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Response by CLLS Joint Working on Banking Bill regarding proposed subsidiary legislation under the Banking Bill, with particular reference to the Draft Order on the Restriction of Partial Transfers and the Draft Order Relating to Third Party Compensation

Introduction

This note addresses the issues which the CLLS joint working party of the Financial Law, Insolvency Law and Regulatory Law Committees have identified in relation to Consultation and which we regard as central to the operation of the Banking Bill in a manner which assists the achievement of long term financial stability and protects the interests of this country as a major financial centre. Some of these comments link to the provisions of the Banking Bill itself, which are important to the effective operation of the Order. We also comment briefly on the Code and on the Order related to Third Party Compensation. The majority of these comments have already been submitted to the Treasury team, but these are now formalised as a consultation response.

We have also submitted three papers on the Bill itself, one on Clause 48 (17th December), one on Clause 75 and one covering a number of other Clauses (including Clauses 22 and 38) (both papers 22nd December). These deal with points in the Bill which we consider require work if the subsidiary legislation is to have the desired effects and should be read in conjunction the comments in this paper, which proceeds on the basis that the points raised in those 3 papers in relation to the Bill can be addressed so to create a harmonious whole.

As a matter of general comment, we should explain that one of our concerns is that powers in the Bill are drawn so widely that they could be used to negate the effect of the Restriction of Partial Transfers and/or create uncertainty as to the law, such that it would cause difficulties in the issue of sufficiently certain legal opinions required as part of the prudential regulation of banks and in compliance by corporates with relevant international accounting standards (on the latter see attached note). These matters are vital to these businesses operating in an efficient and cost effective manner in their financing arrangements.

Although a code of practice may give helpful indications to the way the law may be applied, it does not rule out a different application and therefore does not provide sufficient certainty to enable legal reliance to be placed on its terms. Similarly, where the law can be changed overnight by ministerial order, there is insufficient certainty that there will not be retrospective change. Relatively modest changes to the legislation, which we propose in our 4 papers (including this), would be of considerable assistance in addressing these difficulties and we consider that this would be in the interests of achieving financial stability for Banks subject to the processes in the Banking Bill and their counterparties and corporate customers, without compromising the ability of the Tri-partite authorities to address any future bank failures effectively. We hope that you will find our comments constructive.

Application of the Order – Foreign Assets and Liabilities

We are concerned that the drafting of Regulation 2 could limit the ability of UK Banks to operate under foreign laws or by means of foreign branches. This would place UK Banks at a severe disadvantage as against Banks incorporated in other jurisdictions and mean that international banks operating through UK subsidiaries incorporated here and subject to this law would be motivated to move their operations to subsidiaries incorporated (and possibly operating) in other jurisdictions. It would be impossible to give a legal opinion on the effectiveness of arrangements with a foreign element involving a bank potentially subject to the SRR.

It is commonplace, both as between financial institutions and in transactions by UK Banks with non-bank counterparties and customers for netting, set-off and security arrangements to cover transactions governed by more than one law, involving more than one currency and involving property, rights and obligations arising in more than one jurisdiction. Arrangements of these types might relate to transactions or property where the laws of several jurisdictions, including New York and several European jurisdictions, within and without the European Union, may be relevant. It is worth bearing in mind that nearby financial centres, such as Jersey and the Isle of Man, with which many UK banks have close relations are also foreign for this purpose. Banks operating in the London markets often enter into these transactions and depend upon them to operate in modern financial markets. If these are excluded from the protection of this Order, then effectively the ability of UK banks to enter into such arrangements would be curtailed, even when these banks enjoy perfect financial health, limiting their ability to trade with non-UK institutions and even to serve UK customers outside the United Kingdom.

We consider that the correct approach, so as to safeguard the participation of UK banks in international business, is that foreign property and liabilities should be included within the safeguards of the Order where they are the subject of any of the protected types of transactions and that the parties should be obliged to take all possible steps to perfect the transfer under any applicable foreign law where the decision is to transfer an arrangement involving foreign property or assets.

We refer you to the Railways Act 1993, Schedule 8, Paragraph 5 for an example of a statutory provision dealing with the perfection of vesting of foreign property, rights and liabilities in the context of a statutory transfer order. We note, however, that similar provisions already appear in Clause 39 of the Bill and would be applicable in the case that foreign property etc. were to be included in a transfer, so we do not understand why the sweeping exclusion proposed in Regulation 2 of the draft Order or the clarification in Regulation 3(3) should have been thought appropriate or necessary.

