

Financial Stability and Depositor Protection: July consultation papers (Cm7436 & 7459)

A Submission by the London Investment Banking Association

A. Executive Summary

LIBA is the trade association that represents investment banks with operations in and from London. Our objective is to ensure that the UK continues to be an attractive location for the conduct of international investment banking business, so we pay particular attention to the overall legislative and regulatory framework here in which our Members operate and to potential changes to it. It is from this viewpoint that we have considered the questions raised in the consultation papers.

This submission summarises our Members' response at this stage to the proposals in the July consultation papers as regards the exercise of the new stabilisation powers that are envisaged as part of the Special Resolution Regime. The Authorities acknowledge that the proposals would alter property rights in a fundamental way with respect to the position of both creditors and shareholders.

In summary, our Members are extremely concerned that the proposals, as they stand, will significantly damage the competitiveness of UK banks through the uncertainty that they will create about the efficacy of the protective steps that creditors take to safeguard their interests if a bank counterparty gets into difficulties. The problems are particularly acute in the case of partial transfers and we propose that additional criteria on the factors that the Authorities should consider when deciding whether the special powers should be exercised should be included to help address these concerns.

There are major concerns too about the proposed treatment of particular kinds of transactions. In particular, the proposals for preserving netting and set off arrangements fall short of what is needed.

The concerns already raised by the ambitious legislative timetable have, if anything, been strengthened as Members have gained a greater understanding of the Authorities' proposals. At this stage only 32 draft clauses dealing with the stabilisation options have been published and much is to be left to secondary legislation and to a Code of Practice the status of which – in terms of circumscribing the Authorities exercise of the stabilisation powers – remains unclear. Parliament should not be expected to enact legislation of this significance until the *complete* package has been consulted upon and the implications are clear. If the Government decide to adhere to the original plan to secure the new legislation by the Banking (Special Provisions) Acts end-date next February, the BBA has suggested that the legislation on the partial transfer powers should *not* be included at this stage: we support this proposal.

Finally, at the end of our submission, we deal with the question raised in the consultations about the treatment of investment banking business. The issues here are extremely complex, and a separate consultation will be needed if the Authorities conclude that the scope of their existing powers may be inadequate.

B. Introduction and main themes

1. In this submission we concentrate on our Members' response so far to the questions raised in the July Financial Stability consultation papers as regards the implications of the exercise of the proposed stabilisation powers in the Special Resolution Regime (SRR) for UK deposit-takers. We conclude by considering the further question that has been raised about the position of investment banking business. (Question 4.1). Given our focus, we do not reiterate the points that we have made in our responses to the two previous consultations, but it would be helpful if we highlight the themes that we have borne in mind in preparing this submission.
2. As we have stressed previously, we understand the Authorities' wish to have additional powers to intervene in a failing bank at the pre-insolvency stage but, and as the Authorities recognise, the introduction of the SRR proposed potentially alters property rights in a fundamental way. Accordingly, it is essential to seek to establish a regime that gives the Authorities the flexibility they need to deal with a failing bank whilst, at the same time, seeking to minimise the uncertainty that creditors and shareholders will have about the potential implications of dealing with or investing in an UK bank once the regime has been implemented. Clearly, where this balance is struck will be fundamental to the success of the new regime. (Given our Members' business, we have focussed primarily on the implications for wholesale counterparties of banks rather than the interests of shareholders; we have also focussed on the implications of the stabilisation options in the SRR rather than the special banking insolvency regime.)
 - (a) A balanced SRR regime will be particularly important – and may well be more difficult to achieve than in other jurisdictions – because London is the leading financial centre, where UK banks compete for international business with the branches of foreign banks. So it is essential that clients and counterparties are not prompted to favour dealing with the latter, or to seek better terms from the former, as a result of the changes in the regulatory regime (as regards increasing the uncertainty of the potential implications of dealing with a UK bank rather than a foreign competitor, for example, by including rules which potentially favour one class of creditor over another and which undermine the steps that creditors have taken to protect themselves – see Section D below and in particular paragraphs 22-26).
 - (b) The new legislation envisaged would represent a step change in the Authorities' powers and all the implications need to be thought through carefully. We continue to believe that the timetable for implementation of the new regime must be realistic and should not be dictated by the Banking (Special Provisions) Act's end-date next February. As well as the primary legislation establishing the new powers and making consequential amendments to the FSMA and other measures, the consultations envisage secondary legislation and the inclusion of the Code of Practice – but at the time of writing, only some of the draft clauses have been made available. It is very optimistic, and we fear unrealistic, to be confident that a satisfactory framework can be devised and implemented in less than six months. In some key areas the operation of the new regime remains unclear and our Members are still considering, for example, how the property transfer powers would operate in the case of contracts subject to foreign law – not least the provisions dealing with default events – and how the proposed regime will work in respect of a bank within an international group undertaking business with international as well as UK clients. The answers need to be certain before the new rules can be settled but the consultation does not cover these aspects in any detail (see, for instance, paragraph 5.35 of Cm 7459).
 - (c) The importance of eliminating or at least reducing uncertainty is linked to the Parliamentary process envisaged.

