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City of London Law Society Financial Law Committee and Insolvency Law Committee response to the open consultation (the "Consultation") on the implementation of Bail-in powers issued by HM Treasury ("HMT") on 13 March 2014

A. Introduction

1. The City of London Law Society ("CLLS")

1.1 The 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 multi-national companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

1.2 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 has been prepared jointly by the CLLS Insolvency Law Committee and the CLLS Financial Law Committee. The names of the Committee and working party members are set out in the schedule to this note.

1.3 Section B1 of this note comments on the Consultation. Section B2 comments on the latest draft of the Banking Act 2009 ("BA 2009") (Mandatory Compensation Arrangements Following Bail-in) Regulations – "Compensation Regulations". Section B3 comments upon the BA 2009 (Restriction of Special Bail-in Provisions, etc) Order – "Restriction Order". Section B3 addresses other, miscellaneous, matters.

B. Commentary

1. Comments on the Consultation

Inter-relationship between the Financial Services (Banking Reform) Act 2013 ("BRA"), statutory instruments made under the BRA and the Bank Recovery and Resolution Directive ("BRRD").

1.1 We consider that in an ideal world, the BRA and related statutory instruments would only be promulgated once the BRRD was in final form. The amended text of the BRRD, published on 8 April 2014, was approved by the European Parliament on 15 April 2014 and the European Council adopted the BRRD on 6 May 2014. EU Member states now have until 31 December 2014 to transpose the BRRD into national law. However, the practical implementation of many of the provisions of the BRRD will be influenced by guidance to be published by the EBA and this guidance is not yet available.

1.2 We understand that the BRRD envisages the new bail-in regime need not take effect before 1 January 2016. We further understand that the UK Government does not intend to wait that long before implementing a bail-in process. Many of the key provisions are set out in the statutory instruments such as the proposed Restriction Order and the

Compensation Regulations. The BRA itself contains provisions giving the Treasury the power by order to amend various aspects of the bail-in process. For example, the proposed section 48F BA 2009 gives the Treasury the right to amend the definition of "excluded liabilities" in section 48B(8) BA 2009.

1.3 In any event, the bail-in power is broadly drafted and would be implemented by the Bank of England making one or more resolution instruments containing the bail-in proposals. Those provisions – e.g. the proposed section 12A (3) BA 2009 - allow the Government to make bespoke bail-in provisions for individual banks. Taking these matters together, we believe the UK Government has at its disposal the means to minimise any inconsistencies between the BRA and BRRD by making further legislative amendments as and when necessary.

1.4 We nevertheless recommend that multiple legislation on this important topic is avoided if at all possible. This is in part because the official texts of statutory instruments are not updated (either at all or in a timely fashion). Hence public versions of much amended SIs become very difficult to use. The next drafts of statutory instruments such as the Restriction Order and the Compensation Regulations should therefore be conformed to the final text of the BRRD. Confirmation should be sought that this will amount to proper implementation of the BRRD.

1.5 In addition care should be taken to ensure that any legislation regarding the priority of deposits does not follow an approach which differs from similar, existing, legislation in other EU jurisdictions and plans announced elsewhere in the EU. This is necessary to ensure that there is no regulatory arbitrage between the UK and other EU states that could put UK banks at a competitive disadvantage in raising capital – see question 7 of the Consultation.

Creditor Hierarchy on Bail-in (Question 7)

1.6 The flexibility to bail-in creditors on a basis that does not either wholly reflect their priority on insolvency or equally among creditors with the same priority is very valuable. For example, had a bail-in of the Co-Operative Bank been required with strict adherence to priority in liquidation, then the holders of the PIBS (being individuals many of whom were particularly vulnerable) would have been fully bailed-In before the holders of the Tier II bonds, all of whom were sophisticated investors. That would have been an undesirable outcome. A balance needs to be struck, though, between giving the Authorities sufficient flexibility to make a bail-in work and providing the market with certainty as to how a bail-in will operate. It is suggested that this be done through guidance or a code of conduct regarding how the bail-in tool will be exercised.

1.7 We recognise that the extent to which depositors and other claimants should be preferential creditors in a bail-in or other resolution process is one of policy. Nevertheless, having regard to the way in which the BRRD is finally formulated, the Government should seek to retain as much discretion as is possible to avoid the bail-in of deposits.

