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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 133 – BANKING REFORM, DEPOSITOR PROTECTION – THE SPECIAL RESOLUTIONS REGIME

Legal assessment of the safeguards that are necessary for a Special Resolutions Regime

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ISSUE 133 WORKING GROUP

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1. Introduction

1.1 The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 In April 2008, the Financial Markets Law Committee ("FMLC") produced its response to the 'Financial Stability and Depositor Protection" consultation paper, issued in January 2008. Following that paper, there were further discussions between the FMLC and the Treasury. As a result of those discussions, the Treasury has invited further comments from the FMLC.

1.3 This paper focuses solely on the special resolution regime ('SRR'), and in particular, the safeguards that are necessary to ensure, as far as possible, that the provisions of the SRR do not unnecessarily disrupt the legal certainty which is the foundation of the London financial markets.[1]

1.4 It is assumed that the proposed legislation will embody powers comparable with those in the Banking (Special Provisions) Act 2008 ("the BPSA"). The BPSA enables government, amongst other things, to acquire (directly or indirectly) shares in, or securities issued by, the financial institution in question or to compel the transfer of those shares or securities to another body corporate. It also contains the power to compel the transfer of all or part of the property, rights and liabilities of a financial institution to another body corporate. The power is currently cast very broadly, permitting existing contracts to be rewritten. Importantly, it deprives parties of their termination rights.

1.5 This paper proceeds on the assumption that it is not the intention of the government that the SRR should affect established UK insolvency law. We

[1] It should be noted that this paper is not a response to the Tripartite consultation paper "Financial stability and depositor protection: special resolution regime", published on 22 July 2008.

believe that it is important to make clear, in consultation and in draft legislation, that any power to vary contractual terms under an SRR does not extend to the variation or avoidance of a counterparty's right to terminate for default or vary any contractual term so that the variation would have effect on the insolvency of the regulated institution which is subject to the SRR. Such avoidance should be suspensory rather than permanent, and any amendment made to contractual terms under an SRR should last for no longer than the period in which the institution is in the SRR regime.

1.6 However, should this understanding be incorrect, the FMLC would welcome an opportunity to comment in more detail.

2. Legal certainty

2.1 Any counterparty who deals with a regulated institution does so on the basis that its transaction will be upheld in the event that the institution ceases to be able or willing to perform its terms or becomes insolvent. Legal certainty is important both between solvent counterparties and when an entity becomes unable or unwilling to meet its obligations to all of its counterparties.

2.2 In the financial markets, the acid test of legal certainty is the legal opinion. In order for any contractual term to be treated as binding for regulatory, capital and risk purposes, the contract must be covered by an appropriate legal opinion.[2] The legal opinion must draw two clear conclusions – that the terms of the contract, including any early termination and close-out netting provisions,[3] will be valid between the parties whilst they are solvent, and that

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[2] Although the FSA Handbook does not at any point use the phrase 'legal opinion', it is questionable whether in practice, anything less then a legal opinion will be sufficient to ensure that a contractual term is binding.

[3] Subsequently in this paper when we refer to "netting", we mean "close-out netting", that is netting of transaction values under a master agreement following early termination of transactions, mark-to-market valuation, conversion of those values to a single currency and determination of a net amount due. Other types of netting typically occur prior to insolvency, namely, payment or settlement netting and netting-by-novation, and are aimed principally at operational efficiency and reduction of settlement risk rather than directly at post-default credit risk. Similarly, in this paper when we refer to a "collateral arrangement" or "collateral agreement", we normally mean a financial collateral arrangement of the type contemplated by the Financial Collateral Arrangements (No. 2) Regulations 2003 SI 2003/3226.

as regards each party the contract will be effective in the insolvency of the other party.

2.3 If it is not possible to obtain a "clean" legal opinion in respect of a particular counterparty, [4] transactions with that counterparty will either not proceed at all (effectively barring the counterparty from access to liquidity on a secured basis) or be priced to reflect the increased risk involved in dealing with that counterparty. If the level of risk is very high, the risk premium charged for the transaction will be very high. In addition, if there is insufficient certainty about the operation of the SRR this could make it more difficult for UK banks to obtain finance at all in some circumstances.

2.4 There is, therefore, a direct link between, on the one hand, the operation of the SRR and, on the other hand (a) access to capital and funding and (b) the cost of that capital and funding to banks that are potentially subject to the regime. The FMLC's concern is as to how the proposed regime can be structured to ensure that the SRR does not have the effect of barring access to secured funding, or increasing a bank's cost of funding. This will involve consideration of the degree of legal risk to which a potential counterparty to the bank will be exposed, and in particular as to how the regime can be structured so as to give the highest level of certainty as to the degree of this risk.