- Firms need to be able to see the package *in the round* before the impact can be assessed and before Parliament can be asked to enact the legislation but at this stage the precise contents of the secondary measures and the Code of Practice are unknown.
- The *scope for future changes* to be made is uncertain as well, accordingly, but this is another area where the Authorities must reduce uncertainty. Whilst the legislation as a whole needs to be capable of evolution as markets develop, the key principles must be incorporated in the primary legislation – so that the extent to which changes in the ground rules might be made by secondary legislation in the future would be limited and understood. New measures with retrospective effects as regards impairing the steps that creditors have taken to protect their interests must be avoided.
- Clearly, *consultation* with market experts will continue to be needed to prevent drafting difficulties and unintended effects.

(d) A SRR for banks is founded on the view that pre-insolvency intervention by the Authorities will lead to a better outcome than a full-blown insolvency – and the consultation papers cite examples of cases where this analysis would be applicable. However, the corollary is that in general the Authorities’ intervention should not make the position of creditors any worse than they would have been had the Authorities not intervened and the bank had become insolvent – this is central to the debate about the treatment of creditors whose claims are not transferred in a partial transfer of a bank’s business.

(e) As noted above, we consider the question raised about the treatment of investment banking at the end of this submission: this topic is particularly complex and it is clear to us that further extensive consultation would be necessary before the potential need for new legislation can be determined.

3. We would note finally, that many of our Members are involved in the Financial Markets Law Committee’s work on the SRR regime, the conclusions of which are awaited at the time of writing. We summarise, therefore, our preliminary views and would stress that we may need to return to some of the issues at a later stage.

C. Triggering Special Resolution and the partial/whole transfer decision (Chapters 3-4 of Cm 7436 and Chapter 3 of Cm 7459)

Special Resolution triggers

4. The draft legislation envisages a regime under which the stabilisation powers would be used to bring about an appropriate “stabilisation option”, namely transfers to a private sector purchaser, a bridge bank, or to temporary public ownership; in addition a bank insolvency procedure will be established. (Of the stabilisation powers, draft sections have been provided dealing with the property transfer powers not the share transfer power.) Certain general conditions in respect of a bank’s failure to meet the FSMA Threshold Conditions have to be satisfied before a stabilisation power can be exercised (and before a banking insolvency order can be applied for). In addition, there are separate conditions to be satisfied before the private sector purchaser, bridge bank, or temporary public ownership stabilisation options are pursued. When using the stabilisation powers, the draft legislation provides that the relevant authorities shall have regard to five prescribed special resolution objectives; and a Code of Practice on the use of the powers – to which the Authorities will have regard – is also envisaged.