1.8 Deposits are the stock in trade of a bank and a key component of the overall relationship between a bank and its customers. Therefore a bank in which any standard type of deposit is bailed-in is unlikely to be capable of surviving itself or passing on its client relationship with bailed-in depositors successfully to a bridge bank. Bail-in of deposits will also spread contagion to the wider economy. The management of the Cypriot banking crisis is a bad precedent for the management of a seriously failing bank in an advanced economy that is also a major financial centre.

Preferential Creditors

1.9 Part 2 BRA introduces new provisions to Schedule 6 Insolvency Act 1986 making deposits covered by the Financial Services Compensation Scheme ("FSCS") compensation threshold of £85,000 preferential under Schedule 6 Insolvency Act 1986 (so ranking pari passu with other preferential creditors). Preferential claims rank behind expense claims but ahead of ordinary unsecured creditors and floating charge creditors. They rank behind fixed charge creditors. The rest of an eligible deposit would rank below expenses and preferential claims but ahead of floating charge creditors.

1.10 These provisions are clearly intended to implement Article 108 of the BRRD and Recital 111 BRRD which require eligible deposits to rank ahead of ordinary unsecured, non-preferential creditors and for covered deposits to rank ahead of eligible deposits. However, these provisions of the BRRD do not specify how deposits should rank as against preferential and floating charge claims. While we can see the merit in bringing these provisions of the BRRD into effect early so as to avoid making multiple changes to the creditor hierarchy, it is important to ensure that there is a level playing field between individual EU states. Hence it would be helpful to know how other member states are intending to rank deposits as against preferential and secured creditors and we wonder whether it would be worth carrying out further consultation and/or a risk assessment on such ranking.

1.11 The concept of differentiation between preferential creditor claims is not new to European legislation. The Insurers (Reorganisation and Winding-up) Directive ("WUD") and Insurers (Reorganisation and Winding-up) Regulations 2004 (SI 2004/353) – "IRW Regulations" - each provide that preferential debts are to be paid ahead of "Insurance Debts". "Insurance Debts" – Article 2(1) IRW Regulations - are debts to which a UK insurer may be liable under insurance (not re-insurance) policies.

1.12 The rationale behind WUD is that the holders of insurance policies should receive protection from the legislature over and above given that other unsecured creditors. We do not object to a similar distinction being drawn between depositors with deposits up to but not exceeding the £85,000 FSCS compensation threshold and other depositors. We consider that the legislation should clearly spell out the order of priority which we understand to be as follows:-

- Expenses of the process
- "Covered – i.e. up to the FSCS compensation threshold – depositors and ordinary preferential creditors ranking pari passu
- Eligible depositors for sums over and above the FSCS compensation threshold
- Creditors entitled to payment under a floating charge

1.13 We appreciate that the creation of these new categories of preferential creditor could be said to dilute the power of floating charges. Subject only to the comments in the next paragraph, we do not regard this as an insurmountable difficulty with the new proposals. If the priority of the security is essential (such as in securitisation and structured finance transactions) it is always open to the parties to seek to structure the relevant transactions so that the security is fixed (although it is accepted that this is often not possible to achieve outside the context of a structured finance transaction.

1.14 We believe that the new priority requirements will make it more important to address the treatment of charges over revolving pools of securities and over bank accounts so that

these can, at least for some purposes, be treated as fixed charges. We particularly have in mind charges given by market participants, (including banks) to exchanges, and central counterparties where it is essential that these are not rendered valueless by the operation of these revised priority rules). The current state of the UK Implementation of the Financial Collateral Directive and these new proposals in combination mean that exchanges and central counterparties' security in relation to members that are UK regulated institutions subject to bail-in may be undermined in effectiveness. As this could carry contagion risks, we urge that this is addressed as a matter of urgency and that revisions are in place at the same time as the bail-in legislation.

Netting, set-off and protected arrangements (Questions 9 to 11)

1.15 We agree that while the principle of bail-in on a net basis is correct, calculating a net position where any degree of complexity is involved will be complex and time consuming. Members of the Insolvency Law Committee and the Financial Law Committee all have experience of these delays in work undertaken on the Lehman insolvencies. We are not suggesting that it would be practicable or consistent with policy for the UK Government to exclude net liabilities from bail-in in all cases; clearly the bail-in of net positions may be required by the BRRD. Furthermore, in addition to the powers of the Authorities to carry out a mandatory close-out in article 4(4) of the Restriction Order, close out could result from either automatic termination provisions or counterparties giving notices of close out and netting following those close outs, provided that the automatic or early termination event is triggered by something other than the resolution itself.

