Briefing paper: 11 December 2008

Banking Bill – key issues and proposed solutions

Introduction and timing

1. The Banking Bill (the **Bill**) is intended to give the Treasury, the FSA and the Bank of England (the **Tripartite Authorities**) significant powers for dealing with a UK deposit-taking institution in financial difficulties in circumstances where there is a threat to financial stability. In particular, the Bill:

   (a) contains provisions which allow the Tripartite Authorities to transfer all or part of the shares in, or the assets and liabilities of, the failing UK bank to a private sector purchaser (e.g. another bank) or a State-owned "bridge bank" (the **Special Resolution Regime**);

   (b) proposes two new insolvency proceedings in relation to UK bank, the first a modified liquidation proceeding whereby the primary objective is for the liquidator to assist the FSCS in relation to protected depositors and the second a special administration regime to be used in conjunction with partial transfers.

2. The Bill was introduced into the House of Commons on 7 October and has now been though the Public Bill Committee. It is due to be debated in the House of Lords shortly. It is anticipated that the Bill, together with the secondary legislation referred to below, will be brought into force in February 2009.

3. Although the provisions in the Bill are currently limited to UK deposit-taking institutions, it has been proposed that secondary legislation made under the Bill will modify the insolvency framework in relation to investment firms (particularly in relation to client monies and assets). Such legislation is expected to come into force in Summer 2009 following a consultation process to be commenced later this month.

Partial property transfer provisions

4. The Tripartite Authorities acknowledge that the most contentious provisions in the Bill are those allowing for a partial transfer of assets and liabilities either to a private sector purchaser or to a bridge bank. The Tripartite Authorities consider that such partial transfer provisions are necessary to give them sufficient flexibility to split a bank (e.g. by transferring the "good" part of the business to a new company while leaving behind the unwanted assets and liabilities).

5. However, significant concerns have been raised by stakeholders regarding the impact of the partial transfer provisions on set-off, netting and security arrangements. If the partial transfer provisions are unrestricted (or are not sufficiently restricted), it may be possible for the Tripartite Authorities to "cherry-pick" certain rights and obligations covered by a set-off or netting agreement, and to transfer these to the new company, while leaving behind other rights and obligations (thus interfering with the counterparty's set-off or netting rights). Furthermore, if a counterparty has security for particular obligations owed by the UK bank, and the secured assets are transferred to the new company while leaving behind the secured liabilities, this will interfere with the counterparty's security interests. This could lead to higher funding costs (to reflect the additional risk associated in dealing with a UK bank) and higher requirements for regulatory capital (particularly if counterparties are unable to obtain the necessary legal opinions to allow them to hold regulatory capital on a net, rather than a gross, basis), ultimately resulting in a loss of competitiveness for UK banks.

6. To reflect these concerns, the Tripartite Authorities published a consultation paper in November 2008 entitled "Special Resolution Regime: Safeguards for Partial Property Transfers" (the **November Consultation**). This paper suggested that certain protections for set-off, netting and security would be included in secondary legislation made under the Bill, such legislation to be brought into force at the same time as the Bill becomes law. An "Expert Liaison Group" of industry experts has been appointed to assist the Tripartite Authorities with the relevant secondary legislation. The consultation paper requests comments by 9 January 2009.

Key concerns about the Bill and proposed solutions

7. Clause 47 of the Bill gives the Treasury the power to restrict, by secondary legislation, the making of partial property transfers or to impose conditions on the making of partial

property transfers. **One option would therefore be for the Treasury to use its powers under clause 47 in order to restrict the scope of any partial property transfers**. This is discussed in Part 5 of the November Consultation. For example, the secondary legislation could limit the circumstances in which a partial transfer could be used to a transfer of the retail deposits and/or mortgage contracts[1]. However, the November Consultation makes it clear that this option is not attractive to the Government due to concerns that it would provide insufficient flexibility. We have therefore not provided suggested drafting in respect of this option.