Where a statutory transfer accords with the contractual arrangements between the parties, foreign parties are more likely to agree to a transfer (if their consent is needed) and foreign courts are more likely than not to give effect to the transfer and it is important that this is made possible. If foreign property and liabilities are clearly included in the protections then UK banks will be motivated to draft their documents dealing with these matters so as to facilitate such a transfer if necessary.

It may be appropriate to provide for the longstop situation if a transferred foreign right or obligation is not recognised at the end of the day, but this would be a matter of the rights and obligations of the transferee as against the (presumably insolvent) transferor rather than an exclusion from the protection altogether.

Set-off and Netting

Regulation 3(1) concentrates on arrangements between the banking institution and a particular counterparty. It is important that a partial property transfer should not undermine a cash management arrangement operated by a bank for a group of companies (a typical example of which is outlined in the attached paper, an earlier version of which we believe you have seen) by leaving credit or debit balances on the accounts of one or more participating group companies with the transferor bank and transferring credit or debit balances on the accounts of other participating group companies to the transferee. Regulation 3(5)(a) assists to some extent but a more specific interpretative provision would provide greater legal certainty. Given the magnitude of the amounts subject to such cash management arrangements, complete clarity on this is essential. Companies might otherwise have difficulty in satisfying, amongst others, the requirement of paragraph 42 of International Accounting Standard 32 that they have a legally enforceable right of set-off and the ability and intent to settle on a net basis.

Regulation 3(2) should be amended to make clear that "entitled" includes future or contingent entitlements. It should also refer to "arrangement" as well as or instead of "agreement" as this is the term used in other legislation (eg the Financial Collateral Directive and its UK implementation). This provision would be much improved in effectiveness if the amendments we have proposed to Clause 48 of the Bill are adopted, so that there is a co-incidence of terminology and definitions across relevant legislation. We attach the updated version of that paper for ease of reference. We believe that the Bill is the correct place for those amendments, which address concerns raised by the drafting of the Bill as it stands, as well as addressing the scope of the definitions.

We believe that Regulation 3(3) should be omitted.

If Regulation 3(4) is intended to allow for the transfer of a deposit book only, we consider it should be limited to deposits made by customers eligible for compensation from the FSCS. However, we think this could be adequately covered as an "excluded right". We also have a query whether individuals with offset mortgages should actually have to suffer from the disadvantage of having their offset entitlement removed. We appreciate that the transferee of a deposit book might wish to assess them, but it would be in their interests to try to ensure that if their deposits/current account is transferred, efforts would be made to transfer the mortgage also.

We also do note that transfers of the sort described in Regulation 3(4) could, under the legislation, be from bad bank to good or vice versa and in the latter event this type of transfer (of obligations only to a bank incapable of performing them) would be very damaging to the counterparty, whether a business or an individual. There is, however, nothing in the legislation to prevent this. Transfers of this type should not be allowed to an insolvent or "sink" bank as a matter of law, and the Code does not provide sufficient protection to ensure continued ability to set off.

We have concerns with a number of the exclusions. In essence, as noted in relation to Regulation 3(4), we believe that the exclusion should be limited to deposits made by customers eligible for compensation from the FSCS and, possibly regulated mortgages (Regulation 3(6)(a) and (b)) and, even then, we have some concerns re offset mortgages.

With regard to the proposed exclusion (c), and the related definition in Regulation 3(7) we doubt this is needed and also believe there is a risk that it is written both too widely and too narrowly. The only banking business mentioned in the definition in the Bill is the taking of deposits. There is a risk that other types of business have to be assessed for inclusion at the time and this would give rise to both uncertainty and litigation. All activities which a bank authorised to take deposits may lawfully carry out should be covered. The comprehensive exclusion in Regulation 3(7) could cover a very wide range of normal financial services provided by banks to their customers and counterparties and would stifle innovation. Further monetary obligations and securities are not normally "goods" (which is what their exclusion from the exclusion appears to assume) and along with derivatives could therefore fall within the scope of excluded services, while certain contracts for the delivery of commodities would seem to be at risk of exclusion also. We consider that it would be better to exclude only any type of contract which has been specifically identified as giving rise to a real problem if it is included in a protected arrangement: a possible candidate would be securities expressed to be subordinated to the rights of unsecured creditors.

Given that the UK implementation of the Financial Collateral Directive allows "own securities" to be included in a financial collateral arrangement, we are not clear that exclusion (d) is lawful. The UK has not exercised its option under the FCD to exclude such securities. We also note that that banks taking security over portfolios of shares cannot reasonably exclude their customers from trading in and therefore providing securities which consist of a bank's own shares. If this is intended to be an anti-evasion measure, we are not clear it is necessary, but believe that greater clarity on the mischief feared would be helpful.