1.16 We note that, as a result of sections 22 and 28 of the Banking Act and Arts 68 and 71 of the BRRD, the resolution itself should not give rise to any counterparty exercising close out or termination rights or triggering automatic termination). However, we do consider that the Restriction Order should be much clearer as to how any valuation should be performed (see paragraph 1.27 below).

1.17 In any event, this is another example of "one size fits all" being inappropriate to the operation of the bail-in provisions. In some instances, the bail-in tool may be applied to small financial institutions with few derivative transactions. In such instances, it may be possible to negotiate the close out of those derivatives with the relevant counterparties as part of the bail-in process.

1.18 Conversely, there will be other, more complex, cases equivalent to RBS or Lehman where the extent and complexity of a financial institution's derivatives portfolio will make close out and netting difficult to apply (and the prospects of valuing the net liability impossible over the course of a resolution weekend). In those cases, we consider that the Authorities should have the discretion to exclude in their entirety derivative positions from the bail-in powers. We note that, as currently drafted, the bail-in provisions would give the Authorities this flexibility (provided that they explain any departures from the pari passu principle in a report) and we consider that it is important that this flexibility be retained (although we appreciate that, in due course, the UK's legislation will need to be consistent with BRRD where the flexibility to exclude derivatives and other liabilities is more limited).

1.19 From a drafting perspective, the CLLS understands that the definition of "derivative" in EMIR which the Treasury is proposing to use in the Restriction Order lacks clarity and that there are differences between the definition of "financial contract" in the BRRD and in the Restriction Order which is clearly undesirable.

Valuations, Bail-in and Compensation

1.20 We question more generally the extent to which it would be possible to carry out an accurate valuation of the bailed-in liabilities in the lead up to and immediately after a bail-

in occurs. First, the way in which any given bail-in works will inevitably vary from institution to institution. That is acknowledged by the BRA – Section 12A – providing for the making of special bail-in provisions for individual banks.

1.21 In smaller institutions, it should often be possible to form a clear view of the institution's assets and liabilities at the time of the bail-in. The same could be true if a bail-in process takes place in respect of an organisation that has been steadily underperforming without any sudden and cataclysmic shock to the valuation and composition of its assets.

1.22 In other cases – and RBS, Cyprus and Iceland are examples – the institutions to be bailed-in will be substantial, complex and transnational. Those institutions' counterparties and contractual arrangements will also be transnational.

1.23 In these circumstances, speed must be the essence of the bail-in process. In that event, the conclusion of a formal valuation of the bail-in liabilities during a resolution weekend would be difficult, if not impossible. Any attempt at valuation made at this time will necessarily be provisional.

1.24 Furthermore, the bail-in tool may be used as part of a wider special resolution regime involving, potentially, the transfer of assets and liabilities. This is a further complexity and there may be questions whether certain liabilities should have been transferred with related assets or subject to bail-in on a net basis.

1.25 In these circumstances, the only realistic course of action will be to make the subsequent dispute resolution arrangements as transparent and swift as is feasible. The current draft does not appear to state expressly how any dispute between an individual creditor and the valuer would be resolved, However, the bail-in valuation exercise raises an issue which is different from the general "no creditor worse off" compensation right; namely the question for each bailed-in creditor whether it is receiving its correct equity entitlement[1].

1.26 There are likely to be numerous errors at the level of individual creditor obligation in the netting process. Counterparties are likely to challenge the methodologies and values adapted. This is particularly so as in many netting agreements it is for the counterparty, not the prospective defaulter, to carry out the netting, and because in some cases, netting may require the use of market values not available till the next working day in the relevant financial market.

1.27 No valuation of a netted claim over a resolution weekend is likely to be more than provisional, especially as it is unclear how far contractual processes will be followed. Hence there needs, in our view, to be clarification of whether the contractual netting process and valuation principles in individual derivative agreements will be applied to arrive at the net amounts (with an estimate where this cannot be carried out on available information, or is assigned under the contract to another party and an assumption that a contractual close-out had occurred where the Authorities use their mandatory close-out powers). If not, there needs to be confirmation of what legal over-ride and overriding valuation principles are to be applied. The application of any over-ride could have far

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[1] We have assumed here that the valuation exercise for allocating equity entitlements will be separate from the valuation exercise for the NCWO compensation provisions on the basis that the former will be done during the course of the resolution weekend whereas the latter could occur months if not years after the resolution. However, we understand that there have been suggestions that the NCWO provisions could be used to determine the equity allocations. This suggestion would involve a trust arrangement whereby the equity would be held on trust for bailed in creditors until the allocations could be determined (and the bail-in administrator concept in the BRA allows for this). We query though whether this is going to be acceptable to the market, particularly if the determination of the equity entitlements were to take some time, as it would be unclear who the shareholders of the resolved bank were in the interim period.

