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**FINANCIAL MARKETS LAW COMMITTEE**

**ISSUE 167 – BAIL-IN**

**Observations on legal uncertainties which may arise from the introduction of  
bail-in powers**

The logo for the Financial Markets Law Committee is a light blue, tilted rectangular box containing the text "Financial Markets Law Committee" in a dark blue, sans-serif font. The text is arranged in four lines, following the tilt of the box.

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# FINANCIAL MARKETS LAW COMMITTEE

## ISSUE 167 – BAIL-IN

### **Observations on legal uncertainties which may arise from the introduction of bail-in powers**

This Paper has been produced by the Financial Markets Law Committee (the “FMLC”) Secretariat.<sup>1</sup> The FMLC is particularly grateful to Geoffrey Yeowart of Hogan Lovells for his contribution.

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<sup>1</sup> Joanna Perkins and Roland Susman.

The paper repeats a number of the points made in a letter from the Director of the FMLC (Joanna Perkins) to the Financial Stability Board. That letter is available at <http://www.fmlc.org/Pages/papers.aspx>.

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## 1. INTRODUCTION

- 1.1. The remit of the Financial Markets Law Committee (the “FMLC”), established by the Bank of England, 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. This paper discusses a number of legal uncertainties which may result from the introduction of bail-in powers. In particular, the paper considers issues which arise from HM Government’s Response to the Independent Commission on Banking (the “ICB”) final report (the “Response”).<sup>2</sup>
- 1.3. The Response endorses the key objectives recommended by the ICB. The key objectives are:
  - a. making banks better able to absorb losses;
  - b. making it easier and less costly to handle banks that get into difficulties; and
  - c. curbing incentives for excessive risk-taking.
- 1.4. The policies intended to achieve these objectives are being developed, as the Response makes clear, in the context of wider European and international initiatives for managing banking crises.<sup>3</sup>

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<sup>2</sup> The Government response to the Independent Commission on Banking, December 2011, available at [http://cdn.hm-treasury.gov.uk/govt\\_response\\_to\\_icb\\_191211.pdf](http://cdn.hm-treasury.gov.uk/govt_response_to_icb_191211.pdf) (correct as at 15 March 2012).

Independent Commission on Banking, Final Report: Recommendations, September 2011, available at <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf> (correct as at 15 March 2012).

<sup>3</sup> See the FSB consultation paper ‘Effective Resolution of Systemically Important Financial Institutions’ (available at [http://www.financialstabilityboard.org/publications/r\\_110719.pdf](http://www.financialstabilityboard.org/publications/r_110719.pdf)) and the European Commission’s consultation document on a framework for bank recovery and resolution (available at [http://ec.europa.eu/internal\\_market/consultations/docs/2011/crisis\\_management/consultation\\_paper\\_en.pdf](http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf)) (correct as at 15 March 2012).

1.5. The FMLC recognises that HM Government's views on bail-in have been set out at a high level of abstraction and is aware that HM Government intends to consult further on the bail-in issue.<sup>4</sup> The FMLC, nevertheless, thinks it important to highlight a number of general and specific issues of uncertainty that may arise from the introduction of a bail-in mechanism. The FMLC encourages HM Government to consider these issues in order that future uncertainty might be minimised.

## 2. GENERAL OBSERVATIONS

2.1. The FMLC makes the following general observations regarding the nature of bail-in powers. It is not for the FMLC to comment on the policy objectives which justify bail-in powers or the respective merits of broad and narrow bail-in powers in achieving these objectives. However, the FMLC firmly believes that where a narrow policy objective has been adopted, the statutory or regulatory power which implements this objective should itself be narrowly defined in order to target the policy objective to the exclusion of other outcomes. Legal powers which exceed the purpose for which they are given tend to give rise to legal uncertainty in a variety of ways. For example:

- a. *ipso facto*, such powers are capable of giving rise to unintended consequences; and
- b. wide powers mean that legal opinions supporting transactions are sharply qualified and this may have a significant impact on market activity for both regulatory and cost-related reasons.

