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1 May 2012

Jonathan Faull
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1049 Brussels
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Dear Mr Faull

Issue 167: Bail-In – Discussion paper on the debt write-down tool – bail-in (DG Internal Market and Services)

As you may recall, the role of the Financial Markets Law Committee (the “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.

The FMLC is grateful for the opportunity to comment on DG Internal Market and Services’ working document on bail-in entitled *Discussion paper on the debt write-down tool – bail-in* (the “Discussion Paper”).¹

Herewith please find an addendum to the FMLC paper entitled *Observations on legal uncertainties which may arise from the introduction of bail-in powers* (the “FMLC Paper”) which can be accessed at <http://www.fmlc.org/Pages/papers.aspx>.²

The FMLC Paper underlines the importance of narrowly drawing a bail-in power in order to help ensure that the policy objectives behind the power are achieved to the exclusion of unintended consequences. The FMLC believes that a bail-in power should define in positive terms the specific classes of creditor subject to the power.

The Discussion Paper states that investors need certainty “as to when and under which conditions their claims” could be bailed in. A similar point is made in the FMLC Paper. The Committee notes, however, that the Discussion Paper advocates a *broad* power which, subject to exclusions, applies to all liabilities. The FMLC considers that a broad power is unlikely to provide legal clarity or investor certainty and may be complicated to operate.

Notwithstanding the FMLC’s belief that a tightly constrained bail-in power is strongly preferable, the Committee welcomes the fact that the Discussion Paper attempts to identify exclusions to the broad power advocated. Exclusions would be necessary to prevent the power capturing creditors and claims unintentionally and to stop the power leading to

¹ *Discussion paper on the debt write-down tool – bail-in*, available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bail_in_en.pdf (checked 16 April 2012).

² The FMLC is grateful to the City of London Law Society for its assistance with this letter and the enclosed addendum.

unintended consequences. Paragraph four of the FMLC Paper discusses legal uncertainties which may arise from the application of a bail-in power to various classes of creditor and claim.³ The enclosed addendum updates the assessment of creditors and claims that appears in the FMLC Paper.

The FMLC Paper emphasises that bail-in powers are unlikely to respect the key principle of insolvency law, that assets be distributed amongst non-preferential creditors *pari passu* on insolvency. Albeit that the Discussion Paper acknowledges the need to ensure that “bail-in respects as far as possible the ranking of creditors' claims under insolvency law”, the powers outlined in it could, if exercised, result in differing priorities and recoveries for different classes of creditor. This would result inevitably from the reliance on exceptions which is necessitated by the introduction of a broad bail-in power.

The Discussion Paper describes two options with regard to the ranking of creditors. In the view of the FMLC, however, neither option appears workable in practice. Under both options “equity, equity like and subordinated instruments [are] subject to [bail-in] before any other bail-inable instrument”. All other bail-inable instruments are, under option one, bailed-in on a *pari passu* basis. Under option two, all other bail-inable instruments are ranked on the basis of maturity so that longer-term debt is bailed-in before shorter-term debt. The options present the following fundamental difficulties:

As regards both

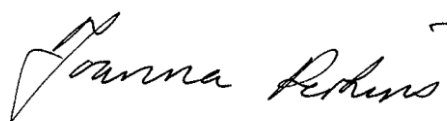
- For the reasons given above, in the FMLC Paper and in the addendum thereto, a power applicable to such a wide range of debts will create legal uncertainty and market disruption; and
- In the event of a resolution, it will be difficult to quantify the sums to be bailed-in because many liabilities are difficult to ascertain (the same is even true for longer-term liabilities).

As regards option two in particular

- Market bias against longer-term deposits may be created; and
- The ranking of debt on the basis of maturity is not, as far as the FMLC is aware, an approach recognised under the insolvency law of any major jurisdiction. Such ranking might give rise to claims by holders of longer-term debt that they are penalised as compared with their position on liquidation.

I would be very happy to discuss the matters raised in this letter with you further. Please do not hesitate to contact me if you would like further information or if you would like to arrange a meeting.

Yours sincerely



Joanna Perkins
FMLC Director

Copied to: Hannes Huhtaniemi (Policy Officer, DG Internal Market and Services)

Enclosed: Addendum to FMLC paper on bail-in

³ The FMLC recognises that some classes of creditor and claim (such as, for example, depositors) referred to in the FMLC Paper are excluded from the proposals set out in the Discussion Paper.

MAY 2012

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 167 – BAIL-IN

ADDENDUM

Further discussion of legal uncertainty which could arise from bail-in: an addendum to the FMLC paper entitled *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

ADDENDUM

Further discussion of legal uncertainty which could arise from bail-in: an addendum to the FMLC paper entitled *Observations on legal uncertainties which may arise from the introduction of bail-in powers*¹

This addendum has been produced by the Financial Markets Law Committee (the “FMLC”) Secretariat.² The FMLC is very grateful to the City of London Law Society for its contribution.

¹ The FMLC paper can be accessed at <http://www.fmlc.org/Pages/papers.aspx>.

² Joanna Perkins and Roland Susman.

