank – if any – might have the potential to be systemically important? If there are any others that may be systemically important what policies should the Government adopt to mitigate the risk they pose to financial stability?***

While these four categories do include entities that are or may be systemically important, we urge against casting the net for special resolution unnecessarily wide.

First, because the UK has a generally effective resolution regime through the use of schemes of arrangement, administration and winding up procedures which has been used for many years to address failures including those of many businesses in the identified categories. Use of special regimes would be more expensive to the public purse and risk greater injustice to stakeholders in failed businesses than the use of the existing regime without necessarily improving financial stability in the case of the majority of the businesses in scope. In addition all affected businesses risk an increase in the cost of capital on a permanent basis, although the circumstances in which they would be resolved are extremely rare. The most systemically important financial services businesses suitable for a variant of the Banking Act 2009 regime (investment banks) are covered by the extension to that regime already in place. A little attention to the general insolvency regime would make it fit to deal with most of the business failures in scope for the proposed further extension and we believe this would be at a lesser overall cost. Although the RRD may require some intervention from regulators for a wider range of businesses, we would urge the Government to argue in Europe that the operation of that regime should be capable of being made as economically as possible using existing structures as far as possible and applicable only where really needed. We urge the Government to work on this matter in close co-operation with EU and international initiatives.

Second, because the impact on cost for the affected businesses and for their competitiveness has not been fully assessed. The adverse effects are greater where the UK acts alone or imposes additional burdens on the businesses concerned. With regard to parent companies, much of the hoped for increase in competition in the financial sector may come from conglomerate businesses (e.g. supermarket chains offering personal banking and other financial services). The proposed banking reforms will already have a chilling effect, but the risk of being resolved under the special regime, merely because the group contains a financial services business, can be expected to add discouragement to market entry. To an extent this could be addressed by clear provisions to halt use of resolution powers with a sub-holding company heading the financial services and banking activities of a conglomerate, even if the ultimate holding company is incorporated in the UK.

Third, because if the UK proceeds ahead of the EU proposed measures it risks subjecting businesses already facing increased regulation to the uncertainty and cost of adopting one set of measures, only to find that the EU measures require something different, while losing the flexibility to respond to EU requirements as far as possible within the existing well respected UK general resolution regime. While it is important for the UK to have a clear vision as to what would be suitable for financial businesses and to put forward its views in the European forum, as this is an area of clear EU competence with draft legislation already published, actually legislating to a different effect carries clear costs and risks, which may well outweigh any perceived benefits at a time when businesses in the financial sector already face burdens which limit their ability to assist the UK economy's return to growth.

There are additional issues applicable specifically to treasury functions of non-financial businesses, CCPs and FMIs and insurance companies, which should be considered in deciding if the proposed regime is actually needed or is well designed, to which we shall allude below.

While there are a number of other businesses which are systemically important to the UK economy: eg suppliers of rail infrastructure, water, energy transmission and distribution and some energy suppliers, we note that they already have resolution regimes which track the normal insolvency regime closely and we do not believe that any further steps are needed as regards businesses outside the financial sector.

- ***What are your views on the UK introducing resolution powers for these firms in advance of conclusion of the negotiation of the RRD?***

As indicated above, we do not believe that the case for acting ahead of the RRD is made out.

- ***Is the definition for investment firm set out above appropriate?***

- ***Are the conditions by which the Bank is required to judge the necessity of exercising stabilisation powers correct?***

We believe that if this broad definition is used it would be appropriate to legislate to exclude firms which are clearly too small to be systemic. They should be left to ordinary insolvency processes and not burdened with the cost of preparation for resolution. We note that the draft RRD proposes such a measure and consider that it is wise. The current UK insolvency and resolution regime has proved adequate for such businesses, a number of which fail in both good times and bad, for a variety of reasons. There seems no reason to involve the Bank of England at all in their resolution.

There would be an adverse impact on innovation and competition if costs and regulatory burdens, as well as increased cost of capital arising from resolution risk, are set at a level which would tend to result in smaller businesses being excluded from the market.

- ***Should any further safeguards be applied to qualify the use of powers within a financial or mixed holding company?***

- ***What should be considered the financial elements of a holding company? Should the authorities define 'financial elements' in the face of the legislation or in the accompanying code of practice?***

As indicated above, we believe that market entry from conglomerates could be stifled and even market withdrawal could occur, unless shareholders in the ultimate holding company and lenders to the ultimate holding company and non-financial businesses in the conglomerate can be assured their rights will not be distorted by the application of the resolution powers to the ultimate holding company if it is UK incorporated. Doubt in this area would only encourage these groups to replace the ultimate holding company with one incorporated in a jurisdiction where this risk would not arise and ensure that any non-financial businesses are held in a chain to that company separate from UK financial businesses. This could have adverse consequences for tax revenue, employment and the wider economy. The proposed language applies to the ultimate and intermediate holding companies so long as incorporated in the UK and would require refinement to address this concern.