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<sup>4</sup> *Id.* Government response to the Independent Commission on Banking. See, for example, paras. 3.31 and 3.38 and question box 3.D.

2.2. In this context, the FMLC urges HM Government to constrain tightly any bail-in powers for which it legislates. In particular, the FMLC believes that the classes of claim and creditor that may be subject to bail-in should be narrowly drawn. The FMLC is, in general, of the view that, rather than arrogating a general bail-in power in respect of all claims (or all unsecured claims) to resolution authorities which is then made subject to exemptions, safe-harbours and the like, it is preferable to define, in positive terms, the specific classes of creditor that may be subject to bail-in. The FMLC believes that such an approach is preferable because (i) it is unlikely that exemptions would accurately cover all of the types of debt intended to be covered and (ii) exemptions would require regular updating as new products entered the market. Where exemptions are not up-to-date, uncertainty as to whether or not an exemption applies will give rise to legal uncertainty.

2.3. Bail-in powers, of the type considered in the Response, are a major departure from the fundamental principle which applies in a bankruptcy or liquidation that unsecured, non-preferential creditors must be treated equally and assets of the insolvent estate distributable to them must be distributed on a *pari passu* basis. Such powers could, if exercised, result in different rankings and recoveries for different categories of creditor. The wider the scope of bail-in powers, the greater the uncertainty their existence is likely to create. Where new rules depart from the principle of equal treatment, it is desirable that they be clear and transparent so that their scope and effect can be understood.

### **3. “PRIMARY” AND “SECONDARY” BAIL-IN**

3.1. The Response appears to endorse the ICB proposal for a “primary” bail-in power which applies to long-term unsecured debt (ie. unsecured debt with a term of at least 12 months at the time of issue) which is unambiguously

identifiable as subject to statutory bail-in.<sup>5</sup> The Response also appears, to some extent, to support the ICB proposal for a “secondary” bail-in power which applies to all other unsecured liabilities. Both the ICB report and the Response recognise that a number of difficulties may arise from, in particular, the “secondary” bail-in power.<sup>6</sup>

- 3.2. The FMLC notes that the Response diverges from the ICB’s recommendations in suggesting that there may be advantages in identifying some long-term debt instruments which should be subject to “secondary” bail-in instead of “primary” bail-in. The Response also notes that retail products, taking the form of long-term unsecured debt, should, arguably, not be subject to “primary” bail-in.<sup>7</sup>
- 3.3. The “secondary” bail-in power, in particular, contemplated by HM Government is a broad power in that it would apply to *all* unsecured creditors (the “primary” power is also general in that it does not apply to specific classes of creditor). Notwithstanding the fact that “secondary” bail-in appears to be intended as a reserve power, it is clear that a very large range of unsecured creditors would, in theory, be subject to it. Even if it is unlikely to occur, the possibility of a financial product being subject to bail-in (whether “primary” or “secondary”) will, as noted above, lead to qualified legal opinions which may have a significant impact on market activity.

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<sup>5</sup> *Id.* ICB, final report, para. 4.77.

<sup>6</sup> *Id.* ICB, final report, para. 4.84 – “Applying a bail-in power to liabilities other than bail-in bonds is more complex. In particular, there may be legal difficulties in applying it to foreign law governed contracts and financial contracts with close-out netting rights protected by the Financial Collateral Arrangements Directive. Neither the entering of a bank into resolution, nor actions taken by the resolution authorities in exercising their resolution powers, should be triggers for the activation of termination or cross-default contractual provisions. Achieving this would be likely to require amendments to standard form financial contracts, and to the Financial Collateral Arrangements Directive. Measures to address these issues would clearly have to be co-ordinated internationally”. See also para. 4.63.

