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Response to the Working Document of the European Commission, DG Internal Market, on bail-in as a debt write-down tool

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Information about the respondent

1. 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.

2. The CLLS responds to consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS Financial Law Committee, made up of solicitors who are experts in their field, has prepared the comments below on the above working document (the "Working Document") from the perspective of English law. Details about the membership of the working party are set out on page 15 below. The working party also submitted a written response dated 7th March 2011 to the European Commission's previous working paper "Technical Details of a Possible EU Framework for Bank Recovery and Resolution".

3. The CLLS is registered in the Interest Representative Register of the European Commission under **registration number 24418535037-82**. If the Commission wishes to make available on its website the responses received to the Working Document, the CLLS authorises the inclusion of this paper amongst those responses.

4. Unless otherwise stated, references in this response to Sections are to Sections of the Working Document.

Preliminary comments

5. As stated in our previous response, we welcome the broad objectives of the proposed legislation and in particular support the aim of ensuring that authorities in Member States have the necessary resolution tools to take fast and effective action to ensure the minimum of disruption to financial markets, the continuity of essential financial services and the avoidance of legal uncertainty. We welcome in particular recognition of the need to ensure:

   (a) legal certainty, transparency and predictability as to the treatment of shareholders and creditors and clarity for investors to enable them to assess the risk associated with their investments and make informed investment decisions prior to insolvency; and

(b) legal certainty be given to investors as to when and under which conditions their claims would be converted to equity or written down.

6. We think, however, that there is an irreconcilable conflict between the idea that all liabilities should be capable of being bailed-in in a manner that respects as far as possible the ranking of creditor claims under insolvency law and the fact that, inevitably (as the Working Document recognises), there will need to be excluded categories of debt, with the potential for arbitrary divisions between what is, and what is not, bailable and the risk that investors will seek to exploit these exclusions. Furthermore, we consider that the role and capabilities of existing insolvency processes (including specially tailored administration processes such as those under the UK Banking Act 2009) should be recognised as making this unnecessary. For example, the establishment of bridge banks with viable assets and the sale of the bridge bank or its business, the transfer of valuable assets and guaranteed deposits and the raising of funds by an administrator to manage an orderly liquidation are all possible without distorting the rights of creditors in an insolvency by changing their relation *inter se* at the outset of the process. That change might have to be reversed, at the cost of a Member State, to meet the "no creditor worse off" principle.

7. We think that bail-in should be confined to categories of debt with known principal amounts where the holders are on notice from the date of creation of the debt that the bail-in regime could be applicable to it. These types of liabilities would be suitable for a rapid conversion process to support the balance sheet of a bank in financial difficulty (or possibly of a bridge bank) so that the bank is in a position to trade normally, including incurring new liabilities (e.g. by accepting new deposits or entering into new derivative transactions). It should be remembered that bail-in does not directly address any cash flow problems that a bank may be suffering (bail-in rearranges and reduces liabilities but by itself does not inject new cash). By restoring or strengthening a bank's balance sheet and protecting its authorisation, however, bail-in may be expected to restore confidence and the willingness of counterparties (including lenders of last resort, such as central banks) to deal with a bank in financial difficulty.

8. We believe that there is another important condition to the adoption of the bail-in tool, namely that all leading economies are committed to its introduction in a consistent manner, for instance, through G20/Basel processes before the EU introduces the tool. Every effort should be made to minimise differences in national approaches.

9. The power of bail-in will need to be interposed into national insolvency law and a Council Directive seems the most appropriate method of doing this, given that national insolvency law varies considerably between Member States. The Winding Up Directives relating to credit institutions and insurers[1] give sole control of the decision whether to adopt winding up or reorganisation measures to a single regulator and presumably this approach will need to be respected for bail-in.

10. We note that the Working Document does not seek to address complex or multi-national group structures where it may not be appropriate to give the bailed-in creditors equity in the bank being resolved (particularly where this is a wholly owned subsidiary of another entity) and where the shares with the real value may be in respect of a different entity that is not subject to the resolution regime. It is essential that these issues are dealt with, together with local tax, accounting and other issues associated with the issuing of new shares.

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[1] Directives 2001/24/EC and 2001/17/EC.

11. There are, in addition, a number of points which in our view require further thought and these are indicated below in relation to the specific questions raised in the Working Document. The fact that we have not commented on every aspect does not necessarily mean that we will not have further comments when legislative proposals are put forward.

Question 1: Do you consider that the point of entry into resolution should be the same as the one for the rest of the resolution tools? Do you consider that it should be a point close to insolvency?

