MEMORANDUM SUBMITTED BY THE FINANCIAL MARKETS LAW COMMITTEE (BAN 04)

1 Introduction and Executive Summary

a) Introduction

1.1. The role of the Financial Markets Law Committee ("FMLC") 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. It is beyond the remit of the FMLC to offer opinions on issues of policy. Accordingly, the submission focuses on the issue from the perspective of legal certainty only.

1.3. The FMLC has commented previously (in April, July and September 2008) on the Government's proposals for the introduction of a special resolution regime ("SRR") for UK-incorporated banks.[1] These proposals are now embodied in the Banking Bill published on 7 October 2008.

1.4. The FMLC has been asked by HM Treasury to nominate a member to participate in the Expert Liaison Group, recently set up to advise on the subordinate legislation which it is expected will be made under powers contained in the Bill. Certain related concerns will, therefore, be communicated through this channel and this paper will not seek exhaustively to address every issue that of which the FMLC has been apprised.

b) Executive Summary

1.5. In its current form, the Banking Bill gives rise to issues that are of fundamental importance to the continued proper working of the UK financial system. Very serious consequences are likely to arise, in particular, from the possible erosion of the certainty of efficacy of security and netting/set-off arrangements.[2] This erosion will take place when provisions come into force which confer powers on the Tripartite Authorities to override a bank's contracts with counterparties in the event that it is subject to a special resolution. These powers were among those referred to during the consultation period as the "stabilisation powers".

2 Credit risk mitigation, and gross and net positions generally

2.1 The risk that lenders may not be repaid in full is inherent in the activity of lending money. Credit risk is part of the risk with which financiers perennially live. What makes the risk manageable-and the activity feasible-however, is that lenders can always reliably calculate the maximum amount which they are at risk of losing. Further, the effectiveness of established credit risk mitigation arrangements, including security, netting and set-off, means that the maximum exposure in question can be assessed and accounted for on a net basis.

2.2 If these credit risk mitigation arrangements were susceptible to being overridden under the powers conferred by the Banking Bill, any calculation of the maximum loss itself would doubtless increase significantly. In contrast, under *current* UK law (and indeed the laws of most developed jurisdictions) security and netting/set-off techniques are generally protected in the event of insolvency and similar procedures.

2.3 It should be noted that such credit risk mitigation arrangements are usually only effective for commercial or regulatory purposes if, and to the extent that, they are guaranteed to be operative and enforceable in all situations, up to and including insolvency (where of course they are most valuable). The relevant regulatory requirements are reflected in the Basel II Accord, the European Capital Requirements Directive (the "CRD"), and in rules published by the Financial Services Authority ("FSA") (which, because of the constraints imposed by the CRD, the FSA has limited ability to waive or vary). These requirements oblige institutions to ensure that credit risk mitigation arrangements are backed up by "clean" legal opinions on their effectiveness in all circumstances, including insolvency. *Without absolutely reliable and all-encompassing safe-harbours from the impact of the stabilisation powers contained in the Special Resolution Regime, and in particular the partial transfer provisions, it is unlikely that legal opinions on transactions with UK banks would satisfy market counterparties or their regulators.*

2.4 In other words, banks throughout the world (including other UK banks) may only be able to report exposures to UK banks on a net, secured or collateralised basis to the extent that the relevant netting, security or collateralisation mechanics are absolutely protected from the impact of the Banking Bill and the stabilisation powers (in particular, the powers as it is expected they may be exercised if the "partial transfer" tool is used and certain contracts are transferred to a "bridge bank").

2.5 The difference between, on the one hand, the gross, and on the other hand, the net/collateralised exposures of any one financial institution to another is immense. Indeed, the scale of market participants' reliance on netting and security is such that, if this aspect of the Banking Bill-namely, the implementation of the stablisation powers-is not managed appropriately, there is every risk that regulated financial institutions in almost any developed jurisdiction may find themselves deterred on commercial or regulatory grounds from dealing with UK banks (i.e., if they calculate that their exposures with those banks must be assigned regulatory capital on a gross basis).

2.6 The Banking Bill contains reference to a number of safeguards-largely those which are to be implemented in secondary legislation pursuant to Clause 43-designed to prevent this scenario occurring. However, it is important to consider the regime devoid of safeguards for two reasons: first, it highlights the need to have secondary legislation in force by the time the Banking Bill itself comes in force. (Otherwise, the legal certainty required for net reporting will not exist for a time, with the consequences outlined above.)

2.7 Second (as discussed further below), to the extent that any credit risk mitigation techniques are not safeguarded from the stabilisation powers conferred under the Banking Bill regime, then the position outlined above will apply to all such arrangements. This could have the following unintended consequences:

(i) decreasing the attractiveness of UK banks as borrowers and counterparties, by increasing the relative cost of doing business with them. This would create an unlevel playing field to the disadvantage of UK banks and would prejudice the ability of UK banks to deal with each other;

(ii) creating a strong motivation for banks to move significant elements of their business to-or possibly even to re-incorporate in-other jurisdictions;

(iii) increasing the systemic risk in the UK system, by leading to the sudden recharacterisation of net exposures to UK banks as gross exposures;

(iv) disincentivising institutions from putting netting or other credit risk mitigation techniques in place. This would increase systemic risk in the financial system.

