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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 133 – BANKING REFORM, DEPOSITOR PROTECTION – THE SPECIAL RESOLUTION REGIME: SAFEGUARDS FOR PARTIAL PROPERTY TRANSFERS

Response to the November 2008 HM Treasury Consultation Document on a Special Resolution Regime: safeguards for partial property transfers

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1. Introduction and Executive Summary

a) Introduction

1.1 In October 2008 a draft Banking Bill was laid before Parliament. In November 2008 the Treasury issued a consultation document ‘Special resolution regime: safeguards for partial property transfers’ (the ‘Consultation Document’). The Consultation Document discusses proposed safeguards for financial market transactions, agreements and arrangements, to protect them from possible adverse effects due to the use of the partial property transfer tool under the special resolution regime set out in the Banking Bill.

1.2 This paper responds to issues raised by the Consultation Document, with particular reference to the safeguards proposed for netting, set-off, title transfer collateral and security arrangements. It also comments on the text of the draft statutory instrument set out in Annex A to the Consultation Document (‘the Safeguards Order’). Finally, this paper comments on provisions of the Banking Bill (as amended and published by order of the House of Commons on 4 December 2008) that affect the scope and effect of the Safeguards Order.

1.3 The role of the Financial Markets Law Committee (‘FMLC’ or ‘the Committee’) 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. This paper therefore does not comment on the many important policy issues raised by the Banking Bill and proposed subordinate legislation discussed in the November Consultation Document, other than as necessary to deal with issues of potential uncertainty or misunderstanding.

1.4 The introduction of the Banking Bill followed a series of three public consultation documents issued by the Treasury, the Bank of England and the Financial Services Authority (the ‘tripartite authorities’) in January, April and July 2008. The Financial Markets Law Committee responded to those consultation documents with papers published in April, July and September

2008, much of the FMLC commentary focusing on the potential impact of the partial property transfer tool on legal certainty for financial market arrangements.

1.5 In November 2008 the FMLC submitted a paper to the Public Bill Committee of the House of Commons on the original text of the Banking Bill.[1] That paper focused principally on the SRR tools, partial property transfers and the clause of the Banking Bill providing for subordinate legislation to set out safeguards for netting, set-off and security (clause 48 of the current text of the Banking Bill). It provides important background for the comments made in this paper. The Committee is pleased to note that some of the concerns raised in our November 2008 paper were, at least in part, addressed by amendments reflected in the current text of the Banking Bill.[2] In a paper published in November 2008 the FMLC underlines the practical consequences of legal uncertainty in relation to netting, set-off, security and title transfer collateral arrangements for regulatory capital of supervised institutions dealing with UK banks, potentially raising the cost of dealing with UK banks and therefore affecting their competitiveness. This would restrict the ability of UK banks to raise credit and generally have a chilling effect on the interbank deposit market. Given the importance of UK banks to that market, this would potentially have an impact far beyond our borders. This is, of course, acknowledged in the Consultation Document, for example, in paragraph 1.17.

1.6 The Treasury has established an Expert Liaison Group to advise the Government on the proposed subordinate legislation under the Banking Bill and other issues. The FMLC is represented on the Group, and this paper includes comments already made by its representative at meetings of the Group.

b) Executive Summary

1.7 The FMLC welcomes the general approach of the Safeguards Order, but believes that the effect of a breach of the Safeguards Order needs to be clarified. The Committee is also concerned about the scope of a number of the proposed

1 A link to the paper may be found on the FMLC website at http://www.fmlc.org

2 For example, clause 75 of the Banking Bill (formerly clause 65) has been amended to exclude its use to disapply or modify any provision of or made under the proposed Act. Concerns, however, remain about this clause, as discussed below.

exclusions from the protection of the Safeguards Order. For example, of particular concern to some members of the Committee is the exclusion for deposits set out in article 3(6)(a) and the effect that this exclusion might have on cash pooling and treasury management.[3] The Committee also has strong views on the provisions relating to financial collateral arrangements and secured liabilities.

1.8 As noted above, the Committee feels that it is necessary to comment in this response on provisions of the Banking Bill that affect the scope and content of the Safeguards Order. Without further amendment to these provisions, the effectiveness of the Safeguards Order to deliver legal certainty will be significantly weakened.