5. The private sector purchaser and bridge bank stabilisation options can be taken forward through whole or partial transfers of a bank's business.
6. Given our Members' concerns about reducing the level of uncertainty in the regime, we believe that greater clarity should be provided about the criteria determining when special resolutions should be triggered in order to prevent unnecessary concerns about whether powers would be used appropriately.
7. In the first instance, within the general conditions in draft clause 7, the second pre-condition should be amended so that the test refers to it being "highly unlikely" that action would be taken to enable the bank to satisfy the Threshold Conditions.
8. Second, and as we discuss further below, although triggered pre-insolvency, a special resolution could involve a partial rather than whole business transfer – potentially disadvantaging creditors whose business is not held by the "good bank" thus established or the bank to whom the business is transferred. To prevent a pre-insolvency resolution from disadvantaging wholesale creditors in this way, an additional condition should be contained in clause 8 stating that the stabilisation powers should only be exercised by the Bank where, by so doing, no creditor would be placed in a worse position than it would have been in had the bank become insolvent. This would not prevent a resolution from favouring retail depositors and would not mean that wholesale creditors might not get less than 100% of their claims, but it would limit the extent to which wholesale creditors whose business was left in the residual bank could be disadvantaged *as a direct result of the Authorities intervention*.
9. Third, we are unclear about the relationship between the specific conditions and the special resolution objectives. The specific conditions in clause 8 are echoed in the first three special resolution objectives, and the Authorities are only obliged to have regard to the latter. While we understand why the Authorities would wish to retain some discretion, we believe that thought must be given as to whether the legislation could confirm that the authorities may only consider factors additional to the SROs in exceptional circumstances. (Our understanding of the case law on language of this kind¹ is that where a body is required to "have regard to" a particular factor, it may consider any number of other factors as well: thus the practical effect of the words "have regard to" is no more than "may not completely disregard". This seems to mean in practice that where a public authority is required to "have regard to" a particular consideration, a particular decision could be challenged only if it could be shown that no reasonable person who had had regard to that factor could have come to the decision in question; so if this reading is correct, the extent to which clauses 4(2) and 5(3) would circumscribe the Authorities' conduct is highly uncertain.)
10. Fourth, the implications of the reference to the Human Rights Act are unclear – in part because the draft clause concludes "the order in which the objectives are listed.... is not significant; they are to be balanced as appropriate in each case....". Since all UK legislation must comply with the HRA in any case – and that the Convention has public interest reservations – we are uncertain what is added by this reference, and it prompts a question about whether the application of the HRA to the new legislation will be different, in some way, from the application to other measures.
11. Fifth, whilst we can understand why it is thought that a Code of Practice will provide a flexible mechanism for giving information about the operation of the regime, and could cover matters not well suited to legislation, the Authorities would only be required to "have regard to the Code". We think it is essential that the legislation introduces a presumption that the Code will be observed and that, in general, matters fundamental to the operation of the regime should be

¹ *Dunnachie v Kingston-upon-Hull City Council* [2004] EWCA Civ 84, [2004] 2 All ER 501.

included in the legislation rather than in the Code – using secondary legislation should provide the necessary flexibility but this will need to be available for review before the primary legislation is enacted. (We note that a Treasury Order is envisaged in draft clause 9(5).) The discussion in Cm 7459 about the “comply or explain” arrangements as regards a partial transfer decision prompts further uncertainty about the role of the Code (paragraph 3.45).

Whole or partial transfers

12. The other area of uncertainty within the basic SRR structure is the decision that the Bank of England will take about whether a whole or partial transfer of the failing bank’s business should be made. The consultation papers explain why a partial transfer could give rise to a better outcome in some circumstances but, as we explain below, many of the difficulties for wholesale markets to which the SRR will give rise stem from the possible transfer of just part of a bank’s business. It is of concern, therefore, that so far the sections in the proposed Code of Practice setting out the situations in which partial transfers might be used are not yet available and that the degree to which the Bank would be expected to adhere to the guidelines would be uncertain given the “comply or explain” approach envisaged. It must not be forgotten that the SRR’s powers will be triggered *before* a bank becomes insolvent, and we think that given that the legislation should provide that the Bank would be required to make a whole business transfer unless it was reasonably considered that a partial transfer would give rise to a better result for the creditors of the bank *as a whole*.

D. The treatment of wholesale transactions (Chapter 4 of Cm 7436 and Chapter 3 of Cm 7459)

13. The Authorities have recognised that using a stabilisation power will adversely effect the rights of creditors potentially. In some areas it is argued that there can be circumstances where this will be necessary and in other cases the consultation papers discuss ways by which the problem can be avoided or mitigated.