8. In the context of partial property transfers, clause 48 of the Bill gives the Treasury the power to protect, by secondary legislation, security interests and/or set-off and netting arrangements. The secondary legislation referred to in the November Consultation is to be made under this clause of the Bill. While the inclusion of such a power in the Bill is welcomed, concerns have been raised regarding the drafting of the definitions of "security interests" and "set-off or netting agreements" in clause 48. While the concerns are technical, the point is an important one as any uncertainty as to the types of arrangement which are covered by the secondary legislation could have an impact on a counterparty's risk assessment and regulatory capital requirements. **The City of London Law Society (CLLS) has proposed various amendments to clause 48 which would resolve any uncertainties as to the defined terms used in that clause (as set out in Appendix 1 to this note) and we would fully endorse these suggested amendments**.

9. The proposed protections in relation to set-off, netting and security are discussed below in the context of the secondary legislation proposed by the November Consultation. However, in order to be able to exercise such set-off or netting rights, it may well be necessary for the counterparty to "close out" or terminate its positions as against the UK bank. In any well-drafted set-off or netting agreement, the counterparty will have a contractual right to terminate the relevant transactions following an event of default on the part of the UK bank. Similarly, as a preliminary step to enforcing its security, the counterparty will generally need to establish that an event of default has occurred, thus enabling the counterparty to accelerate the secured liabilities. Again, a well-drafted security agreement will provide that the security becomes enforceable following such an event of default.

[1] Very broadly speaking, the transfer orders in respect of Kaupthing Singer & Friedlander Limited and Heritable Bank plc were used to transfer the UK retail deposits to ING.

10. A counterparty may, however, be prevented from exercising its contractual rights to close out or terminate its positions as against the UK bank (for the purposes of exercising any set-off or netting rights), or from declaring an event of default (for the purposes of enforcing its security) by virtue of clauses 22 and 38 of the Bill[2]. These clauses allow the Bank of England, in the relevant transfer instrument, to disapply any contractual termination provisions or events of default which would otherwise be triggered by the transfer. In theory, this power could be exercised by the Bank of England even in circumstances where the various transactions under a set-off or netting agreement, or the secured assets and liabilities, are left behind with the residual bank (rather than being transferred across to the transferee) although in practice it is less likely that the Bank of England would exercise its powers in these circumstances[3]. The clauses do not automatically prevent the exercise of the relevant contractual rights; instead the relevant transfer instrument would have to make provision to this effect. However, any legal opinions regarding the enforceability of set-off provisions or security interests would need to refer to the ability of the Bank of England to include such provisions in the relevant transfer instruments with a corresponding loss of legal certainty in this regard.

11. **The simplest solution for dealing with this issue would be to carve out, from the scope of any contractual overrides included in a transfer instrument, any provisions which would have an impact on set-off, netting or security. Some suggested wording is included in Appendix 2 to this note**.

12. A further issue in relation to clauses 22 and 38 (as currently drafted) is that the contractual overrides in those clauses are not limited to default event provisions in contracts to which the failing or failed UK bank is a party. The override can apply to a contract which references the failing or failed bank even where such a bank is not a party to the contract. For example, in a number of derivative products (including credit default swaps, equity derivatives, bond options and forwards), the troubled bank may be the "reference entity" or "underlying share" in respect of a contract between two other parties; in such a case, the payment or delivery obligations in the contract may be triggered by an event in relation to the troubled bank, even though the obligations are owed by and to two other parties (i.e. the

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[2] Where the security in question is financial collateral covered by the Financial Collateral Directive, it is not clear whether clauses 22 and 38, as currently drafted, are consistent with the UK's obligations under article 4(1) of the Financial Collateral Directive. This article requires Member States to ensure that, on the occurrence of an enforcement event (meaning an event of default agreed between the parties), the collateral taker should be able to realize the financial collateral in the manner provided for in article 4(1).

contracting parties). These types of derivative product are essential to the proper functioning of the markets. In the case of credit default swaps, these are an important means for a counterparty to limit its exposure to a particular entity (i.e. by buying protection against a default in relation to such party) and, if the proper functioning of such products is called into question by the Bill, counterparties' appetite for risk may be decreased accordingly.