Care also needs to be taken to ensure that treasury functions of ordinary trading groups are clearly excluded, even if some of their activities might cause them to fall within the definition.

We believe that in order to avoid spreading high costs to non-financial businesses or beyond financial elements of conglomerates, it will be necessary to legislate specifically so as to provide legal certainty. A code of conduct would not be likely to be adequate, especially where formal legal opinions are needed or for fund-raising where a prospectus must be issued.

If investment firms and parent companies are brought into a resolution regime, we believe legal safeguards will be needed in relation to the partial property transfer power and we welcome the statement at para 2.29 confirming this. We also welcome the indication that bail-in would not be implemented outside the framework of the RRD. We note that the bail-in resolution power will not only add to the expense of raising capital, but for conglomerates with financial subsidiaries and non-financial businesses with significant treasury functions would, whenever introduced, exacerbate the risks we identify in the first paragraph of this section of our response.

- ***Is the existing public interest test sufficient for defining the level of the authorities' possible intervention in a holding company?***
- ***Do you agree with the trigger condition for enabling the exercise of stabilisation powers?***
- ***Do you agree with the suite of stabilisation powers proposed for systemic investment firms and parent undertakings?***
- ***Do you agree with the Government's intention not to include a power to transfer assets to an asset management vehicle in the suite of stabilisation powers?***
- ***Are any further safeguards necessary for the resolution of systemic investment firms and parent undertakings?***
- ***Are there any additional areas a code of practice should cover that are particularly relevant to systemic investment firms or parent undertakings?***

We will not comment in detail on these questions, save to say that they require further consideration: for example, the obligation to safeguard client money and assets, would not necessarily assist in avoiding some systemic damage (as in Lehmans) if there is no legally robust mechanism for either returning a high proportion of the clients' entitlements quickly or passing them to another investment management business. This is partly tackled in the extension of the Banking Act regime to investment banks, but further work is needed.

There are also issues of definition of what falls within these categories and what are contractual obligations giving rise to unsecured claims which need to be addressed. Ordinary insolvency law is deficient in this respect (other businesses may hold client assets – eg depositary businesses) and we consider that if this issue were addressed under ordinary insolvency law then a widespread extension of the regime to investment businesses would be unnecessary. The courts have considered the issue in Lehmans, but their finding that each claim has to be assessed and assets traced is impracticably slow and expensive. We believe that the primary legislative effort to assist effective resolution of investment businesses should be addressed to this problem, but this does not need to be in the context of running ahead of the RRD, but by way of improvement of the general insolvency regime.

- ***Should the existing Banking Liaison Panel – established under the Banking Act 2009 – be extended, in its current form, to advise on the effect of the intended regime for investment firms?***

We agree that this should be done if the regime is extended to a wider range of investment firms.

- ***Do you agree with the scope of the intended resolution regime extending to all Recognised Clearing Houses incorporated in the UK which offer central counterparty clearing services?***
- ***Are there any further options available to CCPs, their members and markets to reduce the likelihood of a CCP failing?***
- ***Do you agree that measures that support substitutability of clearing services (e.g. through non-discriminatory access provisions and access to licences on a reasonable commercial basis) are an important underpinning to an effective regulatory and resolution regime?***
- ***Are there any areas where you consider that CCPs should become more transparent about their risk management practices and resolution planning?***
- ***Do you agree with the use of the failure, or likely failure, to meet its conditions for recognition as the general trigger for possible intervention in a clearing house?***
- ***Do you agree with the specific conditions which must be satisfied before a stabilisation power may be exercised?***
- ***Do you agree that the authorities should be able to intervene ahead of action taken by the clearing house to restore its financial position, but only in order to prevent disruption to or termination of critical clearing services consistent with the financial stability objective?***
- ***Do you agree with the intended objectives of a resolution regime for clearing houses?***
- ***Do you agree with the proposed suite of stabilisation powers for clearing houses?***
- ***Do you think there are any additional stabilisation powers necessary to be able to resolve a clearing house in all scenarios for failure?***
- ***Do you agree that the resolution authority should be able to impose losses on members of a failing clearing house as part of resolution action? Should this be applicable to losses arising from any circumstance?***
- ***Should any such liabilities be capped and, if so, how should such a cap be structured and its level determined?***
- ***Do you agree with the proposed safeguards? If not, what additional safeguards should the authorities consider in exercising the stabilisation powers in relation to a clearing house?***

- ***Are there any specific areas the code of practice should cover that are particularly relevant to CCPs?***

- ***Do you agree with the proposed power of direction over insolvency practitioners? Do you agree with the circumstances in which this power is intended to be exercisable? What safeguards do you consider should apply?***

While CCPs are clearly businesses the failure of which would be likely to be systemic, in many ways their structure may make them remote from the usual causes of failure. They are more likely exposed to problems related to an IT failure affecting their ability to operate or to a major disturbance affecting major market participants than to a failure of their own making. In either of those circumstances the proposed resolution tools would be largely ineffective.