Examples of the former are:

- (a) the plan to include legislation stating that a property transfer instrument can provide that the making of the instrument shall *not* be regarded as a default event provision regardless of the contractual arrangements made by the bank and its counterparty;
- (b) the suggestion that restrictions on borrowing including negative pledges should be nullified to the extent that they would prevent financial assistance by the Authorities [or] are otherwise triggered by steps taken by the Authorities;
- (c) the suggestion that powers may need to be created to alter or nullify contracts between group companies; and
- (d) potential limitations to the operation of netting and possible exceptions to the security interests safeguards.

Examples of the latter are:

- (i) confirmation that the regime will be compatible with the Financial Collateral Directive and that financial collateral arrangements would continue to take effect in accordance with their terms;

- (ii) proposals on preserving set off and netting arrangements;
 - (iii) the proposal to include a legislative safeguard that secured liabilities should not be separated from the assets securing those liabilities (save in some specified circumstances);
 - (iv) confirmation that the Authorities would not interfere with creditors' right to enforce a security interest except where the transfer or acts preparatory to it were an event of default under the agreement in question; and
 - (v) the suggestion that there should be safeguards for structured finance arrangements to protect interconnecting parts of an arrangement from being separated in the course of a partial transfer.
14. As part of this framework, the Authorities also propose compensation arrangements and the establishment of the Bank Resolution Funds mechanism in order to provide the residual company with a contingent economic interest in the net proceeds of a resolution. However these arrangements are highly discretionary so will do little to help reduce creditor uncertainty.
15. As with other aspects of the SRR proposals, our starting point in considering these issues has been the need to avoid steps that would damage the competitiveness of UK banks *and* the fact that stabilisation powers would be used pre-insolvency – so they should not have the result of undermining the measures that creditors have taken to protect their interests except where it is clear that these would prevent a stabilisation power being exercised effectively.

Proposals (a) - (d)

16. We understand why the Authorities are proposing the termination rights power in draft clause 19, but the effect will be uncertainty about the extent to which default event provisions in contracts with UK banks can be relied upon. This will make it all the more necessary to ensure that the legislation does not unduly limit other measures that creditors take to protect their interests.
17. We have noted previously that our Members are uncertain about whether these powers could be applied successfully to contracts governed by foreign law. There is also uncertainty about the Authorities' thinking on the application of clause 19. Paragraph(3) seems to confirm that in *all* cases where a contract provides that termination rights arise as a result of a “default event provision” making reference to the making of a property transfer instrument, then such a provision must be disregarded. It is not clear, though, whether this is supposed to affect only contracts to which the bank is a party or whether it would *also* affect other contracts between parties that are not counterparties of the bank which make reference to the bank's position. Is that the intended effect? If so, is clause 19(4) designed to give the Bank of England the ability to limit the contracts to which the powers apply by, for example, specifying in the instrument that only contracts to which the bank is a counterparty would be affected? In this context, we note the suggestion made by ISDA that the power to limit the right of a counterparty to terminate transactions early – if the sole basis for such termination is the exercise of the SRR powers – should not apply to master agreements not transferred to a bridge bank or private sector purchaser: would 19(4) allow this distinction to be made?
18. A particular issue is the potential impact of the proposed provision on the drawstop arrangements that are typically included in revolving loan liquidity facilities. It is essential that it is clear that a decision to exercise the stabilisation powers does not have the result of requiring the provider of the facility to make further loans to the failing bank. If this is not clear, then there will be an unwillingness to provide UK banks with such facilities.

19. As regards the suggestions on restrictions on borrowing, we support the proposal to discourage banks from entering into this kind of arrangement, but we are unsure that they should be prohibited outright unless it is clear that other leading jurisdictions will adopt a similar approach. It may be, therefore, that the Authorities will conclude that a statutory override will have to be included – but, again, this would provide another example of a case where a creditor could no longer be certain that the steps taken to protect its interest would be upheld.
20. Chapter 5 of Cm 7459 provides an additional explanation on the proposal that powers to alter or nullify group contracts should be included. This focuses on limiting action to the steps needed to ensure that a bank remains fully operational and also enabling steps to be taken to prevent the failure of the group a bank sits within if this in the public interest (the example given is where a bank provides essential services – for example a Treasury function or guarantees – to systematically important parts of its group). It will be important to ensure that the powers on group contracts are limited to these purposes.