13. We suspect that it is not the Authorities' intention for clauses 22 and 38 to impact upon contracts to which the troubled bank is not a party and so **this concern could easily be addressed by limiting the application of these clauses to contracts to which the failing or failed UK bank is a party. Some suggested wording is included in Appendix 2 to this note**.

14. Concerns have also been expressed regarding clause 75 of the Bill which enables the Treasury, by secondary legislation, to amend the law for the purposes of enabling the powers under the Bill to be used effectively (the so-called "Henry VIII clause"). It is helpful that this clause has now been amended so as to clarify that the Bill itself, and any secondary legislation made under the Bill, cannot be amended pursuant to the powers granted to the Treasury under clause 75. However, the clause is still very wide and would allow any other primary or secondary legislation to be amended. Furthermore, any amendment to the law made under this provision can have retrospective effect (clause 75(3)).

15. We therefore suggest two options in relation to this clause:

(a) **the clause could be deleted in its entirety –** the Government always has the power to amend existing legislation pursuant to the full and proper Parliamentary process and, as a constitutional matter, it should not be entitled to rely on "short-cuts" to this process. This would therefore be our preferred option;

(b) if the Tripartite Authorities are not prepared to delete the clause in its entirety, **clause 75(3) could be amended as follows so that any changes to the law made pursuant to clause 75 would only affect agreements entered into after the date of such change in the law**. This would protect counterparties' legitimate expectations as to their rights and interests at the time their contractual agreements were entered into

[3] The problem, however, is that legal opinions regarding the enforceability of set-off and netting arrangements would still need to be qualified in respect of the existence of this power in circumstances where the transactions in question are not transferred to the transferee, even if that power is less likely to be exercised than in circumstances where the transactions are transferred across to the new entity.

but could lead to a complex system in which different agreements would be subject to different regimes:

"An order under subsection (2)(c) may only affect agreements or arrangements entered into on or after the coming into force of such order and any agreements or arrangements entered into prior to this date shall continue to be governed by the law prior to such order."

Key concerns about secondary legislation in November Consultation and proposed solutions

16. We welcome the acknowledgments in the November Consultation as to the importance of set-off, netting and security, particularly from a regulatory capital perspective. We particularly welcome the protection that is now afforded to security arrangements. We are also pleased that the Tripartite Authorities have moved away from proposals that would simply protect certain defined "qualifying financial contracts" in favour of a much wider protection for set-off rights, subject to particular carve-outs and exclusions. We consider that any system based on protections for specified "qualifying financial contracts" would lead to arbitrary distinctions between what was, and was not, protected and could stifle product development and new markets[4].

17. We are however concerned about each of the exclusions that have been suggested. These concerns are set out in more detail in Appendix 4 and reflect concerns that have also been raised by others (such as the BBA, ISDA and the CLLS). There are strong arguments in favour of keeping the regime as clean and as straightforward as possible. If there are numerous and complex exclusions, there is a danger that counterparties (and, in particular, overseas counterparties) will not remember the detail but will just remember that there is an issue with set-off in the UK.

18. We consider that any approach to set-off (and any exclusions from the protections set out in the secondary legislation) should be done on a counterparty by counterparty basis rather than identifying particular types of rights or liabilities.

19. **One option would therefore be to have no carve-outs from, or exclusions to, the set-off provisions but simply to provide for the transfer of rights or liabilities of a particular counterparty on an all or nothing basis (i.e. either all of the counterparty's rights and**

liabilities would be transferred to the transferee or none of them would be transferred).