12. While our first instinct is to answer yes to both questions, it must be borne in mind that use of bail-in is only worthwhile if the institution is capable of being saved as a whole or in a substantial separated part. A bank that is hopelessly insolvent will not be benefitted by its balance sheet being strengthened. If the point of entry into resolution is similar to that under the UK Banking Act 2009 for the rest of the resolution tools, this would be sufficiently early for it to be of use.

13. Although every case will turn on its facts, it seems to us most likely that the bail-in power would be exercised with one or more other resolution tools and not in isolation. It is also preferable to have common pre-conditions which must be met before any resolution action may be taken. If the bail-in power were to have its own separate pre-conditions, this might lead to greater complication and uncertainty. If, instead of using the earlier trigger for the other resolution tools, the point of entry is placed too close to that of insolvency, it will not allow time in which to use the bail-in power (and potentially some other bank specific resolution tools) successfully. An alternative may be to use the test for certain "pre-insolvency" procedures in Europe (such as the French safeguard procedure). Here the company must be in a state of financial distress (or likely to become so) but it must not have become insolvent on a cash flow test.

14. We suggest that greater clarity on the following points of detail will be helpful:

    (a) Expressions such as "within reasonable timeframe" and "in the near future" could be usefully clarified. Otherwise there would be scope for different legislators and/or regulators and/or judges to take different interpretations of what those expressions mean.

    (b) There is a reference to "objective elements" to support a determination which, by its very nature, will inevitably have to be a subjective decision. Presumably the idea is that the "objective elements" will be predetermined and objectively verifiable by a resolution authority but it is not clear how this will work.

    (c) If the idea is that the bail-in should come before any extraordinary public financial support, then presumably the test should be whether the institution (or its parent undertaking) would require such support in the absence of the bail-in.

    (d) Although it is perhaps a drafting point, presumably the test of achieving the resolution objectives will be conducted by reference to whether it is expected to achieve those objectives rather than whether or not it in fact does so (which cannot be known until after it is implemented).

Question 2: Do you consider that a credible framework for the resolution of banks should include both the open bank and the closed bank bail-in?

15. We consider that in principle the bail-in power should be exercisable in relation to an "open bank" where the whole entity will continue to operate. This is where the particular ability of bail-in to strengthen the bank's balance sheet and make it an acceptable

counterparty in the markets would be of real value, while reducing the cost of this exercise. In the case of a "closed bank", the question is whether there is a part of the bank that could continue if adequately capitalised and, in that event, whether that is best achieved (in a "good bank/bridge bank" situation) by use of bail-in or the guarantee of a central bank. If there is to be bail-in to a closed bank, then the relevant investors would need to be given a proportionate stake in the good bank. In the case of a bail-in to a closed bank, the best way to ensure that no creditor was left worse off (than if the bank had entered into insolvency proceedings) is probably not to apply the normal insolvency rules of claiming and priority, so avoiding the distortions of first bailing in debt and then valuing claims as if there were no bail-in.

Question 3:

(a) Do you agree with the suggested list of excluded liabilities?

(b) Do you consider that liabilities with an original maturity shorter than a certain period should be excluded from bail-in? Should this period be 1 month, 3 months, or another period?

(c) Do you consider that derivatives should be included in the scope of bail-in? If not, what would be the reason that would justify granting them a preferential treatment?

(d) Do you consider that DGS should be included in the scope of bail-in (i.e. DGS suffers losses instead of covered depositors pari passu with unsecured liabilities)?

(e) Do you consider that secured liabilities should be included in the scope of bail-in when the value of the security is lower than that of the liability? Under what conditions do you consider they could be totally excluded without granting them an unjustified preferential treatment?

(f) How would it be possible to avoid that financial instruments are designed with the purpose of being excluded from the scope of bail in able liabilities (i.e. bonds with embed options?

16. We consider that the bail-in power should be exercisable only in relation to specified classes of liability such as equity share capital, quasi-debt instruments and subordinated debt. This approach should be combined with the use of regulatory tools to ensure that each bank is obliged to create the appropriate amount of liabilities in those classes (see further in response to question 5). This approach offers a higher level of predictability and legal certainty. In our view, this is clearly preferable to the wider approach of making the power exercisable in relation to all liabilities subject to specified exemptions.

17. The second approach where all unsecured liabilities can be potentially bailed in, subject to exceptions, would be much more complex and much less predictable. It would be necessary to identify all appropriate exceptions and ensure that these were regularly updated to reflect market developments. It might involve greater uncertainty as to whether a particular type of liability was potentially subject to bail-in or not. This is a strongly held view. Furthermore, as soon as exceptions are introduced (which is an inevitable consequence of the second approach for the reasons given below), there is a departure from the normal *pari passu* principles under insolvency law and a risk that dividing lines would become somewhat arbitrary and capable of exploitation. Although the Working Document states that the bail-in should encompass all debts that would normally not be paid in full in reorganisation proceedings (see page 10), it should be remembered that, in any restructuring, it will be decided on a case-by-case basis, and depending on the specific facts, what debts should be written off or converted into equity and what debts

should be paid. There is no room for a "one size fits all" approach. This is one reason why we favour a more limited approach to what debt should be capable of being bailed-in.

