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Response regarding the Efficacy of Planned Subsidiary Legislation Related to the Banking Bill

1. INTRODUCTION

1.1 In the course of review of the proposals for draft subsidiary legislation, the joint working party of the Financial Law, Insolvency Law and Regulatory Law Committees, has identified provisions in the Bill which may cause difficulties in relation to the planned subsidiary legislation for the protection of set-off, netting, financial collateral and security arrangements and compliance with the UK's Community obligations in that respect. We have also identified some more general issues in relation to the Bill. This paper addresses these issues. It is in addition to the paper of 17th December 2008 relating to Clause 48 and supplements that paper in so far as it deals with issues related to the planned subsidiary legislation. We have also prepared a separate short paper on Clause 75 submitted at the same time as this.

2. SCOPE OF BILL - CLAUSE 2

2.1 The definition of "bank" is currently wide enough to include an insurance company which carries out the regulated activity of accepting deposits only for the purposes of, or in the course of, conducting regulated insurance business. We note that insurance companies were expressly carved out of the Banking (Special Provisions) Act 2008 by virtue of section 1(2) of that Act. We understand that the Treasury is proposing to exclude insurance companies from the scope of the Banking Bill by means of an order under clause 2(2)(c) of the Bill but we should be grateful if you could confirm that our understanding in this regard is correct.

3. TRANSFERS OF SECURITIES – CLAUSES 14 AND FOLLOWING

3.1 The definition of securities in Clause 14 is extremely wide in that it covers many types of debt instrument. We assume that this was done because it was felt that a transfer of shares for the purposes of a share transfer order or instrument should include the transfer of subordinated debt instruments. However, we feel that such a wide definition could have some unfortunate consequences (some of which are referred to below) and so we would propose that the definition be limited to shares and subordinated debt instruments of the relevant entity counted as equity for capital adequacy purposes.

3.2 Clause 17(5) provides that a share transfer instrument or order may provide for a transfer to take effect free from any trust or other encumbrance. We assume it is there so that the transferee could receive a clean unencumbered title to the transferred securities. Without qualification, this could have a negative impact on any security which has been granted over the securities and we query whether this is consistent with the protections for security interests in the draft Safeguards Order or the UK's obligations under the Financial Collateral Directive. Furthermore, debt securities issued by banks or shares in banks are often held on trust for particular investors (including, for example, by pension funds). If it is possible for a share transfer instrument or order to disapply the proprietary interests created by such trusts, this could have a very significant impact on the investors (including pensioners). Limitation on the use of this power is needed so as to ensure that it has regard to EU law and also does not interfere with beneficial interests save to the extent necessary to give good title to the transferee.

3.3 Clause 19(1) allows a share transfer instrument or order to provide for the conversion of one form or class of securities into another form or class. This would allow the Authorities to convert debt securities into equity. This would be a significant interference with the legitimate expectations of investors and legal opinions in respect of (for example) corporate bonds or other debt securities issued by the bank in question would need to be qualified. Ultimately this could affect the willingness of counterparties to invest in UK banks. Again a clear limitation is needed, either in the Bill limiting the affected securities to shares and subordinated debt instruments or by way of provision for subsidiary legislation. This is important in order to protect the fund-raising ability of UK Banks.

4. CONTRACTUAL OVERRIDE PROVISIONS - CLAUSES 22 AND 38

4.1 These clauses allow a share transfer instrument or order (clause 22) or property transfer instrument (clause 38) to disapply any contractual provision that would otherwise allow the counterparty to terminate a contract or other agreement, or to call an event of default, following the transfer of shares or property of the bank pursuant to the SRR. The events of default affected are not limited to ones in contracts or agreements to which the failing or failed bank is a party (see further below). Furthermore, in theory, an event of default which might otherwise be triggered by a transfer of property can be disapplied under clause 38 even if the rights and obligations under the contract in question are not part of the transfer but are left behind in the residual bank (although in practice it may be less likely that the Bank of England would exercise its powers in these circumstances).

4.2 At the very least, the provisions of these clauses should not apply to contracts or agreements which are covered by the UK implementations of the Financial Collateral Directive or the Settlement Finality Directive so as to ensure that parties are not prevented from exercising their rights given by the Directives.