1.9 Finally, it is crucial to the financial markets that the Safeguards Order come into effect on the same day as the Banking Act in order to avoid there being a period of uncertainty regarding the full enforceability of netting, set-off, security and other credit risk mitigation techniques against UK banks.

2. General approach of the Safeguards Order

2.1 The general approach of the Safeguards Order is to protect all netting and set-off arrangements, subject to certain exclusions. This approach gives greater certainty than the other approaches considered and rejected by the tripartite authorities, as summarised under ‘Other options considered’ in paragraphs 2.19 to 2.25 of the Consultation Document.

2.2 In particular, the FMLC agrees that protecting only ‘industry master netting agreements’ would lead to a number of difficulties of the type summarised in paragraph 2.21 of the Consultation Document as well as excluding many netting and set-off arrangements that are widespread but do not currently use an industry standard form master netting agreement. Examples include prime brokerage agreements, cash pooling and other intra-group cash management arrangements, other on-balance-sheet netting arrangements (including simple

3 Please see paragraph 4.8(a) below.

loan versus deposit set-off arrangements) and many cross-product netting arrangements.[4]

2.3 The Safeguards Order will, however, only provide sufficient certainty if the scope is clear and, in particular, the exclusions are clearly drafted. There are policy arguments for and against certain exclusions, however comments here are limited to concerns about the relative lack of clarity or certainty of some of the currently proposed drafting.

3. Effect of a breach of the Safeguards Order

3.1 In order for the Safeguards Order to achieve the stated aim of the Government of protecting contracts (in particular, those relevant for regulatory capital purposes) from the threat of disruption by a partial transfer order, it must be clear that a breach of the Safeguards Order will not affect the validity of any right of a counterparty to a failed bank to set off or net any obligation owed by the failed bank or against any obligation owed to the failed bank, where the relevant obligation is covered by the partial transfer order. The Safeguards Order currently includes no express statement to this effect.

3.2 Merely providing the remedy currently set out in paragraph 6 of the Safeguards Order will not be sufficient to permit law firms to give a clean opinion[5] on the effectiveness of a set-off or netting agreement. Accordingly, an express statement protecting rights to net or set off from the effect of a partial transfer order is necessary to ensure that netting and set-off arrangements continue to benefit from a high degree of legal certainty, as under current law.

3.3 There are, broadly, two approaches that would provide the certainty necessary to achieve the stated aim of the Safeguards Order. These are (1) to provide that any transfer in breach of the Safeguards Order is invalid or (2) to provide that, notwithstanding a partial transfer order, a right or obligation transferred remains subject to the counterparty's right to set off or net. Which approach is

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4 There is an industry standard form cross-product netting agreement, the Cross-Product Master Agreement published by SIFMA. There are also two standard forms of Cross-Agreement Bridge published by the International Swaps and Derivatives Association (ISDA), which are also sometimes used for cross-product netting arrangements. Nonetheless, many cross-product netting arrangements are bespoke, for a variety of reasons.

5 The importance of obtaining a clean legal opinion is set out at length in the FMLC's September 2008 and July 2008 papers entitled 'Issue 133 – Banking Reform, Depositor Protection – The Special Resolution Regime'. Copies of these papers can be found on the FMLC website at http://www.fmlc.org

preferable will be dictated by policy concerns. The former provides greater certainty, but may not be compatible with other objectives of the tripartite authorities. The latter provides less certainty in practice because of the possibility that the counterparty's right to set off or net might not immediately be identified and a right or obligation subject to the right to set off or net might be transferred onward before the set-off or netting right is exercised. However, this risk would appear to be manageable, provided that the counterparty is permitted to exercise its set-off or netting rights promptly on or following the use of SRR tools in relation to a failed UK bank.

