“Onshoring” Statutory Instruments Comment Series: Credit Institutions Winding-up and Reorganisation

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Financial Markets Law Committee[1]

This paper has been prepared by the FMLC Secretariat.[2]

[1] In view of the role of the Bank of England, the Financial Conduct Authority and HM Treasury in the U.K.'s preparations for withdrawal from the E.U., Sinead Meany, Sean Martin and Peter King took no part in the preparation of this paper and the views expressed should not be taken to be those of the Bank of England, the FCA and HM Treasury.

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1. EXECUTIVE SUMMARY AND 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 June 2016, the U.K. voted by way of an in/out referendum to withdraw from the European Union (known colloquially and in this paper as "**Brexit**"). On 29 March 2017, HM Government took the first step in the withdrawal process and officially served notice to the E.U. of the U.K.'s withdrawal under Article 50 of the Treaty on European Union ("**TEU**"), beginning a two-year "notice" and negotiation period, and setting the date on which the U.K. will withdraw from the E.U. ("**exit day**") as 29 March 2019.[3] A post-Brexit longer-term relationship is, as yet, undecided and, therefore, preparations on the domestic front have focused on a "no deal" eventuality.[4]

1.3. A key element in HM Government's plan to ensure continuity in law during and after Brexit in the U.K. is the European Union (Withdrawal) Act 2018 (the "**Withdrawal Act**") which aims, *inter alia*, to incorporate into U.K. law all applicable E.U. legislation and to give powers to Ministers to make such amendments to retained law as are necessary to deal with any deficiencies arising from withdrawal.[5] In furtherance of these aims, HM Treasury has begun to publish drafts of statutory instruments ("**SIs**") which will "onshore" E.U. legislation related to the financial markets.[6]

1.4. This paper considers legal uncertainties arising from the changes proposed by the Credit Institutions and Insurance Undertakings Reorganisation and Winding Up (Amendment) (EU Exit) Regulations 2019 (the "**CIIURW SI**") which amend the regime for the

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3 Legislative provisions defining exit day as 29 March 2019 can be found in the European Union (Withdrawal) Act. Section 20(4) of that Act gives a Minister of the Crown the power to amend the definition of exit day so that it correctly refers the day on which the E.U. Treaties cease to apply to the U.K.

4 Discussions between the U.K. and the E.U. to agree on a post-Brexit deal are underway—and a 21-month transitional or "implementation" period during which the U.K. will continue to participate in the single market and customs union has been tentatively agreed. See, Blitz, J., "UK and EU agree 'decisive step' with 21-month Brexit transition", Financial Times, (19 March 2018), available at: https://www.ft.com/content/f418a8b2-2b69-11e8-9b4b-bc4b9f08f381.

5 Text of the European Union (Withdrawal) Act 2018 is available at: http://www.legislation.gov.uk/ukpga/2018/16/pdfs/ukpga_20180016_en.pdf.

6 A list of the statutory instruments published in relation to the financial services, included those which have been put before Parliament for approval, can be found on the following webpage: HM Government, *Financial services legislation under the EU (Withdrawal) Act 2018,* (first published 9 August 2018), available at: https://www.gov.uk/government/collections/financial-services-legislation-under-the-eu-withdrawal-act?utm_source=ed3e24c1-615b-4397-a940-f10eb4c57fcd&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate.

reorganisation and winding up of credit institutions and insurers. The current E.E.A.-wide framework is established by Directive 2001/24/EC on the reorganisation and winding up of credit institutions (the "**Credit Institutions Winding up Directive**" or "**CIWUD**") and Title IV of Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance ("**Solvency II**"). Under the Directives, the administrative or judicial authorities of the home Member State of an E.E.A. credit institution or insurer are granted exclusive jurisdiction for the reorganisation and winding up of those institutions which they have authorised and their branches across the E.E.A. Any action they take is automatically recognised throughout the E.E.A., ensuring that the failing institution is treated as a single entity across the E.E.A. by the home state's reorganisation measure or during its winding up proceeding. The Directives also ensure that E.E.A. creditors are notified, maintain their rights and ability to lodge a claim in another E.E.A. state and are protected from discrimination based on their place of residence or the nature of their claims. They also set out requirements for the co-operation and sharing of information between E.E.A. competent authorities. The Directives were transposed into U.K. law by means of the Credit Institutions (Reorganisation and Winding Up) Regulations 2004 (the "**CIRW Regulations**"), the Insurers (Reorganisation and Winding Up) Regulations 2004 (the "**IRW Regulations**") and the Insurers (Reorganisation and Winding Up) (Lloyd's) Regulations 2005 (the "**IRW Lloyd's Regulations**"), each of which is amended by the CIIURW SI.