1. Introduction

- 1.1. The role of the Financial Markets Law Committee (the “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.
- 1.2. In March 2012, the FMLC published a paper entitled *Observations on legal uncertainties which may arise from the introduction of bail-in powers* (the “FMLC Paper”).
- 1.3. The FMLC Paper makes a number of general observations regarding legal uncertainty and bail-in. It provides an analysis of the effect of bail-in on different classes of creditor and claim and raises further general difficulties associated with a bail-in power. The Paper considers, in particular, issues which arise from the UK Government’s response to the final report of the UK’s Independent Commission on Banking.³
- 1.4. The FMLC Paper argues that legal certainty is promoted where narrow policy objectives are implemented by tightly defined statutory or regulatory powers. The Paper suggests that a bail-in power would, therefore, benefit from the clear delimitation of the specific classes of claim to which it applies.
- 1.5. The purpose of this addendum is to provide further detail on the problems of legal uncertainty posed by bail-in in light of a discussion paper regarding such powers from DG Internal Market and Services⁴. The addendum, in particular, develops the analysis of classes of creditor and claim, with respect

³ *The Government response to the Independent Commission on Banking*, available at 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, available at <http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf> (correct as at 15 March 2012).

⁴ *Discussion paper on the debt write-down tool – bail-in*, available at http://ec.europa.eu/internal_market/bank/docs/crisis-management/discussion_paper_bail_in_en.pdf (correct as at 16 April 2012).

to which the application of bail-in raises particular issues of legal uncertainty, found in the FMLC Paper.

2. Classes of creditor and classes of claim

2.1. Contingent or disputed liabilities. When a bank is requested by a customer to provide a third party with, for example, a guarantee, standby letter or bond, the bank's liability will be contingent unless and until it receives a valid demand for payment. Ascertaining the value of such contingent liabilities could be difficult and the accuracy of any estimation could change over time.

2.2. Netting or set-off arrangements. Netting allows for multiple related claims between parties to be reduced to a single claim. The effect of the application of bail-in to a liability falling within a netting arrangement could, therefore, be to undermine the overall arrangement. A counterparty could, as a result of bail-in being applied, be left owing a gross sum to a bank but with a much reduced or extinguished claim against the bank.

2.3. Set-off plays a central role in cash management arrangements offered to company groups by banks. The effect of bail-in on these arrangements is such that, in the event of resolution, a customer's claim against a bank for repayment can be written down or extinguished while its liability for borrowing from the bank remains intact.

2.4. Practical obstacles stand in the way of the application of bail-in to sums after netting or set-off. Where a bank remains a going concern and has a continuing business relationship with a customer, the moment of bank resolution may be an inappropriate time to close-out netting agreements.

2.5. Establishing net values can be a time consuming process. In the context of a resolution intended to take place over, for example, a weekend this would be problematic. During the collapse of Northern Rock and Bradford and

Bingley in the UK, gross calculations were used for the support of deposits, in part, because net values could not be established in a reasonable time

2.6. **Trade creditors.** The FMLC Paper makes the point that trade creditors are unlikely to be in a position, either in terms of knowledge or financial strength, to withstand the bailing in of a bank's liabilities to them. The FMLC Paper also argues that the bailing-in of trade creditors could disrupt the provision of essential services to a bank and, as a result, help to precipitate its collapse.

2.7. The FMLC believes, moreover, that no trade creditor, notwithstanding the goods or services provided, should be subject to bail-in. To apply bail-in to non-essential trade creditors would require a difficult distinction to be drawn between those providing essential and those providing non-essential goods and services. A trade creditor could face considerable uncertainty as to its own status with regard to bail-in if such a distinction were to exist, not least because its status could, presumably, change over time.

3. Further points to note

3.1. **Group structures.** Some bail-in proposals contemplate giving bailed-in creditors equity in the bank being resolved. In the context of group structures where, for example, a bank is a wholly owned subsidiary, the shares with real value will, in fact, be in respect of a different entity (eg. a parent company) that does not fall under the bail-in power.

3.2. **Jurisdictional limits.** Bail-in powers are likely to face barriers to enforcement in foreign jurisdictions unless there is international coordination to achieve coherence and mutual recognition. In particular, an attempt to apply a bail-in power to debt created prior to the creation of the power itself is unlikely to be successful in a foreign jurisdiction (such a retrospective use of the power may, of course, also face legal challenges in its home jurisdiction).

4. Conclusion

4.1. The FMLC's paper entitled *Observations on legal uncertainties which may arise from the introduction of bail-in powers* makes the argument that any bail-in power should, in order to help ensure legal certainty, be narrowly drawn. The clear delimitation, in positive terms, of the classes of claim and creditor to which the power would apply is, therefore, preferable. The Paper analyses specific problems that arise in the context of different classes of creditor and claim.

4.2. This addendum has, in particular, built on the analysis of specific liabilities, in the FMLC Paper. The addendum has also commented briefly on legal uncertainties with respect to group structures and enforcement in foreign jurisdictions.

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⁵ Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only. Whilst the Bank of England, the Financial Services Authority and HM Treasury participate in the FMLC, the views expressed in this addendum are not necessarily those of the three institutions.