2.5 It is important at this stage to clarify the distinction between the techniques which can be used to address market uncertainty, and those which are effective to reduce legal uncertainty.

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[4] A "clean" legal opinion, in market parlance, does not mean an unqualified legal opinion, as virtually all legal opinions are subject to certain assumptions and qualifications. Assumptions establish the scope of the opinion and are often stipulated by the addressee, although the opining firm may add some of its own. Qualifications deal with issues of legal detail that potentially affect the conclusions. Bank regulators do not expect a bank to obtain an unqualified legal opinion that a close-out netting or financial collateral arrangement is effective both before and after insolvency, but they do generally require that any assumptions not unduly restrict the scope of the opinion and that any qualifications be specific and adequately explained. They also typically require that any qualifications not unduly restrict or narrow the principal conclusions. Most legal opinions on financial contracts contain a fairly standard set of qualifications that vary, of course, in detail according to the precise nature of the contracts and from jurisdiction to jurisdiction, but which taken as a whole are acceptable to the addressee(s) of the opinion (otherwise the transaction would not proceed) and, where relevant, are acceptable to the competent regulatory authority for the addressee(s).

2.6 In order to reduce market uncertainty, the circumstances in which contracts can be varied, suspended or abrogated must be articulated clearly. This generally involves the giving of guidance as to the way in which these powers will be used. In giving such guidance it will be necessary to balance the need for flexibility against the reduction of market uncertainty. Guidance of this kind constitutes present statements of the future intention of government, and as such clearly cannot be formally binding.

2.7 Such guidance, however, does not assist in reducing legal uncertainty. In the context of a legal opinion the only thing which can be addressed is the formal limitations on the exercise of particular rights. In a situation where a government has a power to act in a particular way but has given non-binding guidance that it will not do so, the position is identical from a legal certainty perspective to that which would prevail if no such guidance had been given. A law firm giving a legal opinion must draw attention to this power and cannot give an assurance that such power will not be exercised based on a non-binding statement of executive intention.

2.8 As a result, it will be necessary for government to bear in mind the important difference between giving itself reserve, or "just-in-case", powers which it does not intend to exercise, and giving itself limited powers. The former creates potentially very substantial legal uncertainty and could have a significantly damaging impact on the UK banking community. Given the significant damage which the existence of open-ended powers could inflict on the London market, and given that the existence of even formal government guidance to the effect that it will not use powers in a particular way can have no impact on the legal analysis of the risk which their existence poses to legal certainty, the Committee would urge that a restrictive approach be adopted to the drafting of the SRR, and that care is taken to ensure that the powers which the SRR will grant to vary contractual rights be limited to those circumstances where it is reasonably certain that the power is necessary in the form proposed for the SRR to function effectively.[5]

[5] We understand that such concerns had arisen in the market in relation to the broad powers of the Treasury in relation to the BSPA, although market participants have for the time being taken

3. Netting and collateral

3.1 In the context of the financial markets, two legal issues have paramount importance – netting and security.

3.2 Netting is a legal concept, and the assessment of whether transactions can be netted against each other is a legal assessment. In order for netting to be recognised for regulatory and capital requirements purposes, it must be supported by an appropriate legal opinion. It is important that netting opinions can be obtained both as between solvent parties and in respect of insolvent parties – thus the SRR will affect the availability and the effectiveness of legal opinions whether it is an insolvent or a solvent restructuring regime.

3.3 Taking collateral is also important in financial transactions, and any uncertainty as to the effectiveness of collateral arrangements in respect of a firm may either mean that other market participants will refuse to extend credit to the firm or will require a risk premium for doing so. We are also aware from recent market developments that any uncertainty in respect of the reasonably rapid enforcement of collateral rights will impose a very significant liquidity premium on the borrowing firm (if it is able to borrow at all), since other firms will be unwilling to lend to it on a secured basis without a significant premium. The reason for the charging of this premium is that if there is a risk that the arrangements in respect of the collateral which the lender holds may not be immediately realisable, the lender will suffer a liquidity disadvantage. In an illiquid market this disadvantage will be severe.