3.4 It is currently the case under English law that an assignee of a claim that is subject to a contractual right of set-off takes the claim subject to the set-off right of the obligor of the claim, provided that each of the contractual set-off provision and the cross claim that the obligor is using to discharge the primary claim arise under one or more contracts entered into prior to notice to the counterparty of the assignment.[6] This would be true even after the insolvency of the assignor. Although this might be characterised as an exception to the mutuality requirement of the insolvency set-off provisions of the Insolvency Rules 1986 (Rule 2.85 in the event of a distribution under an administration and Rule 4.90 in the event of a winding up), it might more helpfully be characterised as a consequence of the principle *nemo dat quod non habet*: a person cannot transfer a greater property interest than he has to give.

3.5 There should, therefore, be no problem in principle with a provision that preserves the effectiveness of the transfer of a claim against the UK bank's counterparty but clarifies that any such claim remains subject to the counterparty's right to discharge the claim under a set-off or netting arrangement. It is important that this protection be explicit as the partial property transfer power under the SRR regime, being a statutory transfer rather than a voluntary assignment (to which the *nemo dat* rule would normally apply), might otherwise be interpreted as overriding rights of set-off or netting.

6 P.R. Wood, English and International Set off (Sweet & Maxwell, London 1989), paras 16:33 to 16:36.

4. Scope of the Safeguards Order

a) Foreign property

4.1 Article 2 of the Safeguards Order provides that the Safeguards Order does not apply when the only property, rights or liabilities of a banking institution that are not transferred are foreign property (as defined in clause 39(2) (formerly clause 36(2)) of the Banking Bill. Article 3(3) provides that the netting and set-off safeguard set out in article 3(1) does not apply where the only protected rights and liabilities that are not transferred are governed by foreign law. The effect of this exclusion of foreign property would be that a netting arrangement involving rights and/or liabilities governed by foreign law as well as rights and/or liabilities governed by English law[7] would not be fully enforceable. It would therefore not be possible to obtain a 'clean' legal opinion in relation to that netting arrangement, in contrast to the position under current English law.[8] This would be a significant retreat from the intention expressed in paragraph 2.16 of the Consultation Document to protect contracts relevant for regulatory capital purposes from the threat of disruption under a partial transfer.

4.2 The FMLC supposes that the concern underlying this limitation of the Safeguards Order is that a statutory transfer under English law may not be recognised by the *lex situs* of tangible property or by the law applicable to intangible property, rights and liabilities. The intention, therefore, is to permit a transfer order to be made in relation to English law governed property, while leaving the foreign property, rights and liabilities to be addressed separately.

4.3 It is noted, however, that clause 39(3) of the Banking Bill imposes an obligation on the transferor and transferee to take necessary steps (if any additional steps are, in fact, necessary) to ensure the effectiveness under relevant foreign law of any transfer ordered by a property transfer instrument.[9] It would be better for

7 … or, of course, Scottish or Northern Irish law (and all subsequent references to English law should be considered similarly qualified)

8 For both regulatory capital and more general purposes, a 'clean' legal opinion on a financial market agreement is normally understood to be one that confirms the legality, validity, binding nature and enforceability of the agreement under English law, subject to common sense and not unduly restrictive assumptions and to qualifications that are specific, adequately explained and do not materially limit the principal conclusions of the opinion.

9 This approach has, of course, been taken in prior statutes in relation to statutory transfers of foreign law governed assets (for example, under section 112(4) of the Financial Services and Markets Act 2000) as well as in respect of vesting/transfer orders under privatisation statutes, many of which did not involve universal succession, for example, in relation to rail and aspects of electricity.

the legal certainty of a netting agreement for all or none of the rights and obligations of the UK bank under the netting agreement to be transferred by a property transfer instrument as a matter of English law. In other words, the Committee believes that it is better for the Safeguards Order to assume compliance by the parties with their obligation under clause 39(3), even if in some cases a subsequent adjustment is necessary between the transferor and transferee to account for the non-transferability of a relevant right or liability under foreign law.[10]

4.4 Thus the FMLC advocates, in essence, an extension of the set-off and netting safeguard to arrangements that include foreign property. If this proposal is not implemented then, in addition to the very obvious problems that are posed for commercial agreements involving foreign property – which will be very many indeed given the extraordinary width of the concept as it is defined in Clause 39 of the Bill – there are likely to be significant issues of legal uncertainty that arise in the application of the Safeguards Order owing to the large penumbra of uncertainty that inheres in the definition of foreign property.