We believe that the first line that should be taken in relation to CCPs should be to strengthen their own recovery and resolution plans.

We also consider that it would be consistent with the view that investors should bear their fair share of the cost of failure that CCPs should be able to call on their members for support in accordance with the terms of their arrangements. This would, of course, need to be considered in the context of the impact that this may have on members and their ability to function in the markets. A remedy so draconian as to spread contagion among members would be self-defeating and could not achieve financial stability. Thus an unlimited obligation to share in the cost of failure would clearly be unacceptable. Members will need to be aware of the extent of the liabilities they must meet, whether through contributions to the CCP's default fund or in other ways, such as limited capital calls.

In the event of a technical problem affecting the liquidity of a CCP a State loan or guarantee would probably assist successful recovery more than the use of the proposed resolution tools in circumstances short of catastrophic market failure.

- ***Should the existing Banking Liaison Panel – established under the Banking Act 2009 – be extended, in its current form, to advise on the effect of the intended regime on CCPs?***

We agree with this extension in the event that the regime is extended to CCPs, with appropriate representation from CCPs and their members and other dependent users.

- ***Do you agree that the regulatory framework for dealing with the failure of at least some non-CCP FMIs needs to be enhanced?***

- ***If so, what should be the criteria for determining whether a non-CCP FMI should be covered? Should companies providing critical services to FMIs be included?***

- ***Is it sufficient to strengthen the existing insolvency framework, or should a new resolution regime be developed? Should the same approach apply to all non-CCP FMIs? Should some non-CCP FMIs be prioritised over others?***

- ***How should improvements to the insolvency framework, or development of a resolution regime, be designed? In particular, what objectives, triggers***

for intervention, powers and safeguards should be put in place?

- ***What are the competition implications of taking forward the sorts of approaches discussed in this chapter? How could the reforms contemplated here be designed so that they promote competition?***

We agree that the failure of a major payment system for the national currency may raise similar issues as the failure of a CCP. However, there is an important distinction between FMIs (such as CCPs) that take on credit risk and FMIs (such as CHAPS and CREST) that do not take on credit risk. This distinction is explained in the CPSS-IOSCO consultation paper *Recovery and Resolution of Financial Market Infrastructures* (July 2012). For FMIs in the latter category a differently scoped and featured recovery plan would be appropriate. Also some institutions are national in character while the resolution of others would require substantial international co-ordination. Detailed work would be needed to address these differences effectively and without adding unnecessary burdens to FMIs and their members.

So far as competition is concerned there are differences between systems which hold a monopoly (some payment systems) and other FMIs which face competition (albeit from competitors in other states. For these FMIs (eg commodity exchanges) there may well be alternatives for participants (even if in other jurisdictions) and that there will be no or very limited systemic effects on the UK financial system or economy if participants are obliged to move to rival exchanges going forward.

We therefore conclude that these bodies should be included in work on effective resolution plans, but we do not believe that there is an imperative to extend a special resolution regime to them.

- ***Do you consider that some insurance institutions have a degree of systemic potential?***

- ***Do you agree with the Government's overarching objectives that any insurer should be able to exit the market without disorderly impact, and that the interests of policyholders should be appropriately protected? If so, what is the most appropriate means of achieving these objectives?***

- ***Do you consider that the insolvency framework for dealing with the failure of insurers needs to be enhanced? What form should improvements take to provide greater clarity and certainty around securing continuity of cover for policyholders?***

- ***Do you consider that the UK authorities should have resolution tools in the event that the failure of an insurance company raises public interest concerns because it is likely to have systemic implications?***

- ***Do you consider that a portfolio transfer power should be introduced for use as a preventative supervisory tool?***

Historically a number of significant insurers have failed. The effects have not been systemic and the case for intervention in this way appears weak. Insurers are required to hold reserves and can be required to cease to write new business at a time when they are not insolvent under the regime operated by DBiS within an EU framework. We are therefore of the view that the case for extending the bank resolution regime to UK

insurers is not, on present evidence, convincing. We therefore do not respond in detail to the majority of the questions raised.

We should be happy to discuss these views further. Please contact the Chairman of the Financial Law Committee, Dorothy Livingston at Herbert Smith LLP (dorothy.livingston@herbertsmith.com) if you would like to do this.

Yours faithfully

Dorothy Livingston
Chair, Financial Law Committee

(The names of the members of the CLLS Financial Law Committee are available on the CLLS website.)