18. There will be circumstances where the restoration of the balance sheet requires an amount less than the existing tier 1 capital (or less than the existing tier 1 and tier 2 capital combined of a bank). Thought needs to be given to how bail-in can be used in those circumstances without unfairly writing down to nothing the value of existing capital. This may mean that subordinated debt in those circumstances also needs to be capitalised so as to allow bail-in from the bail-in tier also. In these circumstances, it needs to be considered whether bailable debt should carry greater rights on conversion than tier 1 and tier 2 capital (e.g. by grant of preferential rights, although this would require review of Basel and EU requirements on bank capital).

19. We note that the first approach means that the risk factors created by bail-in will not impinge on liabilities outside the scope of bailable-in. This enables both the cost and impact of bail-in risk on availability of funds to any bank to be ascertained and measured accurately. The costing or availability of transactions leading to other types of liability will not be affected by this risk. While this would need economic review, we expect that the cost and impact of bail-in would be reduced, which would be particularly important if the EU decided to "go it alone", when other G20 economies were not saddling their banks with this risk at all.

20. If a bank's balance sheet cannot be made viable without seeking to bail in obligations incurred in the ordinary course of business (e.g. repayment of deposits and payment of derivative and foreign currency obligations), then it is truly insolvent. When such obligations are bailed in, then there would be huge confusion as to which of its trading operations the bank could continue to carry out. A general moratorium on operations might be needed, which would be inconsistent with the purposes of bail-in.

21. A major disadvantage of the second approach is that it would be necessary to make not only the exceptions proposed on page 8 of the Working Document but also the further exceptions indicated in paragraphs 22 to 43 below. This list is not intended to be comprehensive. The main reasons for exclusions are that the precise amount to be bailed-in would take a long time to identify or that effectively the bail-in would block some or all of the ordinary banking activities of the bank. This could result in immense confusion with potential systemic risk to clearing systems and exchanges in which the bank has open obligations as well as to customers of the bank. We foresee that there would be many more exceptions to be identified in the course of developing the proposals.

22. **Netting or set-off arrangements.** Liabilities which are subject to netting or set-off should be excluded. Netting and set-off arrangements are well established and widely used to limit the exposure of parties to the net amount owing between them. Set-off is a fundamental concept of many legal jurisdictions. English law provides for contractual, equitable, procedural (in court proceedings) and statutory insolvency set-off, and includes specialised forms of set-off, such as banker's right to combine accounts. Scottish and Northern Irish law also provide for various forms of set-off in commercial and financial transactions. Set-off is also recognised at the EU level: see, for instance, article 6 (*Set-off*) of the EC Regulation on Insolvency Proceedings.[2]

23. Netting is a more recent concept, but it is of fundamental importance in reducing risk in the financial system. Netting is now widely recognised and protected by various statutory provisions at the EU level and in various UK statutes and regulations, including the UK

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[2] Regulation No 1346/2000/EC

regulations implementing the Financial Collateral Directive[3] and the Winding Up Directives for credit institutions and insurance undertakings.

24. A netting arrangement is a contractual arrangement that reduces related claims between A and B to a single net claim owed by A to B or B to A.[4] If the amount of liability owed to a counterparty by a failing bank could be written down or even extinguished by the exercise of a bail-in power, this could undermine the protection provided by netting or set-off to the counterparty. Instead of being able to achieve a net settlement, the counterparty would be left (after the exercise of bail-in) with a substantially reduced or even nil claim against the failing bank but owing a gross amount to the bank. This would place the counterparty in a fundamentally different and more exposed position. The effect in many cases would be contrary to the principle that no creditor should be worse off than in the case of insolvency. If the failing entity had entered into English administration proceedings and the administrator had given notice of his intention to make a distribution to creditors or had entered into English liquidation proceedings, set-off of mutual claims between the insolvent entity and its creditor would operate by law and be automatic, mandatory and self-executing.[5]

25. As explained in our previous response, it is also important to note that 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, as summarised in paragraphs 36 to 41 of our previous response. If these arrangements were not excluded from the bail-in power, the claim of a customer for repayment of a deposit or credit balance on its account with the bank could be substantially reduced or extinguished (unless it fell into the proposed exception for short term liabilities) while the customer's liability to the bank for borrowed money would remain unaltered, the gross amount of which would be recoverable by the bank. Again, the customer could find itself in a worse position than if the bank had entered into insolvency proceedings.

