c/o Bank of England
Threadneedle Street
London
EC2R 8AH

Fax: (+44) (0)20 7601 5226

Email: fmlc@bankofengland.co.uk

Website: www.fmlc.org

CHAIRMAN:

THE RT.HON. THE LORD WOOLF

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Emil Levendoglu
Banking Reform Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Dear Mr Levendoglu

The Banking Act 2009, The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, The Bank Insolvency (England and Wales) Rules 2009 and The Bank Administration (England and Wales) Rules 2009

The Banking Act 2009

The FMLC has previously raised concerns about the Special Resolution Regime and the Banking Bill in various papers published in April, July, September and November 2008. The Banking Bill received Royal Assent on 12 February 2009 and the Banking Act 2009 came into force on the 21 February. Having reviewed the Banking Act, the Committee wanted to draw attention to a point that it understands others may already have raised namely that the Banking Act potentially applies to insurance companies.

The Banking Act applies to a "bank", which is defined in s2(1) as a "UK institution which has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits". A "UK institution" is defined in s2(3) as "an institution which is incorporated in, or formed under the law of any part of, the United Kingdom". Insurance companies generally have permission to accept deposits. Therefore, a large number of UK incorporated insurance companies could fall within the application of the Act.

s2(2) of the Banking Act expressly excludes building societies and credit unions from the definition of "bank". Building societies and credit unions are brought within the Banking Act 2009 under separate modified provisions instead.

s3(2) provides the Treasury with power to exclude classes of institutions from the definition of "bank". The Treasury could use this power to exclude insurance companies. The interests of legal certainty would be served if the Treasury exercised its powers to clarify that insurance companies are not intended to fall within the scope of the Banking Act.

Another provision which is of concern is section 34(7) of the Banking Act. This provision was introduced at the last minute and without any consultation. This section, which has been widely commented on, allows the Bank of England to modify the terms of a trust, or to

terminate a trust altogether, where the trust is part of a transfer instrument. Under this section it is possible that trust arrangements relating to a bond could be modified or terminated with potentially adverse consequences for bond holders and other interested parties. This creates uncertainty for the future of bond and other trust-reliant transactions. It would be helpful for legal certainty if the Government and/or the Bank of England could provide guidance (by way of a statement or other communication) of how, and in what circumstances, this power will be exercised. Alternatively, the Treasury should consider a proposed amendment which the FMLC understands has already been suggested.[1] As it is not possible to amend the primary legislation, the proposal was to amend the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the "Safeguards Order") to minimise this problem for partial transfers. The suggested wording was as follows:

> *A partial property transfer to which this Order applies may not affect the rights of any beneficiaries of a trust in respect of which the banking institution is the trustee and may only make provision about the trust pursuant to section 34 of the Act to the extent necessary to transfer the legal title in and to the trust property to the transferee.*

The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009

The Safeguards Order also came into force on the 21 February 2009. The FMLC previously contributed to the November 2008 Treasury consultation in relation to the draft Safeguards Order: "Special Resolution Regime: Safeguards for partial property transfers". The Committee was pleased to see that some of the points raised in relation to the draft Safeguards Order were amended prior to enactment of the Safeguards Order. The FMLC has, however, noticed some additional points of concern in relation to the scope of the Safeguards Order itself which are discussed below.

One potential temporary solution to the problems mentioned below is for the parties to put in place a financial collateral arrangement ("FCA") in addition to the relevant netting agreement. If that is done, the whole close-out netting provision would be protected without regard to product type. This would be a temporary but not entirely satisfactory solution.

<u>The scope of the Safeguards Order</u>

1) The protection afforded to netting and set-off arrangements under the Safeguards Order is too narrow in that it does not cover every type of derivative transaction that is currently brought under master netting agreements. The Safeguards Order seeks to protect netting and set-off under contracts that fall within the definition of "Financial Instruments".