We believe it would be clearer if "excluded liabilities" were specifically defined, rather than defined by reference.

Financial Collateral

Regulation 4(1)(b) refers to a "financial institution". In this legislation it should, we think, refer to a "banking institution".

Regulations 492) and (3) appear to say that the only financial collateral to be protected is that which is in the nature of "own securities". It may be intended to say the opposite. We believe that, in order to comply with the UK's community obligation it should be rewritten to safeguard all financial collateral arrangements involving a relevant banking institution that are protected by the Financial Collateral Arrangements (No 2) Regulations 2003 (this would automatically update, we believe, if the 2003 Regulations were amended pursuant to the Interpretation Act), rather than the Directive. While it would be possible, probably, to amend the Regulations so as to exclude own securities from the protection (assuming that the UK can reverse a decision not to use an optional exclusion) we doubt this would be practicable, because of the way own securities are used in financial markets. We believe the legislation would in any event need to be made under the European Communities Act 1972 and not under the Banking Act.

In addition to safeguarding financial collateral arrangements, the order should expressly state that a partial property transfer should not be made of some, but not all, of the rights and liabilities between a bank and a counterparty which are subject to any of the following, which are important to the functioning of financial markets:

> **a "market contract" or "market charge" (or comprising "market property") under Part VII of the Companies Act 1989 and pre-default and default netting under the rles of a recognised clearing house, investment exchange or central counterparty;**
>
> **a "system-charge" under the Financial Markets and Insolvency Regulations 1996; or**
>
> **"collateral security" or a "collateral security charge" or a "transfer order" under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and close out netting under the "default arrangements" within the meaning of Regulation 2(1) of those Regulations. This also reflects a Community obligation of the UK.**

Secured Liabilities

We are pleased that the security provision is comprehensive.

In Regulation 5(2) we suggest that the words "to which this order applies" are inserted in the first line after "a partial property transfer".

In Regulation 5 the reference to "title transfer security" should be changed to "title transfer arrangement".

Effect of partial property Transfers in breach of the order

We believe that the effect of a partial transfer made in breach of a provision of the order should be that it is ineffective. We are concerned that if there is a statutory override, legal opinions would need to be qualified, particularly as there is also no proper compensation provided for and any remedy appears discretionary.

It may be that the Court should be given discretion to make a compensatory order (analogous to the discretion conferred by section 241 of the Insolvency Act 1986), although the question arises as to who would be liable to pay the compensation.

Third Party Compensation

Recent experience of complex financial insolvencies suggests that the process of valuation in the context of a hypothetical insolvency would be extremely difficult and would give rise to great difficulties: any payment will be many years after the event. The difficulties derive partly from uncertainties in the underlying documents, which often do not contemplate the failure of the bank, and partly from complexities over valuing assets and liabilities where obligations remain open and, even when they are closed by reference to close out values, these may be disputed. Although the concept sounds attractive, in practice it will be no substitute for having an undistorted position, either as a creditor of the failed bank with rights of set-off, netting, security and title transfer in the same place, or, alternatively, having the entire package transferred to a new solvent counterparty which remains solvent for the period of application of the arrangements. While the concept addresses the need to provide compensation if property is confiscated, it will not be in practice much solace to affected parties.

In Regulation 4(2) the second occurrence of the word "would" should be "wound" in the second line.

In Regulation 4(3) the word "to" should be inserted between "likely" and "receive".

The Code

We believe it would be desirable if those parts of the Code which would militate against a transfer of the liabilities of P to the failed bank separately from assets held by P with the failed bank were legally binding. Even in circumstances were the restriction of partial transfers would not apply, a customer could be put out of business, or out of his home, by such a transfer. It may be that this could be provided by an additional term in the protection of partial transfer order, providing that where such a transfer is made, then assets of equal value to those previously held by P with the failed bank will be made available to the acquiring transferee.

In paragraph 29 insert "if" before "satisfied on line 3.

In the fourth bullet point in paragraph 36 add "of" after "exercise" on the first line.

In paragraph 74 it should read "choose not to reveal".

In paragraph 75 it should read "in its role as shareholder" on the second line.

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 proposed subsidiary legislation under the Banking Bill, with particular reference to the Draft Order on the Restriction of Partial Transfers and the Draft Order Relating to Third Party Compensation, 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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