4.5 It is beyond the scope of this Consultation Response to address points that arise in relation to the drafting of the Banking Bill, rather than the Safeguards Order. However, since the definition of "foreign property" is incorporated directly into article 3 of the Order, a few brief observations about the definition will be made here:

(a) Intangible property, including financial assets, usually consists of personal obligations in which proprietary rights exist vis-à-vis third parties.[11] It is common under the English conflict of laws for those personal obligations and those proprietary rights to be governed by different legal systems, either of which might be a foreign system of law. (Not) transferring the personal rights would almost certainly involve (not) transferring any relevant proprietary rights

10 The Committee has been given to believe that the US regime for stabilisation of financial institutions does not deal specifically with foreign law governed property of a US bank, but assumes that a transfer under the US regime may apply equally to US and foreign law rights and liabilities. The netting protection of the US regime applies equally to US and foreign law governed rights and obligations.

11 For example a bond represents a personal right against the issuer, held by the investor, governed by the law specified in the bond issue documentation. However, the same bond may also represent, for the investor, a series of proprietary rights vis-à-vis an intermediary or a depositary. Those rights may be governed, say, by the law of the place where the securities account is located.

(and vice versa) and it is unclear whether, if the latter are governed by foreign law and the former by English law, this would constitute (not) transferring foreign property.

(b) In any event, there are notorious difficulties inherent in the task of ascertaining which choice of law applies in any given circumstance to intangibles. Even if the attempt is restricted to identifying the law applicable to the personal rights which constitute the property (rather than the attendant proprietary rights), the recent involvement of HM Government in the negotiations for a Rome I Regulation on the Law Applicable to Contractual obligations has well-illustrated the many difficulties and ramifications of pinpointing the right conflicts rule, let alone the correct substantive choice of law. Some contractual obligations, including those with "consumers" such as high net worth individuals, may be subject to more than one applicable law.

(c) Even in the case of contractual obligations vis-à-vis wholesale counterparties, if there is no choice of law clause (as is universally the case, for example, with letters of credit), there may be a great deal of evidential, as well as legal, difficulty in identifying the governing law.

4.6 In addition, a number of other uncertainties in regard to the definition of "foreign property" in Clause 39 of the Bill have occurred to the FMLC. Rather than discuss them at length in a paper which focuses on the Safeguards Order, Members of the Committee would be happy to discuss these with you if that would prove useful.

b) Transfer only of liabilities

4.7 Article 3(4) of the Safeguards Order excludes from the protection of the netting and set-off safeguard in article 3(1) a transfer of liabilities only of the failed bank. It is understood that the rationale underlying this exclusion is that, from a credit point of view, a counterparty will be better off owing money to the failed bank but being owed money by a (presumably) healthy transferee bank. The

FMLC does not comment on this, but notes that this exclusion would make it impossible to give a clean legal opinion on any netting agreement or set-off arrangement, as opining counsel could never exclude the possibility that a liabilities-only transfer might be made that might include liabilities owed to the counterparty under a netting agreement or set-off arrangement.

c) 'Excluded rights'

4.8 Article 3(6) of the Safeguards Order sets out various rights that would be excluded from the scope of the netting and set-off safeguard in article 3(1). Our comments on each of the exceptions is as follows:

(a) Sub-paragraph (a) is not necessarily unclear, however, excluding deposits generally, including wholesale deposits, would appear to be inconsistent with the Government's stated aim to protect all financial arrangements that are currently reportable on a net basis for regulatory capital purposes. On-balance sheet netting involving loans and wholesale deposits are frequently subject to set-off arrangements in favour of a supervised institution to reduce the regulatory capital charge associated with the debt owed to that institution.[12]

In addition, UK banks often establish 'cash pooling', 'cash management' or 'treasury management' arrangements for their corporate customers, which typically involve the set-off of credit and debit balances on various deposit accounts with the UK bank, either for a single company or for a group of companies. This line of business would no longer be possible if some but not all of the rights and liabilities associated with the credit and debit balances could be transferred by a partial property transfer order.