"Financial Instruments" are defined in the Order with reference to section C of Annex I to Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments ("MiFID"). Using the MiFID definition of "financial instrument" means that several types of transaction which are typically included in master netting agreements are not covered. The principal transactions which appear to be excluded from the protection of the Safeguards Order are:

(a) spot and forward foreign exchange ("FX") transactions;

(b) Over The Counter ("OTC") bullion options that are regulated investments under article 83(1)(c) of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 ("RAO") which would not be financial instruments under MiFID if the restrictive requirements of Commission Regulation 1287/2006/EC (the "Commission Regulation") are not met;

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[1] By Dorothy Livingston of the City of London Law Society Financial Law Committee

(c) OTC physically-settled commodity transactions that are regulated investments under article 84 of the RAO if the restrictive requirements of the Commission Regulation are not met;

(d) longevity and mortality derivatives and other contracts for differences that are regulated investments under article 85 of the RAO but are not financial instruments under MiFID because they relate to an underlying asset or risk class not specified in the MiFID definition of "financial instrument".

2) The scope of the Safeguards Order also appears to exclude the entirety of a master netting agreement from protection under the Safeguards Order if the agreement includes a single transaction that does not fall within the protections.

This issue has arisen because of the inclusion of the word "solely" to sub-clause (c) of the definition of "excluded rights". This in conjunction with 1) above will mean that a number of master netting agreements will inadvertently fall outside that scope of the Safeguards Order. The types of transaction included in 1) above are all routinely included within master netting agreements and so a significant amount of master netting agreements in the market could fall outside the protection of the Safeguards Order because of the inclusion of the word "solely". This was unlikely to be an effect that the Treasury intended when it added the word "solely" to the definition.

The Committee notes however that Mr Ian Pearson MP referred to this point in his response to Mr Mark Hoban MP at the 5th Delegated Legislation Committee on 17 March 2009 (Hansard HC Cols 13-14 (17 March 2009)) and provided some comfort by specifically stating:

> *that it is not the Government's policy intention for the existence of one excluded contract under a set-off and netting arrangement to render the entire arrangement unprotected by the order. One bad apple does not spoil the barrel. The Government's view is that "relates solely to" in the drafting of the safeguard order does not yield that legal effect. However, as with other outstanding concerns, I confirm that that will be part of the banking liaison panels review.*

Lord Myners had also offered reassurances in his speech to the Grand Committee in the House of Lords on 16 March 2009 (Hansard HL Col GC7 (16 March 2009)) that this issue would be on the first agenda of the Banking Liaison Panel and that any necessary changes would be brought in before the Summer Recess.

Bank Insolvency and Bank Administration Rules

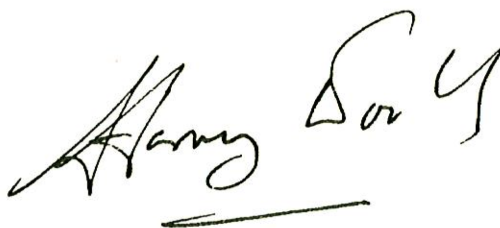
Concerns were raised with the FMLC in relation to the interaction between the newly created Insolvency and Administration Rules under the Banking Act and the work of the Insolvency Rules Committee which was set up by the Insolvency Service. The FMLC understands that the Insolvency Rules Committee has been considering amendments to the current insolvency rules to consolidate and modernise its provisions for some time now. The Insolvency Rules Committee's amendments are due to be put in place in October 2009. The reason that this causes the FMLC concern is because a considerable amount of confusion could be caused if the insolvency rules which support the Banking Act are inconsistent with the new insolvency rules that will be enacted later in the year. It is crucial, therefore, that this point is considered in advance of October to ensure that uncertainty does not ensue.

Furthermore, the Committee understands that the Government is currently working on a new set of insolvency provisions for investment firms, namely the Investment Bank Insolvency Arrangements. As far as the FMLC is aware it is not clear how a UK bank (which is both a commercial bank and an investment bank) will be treated for insolvency purposes – will it be dealt with under the Bank Insolvency provisions in the Banking Act or will it be dealt with

under the Investment Bank Insolvency Arrangements? It would be helpful from a legal certainty perspective if the Government could clarify this position.

The FMLC Secretariat would welcome the opportunity to discuss any of these points further if that would be useful. As you are no doubt aware, two of the FMLC's Members, Bill Tudor-John and Ed Murray, are members of the Banking Liaison Panel. The FMLC will continue to raise any similar concerns through them and the Banking Liaison Panel.

Yours sincerely



Lord Woolf

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