20. **A second option (and one which may be more attractive to the Tripartite Authorities for providing greater flexibility) would be to have a single carve-out for retail counterparties on the basis that such retail counterparties are generally not so concerned (as an economic matter) with rights of set-off or close-out netting**. By contrast, non-retail counterparties will have a legitimate interest in ensuring that rights of set-off are not interfered with and may be expected to levy a cost associated with the loss of that right or, in extreme cases, may cease to do relevant business with a UK bank where such a right of set-off may be in doubt. In the case of regulated counterparties, there are likely to be additional capital requirements as a result of the loss of that right. We understand from preliminary dialogue with UK banks that that cost will be very substantial (substantial multiples of additional capital required against nettable arrangements with UK banks). It should not be overlooked that unregulated entities will bear the same risks albeit that they are not subject to regulatory capital requirements. **We attach, as Appendix 3 to this note, some suggested amendments to paragraph 3 of the draft Safeguards Order (which forms part of the November Consultation) in relation to such an exclusion**.

[4] By way of example, we understand that the covered bond market has not been so successful in the United States as it has in the UK due to concerns as to whether such bonds would fall within the relevant safe-harbour provisions in the Federal Deposit Insurance Act.

Appendix 1

CLLS proposed amendments to clause 48 of Bill

[*Amendments recommended by the City of London Law Society to clause 48(1) of the Banking Bill 2008, as amended in Public Bill Committee of the House of Commons and ordered to be printed on 18 November 2008*]

48 Power to protect certain interests

(1) In this section—

(a) "security interest" means any legal or equitable interest or any right in security, (but not a title transfer collateral arrangement), created or otherwise arising by way of security, including a charge, mortgage, pledge or lien,

(b) "set-off or netting arrangement" is an agreement or arrangement between two or more parties under which Debt 1 can be set off or netted against Debt 2 to discharge or reduce the amount of Debt 2 or different claims or obligations can be converted into a single net claim or obligation (including under a close-out netting provision or a title transfer collateral arrangement), whether by contract, operation of law or otherwise, whether on a bilateral or multilateral basis or whether through the interposition of a clearing house, central counterparty, settlement agent or otherwise,

(c) "close-out netting provision" means a term of an arrangement, or any legislative provision under which on the occurrence of a specified event, whether through the operation of netting or set-off or otherwise -

(i) the obligations of the parties are accelerated to become immediately due and expressed as an obligation to pay an amount representing the original obligation's estimated current value or replacement cost, or are terminated and replaced by an obligation to pay such an amount; or

(ii) an account is taken of what is due from each party to the other in respect of such obligations and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party;

(d) "title transfer collateral arrangement" means an agreement or arrangement, including a repurchase agreement, evidenced in writing, where—

(i) the purpose of the agreement or arrangement is to secure or otherwise cover obligations owed to the collateral-taker;

(ii) the collateral-provider transfers legal and beneficial ownership in collateral to a collateral-taker on terms that when the relevant obligations are discharged the collateral-taker must transfer legal and beneficial ownership of equivalent collateral to the collateral-provider.

(2) The Treasury may by order—

(a) restrict the making of partial property transfers in cases that involve, or where they might affect, security interests or set-off or netting arrangements;

(b) impose conditions on the making of partial property transfers in cases that involve, or where they might affect, security interests or set-off or netting arrangements;

(c) require partial property transfers to include specified provision, or provision to a specified effect, in respect of or for purposes connected with security interests or set-off or netting arrangements;

(d) provide for a partial property transfer to be void or voidable, or for other consequences (including automatic transfer of other property, rights or liabilities) to arise, if or in so far as the partial property transfer is made or purported to be made in contravention of a provision of the order (or of another order under this section).

(3) An order may apply to arrangements generally or only to arrangements—

(a) of a specified kind, or

(b) made or applying in specified circumstances.

(4) An order may include provision for determining which arrangements are to be, or not to be, treated as security interests or set-off or netting arrangements; in particular, an order may provide for arrangements to be classified not according to their description by the parties but according to one or more indications of how they are treated, or are intended to be treated, in commercial practice.