*Id.* Government response to the Independent Commission on Banking, para. 3.30 – “Bailing in unsecured liabilities other than long-term unsecured debt is in practice likely to be more problematic – in particular, imposing losses on short-term funding and derivatives exposures (to the extent uncollateralised) may increase disruption in financial markets in a crisis. But giving the authorities the flexibility to do so – through a ‘secondary’ bail-in power – would expand the options available to them in resolving a bank”.

<sup>7</sup> *Id.* Government response to the Independent Commission on Banking, para. 3.31.

#### 4. CLASSES OF CREDITOR

4.1. The FMLC highlights a number of issues of legal uncertainty, regarding specific classes of creditor which could be subject to bail-in under the proposals as contemplated in the Response.<sup>8</sup>

4.2. **Depositors.** Depositors are by definition unsecured creditors and therefore fall logically within the scope of the “secondary” bail-in power as defined. As far as the FMLC is aware, other proposals for national and supranational bail-in regimes consistently exclude retail and other depositors because of the very significant political and systemic consequences of suggesting that those who deposit monies with a bank have a real and practical credit exposure to that institution (which in the case of bail-in would pre-date insolvency).

4.3. With regard to depositors, the ICB recognises in its report that

most ordinary deposits are insured by the Financial Services Compensation Scheme (the “FSCS”) so losses imposed on them would largely fall to the FSCS. The FSCS is funded by other banks, but effectively operates with a taxpayer-funded backstop.<sup>9</sup>

This is a factor which will doubtless be accorded significance by HM Government as it further develops its proposals.

4.4. **Counterparties to inter-bank loans.** The FMLC notes that one of the dominant features of the 2007/2008 financial crisis was that unsecured cash lending between banks dried up as the money markets became impaired.

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<sup>8</sup> Further details and comments regarding the classes of creditor that may be found to be affected by bail-in powers can be found in the appendix to the FMLC’s letter to the Financial Stability Board, *id.*

<sup>9</sup> *Id.* ICB, Final Report, para. 4.63, bullet point 2.



Interbank cash loans are often made on an unsecured basis in the money markets. *Prima facie*, creditors who make these loans will be subject to “primary” or “secondary” bail-in powers and this may further heighten the stress placed on money market liquidity and interbank lending in a crisis. The ICB report notes that

imposing losses on short-term unsecured debt and uninsured deposits may – depending on the extent to which such liabilities are regarded as lossbearing *ex ante* – cause significant disruption to funding markets, and act as a channel for contagion from a failing bank to other, previously healthy financial institutions.<sup>10</sup>

- 4.5. **Counterparties to foreign exchange transactions.** The spot and forward foreign exchange markets have historically been largely uncollateralised. Where a counterparty purchases a foreign exchange forward, it has a credit exposure (if the forward is profitable) to the seller. If counterparties to forward foreign exchange transactions were subject to bail-in, this could have a negative impact on a marketplace which currently benefits from unparalleled liquidity.
- 4.6. **Counterparties to derivatives.** Large banks active in the OTC derivatives market do not collateralise all their positions or do not always collateralise them according to current mark-to-market values. Corporate swaps do not involve intraday margin calls as companies lack the resources to meet such requirements. Assets are marked-to-market by estimate and companies could be under-collateralised when a bank is bailed-in, leaving them with a residual unsecured claim under the swap. These claims fall logically within the types of claims subject to “secondary” bail-in. Here, the mere possibility of bail-in is likely to affect the availability of “clean legal opinions” under ordinary solvent

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<sup>10</sup> *Id.* ICB, Final Report, para. 4.63, bullet point 4.

trading conditions and may have a negative impact on the wholesale and retail financial markets. Were a bail-in power actually exercised, the consequences would be yet more serious.

4.7. With regard to derivatives, the ICB report notes that

imposing losses on derivatives counterparties would prompt them to close out their contracts (where this is permitted under the terms of their contracts). This process is likely to exacerbate losses for the shareholders and other creditors of the failing bank. More damaging could be the disruption to financial markets, including as a result of indirect losses to other market participants resulting from a fire sale of collateral and consequential adverse market and confidence effects.<sup>11</sup>

4.8. Where a swap has been entered into by a company with a bank for the purposes of hedging an interest rate, currency or other exposure of the company in relation to a separate transaction, a mismatch would occur if the swap in question were subject to bail-in but the underlying transaction continued in full force.