Proposals: (i) - (v)

21. Given that the Authorities will be intervening pre-insolvency, any limitations to creditors' rights should be kept to a minimum as stressed previously. So the Authorities' willingness to consider the safeguards outlined in the CPs is welcome. We are concerned, though, that the proposals do not go far enough.
22. As regards netting arrangements, the Authorities have recognised that cherry-picking particular transactions should be prevented, but it is proposed that this safeguard should be limited to defined qualified financial contracts (many of which would in fact, be protected by the Financial Collateral Directive in any case). The major problem with this approach, as the Authorities acknowledge, is the maintenance of a clear and comprehensive list of QFCs, with the risk that in practice UK banks would be ruled out of entering contracts not specified on the list. This is a serious weakness to the QFC proposals and we would urge the Authorities to consider again the suggestion that all agreements should be protected: in particular, we are not convinced that the risk that counterparties will seek to include a number of different types of contracts which are not typically netted under a particular master agreement will prove to be a real one in practice.
23. The impact of the proposals on master netting agreements is unclear. Counterparties to UK banks can view their overall position net by virtue of master netting arrangements and it is essential that the SRR does not prevent this.
24. We see no reason why the regime should affect set off arrangements except in the case where changes will be needed to permit compensation payments being calculated on a gross basis (as discussed in chapter 5 of Cm 7436).
25. In respect of creditors with security, the only type of security interest to be excluded from the proposed legislative safeguard should be floating charges (we had understood that the FSA already strongly discourages banks from granting floating charges).
26. As regards structured finance arrangements, concerns have been raised about the implications for UK covered bonds in the light of the apparent power to overturn the assignment of mortgages from a bank to the LLP in a covered bond transaction (and possibly other key provisions in programme agreements). It is very important that the SRR proposals do not result in the "true sale" opinions that are issued being called into question, so the legislation must confirm that the powers of the Bank of England do not extend to overturning transactions between the issuer and LLP in a covered bond transaction. There may be similar issues as regards true sale opinions for securitisations such as residential mortgage backed securities.

E. Roles of the three Authorities (parts of Chapter 4 and Chapter 6 of Cm7436)

27. We broadly support the division of responsibilities proposed in the consultation papers and also the proposals for strengthening the Bank's role and Tripartite coordination. However, we are considering whether the establishment of the Financial Stability Committee – to be a sub-committee of the Court – and the proposed enhancements of the Court's arrangements will provide sufficient accountability.
28. The consultation paper refers to future work on clarifying responsibilities within the MOU. We trust that modifications will be consulted upon before they are finalised.
29. A particular issue is the *practical arrangements* for moving a bank into special resolution. Clearly considerable preparatory work will be necessary, so the Bank will need to be involved well before the stabilisation powers are exercised. However, it is essential that these steps do not produce uncertainty about the *FSA's* responsibility for supervision. A protocol will be needed to confirm the position and it would seem that this could be included in the Code of Practice.

F. Other Issues (Chapter 5 of Cm 7436)

30. As previously, the BBA will be covering in detail the proposals on FSCS arrangements. There is, however, one aspect we must stress again. The consultation papers report that work is continuing on the eligibility criteria for compensation and, in particular, on whether to proceed with the proposal to assist rapid compensation payouts by terminating the current exclusion for wholesale deposits. We have emphasised previously the major problems that such a change would bring about for banks in London undertaking wholesale business, and we note that other consultees have done the same. We should stress, though, that the concern is not prompted just by the potential changes to compensation financing that would be brought about if the rules were altered in this way, there is also the potential cost of applying the single customer view to banks' wholesale clients who are likely to be undertaking business with many companies in a banking group.
31. The treatment of client accounts in the new regime has still not been clarified. As we stressed previously, EU law requires investment firms to segregate client money in accounts held at banks and it would be contrary to this policy if such monies were treated less favourably than other creditors' deposits protected through the exercise of the stabilisation powers. In the case where a partial transfer was made, the client accounts established in accordance with MiFID that were held by the failing bank should be transferred as a whole to the private sector purchaser or bridge bank, and the underlying investors whose monies were held in the client account thus transferred would not need to be included in any "single customer view" exercise.
32. Our members have not asked us to comment on the proposals in the consultation papers as they affect building societies other than to note the request already made by the Financial Markets Law Committee that the opportunity provided by new legislation should be taken to introduce the measures needed to confirm statutory set off arrangements for building societies and friendly societies.
33. We are examining the extent to which the Authorities will be committed to consulting on aspects of the new regime. In this regard we note that draft clause 6 dealing with the Code of Practice does not require public consultation and that there is no reference to consultation upon *revisions* to the Code (26(4) refers just to re-issues).

