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FINANCIAL MARKETS LAW COMMITTEE

Bank Recovery and Resolution Directive

**Response to HM Treasury's consultation paper on the transposition of the Bank Recovery
and Resolution Directive**



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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. The FMLC welcomes the opportunity to respond to HM Treasury’s consultation document (“**CD**”) on the transposition of the Bank Recovery and Resolution Directive (“**BRRD**”). As the United Kingdom already has a special resolution regime (“**SRR**”) for dealing with failing financial institutions, HM Government intends to build on the SRR by aligning it with the BRRD. The CD sets out HM Government’s preliminary views on transposing the BRRD. Annexed to the CD are two draft statutory instruments: the Banking Act 2009 (Recovery and Resolution Directive) (Amendment) Order 2014 (the “**RRD Amendment Order**”), and the Banks and Building Societies (Depositor Preference and Priorities) Order 2014 (the “**Depositor Preference Priorities Order**”).
- 1.3. This paper draws attention to the issues of legal uncertainty that may arise from proposals in the CD relating to:
 - the resolution objectives;
 - bail-in; and
 - depositor preference.
- 1.4. It also discusses the temporary stay of execution powers under the BRRD which is not considered in the CD.

2. Resolution Objectives

- 2.1. The CD proposes to amend the extant resolution objectives to align them with those in the BRRD. In fact, however, Objectives 2 and 3 (set out in Section 5 of the RRD Amendment Order) are concerned with the protection and enhancement of the financial stability of the United Kingdom, which is not a BRRD objective, and there is no corresponding language qualifying the new objectives which concern the stability of other Member States and the Union as a whole (contrast this with Articles 3(7), 17(7), 34(2) and 87(e)-(h) and with

Recitals 3 and 42 of the BRRD).¹ This departure from the framework objectives of the BRRD may give rise to uncertainty in circumstances where the primary threat to financial stability arises elsewhere in the Union.

- 2.2. The FMLC recommends that HM Treasury consider whether this uncertainty could be resolved by transposing those articles (listed above) which expressly refer to the need to assess the impact of resolution on the Union and Member States and by requiring the Bank of England, as resolution authority, to have regard to general principles aligned with those set out in Article 87(e)-(h) of the BRRD in cases with a cross-border element.

3. Exclusion from bail-in: pension liabilities

- 3.1. Among the liabilities which are to be excluded from bail-in according to paragraph 11.17 of the CD is the liability owed by the bank as the employer under an occupational pension scheme. Such liabilities may fall into any one of several categories:

- deductions from salary or regular payments of employers' contributions which have not yet been paid to the trustees of the relevant scheme;
- amounts owed as a result of an agreement between the bank and the trustees of a defined benefit scheme, for example to remedy a deficit in the scheme over time; and
- amounts owed to a pension scheme as a result of Financial Support Directions or Contribution Notices made by the Pensions Regulator under the Pensions Act 2004.

- 3.2. Liabilities in the first category above are covered by section 26 of the RRD Amendment Order. It is unclear, however, whether liabilities in the second and third category are covered. The FMLC would be grateful for clarification in this regard.

- 3.3. The Committee notes that there is a related question whether resolution and, in particular, the operation of the bail-in tool may itself trigger the Pensions

¹ The FMLC notes that Article 31 (Resolution Objectives) of the BRRD does not make express reference to the financial stability of other Member States.

Regulator's powers to make contribution or financial support orders in respect of group companies, i.e. whether resolution is an "insolvency event" within the meaning of section 75 of the Pensions Act 1995. Recital 41 of the BRRD provides that resolution may occur before a financial institution is balance-sheet insolvent.²

4. Impact of bail-in on "market charges" and "market contracts"

- 4.1. Paragraph 11.10 of the CD states that it is necessary to amend the exclusion for liabilities arising from participation in designated settlement systems and central counterparties ("CCPs") because the exclusion in the BRRD is more limited.
- 4.2. This indicates that, although "collateral security" and "collateral security charges" within the meaning of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 ("SFRs") will fall within the scope of the exclusion, "market contracts", "market charges" and "qualifying collateral arrangements" within the meaning of Part VII of the Companies Act 1989 and "system-charges" within the meaning of the Financial Markets and Insolvency Regulations 1996 will fall outside the scope of the exclusion. The FMLC urges HM Treasury to consider whether excluding the former from bail-in but not the latter may create an anomaly. All three legislative measures are designed to ensure the effectiveness and enforceability of these particular types of charge and contract in the interests of financial market stability.
- 4.3. Two further exclusions are proposed:
 - An exclusion for any liability so far as it is "secured" (para 11.17(2)), which will exclude liabilities secured by "market charges" and "system-charges". It is unclear, however, whether any unsecured shortfall (i.e. the net amount by which secured liabilities exceed the value of the security) would be susceptible to bail-in. If all secured liabilities are excluded (even if there is, or may be, a shortfall), this issue will not arise. Unsecured "market contracts" will, however, still be susceptible to bail-in.
 - An exclusion for liabilities that the bank has by virtue of holding "client assets" (para 11.17(3)). A bank that is a member of a clearing house may enter into market contracts for the account of its own clients or indirect clients and instruct the CCP to record those transactions on an individual