reaching implications in a major EU jurisdiction. The resultant issues of comity and recognition will need careful review[2]

1.28 We consider that there should also be legislation for a separate process to deal with disputes about the netting of individual rights and liabilities of this sort speedily so as to ensure that each bailed-in creditor receives its correct entitlement to equity and the total equity created by the bail-in is determined on a legally certain basis. This could be, for example, a timetable for agreement, followed, if this fails, by a short arbitral process, reducing the prospect of these disputes spending years before the courts.

1.29 This would need to command the confidence of bailed-in creditors as a fair process to achieve the aim of facilitating the management of the bailed-in equity and its marketability. This will be very important to bailed-in creditors. Accordingly we urge the Government to consider whether paragraph 7 of the Compensation Order should include arbitration or other dispute resolution provisions.

1.30 This process needs to be separate from the overall consideration of whether bailed-in or other creditors or any class of them are worse off than they would have been in an insolvency – eg because their equity entitlement turned out to have little or no value overall, while the class of creditors would have received a greater pay-out in a liquidation. The process laid down for the "no creditor worse off" assessment is not well suited for the adjustment of individual creditor claims that have been wrongly assessed for bail-in and would be undermined if it was carried out at a time when many claims were subject to disputes turning on individual factors. The overall relative amounts in issue would be unclear and for this reason, a two stage process is necessary.

1.31 We note the absence of prescribed qualifications or expertise for an independent valuer – paragraph 6 of the Compensation Regulations. We assume that the absence of qualifications is an attempt to preserve flexibility. No two banks' asset and liability portfolios will be identical. To that extent, the absence of prescribed criteria reflects reality.

1.32 We recognise that the valuation of claims and compensation will call for a wide range of skills and experience going beyond pure insolvency. We also recognise that a bail-in provision may, with explanation, depart from the usual insolvency rules (section 48E BA 2009). Nevertheless, the basis for compensation is ensuring that ultimately, no creditor is worse off than would have been the case in an insolvency of the bank to which bail-in is applied. In these circumstances, the ILW considers there should be some requirement for familiarity with insolvency practice and procedure in the valuation process, so as to minimise room for dispute about the overall approach.

1.33 In similar vein, the legislation (section 12B BA 2009) makes as yet no provision for the qualification of a bail-in administrator, although it does state (section 48J BA 2009) that a bail-in administrator is "not a servant or agent of the Crown" and in particular "not a civil servant". Although we recognise that the legislation provides flexibility, we consider there are grounds for saying that a bail-in administrator should be a person who is or who can demonstrate access to restructuring or insolvency expertise as part of his or her core skills. This is because it is necessary to understand the practice of restructuring and insolvency to be able to determine, on an informed basis, when restructuring and insolvency principles should be inapplicable to particular aspects of a bail-in; cf paragraph 1.31 above.

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[2] We understand that, under Art 48 of the BRRD, the EBA has to prepare a regulatory technical standard (RTS) on the methodologies for valuing net amounts on close-out and that ISDA has been working with the EBA in this respect. It is possbile that such RTS will address some of the concerns set out in this section of our paper.

2. Comments on the Compensation Regulations

2.1 Bail-in compensation is only payable to “relevant persons” (regulation 6(2)) meaning pre-resolution shareholders and creditors of the bank. The Bank of England has powers under Sections 81BA and Section 48B(2) BA 2009 to make a “Special bail-in provision” which can cancel or modify a contract under which a banking group company has a liability. If that causes loss to persons then there would not appear to be any bail-in compensation available to such persons. It should be clear that compensation will be available to shareholders or creditors who are caused loss by a special bail-in provision. This could be dealt with by clarifying that Section 81BA BA 2009 extends the compensation provisions to banking group companies.

2.2 Additionally, section 60B(3) BA 2009 refers to relevant persons as persons who “held” securities or were “creditors” of the institution. This does not appear to address persons with a beneficial as against a legal interest. Absent any clarification the holders of beneficial interests appear to be excluded from this provision. The Treasury should consider if that is intended and if appropriate, use regulations to clarify the point.

2.3 The independent valuer appointed under Regulation 6 need not have particular qualifications or experience. See our comment in section B1.32 above.

2.4 We note the insertion of the words “subject to any necessary modifications") in Regulation 7(1). What precisely are the modifications contemplated here? (See also Regulation 9(1), 10(1)).