In fact, the implications of this exclusion, as currently drafted, are much broader than perhaps intended. Sub-paragraph (a) refers to the definition of 'deposit' in article 5 of the Regulated Activities

12 The existence of the standard form International Deposit Netting Agreement – IDNA Terms (October 1996), published by the British Bankers Association, is evidence that deposits are frequently subject to netting arrangements.

Order, which defines 'deposit' broadly enough to cover virtually any lending and borrowing of money, including most sorts of bank lending and the issuance of debt securities. This exclusion, therefore, from the protection of article 3(1) would appear to take almost any borrowing or issuance of securities out of the safeguard. This seems to be unintentional, and therefore to lead to legal uncertainty, as it does not appear to fit with the stated policy intention in the Consultation Document and also because it would make the exclusion in sub-paragraph (d) redundant.

(b) Regarding sub-paragraph (b), the FMLC believes that the ability of mortgage lenders to offer so-called 'offset mortgages' or similar products might be adversely affected by this exclusion. The only purpose of our raising this is to seek clarification as to whether it is intended to affect such products.

(c) Regarding sub-paragraph (c), the Committee is concerned that the phrase 'in the course of carrying on its business as a banking institution' is too restrictive. The definition of a 'banking institution' refers to the definition of 'bank' in clause 2 of the Banking Bill. The definition of 'bank' refers to the carrying on of the regulated activity of accepting deposits. The modern business of a banking institution is much broader than the business of regulated deposit-taking. It is here assumed that the intention is to protect all contracts entered into by a UK bank in the ordinary course of its business, whether or not those contracts relate to the accepting of deposits. The FMLC believes that this is purely a drafting point and are not proposing that the definition of 'banking institution' in the Safeguards Order should be amended. Instead, the Committee suggests that the words 'in the course of carrying on its business as a banking institution' should be replaced by the words along the following lines 'in the course of carrying on its business relating to financial contracts'.

(d) Regarding sub-paragraph (d), the Consultation Document in paragraph 2.12 states the view that counterparties do not generally expect debt securities issued by a failed bank, such as bonds, medium term notes and commercial paper, to be included within set-off or netting arrangements. The FMLC understands, however, that this is not the case and that a number of market participants have put in place set-off arrangements under which debt securities are subject to a contractual set-off right against debts owed to the issuer of the securities. In relation to such arrangements, a number of financial institutions have spent considerable amounts in legal fees investigating issues such as the enforceability of a right to set off the debts represented by intermediated securities, whether mutuality of obligation would exist between such a debt and a separate contractual claim owed to the issuer (for example, under a deposit or as a close-out amount under a derivatives master agreement), whether the mutuality (if it exists) may be disrupted by clearing system charges or custodian liens imposed at different tiers in a chain of intermediated securities, whether an interest in intermediated securities held through an omnibus securities account is sufficiently specific to pass beneficial ownership to the ultimate holder and so on. These technical details are mentioned merely to corroborate the suggestion that financial institutions have investigated these issues with some degree of thoroughness, which supports the view that such set-off arrangements are important in practice.[13]

Paragraph 2.12 of the Consultation Document also suggests that if securities are not carved out of the netting and set-off safeguard, it would have the effect of raising subordinated debt securities issued by a failing bank to a higher insolvency ranking than was intended. It is doubtful, however, whether a contractual set-off provision purporting to allow subordinated securities to be set off against

13 These issues were considered by the FMLC a few years ago in the context of its working group on property interest in investment securities, chaired by Professor Sir Roy Goode QC.

senior debt owed to the issuer of the securities would be enforceable.[14] For this reason, an exclusion limited to subordinated securities would most likely not trouble the financial markets.

(e) Regarding sub-paragraph (e), the FMLC has been given to understand from a Treasury statement at the Expert Liaison Group meeting on 15 December 2008 that there is no current proposal to include an additional exclusion.

d) 'Excluded liabilities'

4.9 It would be clearer if excluded liabilities were expressly defined rather than defined simply by reference to 'excluded rights'.

e) Alternative approaches

4.10 The greater the number of exclusions from the basic netting and set-off safeguard, the greater the room for uncertainty as to whether certain arrangements fall within or outside certain carve-outs. One simpler clearer approach, assuming it is accepted on a policy basis, would be to carve out all retail business, but otherwise leave all wholesale business within the protection of the safeguard. This would enhance legal certainty for the wholesale markets.