² As to Financial Support Directions and Contribution Notices in general, see *Trustees of the Lehman Brothers pension Scheme v Pensions Regulator and others* [2013] EWCA Civ 751.

or omnibus client account with the CCP in accordance with Article 39 of the European Market Infrastructure Regulation.³ In the event of the clearing member's insolvency, its assets and positions on client account are required to be capable of "porting" (transfer) to a non-defaulting clearing member. Further attention to the proposed exclusion may be required to ensure that bail-in does not create legal uncertainty or even an impediment in relation to porting.

- 4.4. The exceptions above appear inadequate to exclude all "market contracts" (as defined in section 155 of Part VII). Such contracts include, for instance, contracts made between a CCP and a member on proprietary (or "house") account, or between a CCP and a member, or a client or indirect client of that member, for the account of that client or indirect client. To the extent that these are secured, it will normally be only by way of margin (calculated by reference to risk factors and normally representing substantially less than the actual amount of the exposure). If a market contract fell to be bailed-in (even in part), then, depending on the size of the liability involved, this could adversely affect liquidity in the exchange or clearing house.
- 4.5. The FMLC suggests that, to avoid any residual uncertainty, the proposed exception should cover arrangements currently protected by Part VII and the 1996 Regulations as well as those protected by the SFRs. The same point applies to the exceptions required to implement Articles 69(4)(b) and 70(2) of the BRRD.

5. Depositor preference and floating charges

- 5.1. "Collateral security" has priority over the existing classes of preferential debt by virtue of regulation 14(6) of the SFRs and similarly "security financial collateral arrangements" have priority over them by virtue of regulation 10(2A) of the Financial Collateral Arrangements (No 2) Regulations 2003 ("FCARs"). It is assumed that they will also have priority over the new classes of preferential debt to be introduced in compliance with the BRRD. It would be helpful if the position could be made clear in the legislation in order to avoid any potential legal uncertainty.
- 5.2. "Market charges" in the form of floating charges which are not collateral security, however, will not achieve priority under regulation 14(6) of the SFRs. Similarly, if

³ Regulation (EU) No. 648/2012.

they are not “security financial collateral arrangements”, they will not achieve priority under regulation 10(2A) of the FCARs.⁴ The effect of the policy proposal in paragraph 17.9 of the CD to prefer depositors will, therefore, be that such charges will rank behind deposits. The FMLC does not comment on policy and has no view on whether floating charges should rank after secondary preferential debts. The Committee notes, however, that the CD does not distinguish between different categories of floating charge, as to their role and function, and urges HM Government to consider carefully whether any policy developed for floating charges is equally appropriate for “market charges” and “system charges”, both of which play a key role in financial markets infrastructure.

6. Powers to suspend payment and delivery obligations and to restrict the enforcement of security interests

- 6.1. There is little discussion in the CD as to how Articles 69 and 70 of the BRRD (requiring Member States to confer on resolution authorities’ powers to suspend payment and delivery obligations and to restrict the enforcement of security interests) will be implemented in the UK. It would greatly assist in resolving current uncertainty if HM Government were to clarify whether or not it will be taking these powers and, if so, in what terms.

7. Conclusion

- 7.1. The FMLC welcomes the opportunity to comment on HM Treasury’s work on transposing the BRRD. The Committee would, however, welcome clarification or further guidance in respect of the issues discussed in this paper. The issues are: (i) resolution objectives, (ii) the exclusion of pension liabilities from bail-in, (iii) the impact of bail-in on “market charges” and “market contracts”, (iv) depositor preference and floating charges, (v) and powers to suspend payment and delivery obligations and to restrict the enforcement of security interests.

⁴ The FMLC refers to its paper entitled “Analysis of uncertainty regarding the meaning of “possession” or “control” and “excess financial collateral” under the Financial Collateral Arrangements (No. 2) Regulations 2003. The paper discusses the legal uncertainty surrounding the control test when determining whether or not a charge qualifies as a security financial collateral arrangement.

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