FINANCIAL MARKETS LAW COMMITTEE

5 October 2015

Suzy Kantor
Resilience and Resolution
Financial Stability Group
HM Treasury
1/34,1 Horse Guards road
London, SW1A 2HQ

Dear Ms Kantor,

Bank Recovery and Resolution

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 takes this opportunity to comment on aspects of the bail-in regime for UK banks established by the Banking Act 2009 as amended by the Financial Services (Banking Reform) Act 2013 which implemented Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the "BRRD"). In particular, the FMLC wishes to clarify the treatment of set-off in the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (the "2014 Order") and in the Banking Act 2009: special resolution regime code of practice published in 2015 (the "Code of Practice").

Certain liabilities are excluded from the scope of the power to make special bail-in provisions by section 48B(8) of the Banking Act 2009. Other liabilities, however, such as non-guaranteed deposits are not automatically excluded from bail-in. These non-excluded liabilities may nevertheless qualify as "protected liabilities" under the 2014 Order if they benefit from protection in insolvency owing to particular set-off and netting rights. This safeguard has the effect that protected liabilities must be subject to set-off or netting before the net liability can be bailed-in. That is, they can only be bailed in on a net basis. The "protected liabilities" regime is an implementation of the BRRD's safeguard for derivatives in Article 49(3)—which requires derivatives to be bailed-in on a net basis—but one which has been extended in the UK to protect certain set-off and title transfer collateral arrangements benefitting from set-off or netting.

"Protected liabilities" benefitting from the safeguard are defined in Article 4(2) of the 2014 Order so as to include liabilities owed by the bank—

> *which either the person or the relevant banking institution is entitled to set-off or net under particular set-off arrangements, netting arrangements* or *title transfer collateral arrangements into which the person has entered with the relevant banking institution*

It would appear that this definition includes only those liabilities subject to contractual set-off, since other forms of set-off are not easily described as a set of "particular set-off arrangements" into which the creditor and the debtor have entered. Both "arrangements" and "entered" imply an agreement with regard to set-off and this is

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consistent with references to set-off in the BRRD. A wider approach, however, would include forms of set-off which become available by operation of law when the creditor and the bank enter into certain claims and cross-claims.

A wider approach would include several important forms of set-off which are likely to apply in the situation of a bank approaching insolvency, including: current account set-off;[1] legal set-off (also known as independent set-off);[2] transaction set-off (also known as equitable set-off);[3] and, eventually, insolvency set-off.[4]

If an exercise of the bail-in tool ignores any form of set-off available to a creditor, the creditor will likely have a new claim against the resolution funds under the Banking Act 2009 (Mandatory Compensation Arrangements following Bail-in) Regulations 2014 (the "2014 Regulations") which implement Articles 73-75 of the BRRD and which codify the "no creditor worse off" principle. The claim will be for an amount representing the difference between the creditor's net position under resolution, after bail-in, and the creditor's hypothetical position "under normal insolvency proceedings". The convoluted nature of this process—bailing in claims on a gross basis, only to compensate creditors according to their rights of set-off—arguably militates strongly against an approach which allows bail-in on a gross basis by restricting the definition of "protected liability" to those liabilities benefitting from contractual rights of set-off.[5]

In light of this, the picture has, in the view of the FMLC, been considerably muddied by a lack of clarity in paragraphs 8.27 to 8.32 of the Code of Practice—a document in which the intended practice of the Bank of England with regard to resolution is set out. Where set-off arrangements apply, according to the Code, protected liabilities may be either (i) converted into a net debt, claim or obligation, or (ii) treated as if they had been. Paragraph 8.29 goes on to say:

> *For example, if a counterparty of the banking institution has both a liability to the bank (such as a loan) and holds a liability of the bank (such as a deposit) as an asset, and they are subject to set-off rights, then the Bank of England may treat these as if set-off had been applied, rather than actually closing the contracts to create a net liability. The Bank of England would then exercise the bail-in powers in such a way that results in the counterparty being exposed to a loss that is equivalent*

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1 Current account set-off (sometimes mistakenly referred to as a banker's lien) arises where two bank accounts—e.g. one in credit and one in overdraft—can and must be netted off against each other before a claim is made on the customer. This form of set-off can also be exercised by the customer according to *dicta* in *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] AC 785.

2 Legal set-off is form of set-off which applies to mutual claims between a claimant and defendant if they are liquidated, due and payable. It is not self-executing and can only be given effect in the judgment of a court (*Stein v Blake* [1996] AC 243; *per* Lord Hoffmann). Subject to these restrictions, this form of set-off is likely to apply to cross-claims between a bank and its customer such as a deposit and a mortgage.

3 Equitable set-off arises when two claims are so closely connected that it would be unjust to allow one party to enforce its claim without giving credit for the claim of the other party. An equitable right of set-off often arises where the claimant has defaulted in performing the obligation for which it is seeking payment. In certain circumstances, there may be an equitable right to set-off a bank account held with a mortgagee against the mortgage debt.

4 For example, as provided for in the case of bank liquidation under Rule 72 of the Bank Insolvency (England and Wales) Rules 2009 (SI 356 of 2009).

5 This convoluted process may become yet more complicated where the bank's cross-claims against a creditor—for example, a mortgage into which a depositor has entered—has been equitably assigned, as with a securitisation. Here, a new mutuality for the purposes of set-off is established between the creditor and the assignee. *Prima facie*, this permits the creditor to assert legal or independent set-off to the value of its pre-existing claim against the bank as a defence in proceedings brought by the assignee, following perfection, to recover the value of the assigned cross-claim. If resolution and bail-in are imposed on the bank instead of liquidation or administration, however, bailing in the creditor's claim will reduce the value of the legal set-off vis-à-vis the assignee and the creditor will be worse off to that extent.

to the loss they would have experienced had the contracts been closed out and the net liability bailed in.

Referring to set-off rights generically in this way and using the example of a loan and deposit—which are claims and cross-claims that do not typically benefit from contractual set-off arrangements—coupled with references in paragraph 8.27 to "protection in insolvency" give the impression that claims and cross-claims entered into between the creditor and the bank which are likely to benefit from insolvency or other forms of set-off are protected liabilities, notwithstanding that this is not the apparent intent of Article 4(2) of the 2014 Order.

The FMLC would be grateful for clarification as to the forms of set-off which are safeguarded by the 2014 Order. Should it prove desirable to amend the Code of Practice, the FMLC would be delighted to assist with drafting suggestions for any revisions.

I and Members of the Committee would be delighted to meet 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

Joanna Perkins

FMLC Chief Executive