3.4 The EU Directive on Financial Collateral Arrangements (2002/47/EC) ("FCAD") requires member states to ensure that netting and collateral arrangements are effective on the occurrence of an enforcement event; that is, an event that the parties have agreed will give rise to a right to terminate, value and net transactions between them. This places an obligation on the UK government to ensure that the agreements of the parties are given effect, and

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comfort from the emergency nature of the legislation, the specific context in which it was principally intended to be used (namely, the nationalisation of Northern Rock) and limited life of the legislation, expiring in February 2009.

prohibits it from making any provision which would have the effect of altering the terms of any netting and collateral agreement in a way which would prevent an agreed enforcement event from triggering a legally effective netting provision or the realisation of collateral. Delays in enforceability of collateral rights also carry incremental capital costs under Basel II. By Article 4(5) this obligation is imposed regardless of the legal form of the SRR; in particular, as to whether the SRR is regarded as a pre-insolvency exercise of regulatory power or a form of winding-up, reorganisation or other collective proceeding.

3.5 Netting and collateral arrangements within the scope of the FCAD must therefore be preserved from interference by the SRR. This will not, however, cover more than a fraction of the total number of contracts entered into by a UK institution. The directive is limited both by type of contract (it applies only to financial collateral arrangements and related netting agreements)[6] and by type of counterparty. In the latter respect, the UK chose to implement the directive in such a way as to apply to all financial collateral arrangements between non-natural persons.[7] It would arguably be permissible for the UK to change its policy on this issue and to restrict the scope of the directive in this respect to apply only to arrangements between the institution subject to the SRR and any public body, financial institution or clearing house. However, if this policy choice were implemented, it would deliver the highly undesirable outcome that a financial collateral arrangement between a UK bank and a non-bank would be entered into on significantly worse terms, from the point of view of the non-bank, than such an arrangement between a UK bank and another bank, public body or clearing house. Given the importance of non-bank providers of funding to the banking system (hedge funds, sovereign wealth funds, private depositors and others) this would appear a perverse outcome. Consequently, the FMLC takes the view that the current UK policy in this regard is correct, and that collateral and related netting arrangements between banks and non-natural persons should remain within the scope of the

6 The FCAD does not apply to all netting agreements, but only bilateral close-out netting agreements entered into in connection with a financial collateral arrangement.

7 Financial Collateral Arrangements (No. 2) Regulations 2003 SI 2003/3226.

directive as implemented in the UK and therefore unaffected by the SRR regime.

3.6 More importantly, the protections conferred by the financial collateral directive only apply to financial collateral arrangements and related netting agreements. They do not apply, for example, to a loan raised by the institution, whether in the loan market or in the bond market, are not subject to the restrictions imposed by the directive. Thus where a person lends money to an institution, it may be agreed that the loan will be immediately repayable if certain events happen. This will also be true of other forms of accommodation — financial and otherwise — made available to the institution, so, for example, a lease of equipment might provide for termination if the tenant entered any restructuring arrangement. Such arrangements will fall outside the directive, and will therefore be capable of being varied by the SRR.

4. Objectives of the regime and appropriate powers

4.1 The FMLC believes that the aim of the SRR is to enable it to achieve one of two broad outcomes; a) to vary, suspend or abrogate termination provisions relating to a special resolution as an event of default; and b) to de-link contracts within a single business relationship, or an arrangement of relationships, so that the benefit of certain contracts can be transferred to effect a change of control. The first of these is capable of being created with an increase in legal uncertainty; the second may be impossible without striking at the root of an institution's ability to enter into binding contracts with others.

4.2 The most benign use of the SRR from the perspective of financial market participants is the effecting of a change of control for the entire business of a struggling financial institution. There would be no immediate necessity for any suspension or adjustment of contracts in the event of such a transfer. The FMLC understands that under the BSPA the Treasury purportedly used its power to adjust contracts with Northern Rock so as to suppress provisions which would otherwise have had the effect of terminating those contracts on the occurrence of the change of control. However, the effectiveness of this

exercise of power by the Treasury has not yet been subject to judicial scrutiny, to public knowledge.

4.3 In this case the legal uncertainty which is created is that terms in agreements with a UK regulated bank which have the effect of terminating the agreement (or giving a party the right to terminate the agreement) on a change of control of the bank may be ineffective if the transfer occurs pursuant to the exercise of powers under the SRR. This is an uncertainty which can be included in a legal analysis as a quantifiable variable, and can be weighed for risk and regulatory purposes.

4.4 Where a concern begins to arise is where the SRR gives government broader powers to vary contractual terms. An example would be the situation where the right exists to vary not only provisions terminating contracts on change of control but also provisions affecting rights that allow the counterparty to terminate for other events such as pre-existing or subsequent payment defaults or insolvency events. With suitably careful drafting, it might be possible to expand the power to vary contractual provisions to cover circumstances where the event in respect of which the provision is varied is the same event which gave rise to the making of the order establishing the SRR regime. However, beyond this there appears to be no clear mechanism which would not, on examination, turn out to be an unfettered government right unilaterally to vary, suspend or abrogate contracts.