4.11 If the approach in paragraph 4.8 above is not adopted and several exclusions are retained in the Safeguards Order, it may be worth considering the addition of a provision to allow a counterparty, any of whose rights against or liabilities to a failed bank were transferred under a partial property transfer order, to make a once-off election, promptly after the transfer order, requiring such rights or liabilities to be transferred back to the failed bank. It would be necessary, of course, to ensure that the reverse transfer powers under the Banking Bill were broad enough to accommodate this. This approach would not require the authorities to consider each counterparty on a case by case basis (which is an approach that the authorities appear to have previously considered and rejected). Instead, it would only be necessary to consider any individual counterparty who exercised this right within a prescribed period in order to consolidate all of its

14 See S.R. Derham, The Law of Set off (3rd edn Oxford University Press, London 2003), paras. 6.74 6.77.

position with the failed bank (something, presumably, most counterparties would be disinclined to do). The advantage of this provision would be, for example, that it would allow a counterparty to keep a wholesale deposit and loan together with the same entity, namely, the failed bank, to preserve a position that was netted for regulatory capital purposes. Although the transfer order would, for a brief period, interrupt the mutuality between the wholesale deposit and loan, nonetheless mutuality could be restored (and it would be necessary to clarify that the transfer and reverse transfer would be ignored for purposes of the transaction rules under the Insolvency Act 1986, in particular, under section 239 (relating to preferences)). Although an opinion on such an arrangement would presumably need to include a qualification regarding this temporary disruption of the arrangement, this would, if appropriately drafted, presumably be a qualification that would be acceptable to regulatory authorities (it would, however, be helpful to hear the views of the Financial Services Authority on this point).

5. Financial collateral arrangements

5.1 'Financial institution' in article 4(1)(b) of the Safeguards Order should presumably be 'banking institution'.

5.2 The purpose of article 4(3) of the Safeguards Order is unclear, and its application would lead to uncertainty. Is there any need for it? The FMLC understands that the concern underlying this provision is that the UK implementation of the Financial Collateral Arrangements Directive (under the Financial Collateral Arrangements (No. 2) Regulations 2003) exceeded the scope of the Directive. It is not clear, however, why that requires the Safeguards Order to be limited as set out in article 4(3).

5.3 The most significant way in which the UK exceeded the scope of the Collateral Directive when implementing it was by extending the scope to include all non-natural persons. This means that a financial collateral arrangement between two non-financial corporates would be within the personal scope of the UK implementation, but not the Directive. However, every financial collateral arrangement involving a failed UK bank would necessarily be within the scope of the Directive, as the failed UK bank would be a supervised financial institution. The other ways in which the UK implementation exceeded the scope of the Directive are minor (for example, the slight extension of the definition of ‘cash collateral’). There therefore appears to be no need for article 4(3) on legal certainty grounds, and its inclusion might, in fact, be counterproductive.

6. Secured liabilities

6.1 Paragraph 5 of the Safeguards Order uses the term ‘title transfer security’ arrangements. This term, however, is not a term in normal commercial usage, largely because a title transfer financial collateral arrangement does not involve the creation of a security interest, and market participants are normally careful not to use the term ‘security’ in relation to title transfer arrangements to avoid raising the spectre of recharacterisation risk (that is, the risk of the title transfer arrangement being recharacterised as security), which exists in some other countries and could, in certain circumstances, arise in an English case.[15] The normal terms used commercially are ‘title transfer financial collateral arrangement’, ‘title transfer collateral arrangement’ and often simply ‘title transfer arrangement’ (in each case ‘agreement’ is frequently used instead of ‘arrangement’).

6.2 The extension of the security safeguard to protect all floating charges is a welcome enhancement to legal certainty, as discussed in paragraph 1.35 of the Consultation Document.

6.3 It would be a helpful clarification to include the words ‘to which this Order applies’ after the words ‘A partial property transfer’ in article 5(2).

