

22 May 2014

FINANCIAL
MARKETS
LAW
COMMITTEE

Resilience and Resolution Team
HM Treasury
1 Horse Guards Road
London
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Dear Sirs,

Issue 167: Bail-in.

Discussion of legal uncertainties arising from the consultation on the implementation of bail-in powers under the Financial Services (Banking Reform) Act 2013

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.

In furtherance of its remit, the FMLC welcomes this opportunity to respond to HM Treasury’s recent consultation on the implementation of bail-in powers (the “Consultation”) under the Financial Services (Banking Reform) Act 2013 (the “2013 Act”), which was published on 13 March 2014. The 2013 Act expands the resolution powers available to the Bank of England and HM Treasury under the Special Resolution Regime (established by the Banking Act 2009, the “2009 Act”) so as to include a new power to bail in creditors of a bank in resolution. The proposals set out in the Consultation are intended to develop, support and circumscribe the use of this new power, referred to in the legislation as the “bail-in stabilisation option”.

The Consultation invites comments on three draft statutory instruments:

1. the Building Societies (Bail-in) Order;
2. The Banking Act 2009 (Restriction of Special Bail-in Provision etc) Order (the “Restriction Order”); and
3. The Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations (the “Compensation Regulations”).

This letter addresses specific issues arising under the second and third of these draft measures.

The Consultation also seeks views on three other issues, two of which concern the transposition of the European Bank Recovery and Resolution Directive (“BRRD”), itself still subject to technical finalisation. A word on this subject is included in the paragraphs below. The third issue concerns the question whether covered bond vehicles and securitisation vehicles should be within the scope of bail-in. This is a policy question which falls outside the FMLC’s remit.

The Restriction Order: Protected Liability

The Restriction Order sets out a number of safeguards in respect of the exercise of the bail-in stabilisation option, in particular for certain types of set-off and/or netting arrangements, referred to as “protected liabilities”. These safeguards supplement the exclusions (“excluded liabilities”) set out in section 48B(8) of the 2009 Act, as inserted by paragraph 4 of Schedule 2 to the 2013 Act. (Thus, excluded liabilities are not protected, since the bail-in stabilisation option does not apply to such liabilities and safeguards are not required.)

Article 4(1) of the Restriction Order provides:

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an instrument to which this Order applies may not make special bail-in provision in respect of a protected liability (subject to paragraph (4))

Article 4(2) further provides that a protected liability is a liability which meets *inter alia*, Condition 2 which according to Article 4(2)(b) states:

...that the liability is a liability which...

(i) either the person or the relevant banking institution is entitled to set-off or net...

(ii) has not been converted into a net debt, claim or obligation, whether in accordance with the relevant arrangement or through the making of special bail-in provision or otherwise.

Article 4(4) concludes:

Paragraph (1) does not prevent special bail-in provision from being made in order to convert, or in connection with converting, the protected liability into the net debt, claim or obligation that would be due under the set-off arrangement, netting arrangement or title transfer collateral arrangement at the time the special bail-in provision providing for this is made (or an estimate of the net debt, claim or obligation).

It is clear that under Article 4 certain set-off and/or netting arrangements are protected until they are exercised and also that, by virtue of Condition 2, once the right has been exercised, the net debt or claim is itself subject to bail-in.

What is less clear, however, is the intended effect of Article 4(4) as drafted, and in particular its intended ambit. One view is that this draft sub-provision is intended only to support any decision by the competent resolution authority (i.e. the Bank of England) to exercise termination rights—subject always to the contractually prescribed set-off and netting arrangements—at the point the bank enters resolution. (Section 48B(1) of the 2009 Act, as inserted by the 2013 Act, permits a resolution instrument to make provision, in particular, for a contract to have effect as if a specified right had been exercised under it.) No reference to section 48B(1), however, is made in draft Article 4(4) and thus another view is that the sub-provision could be intended to have wider (or other) ambit. The FMLC respectfully recommends, therefore, that the draft order is clarified or at least that additional illustration or clarification is provided in the Explanatory Note to the draft order.

The Compensation Regulations

Where the competent resolution authority makes a property transfer instrument in accordance with section 12(2) of the 2009 Act (i.e. to effect a transfer to a bridge bank), it will be required to comply with The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 (the “2009 Regulations”). These set out a scheme for mandatory compensation which is very similar to that contained in the Compensation Regulations. Regulation 3 of the 2009 Regulations provides that the resolution fund order which HM Treasury is required to make under section 52 of the 2009 Act in the case of a property transfer to a bridge bank must, in the case of partial property transfers, contain a third party compensation order.

Where the competent resolution authority makes a property transfer instrument under section 12(2) which also makes special bail-in provision, or such provision is subsequently made by a supplemental instrument, the Compensation Regulations themselves will apply. Regulation 4 specifies that a third party compensation order must be included in either case.

The FMLC observes that it is theoretically possible for the competent resolution authority to exercise the bail-in stabilisation option by means of a supplemental instrument after a partial property transfer has been effected. In this case it would appear that both the property transfer instrument and the supplemental instrument must incorporate third party compensation orders in respect of the same claim or debt. Since the creditor's position following both the transfer to the bridge bank and the bail-in will be assessed against the baseline of "insolvency treatment", under both sets of regulations, rather than against the baseline of prior recovery, it is theoretically possible that the creditor will be compensated twice in respect of the same loss in value. Were this to occur it would be unfortunate and undermine the perceived fairness of the compensation scheme. The FMLC recommends, therefore, that attention is given to this area of potential overlap in the draft Compensation Regulations.

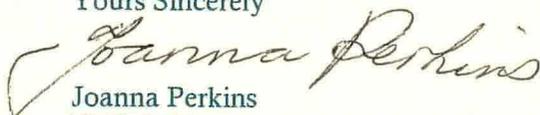
Early Transposition of the BRRD

Two of the proposals in the consultation relate to the early transposition of Articles 98a and 107 of the BRRD. The FMLC notes that the final legislative text of the BRRD is yet to be available. In the unlikely event that the provisions of the BRRD change during technical finalisation, early transposition would necessitate changes.

It is worth noting in this respect that the European Parliament draft of the BRRD published on 8 April 2014 and reportedly adopted by the Parliament on 15 April, defines short term deposits as up to one month in duration while legislative scheme adopted by HM Treasury is consistent with the shorter period in the Council draft of June 2013 (see section 48B(8)(d) of the 2013 Act).

I and Members of the Committee would be delighted to meet with you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours Sincerely



Joanna Perkins
FMLC Director