26. Although it would be possible to apply bail-in to the net amount (after netting or set-off), it might often be inappropriate to exercise the right of netting or set-off to achieve a net settlement, particularly where the bank is continuing as a going concern and has a continuing relationship with the customer. In addition, it may well take considerable time to work out the net amount which is inconsistent with the idea of carrying out the bail-in over a short timeframe (e.g. a resolution weekend). This was a practical problem in the failure of banks such as Northern Rock and Bradford and Bingley, where deposits were supported on a gross basis and for amounts in excess of the amounts covered by the Deposit Guarantee Scheme or falling outside it, partly because of uncertainties that net amounts could be ascertained in any reasonable time.

27. **Financial collateral arrangements.** We consider that all financial collateral arrangements protected by national law adopted by EU Member States (pursuant to the Financial Collateral Directive) should be excluded, irrespective of how widely or otherwise the Directive has been implemented in the relevant Member State. The potential application of a bail-in power to a liability secured or otherwise covered by a financial collateral arrangement (or a close out netting provision forming part of it) would be contrary to the purpose of the Directive which is to contribute to the stability of the EU financial system and improve legal certainty.

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[3] Directive 2002/47/EC as amended by Directive 2009/44/EC.

[4] A netting arrangement may use contractual set-off to determine the net claim, but there are other legal techniques that may be used instead of contractual set-off (so, in that sense, netting is a broader concept than contractual set-off).

[5] Rules 2.85 and 4.90 of the UK Insolvency Rules 1986.

28. **Clearing, settlement and payment systems.** All clearing, settlement and payment systems, central counterparties ("CCPs") and settlement agents should be excluded to ensure legal certainty and stability in the financial markets, including those protected by national law adopted by EU Member States (pursuant to the Settlement Finality Directive[6]). Similarly, where a Member State has created special statutory regimes to protect clearing houses and exchanges, transactions protected in this way should be outside the scope of bail-in. One example is the special regime created by Part VII of the UK Companies Act 1989. This provides protection for recognised investment exchanges, recognised clearing houses, recognised overseas investment exchanges and recognised overseas clearing houses.[7] Another example is the protection provided to settlement banks such as CREST settlement banks.[8]

29. It is essential that transactions and arrangements protected by the above legislation, including the default rules which lie at the heart of recognised clearing houses and settlement systems, should be excluded from the scope of bail-in in the interests of systemic integrity. Default rules are particularly important to enable a clearing house or system operator to take swift and effective action to achieve an orderly close out netting.

30. CCPs are typically interposed between two contracting parties to a transaction, with the original contract being replaced by two new contracts – one contract between the seller and the CCP and the other between the buyer and the CCP. A mismatch could arise (to the CCP's detriment) if one contract was subject to a bail-in but the other was not. The margin, collateral and default fund contributions provided to a CCP should also be ring fenced from the effect of bail-in.

31. **Inter-bank loans.** We suggest that unsecured loans made between banks on the inter-bank market should be excluded from bail-in, whether or not they have a maturity of less than one month. If such loans were potentially subject to the bail-in power, this could seriously affect the willingness of banks to lend to each other (through that market) and could impair its liquidity and volume of activity, as occurred during the 2007/2008 financial crisis. If this occurred again, it would disrupt the inter-bank market and seriously affect the ability of banks to fund themselves in order to finance loans to borrowers. Furthermore, a distinction between inter-bank loans of less than, or more than, a month creates an arbitrary division and could encourage short term lending with roll-over provisions to avoid liabilities falling within the bail-in regime.

32. **Foreign exchange transactions.** We suggest that spot and forward foreign exchange transactions be excluded, in the interests of avoiding any disruption to the foreign exchange markets. While spot foreign exchange transactions would create only short term liabilities, forward foreign exchange transactions often have maturity dates exceeding one month. The foreign exchange markets have extremely high volumes of trading but are largely uncollateralised. Where a counterparty purchases a foreign exchange for delivery at a future date, it has a credit exposure (if the forward is profitable) to the seller. If counterparties to forward foreign exchange transactions were subject to bail-in, this could have a negative impact on the marketplace.

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[6] Directive 98/26/EC as amended by Directive 2009/44/EC.

[7] For a full list of the 25 or so clearing houses and exchanges protected by Part VII, see the FSA Register at http://www.fsa.gov.uk/register/exchanges.do.

[8] See the UK Financial Markets and Insolvency Regulations 1996. CREST settlement banks are key providers of the intra-day liquidity to CREST members (including market makers) required to enable the CREST system to function. The daily average value of securities moving through the CREST system in February 2012 was in the order of £1,262 billion: www.euroclear.com.