G. The treatment of investment banking business (Question 4.1 in Cm 7436)

34. The Banking Reform consultations so far have been focused on the need to maintain critical banking functions and, as part of this, Cm 7436 also raises questions about the treatment of payment systems. The Authorities have now invited views in a general way on “the most appropriate ways to deal with other relevant entities in investment banking groups with the aim of helping to maintain financial stability”. In this context, “other relevant entities” means “non-deposit takers”.
35. Underlying the question seems to be the following presumptions:
- There may be non-deposit taking parts of investment banking groups which are of sufficient systemic importance that consideration should be given to the need to apply special measures to them in order to protect the public interest.
 - It may not be possible to provide adequate protection through existing and foreseen mechanisms.
 - Consideration should therefore be given to whether additional measures should be available to the Authorities.
36. It is worth noting that most investment banking entities in the UK are either parts of wider banking entities – in which case, if the banks are UK incorporated, they will already be subject to the new regime under the proposed SRR legislation – or are parts of international groups, or both. It is also worth bearing in mind that, given EU legislation, the UK must apply the prudential requirements set by the Capital Requirements Directive to non-bank investment firms: hence such firms are subject to a Basel II equivalent regime.
37. It is not immediately clear, therefore, that the set of entities here which might be of concern to the Authorities are not adequately covered by existing or prospective arrangements. Conversely, it is not at all clear which parts of investment banking groups are of sufficient systemic significance – and can be defined as such *ex ante* – as to warrant some form of intervention beyond standard insolvency procedures. If such entities or activities *can* be defined, this is likely to raise issues about whether other entities of similar systemic significance outside the investment banking sector should also be covered by the new legislation. Given that the financial stability objective is – as the consultation document states – not susceptible to quantification in the manner of the monetary policy targets, it is likely to be particularly hard to define how, whether, and when intervention in the activity of a non deposit-taker might be justified for this purpose.
38. Overall, it seems clear that many kinds of investment banking business could not give rise to financial stability difficulties – however defined – so as part of any further consideration of the issues it will be necessary to articulate clearly the kind of problem to which particular investment banking operations could give rise, whether in such cases the Treasury and Bank would be the appropriate authorities to act given the nationality of the firms involved, and also to determine whether other kinds of firm undertake the same kind of business so would need to be covered too. In addition, it would be necessary to consider whether the special resolution tools envisaged for reducing the impact of a distressed bank were apt to deal with the stability issues prompted by a “problem” in an investment bank. So it is not just a question of considering whether there are dangers that should be addressed – it is also necessary to establish clearly what specific powers would be appropriate to deal with the dangers thus identified.

39. Investment banking operations cover securities and derivatives trading, corporate finance advice, prime brokerage and the provision of clearing facilities where the bank is a clearing firm. The markets are fiercely competitive so that clients of a failing firm would not be confronted by high switching costs if forced to move their business elsewhere and creditors' positions would generally be collateralised. It may be, though, that the provision of clearing services – if a failing firm was an important provider – could give rise to a chain of adverse consequences beyond the firm's immediate counterparties if timely payments could not be maintained. Is this the issue that has prompted the Authorities' question? If so, it is not apparent that all the proposed stabilisation options would be helpful to the Authorities in such a case since they are primarily designed to maintain essential banking services and entail distinguishing between different types of creditor except in the case of whole business transfers or public ownership (and, on the former, the consultations suggest that *partial* transfers are likely to be the best method for optimising value).
40. Clearly the question posed requires serious and careful consideration and, in our view, a separate consultation on the issues will be needed before the Authorities are in a position to decide whether additional measures are needed.

H. Conclusion

41. We would be pleased, of course, to discuss the issues covered in this submission with the Authorities or to provide further information about any of the matters which our Members have raised if that would be helpful.

London Investment Banking Association
12th September 2008