4.3 There is also a concern that these provisions (and particularly clause 38) could give rise to doubts as to the efficacy of set-off, netting or security arrangements and give rise to a need to qualify legal opinions in a manner that would give rise to issues for UK banks in entering into such arrangements and thus raising the cost of capital for UK banks. In any well-drafted set-off or netting agreement, the counterparty will have a contractual right to terminate the relevant transactions following an event of default on the part of the UK bank. Similarly, as a preliminary step to enforcing its security, the counterparty will generally need to establish that an event of default has occurred, thus enabling the counterparty to accelerate the secured liabilities. Again, a well-drafted security agreement will provide that the security becomes enforceable following such an event of default. If the counterparty is not able to close out its positions, or declare an event of default, following a share or property transfer, the right to set-off, net or enforce security will be jeopardized. This affects both interbank and banker/customer arrangements, and so goes to issues of risk reporting and compliance by companies with para 42 of IAS 32. The provisions are not qualified in any way by reference to the proposed Safeguards Order and we recommend that this qualification should be added.

4.4 It may be less objectionable if these clauses were restricted to circumstances in which the agreement containing the relevant default event provision was transferred to the private sector purchaser or bridge bank; provided that the draft Safeguards Order prevents the cherry-picking of transactions covered by a set-off or netting arrangement, the counterparty may be prepared to waive its right to terminate its positions, or to enforce its security, if all of its contractual positions are transferred to the new bank. However, there are three problems with this approach. First, the terms of these clauses are currently very widely written and they could be applied to rights and obligations left behind with the old bank, not merely to those transferred. Secondly, it is possible that the old bank (rather than the new bank) could be the "good bank" in the sense that the good parts of the business could be left behind, whereas the bad parts of the business could be transferred into another entity, so the better credit risk may be with the transferor. Thirdly, clauses 22(5)(c) and 38(5)(c) are very widely drafted so that, if there was a subsequent default by the transferee, and this was held (with the benefit of hindsight) that this default was connected to the share or property transfer, the subsequent default could be disapplied pursuant to clauses 22 and 38. This would have a significant impact on netting and collateral opinions as it will be essential to the counterparty that it can rely on any subsequent event of default on the part of the transferee.

4.5 The following changes to clauses 22 and 38 would address the issue:

"22(2) A share transfer instrument or order may provide for subsection (3) or (4)) to apply (but need not apply either) except that such an instrument or order shall not be disregarded in determining whether a default event provision applies if such default event provision is necessary or incidental to the exercise by the counterparty of any set-off or netting arrangement, or the enforcement of any security instrument, as those expressions are defined in section 48."

"38(2) A property transfer instrument or order may provide for subsection (3) or (4)) to apply (but need not apply either) except that such an instrument or order shall not be disregarded in determining whether a default event provision applies if such default event provision is necessary or incidental to the exercise by the counterparty of any set-off or netting arrangement, or the enforcement of any security instrument, as those expressions are defined in section 48."

4.6 With regard to clause 22, if the suggestion set out above were to be adopted, and the definition of securities in clause 14 were to be limited to shares or subordinated debt counted as equity for capital adequacy purposes, Other forms of debt instrument would fall outside the capital structure of a bank and so would be dealt with under the property transfer provisions, where the concerns we express about clause 38 would continue to apply.

4.7 With regard to clause 38, if the intention is to prevent a counterparty from terminating contracts which are part of a transfer to a new bank so as to provide the transferee with an ongoing, rather than a closed out, transaction, we suggest the best way to address this would be to provide specifically for this (subject to the issues identified in paragraph 4.4 above. Probably the most effective and lawful way at the present time would be for the FSA to forbid UK banks to accept such an event of default, potentially backed up with a proviso to the revised language suggested above. However, such a proviso could give rise to a concern about compliance with EU law, which might be best addressed in the context of the EU review of the laws on financial stability, and would need to address the concerns outlined in paragraph 4.4 above. We feel confident that the exclusion of an event of default specifically relating to a transfer to a solvent counterparty in the context of a rescue measure would be regarded by the European authorities as an appropriate contribution to financial stability.