33. **Transactions in securities.** Similarly, where a liability arises out of a transaction under which a sale and purchase has been agreed and not yet performed, this should be excluded. At this stage the buyer is contractually entitled to delivery pending settlement and the seller is entitled to payment of the price. If a bail-in power were exercised during the interval between trade and settlement, this could lead to difficulty. The implications for repurchase agreements (repos) and stock lending transactions would also need to be carefully considered.

34. **Custody arrangements.** We agree that, where a bank holds money, securities or other property as custodian on trust for a client (or another custodian as part of a chain of custody arrangements), the rights of the client or other custodian to that property (which may not be liabilities of the bank or firm in any event) should nonetheless be expressly excluded from bail-in.

35. **Trade creditors.** We suggest that trade creditors should be entirely excluded from bail-in, since it would be inappropriate and impractical to apply this power to them. It is recognised in most consensual, multi-creditor restructurings of businesses in financial difficulty that the claims of trade creditors should not be compromised but paid in full. This is partly to ensure that the number of creditors involved in the restructuring process is manageable and partly to ensure the continuing supply of essential goods and services. It is likely that a bank in resolution would, for instance, need the continued supply of electricity, IT systems, software, hardware, data processing and other essential services in order to continue as a going concern. Hence it would be sensible to exclude such suppliers from bail-in. Exclusion of such trade creditors may also help minimise contagion from the failure of the bank into the wider economy.

36. If trade creditors were to fall within the scope of bail-in, it would be necessary to decide who determines whether particular goods or services are essential and when. What would happen if essential items were to become non-essential or vice versa? How would the counterparty know where it stands?

37. If there was no general exception for trade creditors, we suggest that consideration be given to some form of de minimis or other minimum threshold so that smaller trade creditors were not unduly affected. Trade creditors may have less access to information about the relevant business than sophisticated lenders or investors and be less able to withstand the economic impact of loss resulting from the exercise of a bail-on power against them.

38. It should also be born in mind that a bank is a trader in financial liabilities and it would be right to regard its obligations to repay customers' money from current accounts or term accounts (both of which are forms of deposit) as part of the trade obligations of a bank.

39. **Short term liabilities.** We agree that short term liabilities should be excluded from bail-in but consider that these should be defined as having a longer maturity (such as a maturity not exceeding 12 months) and as including liabilities repayable on demand (such as amounts owing under overdraft facilities).

40. **Derivatives.** We consider that derivatives and amounts owing under related master agreements should not be included in the scope of bail-in for the reasons explained by ISDA in its response to the Working Document. In addition, swaps are widely entered into by customers with banks in order to hedge an interest rate, currency or other exposure of the relevant customer under a transaction. If the swap were subject to bail-in but the underlying transaction continued in full force and effect, the customer would be left unhedged with a mismatch.

41. **Deposit guarantee schemes (DGS).** We agree that, although deposits guaranteed by a DGS should be excluded from bail-in, there is a case (at least in principle) for treating the claims of the DGS itself against the bank pari passu with other creditors subject to bail-in, where bail-in has the effect that the bank will be restored to viability and depositors will have free access to their deposits. The write down to which the DGS would be exposed should not exceed in amount the cost it would otherwise incur in reimbursing deposits up to the level guaranteed by the DGS. However, it seems to us better that, unless designated as outside of the DGS and as specifically liable to bail-in, deposits as a general matter should be recognised as trade debts in an open bank (and, if used in a closed bank, also to the extent transferred to a "good bank"/bridge bank which continues trading).

42. **Secured liabilities.** We consider that secured liabilities should be excluded from bail-in, whether they are secured over the bank's own assets or secured over the assets of a third party such as a parent company (or by a combination of both methods). We suggest that this should be clarified. If secured liabilities were excluded only to the extent that they were secured on the bank's own assets, this could be complicated to apply in working out what proportion of the secured liabilities should be written down. We assume that covered bonds would not be bailable.

43. **Shortfalls.** We can see the logic of including within the scope of bail-in a shortfall on a secured lending where the value of the security is less than the amount of the liability. The serious practical difficulty, however, is that where a secured asset (other than cash) is not traded on a recognised market and does not have a readily ascertainable market value, it would be difficult to value the asset quickly and inexpensively for the purpose of working out the amount of the unsecured shortfall. If an estimate were made, this might differ (upwards or downwards) from the actual net amount received on actual realisation. Depending on the nature of the asset in question, these could also be affected by currency fluctuations or other market events which could trigger unexpected windfalls or extra losses.

44. **Tax.** While we can see the logic of excluding tax liabilities which do not benefit from statutory preference, it seems slightly at odds with one of the other objectives which is to avoid costs to taxpayers because the tax is potentially lost and so it seems to us that it is an indirect cost to the taxpayer.