4.9. **Counterparties to purchases and sales of securities.** Counterparties to transactions which have been agreed and not yet performed are merely contractually entitled to delivery pending actual settlement. Under the ICB proposals, these same counterparties will be, during the interregnum between trade and settlement, theoretically subject to “secondary” bail-in powers. Bail-in in such circumstances would lead to very great difficulty on the part of individual counterparties, who are likely to be contractually obliged to replicate

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<sup>11</sup> *Id.* ICB, Final Report, para. 4.63, bullet point 3.

the trade elsewhere. Related issues were considered by the FMLC following the collapse of Lehman Brothers (International) Europe Ltd.<sup>12</sup>

4.10. Similarly, the implications for repurchase agreements (“repos”) and stock lending transactions need to be carefully considered.

4.11. **Central counterparties and settlement banks.** A number of regimes (listed below) which insulate market infrastructure bodies (such as clearing houses and payment and settlement systems) and settlement banks from normal rules on insolvency have been put in place. The policy objective behind such regimes is apparently the maintenance of the stability and durability of infrastructure bodies and settlement banks with a view to promoting certainty, efficiency and stability in the financial markets. The application of a form of bail-in power to transactions to which infrastructure bodies (or their members) and settlement banks are parties may not be compatible with the successful obtention of these objectives.

4.12. By way of example, default rules lie at the heart of recognised clearing houses and settlement systems. Such rules are important for enabling clearing house or system operators to take action to achieve orderly close-out netting of a member’s existing market contracts where a member appears unable to meet its obligations. The application of a bail-in power to transactions entered into by a clearing member could interfere with the functioning of such default rules.

4.13. The regimes referred to are:

- a. Part VII of the Companies Act 1989 and its secondary legislation, which provide protection for recognised investment exchanges, recognised

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<sup>12</sup> FMLC, “FMLC Issue 140: Unsettled OTC Trades”, <http://www.fmlc.org/papers/Issue140Sept09.pdf>.

clearing houses, recognised overseas investment exchanges and recognised overseas clearing houses;<sup>13</sup>

- b. The Financial Markets and Insolvency Regulations 1996, which provide protection for settlement banks such as CREST settlement banks;<sup>14</sup>
- c. The Financial Markets and Insolvency (Settlement Finality) Regulations 1999, which implement Directive 98/26/EC and provide protection for designated systems;<sup>15</sup> and
- d. The Financial Collateral Arrangements (No 2) Regulations 2003 which implement Directive 2002/47/EC and provide protection for financial collateral providers and takers.

4.14. Central counterparties ("CCPs") are typically interposed between two contracting parties to a transaction, with the original contract being replaced by two new contracts: one contract between the seller and the CCP and the other between the buyer and the CCP. The resilience of CCPs is seen as important to the stability of financial markets. It may, therefore, be of concern to public authorities that a mismatch could arise (to the detriment of a CCP) if one of the dual contracts to which a CCP is a party were subject to bail-in while the other was not. It may, by the same token, be of concern that bail-in powers could, by interfering with CCPs' margin, collateral and default fund contributions, present a threat to the stability of CCPs.

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<sup>13</sup> For a full list of clearing houses and exchanges protected by Part VII, see the FSA Register at <http://www.fsa.gov.uk/register/exchanges.do>.

<sup>14</sup> CREST settlement banks are key providers of intra-day liquidity to CREST members (including market makers) required to enable the CREST system to function. The daily average value of securities moving through the CREST system in February 2012 was in the order of £1,262 billion (see [www.euroclear.com](http://www.euroclear.com)).