1.5. As with all the SIs published pursuant to the aims of the Withdrawal Act, the FMLC understands that the CIIURW SI has been made with the intention of implementing a policy position arising from a "no deal" Brexit. The deletion of most instances of "E.E.A." or provisions which set out guidelines by which U.K. courts might deal with E.E.A. winding up and reorganisation processes are a necessary by-product of such a policy and the Committee does not comment on matters of policy or the form that future regulatory approaches, if any, should take. Nevertheless, the Committee has drawn attention to some legal and operational uncertainties which will arise in a "no deal" context in which it is anticipated the CIIURW SI will be implemented.

2. LEGAL UNCERTAINTIES AND IMPACT

Jurisdiction

2.1. One consequence of the approach proposed by the CIIURW SI is that the U.K.—and U.K. regulatory authorities—will lose most provisions governing choice of law and

procedural cooperation with authorities in E.U. Member States (which, intuitively, are invaluable when a large credit institution is failing). The CIRW Regulations, as amended by the Bank Recovery and Resolution (No. 2) Order 2014, contain provisions which ensure the recognition of proceedings begun in one E.E.A. Member State by all other E.E.A. Member States. For example, regulation 3 of the CIRW Regulations imposes a prohibition upon U.K. courts from making a winding-up order, appointing a provisional liquidator or making an administration order in relation to E.E.A. credit institutions. Regulation 5 of the CIRW Regulations provides that an E.E.A. insolvency measure in relation to any branch, property or other assets and debt or liability of an E.E.A. credit institution has effect in the U.K. as if it were made under general U.K. insolvency law.

2.2. These provisions, together with others relating to schemes of arrangement and the confirmation of creditors' voluntary winding up, are deleted by regulation 2(3) of the CIIURW SI. Other provisions, such as those on the applicable law in the context of regulated markets (regulation 29 of the CIRW Regulations) and in relation to netting agreements (regulation 34 of the CIRW Regulations), have been limited to U.K.-incorporated institutions and U.K. Markets. This, ultimately, creates the possibility of parallel proceedings in the U.K. and E.U. and inconsistent conflict of laws outcomes with respect to a failing credit institution and leaves its creditors, already grappling with a degree of uncertainty, in a possibly more precarious position.

2.3. The loss of recognition and reciprocity poses a greater danger in this context, not least because of the market impact of such insolvency proceedings. The cooperation arrangements set out in latter sections of the CIRW Regulations are derived from the post-financial crisis framework of Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms **(**the "**BRRD**"). No comprehensive domestic framework preceded this E.U. legislation and its removal will not leave U.K. courts with an applicable precedent, unlike in the case of corporate insolvency, for example, where any gap left by the partial repeal of Regulation (EU) 2015/848 on insolvency proceedings (the "**Recast EUIR**") is ameliorated to a degree by the U.K. having implemented the Model Law on cross-border insolvency proceedings (the "**Model Law**") adopted by the United Nations Commission on International Trade Law ("**UNCITRAL**"). In the case of insolvency proceedings for credit institutions, however, there is very little other legislative, case law or conventional provision: the U.K.'s Cross Border Insolvency Regulations 2006 do not have any application to banks or insurers. It is likely that courts and insolvency practitioners will

have to deal with such proceedings on a case-by-case basis, generating further legal uncertainty for creditors and liquidators. In doing so, they will doubtless draw on experience obtained in respect of 15 special administrations under the Investment Bank Special Administration Regulations 2011, but these Regulations are not directly applicable to deposit-taking institutions. The FMLC would recommend that HM Government give some consideration to civil-jurisdictional and procedural principles by which courts and insolvency practitioners might manage, or contribute to, the orderly winding-up of cross-border credit institutions.

Choice of law

2.4. Equally worrying is the removal by regulation 13 of the CIIURW SI of regulations 23 (*Employment contracts and relationships*), 24 (*Contracts in connection with immovable property*), 25 (*Registrable rights*), 26 (*Third parties' rights in rem*), and 27 (*Reservation of title agreements, etc*) of the CIRW Regulations which give market participants and authorities guidance on the law to be applied with respect to various aspects of a winding up or reorganisation. Choice of law provisions, such as the ones enumerated above, are, in essence, a code by which courts allocate questions of law to a relevant legal system. They give little by way of reciprocity which means, even in a "no deal" scenario, it is arguably unnecessary to remove these provisions completely.

2.5. The FMLC would recommend retaining these provisions—the potential issue of seeming to provide E.E.A. Member States with preferential treatment might be circumvented by expanding the scope of choice of law provisions to include the legal systems of Third Countries.