7. Structured Finance Safeguard

7.1 As noted in paragraph 3.14 of the Consultation Document, the Safeguards Order does not currently include specific language for structured finance arrangements, although the Treasury has acknowledged the importance of a structured finance safeguard in paragraphs 1.36 to 1.38 and in chapter 3 of the

15 For example, where the transaction is a sham, so that the label of ‘title transfer’ is applied, but the true intention of the parties, considering the substantive rights and obligations of each party, is the creation of security. Whether this is true will depend on the specific facts of the case.

Consultation Document. Of course, the netting, set-off, financial collateral arrangements and secured liabilities safeguards would protect important aspects of a structured finance arrangement but would not protect the integrity of the whole structure. It is important that the market have the opportunity to review and comment on any proposed language as soon as possible, given the tight timetable for this legislation, with a view to identifying and resolving any possible areas of uncertainty. The Committee has been given to understand that at least one private sector proposal in this regard has been forwarded to the Treasury for consideration by the Expert Liaison Group.

8. Banking Bill issues directly affecting the scope and certainty of the Safeguards Order

a) Generally

8.1 Various provisions of the Banking Bill affect the scope or potential effectiveness of the Safeguards Order. The Committee therefore feels it is appropriate in this response to the Consultation Document to raise the issues below for further consideration by the tripartite authorities. The Committee understands that similar points are likely to be made by representatives of various financial market trade associations, which indicates that these issues are of general and significant concern to financial market participants.

b) Clauses 22 and 38

8.2 Clauses 22 and 38 of the Banking Bill each provide that a ‘default event provision’ may not be triggered by a share transfer instrument or order (clause 22) or a property transfer instrument (clause 38) to the extent that the relevant instrument or order so provides. At least three issues arise, which the Committee believes would benefit from further clarification:

(a) The clauses appear to include contracts or other agreements to which the failed bank is not a party. This would therefore include transactions such as credit derivatives, equity derivatives and fixed income derivatives (such as bond options and forwards) under which a failed bank is merely a reference entity. The Committee would be concerned if this is the intention, as it would create considerable uncertainty, having a significantly adverse effect on the use of credit derivatives to hedge financial institutions' exposures to UK banks and therefore further restrict the availability of credit. This can be relatively easily clarified in the text of each of clauses 22(1) and 38(1). It would enhance legal certainty if the tripartite authorities were to confirm the correct interpretation of these clauses and, if the broader scope is intended, to provide an explanation of the policy basis for this broader scope.

(b) The Committee assumes that there is no reason not to allow a counterparty to close out a master agreement with a failed bank where the master agreement has not been transferred. It would be helpful to the financial markets to amend clauses 22 and 38 to clarify that 'default event provisions' in contracts or other agreements that are not transferred and that are otherwise within the scope of the Safeguards Order would not be affected by clauses 22 or 38, as the case may be. If the intention is to prevent early termination of master agreements left with the failed bank, this should be clarified. Such an intention is likely to be highly controversial with market participants, but as this is a policy question, no further comment will be offered on this point.

(c) Paragraph 5 of each of clauses 22 and 38 is very broad and might be construed to prevent any subsequent termination of a transferred contract or other agreement, given that virtually everything that occurs subsequently in relation to the contract or agreement will have occurred 'by virtue of the instrument [or order][16]'. Sub-paragraphs (b) and (c) of paragraph 5 could perhaps be tightened or a provision added to confirm that a subsequent default by the transferee would not be affected by clause 22 or 38, as the case may be.

16 In the case of clause 22.

c) Clause 48

8.3 Article 3(6) of the Safeguards Order provides that the terms ‘set-off arrangements’ and ‘netting arrangements’ have the meanings given to those terms in clause 48 (formerly clause 43) of the Banking Bill. The scope of the Safeguards Order is determined in part by those definitions. It is noted that the City of London Law Society Financial Law Committee has recommended amendments to clause 48(1) to clarify and make more precise each of those definitions (as well as to clarify the definition of ‘security interests’ and to clarify that title transfer collateral arrangements are also to be protected under subordinate legislation made under that provision). The FMLC endorses those proposed amendments, which are technical and do not raise issues of policy.

d) Clauses 64(2) and 67(2)

8.4 Clauses 64(2) and 67(2), each of which deals with special continuity obligations (the former in relation to property transfers and the latter in relation to share transfers), provides the Bank of England with the power to modify the terms of a contract or other arrangement between the residual bank and a group company (whether or not rights or obligations under it have been transferred to a transferee). A group company could, of course, be an overseas bank with an intragroup netting or set-off agreement with the failed bank. In order for the overseas bank group company to ensure that it can obtain a clean legal opinion in relation to that netting or set-off agreement, it would need to consider whether the Safeguards Order sufficiently clearly protects such an agreement from the effect of clause 64(2), which can operate in the context of a full as well as a partial property transfer order, as well as from the effect of clause 67(2).