45. **Contingent or disputed liabilities.** By definition such liabilities cannot be valued for bail-in in the short term and may not exist at all (for example, where it is unknown whether a contingency will occur or where the question of liability is dependent on the outcome of litigation).

46. The liability of a bank under a guarantee, standby letter of credit or performance or other bond issued by it at a customer's request to a third party will be contingent unless and until the bank receives a valid demand for payment under it. Whether or not such a demand was made would depend on whether the primary obligor covered by the guarantee, standby letter of credit or bond performed, or failed to perform, its obligations to the third party. The estimation of such contingent liabilities might not be straightforward and might prove inaccurate with the passage of time.[9]

47. **Territorial limits.** The proposals will need to recognise the jurisdictional limits of European Union law. Many EEA banks operate globally and have extensive operations outside the European Union. In the absence of broader international agreement on bank

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[9] A similar point applies to letters of credit used in trade finance, although they are more likely to be called (e.g. where payment is to be made against presentation of specified shipping or other documents).

recovery and resolution, the efficacy of the proposed EU framework would be limited in relation to banking arrangements involving foreign property and contracts governed by the law of a jurisdiction outside the EU (in respect of which resolution authorities of Member States would not have jurisdiction to apply resolution tools). In order to be able to act decisively to prevent bank failure, it is necessary that tools used in the European Union and the rest of the world are deployed in a coherent manner and are mutually recognised.

48. In particular, it is unlikely that any application of bail-in to liabilities created prior to the passage of the EU legislative instrument would be recognised outside of the EU and there may be challenges based on constitutional provisions in some Member States and on the European Convention of Human Rights which EU Member States law is bound to respect. It is submitted that further work in this area needs to be undertaken by the FSB.

Question 4:

(a) Which of the two options do you consider more appropriate in order to mitigate any systemic impact of the use of the tool and minimise the impact in funding costs?

(b) If you do consider the sequential model to be suitable do you consider that derivatives that are cleared through a CCP should be treated differently from other derivatives in a bail-in?

49. For the reasons given above we think that the first option is impractical: we are assuming that senior debt is all unsecured debt. As illustrated in our response to question 3, apart from particular classes of liability with clear principal amounts designated to investors as bailable, other debt in that category is either difficult to ascertain or part of the core business of a bank required to meet its obligations to customers and systems. We agree that equity share capital, quasi equity instruments and subordinated debt should be written down in full, before bail-in is applied to any other class of liability, but we believe that it would be difficult to achieve the purpose of bail-in if it were applied to those other categories of liability.

50. Option 2, while clearer, carries a number of potential difficulties:

(a) Many liabilities due in more than 12 months time are for uncertain amounts in the same way as short term liabilities.

(b) Trade obligations often also have longer dates, (e.g. a two year deposit or a multi-year contract for the supply to the bank of goods or services).

(c) If longer dated deposits are included, they are likely to cease to exist or will carry a cost premium regardless of risk (not just those designated as bailable). This will be costly for EU banks regardless of whether this bail-in power is ever used. An economic impact assessment on this risk would need to be made to assess the cost to banks, feeding through into cost and availability of loan capital to bank customers.

(d) For the reasons stated above, we do not consider that derivatives (whether cleared through a CCP or otherwise) are suitable for bail-in.

(e) Furthermore, Option 2 cannot be described as being consistent with insolvency rules. We are not aware of any jurisdiction where, in a liquidation, the priority of debts depends on their maturity. Hence Option 2 could give rise to claims by long-term creditors that they are worse off than the position in which they would have been in a liquidation.

51. We consider that, if a bank (or bridge bank) cannot restore or create its balance sheet from clearly designated bailable securities or deposits, then bail-in is not a suitable tool and the normal insolvency hierarchy of claims should apply in an insolvency process.

52. The Working Document refers to equity, equity like and subordinated instruments. It would be interesting to know how ordinary convertible debt instruments would be treated (i.e. instruments not specifically targeted at conversion when the issuer is in financial difficulty). Are these "equity like" for these purposes, particularly if the option is available to holders only? What is the position if the Issuer has an option to require conversion which is not specifically triggered by the financial situation, solvency or levels of own funds?

Question 5:

(a) Which do you consider is the best way to fix a minimum amount of bail-inable liabilities – option 1 or 2a), 2b)? If you consider option 1 preferable how could possible fragmentation of the internal market and unlevel competitive conditions within the Internal Market be avoided? How would clarity and predictability be ensured under option 1?

(b) What do you think is the optimal minimum level of bail-inable liabilities + capital (e.g. 10% of total liabilities excluding own funds) to prepare for future potential crisis?