References to other legislation

2.6. As the CIIURW SI and the legislation it amends form but a component of the vast landscape of financial markets legislation, it contains cross-references to definitions, standards and rules from other relevant pieces of directly applicable, domestically implemented (pre-Brexit) or retained (post-Brexit) E.U. law. One example is in regulation 3(2)(b) of the CIIURW SI which states that the definition of the "capital requirements regulation" in regulation 2(1) of the CIRW Regulations is to be read as a reference to Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (the "**Capital Requirements Regulation**") "as it had effect on the day on which" the CIIURW SI is made. This date will, undoubtedly, occur before exit day which, according to Schedule 8 of the Withdrawal Act, is the

point in time at which the U.K. will stop receiving E.U. legislation. The onshored version of the Capital Requirements Regulation will be frozen as of exit day.

2.7. While there is an undisputed practical need to have a snapshot of E.U. law as of the date on which the SI is made—that is, because certain provisions of the SI come into force not on exit day but on the day after the SI is made—this does give rise to an uncertainty regarding the manner in which this regime will take account of any changes to the CRR—including, for example, *via* opinions of the European Court of Justice—in the *interregnum* before exit day. Similarly, the Committee observes that the SI would have to adapt were the proposed 21-month implementation period to be agreed, during which the U.K. will continue to receive E.U. law which comes into effect. In that case, the cross-references in the SI to other E.U. legislation which were cut-off on the day on which the SI is enacted will have to be amended to account for the implementation period, which gives rise to concerns that the existence of two snapshots will complicate the continued reception of E.U. law.

Ambiguities in the new savings provisions

2.8. Part 3 of the CIIURW SI contains savings provisions for reorganisation or winding-up processes which have begun in respect of E.E.A. credit institutions or insurers before or on exit day in an E.E.A. State. For credit institutions, regulations 6 and 7 explain the applicability of the savings provisions, regulation 8 sets out conditions under which savings may be disapplied, and regulation 9 provides the grounds for making a court order under regulation 8.[7] Regulation 9(2)(b) requires the courts to establish, *inter alia*, that

> under the relevant measure or in the relevant proceedings U.K. creditors of the relevant institution would be materially prejudiced by the operation of the law of the E.E.A. State under which the measure was adopted or imposed or the proceedings were opened—
>
> (i) in relation to its treatment of the United Kingdom as a State which is outside the E.E.A.; or
>
> (ii) by reason of its different treatment of U.K. creditors by comparison with its treatment of E.E.A. creditors who have similar rights […]

[7] A similar savings regime is established for insurers in regulations 12 to 14 of the CIIURW SI.

2.9. HM Treasury, in an earlier stage in the drafting of the SI, had circulated a draft of the CIIURW SI (the "**confidential draft CIIURW SI**") to certain experts—the FMLC Secretariat is grateful to have been included in that group. At that stage, regulation 9(2)(b) comprised a test predicated solely on the court's assessment that creditors located or payable in the U.K. would not, by reason of being located or payable in the U.K., receive the same treatment as an E.E.A. creditor. In a meeting with HM Treasury, the Secretariat had noted that the likelihood of such a court order being necessary seemed quite remote but observed that this test might lead to unnecessary duplication of proceedings. The FMLC welcomes the step towards a material prejudice test which might avoid duplicative proceedings and is more closely aligned with concepts of fairness to creditors.[8]

3. RECOMMENDATIONS AND CONCLUSION

3.1. In this paper, the FMLC has highlighted legal uncertainties arising from the statutory instrument which will onshore the regime for the reorganisation and winding-up of credit institutions and insurers. These have included uncertainties related to: (1) jurisdiction; (2) choice of law; (3) references to other legislation; and (4) ambiguities in the new savings provisions. In view of the substantial work which has evidently gone into drafting the SIs, the FMLC is certain that HM Treasury has already taken into account both the drafting and policy issues highlighted above. The FMLC would, nevertheless, encourage HM Treasury and HM Government to publish, wherever possible, guidance which might clarify these issues.

[8] The material prejudice test has also been incorporated in safeguard provisions in respect of cross-border corporate insolvency in regulation 5 of the draft Insolvency (Amendment) (EU Exit) Regulations 2018. In that context, the Joint Committee on Statutory Instruments has reported regulation 5 of for defective drafting and for unexpected use of powers. The FMLC has addressed these concerns in a separate letter and would support an even narrower test in relation to safeguard mechanisms in both contexts. (See, FMLC, *"Onshoring" Statutory Instruments Comment Series: Insolvency Regulation*, (24 January 2019), available at: http://fmlc.org/onshoring-statutory-instruments-comment-series-insolvency-regulation-24-january-2019/.

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