<sup>15</sup> Systems designated under the Settlement Finality Regulations include CHAPS Sterling, Continuous Linked Settlement (CLS) System, BACS, Cheque Clearing System and Credit Clearing System, and systems operated by LCH.Clearnet Ltd, Euroclear UK and Ireland Ltd., ICE Clear Europe and European Central Counterparty Limited.

4.15. In the same vein, the ICB report recognises that:

There may also be systemic risks involved in imposing losses on “central counterparties”, or in other circumstances where market participants rely on the use of collateral and “close-out netting” to control their mutual exposures.<sup>16</sup>

4.16. **Custody arrangements.** The rights of a client to property (such as money or securities), held on trust for it by a bank, may be at risk if such property is not expressly excluded from the bail-in powers as defined.

4.17. **Trade creditors.** In theory, trade creditors will be subject to “secondary” bail-in. The FMLC notes that these parties may have comparatively limited commercial knowledge and/or ability to withstand bail-in. It is common practice, in the case of a consensual multi-creditor restructuring of a company in financial difficulty, not to compromise the claims of trade creditors but to pay these in full. It is likely that a bank in resolution would need the continued supply of electricity, IT systems, software, hardware, data processing and other essential services in order to continue as a going concern. The application of a bail-in power to these trade creditors’ claims might jeopardise this continuation of service and, as a result, help to precipitate a disorderly restructuring which could be destabilising for the market.

4.18. It is the view of the FMLC that it is probably not the intention of HM Government, in the vast majority of circumstances, to include the classes of creditor above within the scope of bail-in powers. It is, therefore, even at this early stage in the development of bail-in proposals, regrettable that there is not

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<sup>16</sup> *Id.* ICB, Final Report, para. 4.63, bullet point 3.

more precision and clarity as to which creditors could be subject to bail-in and in what circumstances.

## **5. FURTHER POINTS TO NOTE**

- 5.1. The Response notes the ICB's recommendation that the resolution authorities' bail-in powers be discretionary. Such discretion might enable quick resolution of a bank but will also create uncertainty among creditors as to which claims will be affected.<sup>17</sup>
- 5.2. Whilst it is not the role of the FMLC to comment on policy issues, the Committee urges HM Government to carry out a thorough impact assessment to ensure that the increased risk of write-off, caused by any provision for creditors of contractual bail-in instruments to suffer the burden of contractual and statutory bail-in, will not make financial instruments too costly to insure.
- 5.3. The Response endorses the ICB's recommendation that bail-in should function by way of debt write-down or conversion to equity. The latter mechanism raises the question whether the conversion of large amounts of debt could transfer ownership of a bailed-in bank to bondholders subject to bail-in. In practice, this would depend on a number of factors including (i) the proportions of debt held by bondholders, (ii) the relative conversion value of the new equity to existing capital, (iii) the shareholdings constituting control over the organisation for the purpose of national and/or supranational merger control regimes and (iv) the presence of grace periods. Contractual terms regarding how debt is held or is to be converted determine whether merger review will defeat speedy resolution. This will not, however, be the case if transactions can be derogated from, for example, Article 5(3) of EC Merger Regulation

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<sup>17</sup> *Id.* Government response to the Independent Commission on Banking, para. 3.39.

139/2004. Whilst complex in practice, it is possible that debt conversion could trigger a change of control. Indeed, the restructuring of Eurotunnel resulted in a change of control to leading creditors. A further issue may be whether a conversion of sufficient size might give rise to difficulties in cases where there are requirements for prior notification to regulators of changes in control.

## **6. CONCLUSION**

- 6.1. The FMLC notes that HM Government's proposals for bail-in are at an early stage. Nevertheless, the FMLC feels that the importance of the issues raised in this paper warrant their timely consideration.
  
- 6.2. The FMLC does not wish to comment on the policy objectives behind bail-in. It is, however, the belief of the FMLC that the implementation of narrow policy objectives by tightly defined statutory or regulatory powers is likely to promote legal certainty. In view of this, the FMLC suggests that future bail-in powers would likely benefit, in particular, from the classes of claim to which they apply being clearly and specifically delimited.

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