2.5 In Regulation 7(6) the “initial instrument” is defined as in Section 60B(2) BA 2009. That is the first instrument made with respect to that bank. Is that principle correct? Should not the relevant instrument be the first instrument which resulted in loss to that relevant person? This has a consequential impact on Regulation 9(2). (See questions 18 and 19).

2.6 Regulation 8(a) allows specification of a particular insolvency process. Alternatively, Regulation 8(b) allows a valuer to determine the applicable insolvency process. Section 60B(4) BA 2009 allows for a wide variety of potential processes but they are not all liquidation. In particular they include compositions with creditors and schemes of arrangement. As the outcome of a hypothetical composition or scheme is entirely dependent upon its terms and that the approval of those terms by the requisite majorities it is difficult to see the basis on which the Treasury or the valuer can assess the outcome of such an insolvency treatment.

2.7 Although we note that this provides flexibility, assessing compensation in this way may result in considerable uncertainty and risk of challenge. Guidance should be given that these forms of insolvency will not be used as a basis of compensation except in exceptional circumstances where the terms of the composition or scheme is public, certain and sufficiently advanced pre-resolution that they are or are reasonably likely to have been approved by the requisite creditor majorities and the Court, as applicable.

2.8 Regulation 10 permits arrangements to be made for payments on account. We support providing that no payment on account shall be made to any relevant person unless that relevant person has confirmed (at least in respect of those parts of this claim that are no in dispute) that he or she accepts the determination of the compensation payment and the amount of payment on account.

2.9 Regulation 11 does appear to open up a significant area for potential challenge on the basis that the valuer failed to have proper regard to information provided by a dissatisfied relevant person.

2.10 Regulation 12(2) allows the order to specify the value at which property is to be treated as having been sold whether or not it is in fact sold. This is a potential loophole allowing for manipulation of the calculation of compensation by the Treasury. A similar point applies to Regulation 12(3) and (4).(Question 15). We recommend, to ensure confidence in the process, the introduction of an independent valuation procedure for use in these cases.

3. Comments on the Restriction Order

3.1 The concept of "Remedy" under Paragraph 7 is welcome but as the Restriction Order only protects counterparties where no mandatory (or other) close out has occurred and as it requires a positive act in the bail-in order to force a mandatory close out in which case no protection applies it may be unlikely that the bail-in will purport to harm counterparties in contravention of the order. Perhaps if the order wrongly assumes that automatic or optional close out has occurred and bails in the net claim when there is no net claim (as no actual close out) then that is the circumstance where a remedy may be required.

4. Miscellaneous Matters

Building Societies

4.1 We understand that the Building Societies Association ("BSA") is making its own submissions on the Consultation. We accept that demutualisation provides an effective means of bailing-in a building society, however we will not comment on whether a way could be found to reserve mutuality in the context of a bail-in – eg through the use of a profit dependent instrument for bailed-in parties, rather than an equity entitlement. We urge the Government to consider the submission of the BSA carefully.

Banking Group Companies and Securitisation Vehicles

4.2 We are aware of concerns expressed by capital markets lawyers at the "Banking Group Companies provisions" applying to securitisation structures. We understand that capital markets lawyers will be making more detailed submissions on this matter. For that reason, we refrain from making our own submissions on the inter-relationship between capital markets transactions and the "Banking Group Companies" provisions to be included in the new section 81 BA 2009.

4.3 We approve of the suggestion that secured liabilities should be excluded from the bail-in proposals but notes that this is only so far as they are secured. This gives rise to similar valuation issues as were discussed in Sections B1.20 to B1.23 in relation to net liabilities. While we can see the logic behind this proposal, working out the extent to which the liabilities are covered by collateral could, in practice, take considerable time. We suggest that the authorities should have the flexibility to exclude all secured liabilities from the bail-in, not only the part that is covered by the collateral, if the factual circumstances require. We believe this is consistent with the BRRD.

Schedule

Part 1

THE CITY OF LONDON LAW SOCIETY
INSOLVENCY LAW AND FINANCIAL LAW COMMITTEES

Individuals and firms represented on the Insolvency Law Committee are as follows:

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Ms C. Balmond (Freshfields Bruckhaus Deringer LLP)
J. Bannister (Hogan Lovells International LLP)
G. Boothman (Ashurst LLP)
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S. Frith (Stephenson Harwood LLP)
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Individuals and firms represented on the Financial Law Committee are as follows:

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Part 2

Working party members for this consultation:

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