(5) In this section "arrangements" includes arrangements which—

(a) are formed wholly or partly by one or more contracts;

(b) arise under or are wholly or partly governed by the law of a country or territory outside the United Kingdom;

(c) wholly or partly arise automatically as a matter of law.

(6) An order—

(a) shall be made by statutory instrument, and

(b) may not be made unless a draft has been laid before and approved by resolution of each House of Parliament.

Appendix 2

Proposed amendments to clauses 22 and 38 of the Bill

Clause 22

22(1) In this section "default event provision" means a provision of a contract or other agreement <u>to which the bank is a party</u> that if a specified event occurs:

(a) the agreement is terminated, modified or replaced,
(b) rights or duties under the agreement are terminated, modified or replaced,
(c) a right accrues to terminate, modify or replace the agreement,
(d) a right accrues to terminate, modify or replace rights or duties under the agreement,
(e) a sum becomes payable or ceases to be payable,
(f) delivery of anything becomes due or ceases to be due,
(g) a right to claim a payment or delivery accrues, changes or lapses,
(h) any other right accrues, changes or lapses, or
(i) an interest is created, changes or lapses.

(2) A share transfer instrument or order may provide for subsection (3) or (4) to apply (but need not apply either) <u>except that such an instrument or order shall not be disregarded in determining whether a default event provision applies if such default event provision is necessary or incidental to the exercise by the counterparty of any set-off or netting arrangement, or the enforcement of any security interest, as those expressions are defined in section 48</u>.

(3) If this subsection applies, the share transfer instrument or order is to be disregarded in determining whether a default event provision applies.

(4) If this subsection applies, the share transfer instrument or order is to be disregarded in determining whether a default event provision applies except in so far as the instrument or order provides otherwise.

(5) In subsections (3) and (4) a reference to the share transfer instrument or order is a reference to:

(a) the making of the instrument or order,
(b) anything that is to be, or may be, done under or by virtue of the instrument or order, and
(c) any action or decision taken or made under this or another enactment in so far as it resulted in, or was connected to, the making of the instrument or order.

(6) Provision under subsection (2) may apply subsection (3) or (4) generally or only for specified purposes.

Clause 38

38(1) In this section "default event provision" means a provision of a contract or other agreement <u>to which the bank is a party</u> that if a specified event occurs:

(a) the agreement is terminated, modified or replaced,
(b) rights or duties under the agreement are terminated, modified or replaced,
(c) a right accrues to terminate, modify or replace the agreement,
(d) a right accrues to terminate, modify or replace rights or duties under the agreement,
(e) a sum becomes payable or ceases to be payable,
(f) delivery of anything becomes due or ceases to be due,
(g) a right to claim a payment or delivery accrues, changes or lapses,
(h) any other right accrues, changes or lapses, or
(i) an interest is created, changes or lapses.

(2) A property transfer instrument may provide for subsection (3) or (4) to apply (but need not apply either) except that such an instrument shall not be disregarded in determining whether a default event provision applies if such default event provision is necessary or incidental to the exercise by the counterparty of any set-off or netting arrangement, or the enforcement of any security interest, as those expressions are defined in section 48.

(3) If this subsection applies, the property transfer instrument is to be disregarded in determining whether a default event provision applies.

(4) If this subsection applies, the property transfer instrument is to be disregarded in determining whether a default event provision applies except in so far as the instrument provides otherwise.

(5) In subsections (3) and (4) a reference to the property transfer instrument is a reference to:

(a) the making of the instrument,
(b) anything that is to be, or may be, done under or by virtue of the instrument, and
(c) any action or decision taken or made under this or another enactment in so far as it resulted in, or was connected to, the making of the instrument.

(6) Provision under subsection (2) may apply subsection (3) or (4) generally or only for specified purposes.