4.5 Such a power would clearly have to be subject to significant legislative limits – if the proposed legislation were to purport to give government a broad power to vary the terms of any contract as it saw fit, it would become impossible to give a legal opinion or for there to be any legal certainty in respect of any contract with a UK institution subject to the regime.

4.6 The other power which the SRR is expected to confer is one whereby some or all of the assets and liabilities of, or the entire undertaking, of a bank is transferred to another entity. Such a transfer may be effected either indirectly

— in two stages with an initial transfer to government and a subsequent transfer to the other entity — or directly, by means of a statutory scheme.[8]

4.7 The powers conferred by the SRR should, in these circumstances, be limited to overriding the terms of contracts that would prevent the transfer (i.e. non-assignment provisions or the general law provisions that would prevent novation) or give rise to termination rights solely as a result of the transfer or proposed transfer. However, they should not override other provisions. Also, the powers should not prevent the exercise of termination rights for other reasons e.g. if there is a pre-existing or subsequent payment default.

4.8 Government should not otherwise have the right to vary the terms of contracts. In this respect the position is similar to that which exists in respect of a scheme under Part VII of the Financial Services and Markets Act 2000 ("Part VII"), where the court does not have general powers to amend contracts.

4.9 The most complex position arises where the aim of the SRR scheme is to separate the assets and liabilities of the institution subject to it and to transfer part of these to another entity (a "good bank/bad bank" arrangement).

4.10 In these circumstances, in addition to limitations on the power to affect contracts, there will need to be some protection against cherry picking to prevent transfer of part of a relationship. The reason for this is that such cherry-picking could leave counterparties exposed to a different set of obligations than those to which they believed that they had.

4.11 This limitation could be specified as that no rights and liabilities should be treated differently under any such scheme if they are of a type which could be the subject of set-off or netting in a liquidation. This would have the advantage of ensuring that subordinated debt holders would be capable of

[8] On the assumption that it will take some time to implement a transfer of assets under an SRR, in between the time the SRR is declared and the transfer completed, consideration should be given to imposing an administration style moratorium in relation to all enforcement action and not just those arising from SRR specific defaults. Without this, in practice an SRR would be difficult to execute successfully. Obviously the longer the moratorium, the greater the risk of domino effects or other unfairness on counterparties and this needs to be taken into account in terms of speed of execution — hence an open ended period should not be allowed.

being treated differently from ordinary creditors, so that such debt holders could be cleanly left behind in the transferor entity.

4.12 Even if such a restriction is put in place, there remains the fact that counterparties dealing with an institution which is subject to an SRR may be forced to accept a counterparty with potentially a very different risk profile from that which they agreed to deal with. It would be better if there were some element of judicial protection for counterparties that are compulsorily transferred to the transferee entity, as there is under Part VII.

4.13 It is in respect of partial transfers that there is the greatest risk of market uncertainty. Market participants and stakeholders need be able to predict the outcome of any such transfer at the time they are considering whether and on what terms to deal with a bank.

4.14 As such the FMLC considers that the following safeguards should be included in the SRR regime:

(i) A "whole relationship" safeguard so that there is no cherry picking of transactions from the same counterparty i.e. relationships should be removed or transferred in their entirety. This is the current position in the US which requires that a financial market master agreement must be transferred as a whole, or not at all.

(ii) If that is not feasible, counterparties needed to be certain which category they fall into. Therefore, clear criteria for the partial transfer need to be made explicit.

(iii) As above, any power to amend contracts should be restricted to the achievement of certain purposes and objectives e.g. de-linking and termination.

4.15 Finally, it seems to the Committee to be important that there is nothing in the objectives of the SRR regime which requires the power to acquire senior debt. It is clear that the acquisition of equity and subordinated debt issued by the institution subject to the SRR may well be necessary for an effective transfer

of ownership and control, but we do not believe that it is necessary to give any power to acquire senior debt.

4.16 Predictability will be the key to the success of the SRR as a whole and to ensuring that legal uncertainty does not have a negative impact on market operations. The degree to which the execution of a particular resolution is orderly and predictable will be determined by the detail provided in advance by the Authorities, on establishing the legislative regime, in relation to various sets of triggers and criteria.

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[9] Clive Maxwell abstained from discussions surrounding FMLC Issue 133 and involvement in the preparation of this paper in recognition of his prior official responsibilities.