8.5 Clauses 64(2) and 67(2) could also potentially affect contracts or other arrangements with a group company that is an issuance vehicle for a structured financing arrangement. Where those contracts or other arrangements form part of the structured financing arrangement, they should be clearly protected from the effect of this clause by the proposed structured finance safeguard.

8.6 It has been suggested that, depending on how onward transfers are affected, clauses 65(2)(b) and 68(2)(b) might raise similar concerns, and the FMLC recommends that further thought be given to this. Also, it is not clear that the powers of the Treasury under clause 69 could be used to provide the necessary protections in relation to the continuity obligations clauses as the Treasury only has the power to specify that certain matters be taken into consideration rather than to limit the Bank of England's powers.

e) Clause 75

8.7 The Committee commented on the prior version of clause 75 (formerly clause 65) in its November 2008 paper on the Banking Bill, referred to above and welcomes the limitation of clause 75 so that it cannot be used to disapply or modify the effect of any provision of the proposed Act or subordinate legislation under the proposed Act. Paragraph (8) of clause 75 still raises a difficulty for the obtaining of 'clean' legal opinions on netting, set-off, title transfer collateral and security arrangements, since any such opinion would need to be qualified by reference to the power of the Treasury to make an order modifying any legislation on which such an opinion might rely, for example, Rule 2.85 or Rule 4.90 of the Insolvency Rules 1986 (the administration and liquidation set-off provisions) or one or more provisions of the Financial Collateral Arrangements (No. 2) Regulations 2003.[17]

8.8 There is a fundamental difference in principle between a change of law that requires the approval of the legislature or a decision of the judiciary, on the one hand, and a change of law that can be effected simply by executive action, on the other hand. While the Financial Services Authority, as the principal prudential supervisor of UK banks, might accept a qualification of a legal opinion by reference to clause 75 of the Banking Bill, it seems unlikely that financial supervisors in other countries would accept such a qualification. The effect of clause 75(8) of the Banking Bill is to make the intention of the Treasury at any moment, which is not accessible to or verifiable by market participants generally, part of the law of England on which opinion counsel must opine. The fear, therefore, is that clause 75(8) potentially undoes much of the good work intended to be done by the Safeguards Order.

17 Members of the Committee also have concerns in relation to the broad power set out in clause 119 but this point is beyond the limited scope of this paper.

9. Timing of implementation

9.1 It is, of course, essential that the protections effected by the Safeguards Order come into force on the same day that the proposed Banking Act comes into force. Otherwise, law firms (including those firms that provide the industry opinions for the derivatives, securities lending and securities sale and repurchase (repo) markets, relied on by financial institutions around the world when dealing with UK banks) will need to issue material and adverse qualifications to their opinions on the enforceability of netting, set-off, title transfer collateral and/or security arrangements, as the case may be, against a UK bank. These qualifications would need to apply for the duration of the period between the effective dates of the Banking Act and the Safeguards Order, with severe consequences for the capital position of financial institutions dealing with UK banks and therefore for the competitiveness of UK banks.

9.2 Also, in view of the issues set out in this paper, it is crucial that the Safeguards Order is properly considered prior to enactment otherwise legal uncertainty will arise. Given that, as mentioned above, it is crucial that the Banking Act and Safeguards Order come into force on the same day, it is advisable that suitable time and consideration are given to both the Banking Bill and the Safeguards Order. One course of action which might help facilitate this would be to extend the Banking (Special Provisions) Act (which is due to expire on 20 February 2009) for a short period to allow sufficient time to settle the provisions of the Banking Bill and Safeguards Order and thereby ensure legal certainty.

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