Appendix 3

Proposed amendments to paragraph 3 of draft Safeguards Order in the November Consultation

Annex

Revised Article 3

Set-off and netting (marked up version)

3.—(1) ~~Subject to paragraphs (3) and (4), a~~A partial property transfer to which this Order applies may not provide for the transfer of some, but not all, of the protected rights and liabilities between a particular person ("P") and a banking institution.

(2) For the purposes of paragraph (1), rights and liabilities between P and a banking institution are protected if they are rights and liabilities of P which P is entitled to set-off or net under a set-off or netting arrangement so long as they are not excluded rights or excluded liabilities.

(3~~) Paragraph (1) does not apply if the only protected rights and liabilities which are not transferred are foreign property (within the meaning of section 36(2) of the Act).~~

~~(4) Paragraph (1) does not apply if only liabilities of the banking institution to P are transferred.(5~~) For the purposes of paragraph (2), it is immaterial whether—

(a) the set-off or netting arrangement which permits P to set-off or net rights and liabilities also permits P or the banking institution to set-off or net rights and liabilities with another person; or

(b) P's right to set-off or net is exercisable only on the occurrence of a particular event.

(~~6~~4) In paragraph (2)—

"excluded rights" means rights~~—~~

~~(a)~~ which relate to a ~~deposit (within the meaning of article 5 of the Regulated Activities Order(**b**)) made by P with the banking institution;(b) which relate to a regulated mortgage contract (within the meaning of article 61 of Regulated Activities Order(**c**))~~contract between the banking institution and P~~;~~

~~(c) which arose otherwise than in the course of the banking institution entering into a contract in the course of carrying on its business as a banking institution;~~

~~(d) which relate to securities issued by the banking institution or by P;~~

~~(e) [ ]~~, where P is a retail counterparty and "excluded liabilities" shall be interpreted accordingly;

"retail counterparty" means—

(a) a depositor who is specified under the Financial Services Compensation Scheme as eligible for compensation in the event of the banking institution becoming unable, or likely to become unable, to satisfy claims against it; or

(b) a person who would be so specified were he a depositor;

"set-off or netting arrangement" has the meaning given in section 48 of the Act.

~~(7) For the purposes of paragraph (c) of the definition of "excluded rights", contracts entered into by the banking institution with the principal purpose of securing the supply of services (other than the provision of credit) or of goods (other than cash or a specified investment within the meaning of section 22 of the Financial Services and Markets Act 2000, read in conjunction with the Regulated Activities Order) are to be treated as having been entered into by the banking institution otherwise than in the course of carrying on its business as a banking institution; this paragraph also applies for the purposes of the definition of "excluded liabilities".~~

Set-off and netting (clean version)

3.—(1) A partial property transfer to which this Order applies may not provide for the transfer of some, but not all, of the protected rights and liabilities between a particular person ("P") and a banking institution.

(2) For the purposes of paragraph (1), rights and liabilities between P and a banking institution are protected if they are rights and liabilities of P which P is entitled to set-off or net under a set-off or netting arrangement so long as they are not excluded rights or excluded liabilities.

(3) For the purposes of paragraph (2), it is immaterial whether—

(a) the set-off or netting arrangement which permits P to set-off or net rights and liabilities also permits P or the banking institution to set-off or net rights and liabilities with another person; or

(b) P's right to set-off or net is exercisable only on the occurrence of a particular event.

(4) In paragraph (2)—

"excluded rights" means rights which relate to a contract between the banking institution and P, where P is a retail counterparty and "excluded liabilities" shall be interpreted accordingly;

"retail counterparty" means—

(a) a depositor who is specified under the Financial Services Compensation Scheme as eligible for compensation in the event of the banking institution becoming unable, or likely to become unable, to satisfy claims against it; or

(b) a person who would be so specified were he a depositor;

"set-off or netting arrangement" has the meaning given in section 48 of the Act.

Appendix 4

Concerns about current exclusions from set-off and netting protections in the draft Safeguards Order

As discussed above, we have concerns about each of the carve-outs from the set-off and netting protections which have currently been proposed in the November Consultation and the draft Safeguards Order. We discuss each below.