(c) Would a minimum amount of bail-inable liabilities + regulatory capital have an excessive negative effect on certain types of banking businesses present in Europe (retail vs. investment banking)? Would it be necessary to establish an exclusion from the minimum rule for certain banks or no rule at all (e.g. small banks, overwhelmingly deposit financed, mortgage banks)?

(d) Do you consider that the requirement to hold a minimum amount of bail-in-able liabilities should be set both at holding and subsidiary level? Do you consider that resolution authorities should be allowed to apply the requirement exclusively at holding level if that is agreed by all the competent resolution authorities in the context of the resolution plans?

53. We consider that the regulator of a bank should be given a discretion to set the minimum amount of bailable liabilities at a level which the regulator considers appropriate on a case by case basis, taking account of the business of the bank. This is the 2(b) solution, although 2(a), if it can be given an objective rather than a circular definition, may be worth consideration. Guidance would need to be given to regulators to ensure that they adopted a broadly consistent approach and a G20 standard would be important to reduce impact on international competitiveness.

54. Question 3(b) is best answered by banks and regulators.

55. With a flexible set of principles, we do not think that exclusions would be necessary.

56. Where a holding company and a bank subsidiary are both regulated within a single EU jurisdiction (and potentially where both are regulated within the EU), regulation at both levels may be desirable, although issues may arise if only one entity is experiencing difficulties (which we suspect will be uncommon in practice). The parent is likely to have the relevant share capital and bailable securities, although a subsidiary may also have some bailable liabilities. It is desirable to avoid de-grouping of a financial group wherever possible, as this may create further large liabilities (e.g. for tax). Where only a subsidiary

is regulated within the EU, the rules can only be applied at that level but this may cause difficulties in achieving the bail-in. Further thought needs to be given to these group issues.

Question 6: Do you agree that there should not be an absolute obligation to cancel existing shares? Would it be enough in certain cases to establish a sufficiently penalising rate of conversion?

57. We can see that, in order to implement a bail-in, a resolution authority would need the power to cancel existing shares or to convert liabilities into shares in the bank at a rate of conversion which severely dilutes existing shareholdings.

58. The method and consequences of writing down share capital and debt instruments will need to be carefully considered, both as a matter of company law and tax law. In particular, the rules on maintenance of capital and on the pre-emption rights of existing shareholders in relation to new issues (both enshrined in EU company law) would need to be abrogated to allow bail-in. Similarly, if it is proposed that a bank's share capital could be reduced (by means of bail-in) without the necessity of shareholders' approval and court sanction, this is likely to require changes to existing law. These issues would need to be addressed in the enabling legislation.

59. If the share capital of a bank were partly written down, this would affect shares of fixed nominal amount. One method of avoiding the need for the renominalisation of partly written down shares would be to permit the use of "true" no par value shares[10]. This represents the share for what it is – a fraction of the equity. It would avoid the complication and confusion that can result from giving a share a fixed nominal value which is unconnected with its true market value. If share capital could be converted wholly into shares of no par value, this would reduce the problems which would otherwise arise when shares are partly written down. Although the amount of total share capital would be reduced (on the exercise of the bail-in power), individual shares would be unaffected. Where shares of no par value had been partly written down, the number of shares in issue could remain the same; there would be no par value to renominalise or round to the nearest decimal figure; and changes to registers and certificates would be minimal. It would also avoid the need to deal with any awkward fractional interests which might arise when shares were renominalised.

60. Particular issues arise where the capital needed means that existing tier 1 and tier 2 capital need not be completely written off (see paragraph 18 above).

61. The tax consequences for creditors of liabilities owing to them being written down or converted into equity would be important and this subject merits separate consideration.

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[10] In order to permit "true" no par value shares, it would be necessary to alter the framework laid down by the 1976 Second Company Law Directive (which applies to public limited companies): 77/91/ECC. The Directive is linked to a system of no par value shares which, in its then existing form, was rejected as an unsatisfactory "halfway house" by the UK Gedge Committee Report in 1954. In particular, the Directive contemplates that, although shares may be issued without a par value, they will have an "accountable par". This concept is not defined in the Directive. It is based on the Belgian type of no par value share which evolved in the 1870s, although it was only recognised by legislation in 1913. The "accountable par" variant is more restrictive, as it applies the principle of parity. The Directive does not deal with the possibility that new shares might have to be issued at a price lower than "accountable par" because of a change in market conditions. In addition, where the Directive refers, in the capital maintenance, reserve, reduction, redemption provisions, to the nominal value of a share, it includes a reference to its "accountable par" if it has no nominal value. As a result, "accountable par" appears to be treated for many purposes in a similar way to par value. See "The Equity Markets and Company Share Capital" by Geoffrey Yeowart, [1998] JIBL at 269.