4.8 A further issue in relation to clauses 22 and 38 (as currently drafted) is that the contractual overrides in those clauses are not limited to default event provisions in contracts to which the failing or failed bank is a party. The override can apply to a contract which references the failing or failed bank even where such a bank is not a party to the contract. For example, in a number of derivative products (including credit default swaps, equity derivatives, bond options and forwards), the troubled bank may be the "reference entity" or "underlying share" in respect of a contract between two other parties; in such a case, the payment or delivery obligations in the contract may be triggered by an event in relation to the troubled bank, even though the obligations are owed by and to two other parties (i.e. the contracting parties). These types of derivative product are essential to the proper functioning of the markets. In the case of credit default swaps, these are an important means for a counterparty to limit its exposure to a particular entity (i.e. by buying protection against a default in relation to such party) and, if the proper functioning of such products is called into question by the Bill, counterparties' appetite for risk may be decreased accordingly.

4.9. We suspect that it is not the Authorities' intention for clauses 22 and 38 to impact upon contracts to which the troubled bank is not a party and so this concern could easily be addressed by limiting the application of these clauses to contracts to which the failing or failed UK bank is a party. This would simply involve adding the words "to which the bank is a party" after the words "contract or other agreement" in clauses 22(1) and 38(1).

5. FOREIGN PROPERTY - CLAUSE 39

5.1 We suggest that, given the overall policy requirement to support collateral, security and set-off or netting, in addition to requiring the transferor and transferee to take any necessary steps to ensure that the transfer of foreign property is effective as a matter of foreign law, the transferor and transferee should be required to ensure that following a transfer all necessary steps are taken to ensure that the collateral, security, set-off or netting rights are effective as a matter of foreign law, including by making any necessary registrations and carrying out any other necessary formalities.

5.2 It is unclear whether clause 39(4)(a) is intended to create a trust so that the transferee has a proprietary interest in the relevant property or right, or whether (as clause 39(6) suggests, the transferee's rights are merely contractual. While the creation of a trust might give rise to recognition issues in jurisdictions where the trust is not available (subject to that jurisdiction being a signatory to the Hague Convention on the Recognition of Trusts), if the transferee's rights are merely contractual, it will simply have an unsecured claim in the event of any insolvency proceedings in respect of the transferor (such proceedings being likely in practice in the circumstances). It would be clearer if clause 39(4)(a) could clearly state that the property or right was held on trust for the transferee, despite any cross-border recognition issues that might arise.

6. COMPENSATION – CLAUSES 49 AND FOLLOWING AND "NCWO" PROVISIONS IN NOVEMBER CONSULTATION

6.1 The original suggestion in the November consultation paper was that the compensation rights of creditors left behind with the residual bank would be assessed by reference to a hypothetical liquidation of the troubled bank, without the exercise of the Authorities' powers under the SRR. We understand that concerns were raised as to why a liquidation model was used, particularly as (absent the provisions in the Bill) an insolvent bank was more likely to be placed into administration than liquidation. As a result of these concerns, we understand that the Authorities are considering using a hypothetical administration, rather than a liquidation, as the model for assessing compensation rights.

6.2 While we have some sympathy with the concerns regarding the use of a hypothetical liquidation model, we do not see how the alternative model of a hypothetical administration will be workable. There are various different outcomes that can be achieved through an administration including rescue of the company (usually following the compromise of some or all of the debt through a scheme of arrangement or voluntary arrangement), a sale of the business as a going concern or the realization of assets, and the recoveries for creditors will very clearly depend on what outcome is pursued in practice. It is not clear to us how the Authorities will determine what the most appropriate outcome should be for the basis of the model or, in the case of a rescue following a compromise, what percentage of the debt it should be assumed would have been waived or converted into equity. This may be why a hypothetical liquidation (where the outcome is more certain) is currently used as the means of assessing the rights and interests of creditors for the purposes of determining whether the meetings of the different classes of creditors in a scheme of arrangement have been properly convened.

7. CONTINUITY PROVISIONS – CLAUSE 63 AND FOLLOWING

7.1 As "group company" in clause 63(1) is very widely defined, this could include the limited liability partnership (**LLP**) in a covered bond structure (where the originator will have a membership interest in that LLP) or, possibly, the special purpose vehicle issuer in a securitisation transaction (although, generally speaking, the issuer will be an orphan and not part of the Originator's group). In this context, the power of the Bank of England (in clause 64(2)) to cancel a contract or other arrangement between the residual bank and a group company or to modify the terms of such contract could have a detrimental impact on such covered bond structures or securitisation transactions, particularly if the Bank of England purported to use its powers under this clause to cancel or modify the contract pursuant to which assets were transferred to the LLP or issuer. It is therefore important that the structured finance safeguards in the proposed Safeguards Order extend to these continuity provisions as well as partial transfers more generally.

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