(i) Foreign Property

Paragraph 3(3) carves out foreign property. Arrangements involving foreign property are widespread, and will typically include repurchase and stocklending arrangements (where the securities sold or lent are held with a foreign depositary or custodian), prime brokerage agreements and exchange-traded derivatives clearing agreements. If foreign property forming part of a nettable arrangement may be ignored for the purposes of the safeguards, this raises the possibility of the Authorities cherry-picking nettable arrangements which include foreign property.

Most foreign property arrangements will be with foreign counterparties. In an international financial centre, any suggestion that foreign counterparties should suffer worse consequences than domestic ones seems highly unpalatable (and possibly in breach of our European obligations).

The ability to cherry-pick foreign nettable arrangements is also fundamentally inconsistent with the regulatory capital regime, as it will prevent counterparties from receiving opinions as to the enforceability of such arrangements in accordance with applicable regulation.

Appreciating that the issues raised by foreign property are intractable given the jurisdictional limits of UK law, we believe that the only way to leave the UK banking industry competitive in the international markets is to **carve out all netting arrangements involving foreign property from the partial transfer powers.**

(ii) Liabilities-only transfer

Paragraph 3(4) permits a liabilities-only transfer. Such a transfer may be commercially desirable from the perspective of a counterparty (if it receives performance of its contract by the transferee) but this assumes that the transferee does not fail and remains in a position to perform its obligations.

Furthermore, the carve-out contravenes regulatory capital requirements. If the Authorities have the power to transfer all the liabilities owed to any of a bank's counterparties, banks would not be able to obtain clean legal opinions on any netting agreement. This in turn would render all nettable arrangements ineffective for regulatory capital purposes, with significant negative consequences for regulated counterparties. The carve-out should be deleted.

(iii) Deposits

Paragraph 3(6)(a) carves out deposits. It is understood why the Authorities might wish to carve out retail deposits – this is conceptually in line with the carve-out for regulated mortgage contracts in sub-paragraph (b) – but the draft statutory instrument allows for the carve out of all deposits.

This would cast doubt on the enforceability of on-balance sheet netting agreements for counterparties, and any set-off/netting agreements which included deposits would not be eligible for net regulatory capital treatment in the hands of a regulated counterparty.

We believe that this carve-out should be limited to retail exposures – i.e. all rights and liabilities (including under deposits) in respect of a retail counterparty.

(iv) Regulated mortgage contracts

Paragraph 3(6)(b) carves out regulated mortgage contracts. We have some sympathy with the policy of carving out regulated mortgage contracts (as they are exposures to retail counterparties) but believe that a wider carve-out applying to all retail exposures – i.e. all rights and liabilities (including under regulated mortgage contracts) in respect of a retail counterparty – would be wider and give the Authorities greater flexibility.

(v) Non-banking exposures

Paragraph 3(6)(c) carves out non-banking exposures. We do not understand the policy grounds for carving out non-banking business exposures. In addition to the inevitable problems identifying the border between the banking and non-banking business of an institution, the carve-out is inconsistent with the regulatory capital position and seems to be *de minimis* in terms of likely impact. We believe that it should be deleted.

(vi) Self-issued securities

Paragraph 3(6)(d) carves out securities issued by the banking institution. We do not understand the policy grounds for carving out exposures relating to self-issued exposures. It is suggested in the consultation paper that this is aimed at subordinated securities but such securities are unlikely to be available for set-off in any event. The carve-out would also render nettable arrangements involving self-issued securities ineffective for regulatory capital purposes, with significant negative consequences for regulated counterparties. The effect would be that banks would be unable to use self-issued securities as collateral for repurchase or stock lending arrangements (other than where those arrangements fell under the Financial Collateral Directive). It seems to serve no specific purpose and should be deleted. If the Authorities do have specific concerns about subordinated securities, the carve-out should directly reflect such concerns and should not extend to all self-issued securities, including *pari passu* corporate bonds.