Question 7: Do you consider that a business reorganisation plan should be presented soon (e.g. 1 month) after the application of the bail-in tool? Should this only apply in the case of an open bank bail-in or also for a closed bank bail-in?

62. Given the range of possible resolution options (including transfer to a bridge bank, sale to a private sector purchaser or nationalisation), a business reorganisation plan may not be appropriate or necessary in all cases, nor is it always the case that an administrator will replace the existing management. In the case of a closed bank bail-in, there is unlikely to be a need for a business reorganisation plan in respect of the bad bank (where the objective is likely to be to collect in whatever assets there are and to distribute the proceeds to creditors). Whether such a plan is needed in respect of the good bank will depend upon the facts of the case. If the good parts of the business have been acquired by another healthy bank, there may not need to be a separate reorganisation plan and instead the question will be one of integration. Hence it is important that the legislation is not too prescriptive in this respect.

63. Furthermore, it may be that a bank already has a resolution and recovery plan (or living will) that would circumvent the need for a further reorganisation plan. A recovery and resolution plan ("RRP") will be required to be maintained by financial institutions at all times. We assume that any proposals for bail-in will already have been factored in to the RRP and so any new business recovery plan will effectively be an update of the RRP which should presumably help to enable institutions to produce the RRP sooner than one might otherwise be entitled to expect it. Given the requirement for a RRP, we do not see why this should not cover both the open and the closed bank.

64. In any event, a period of one month after application of the bail-in tool is unlikely to be practicable. By way of analogy, a UK administrator is given a period of 6 to 8 weeks to put together proposals for how he or she intends to achieve the purposes of the administration and this time period is sometimes extended in complex cases.

65. Resolution authorities should have the ability to require the production of a business reorganisation plan following application of any of the resolution tools, if they consider it appropriate. The resolution authorities should also have flexibility as to the timing of production of the plan, to take into account the size and nature of the organisation concerned.

Question 8: Do you consider that including a contractual recognition of the debt write down would facilitate the enforcement of the debt write down powers with respect to instruments issued under the law of a third country?

66. Yes, if a debt instrument governed by the law of a jurisdiction outside the EU includes an express provision enabling a power of bail-in to be exercised in relation to the relevant debt, this may well be helpful subject to obtaining specific advice from legal advisers in that jurisdiction as the legal efficacy of the provision. So long as the relevant liabilities came into being after the date of the bail-in legislation and there is no element of "retrospectivity", we believe this would be likely to assist recognition in jurisdictions such as New York. A G20 commitment to bail-in would assist recognition in major jurisdictions.

67. A contractual position would need to be consistent with the relevant EU and national legislation. One point to bear in mind is that, if institutions start issuing or incurring debt on such contractual terms before the relevant legislation is finalised, there is a risk that they may end up with such an inconsistency.

Question 9:

(a) According to your views, what would be the likely impact of the debt write down tool? What measures (if necessary) could be envisaged to mitigate such impact?

(b) Do you consider that the bail-in tool provisions should only become applicable after a certain date in the future? What do you think that date should be?

(c) Do you consider that it would be desirable to exclude debt issued before a certain date from the scope of bail-in (grandfathering)?

(d) Do you consider that there is a need to foresee a transitional period/progressive phase-in for the building of the minimum requirement of "bail-in-able" liabilities? What do you think it should be and over how many years?

68. The proposed resolution regime needs to strike a balance between the perceived need to take action in the interests of financial stability and the private law rights of stakeholders in a bank.

69. We take the view that interference with private law rights should be kept to the minimum necessary to achieve the aims of the regime. For this reason we believe that all obligations capable of bail-in should be clearly identified as such so that those dealing with banks do so with their eyes open as to the possible consequences. We have indicated above what we suggest would be suitable classes of liability for bail-in. We believe that it would be difficult and futile to try to cast the net more widely.

70. There should be a sufficiently long transition period to enable the implications to be assessed and understood. Ideally, existing liabilities incurred before a specified date should be excluded from the scope of bail-in. If the bail-in power were to be given retrospective effect, great care would need to be taken to ensure that the "no credit worse off" principle was fully respected. For this reason it might be necessary to consider whether, if the power were exercised retrospectively, an investor should in certain circumstances have a right to claim compensation for any loss resulting from bail-in.

Membership of the Working Party of the CLLS Financial Law Committee

This response has been prepared, on behalf of the CLLS Financial Law Committee, by the following working party:

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Details of the individuals and firms represented on the Financial Law Committee are set out in the Appendix.

Financial Law Committee
The City of London Law Society

20th April 2012

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THE CITY OF LONDON LAW SOCIETY
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