3 Security

3.1 Credit risk mitigation techniques largely fall into two categories: (i) financial collateral and other arrangements for conferring security interests ("security arrangements"); and (ii) netting/set-off arrangements. [3]

3.2 Security arrangements could be undermined by the stabilisation powers set out in the Banking Bill which permit interference with contractual arrangements, and also by the splitting of the secured liability from the charged asset under a partial transfer. However, the FMLC understands that the Government does not intend to undermine the efficacy of security arrangements in this manner, except in respect of some or all floating charges.

3.3 The exclusion for floating charges raises a difficult technical issue in relation to recent developments in both law and market practice, namely the increased commercial use of charges over single assets which reserve a significant degree of control to the chargor and the (re)characterisation of those charges as floating charges rather than fixed charges, regardless of the language used by the parties to the charge.[4] Common examples include:

(i) a bank account which the chargor is allowed to continue to use;

(ii) a pool of receivables where the chargor is allowed to continue to collect the debts; and

(iii) a pool of financial instruments where substitution rights and continuing margining provisions allow the chargor some control over the make-up of the pool.

3.4 If these types of arrangement are not safeguarded from the stabilisation powers, the commercial and regulatory impact could be very serious.

3.5 As an aside, the FMLC would strongly recommend that the Government does not follow the attempts to distinguish between these different types of floating charge in the *Financial Collateral Arrangements (No2) Regulations 2003* (the "FCAR"), as the ambiguities in the FCAR in exactly this regard have led to those Regulations being treated as lacking sufficient certainty to be relied on in a wide range of security arrangements, particularly in the banking markets (see also below).

4 Netting and Set-off

4.1 Netting and set-off techniques are the basis of very common quasi-security arrangements. These have the effect of reducing systemic risk, by reducing the total exposures in the system from gross to net positions. Common examples include the close-out netting arrangements under the ISDA Master Agreement and the set-off arrangements under the GMRA Master Agreement (for repos) and the GMSLA Master Agreement (for stock loans). However, there are also a huge number of bilateral and bespoke netting and set-off arrangements beyond these master agreements. These include both cross- product netting arrangements and one-off arrangements of quasi-security over the types of assets which are commonly the subject in other circumstances of actual security arrangements.

4.2 Arrangements of this kind vis-à-vis a UK incorporated bank could become ineffective if that bank were subject to an SRR, either through a partial transfer (if the obligations to be netted/set-off were now located in two different legal entities, thereby destroying the mutuality needed for netting/set-off arrangements to be effective in insolvency), or simply by exercise of the stabilisation powers, in particular the powers to override contractual provisions.

4.3 There is provision in the Bill for secondary legislation which would create a list of approved types of netting/set-off arrangement which would be protected from the impact of the stabilisation powers, leaving other types of arrangement outside such protection. This would give rise to significant problems: any distinction between different types of netting/set-off arrangement would be artificial in practice. It would create unacceptable uncertainty for the markets given the inherent difficulty of deciding whether any particular agreement fell within the approved category.

4.4 It should also be noted that the experience of other jurisdictions in creating protections for some, but not all, types of arrangements is that such an approach leads to a substantial stifling of innovation, to the detriment of the efficiencies of the market as a whole. The most obvious example is the artificialities and brakes on developments created by the "securities contract" regime under Chapter 11 of the US Uniform Commercial Code.

4.5 *The optimal approach is that, on a partial transfer, any pre-existing netting and close-out arrangements should continue to be effective. Where there is provision for netting across transactions, and the benefit of one transaction has been transferred but not the other, sustaining the effects of the netting arrangement will require an exception to the normal rules requiring mutuality, on insolvency.* Other similar exceptions may also be required.[5]

4.6 A related concern is that clause 43 of the Bill may only address the type of arrangements falling within the scope of the FCAR. In this context, it should be noted that, partly as a result of the drafting of the relevant EU Directive, the FCAR are the subject of material criticism by academics and practitioners, in particular for the ambiguity and obscurity of their drafting.[6] It would therefore be extremely unfortunate if they were used as a hook on which to hang any protections. As the FCAR themselves are purely permissive, the lack of clarity in the drafting is something with which, in this context, the markets can deal. However, in the context of a vital safe harbour from draconian powers to override commercial contracts, the language of the FCAR would be wholly inadequate. In any event, the FCAR were only intended to address part of the universe of netting and set-off arrangements, whereas the arrangements which can currently be reported net are very much wider.

5 Other Protections?

5.1 The code of practice mentioned in Clause 5 will not be legally binding. It is possible that it might provide some psychological (rather than legal) comfort to participants in the financial markets. However, it will be of no use at all in determining the legal rights of the parties, which is what matters for regulatory-and ultimately commercial-purposes.

5.2 The proposed provision of compensation under Clause 55 (known colloquially as the "no creditor worse off" safeguard) is also intended to give some comfort, depending on the form of the secondary legislation. However, as a commercial matter, the timing and basis of valuation and the payment of compensation would raise problematic issues. More pertinently, as a legal matter, in order to allow legal opinions to be given that the effect of any security or quasi-security arrangements would always be achieved, the secondary legislation would have to provide for the UK Government to give a complete indemnity to counterparties for any loss suffered by them if such arrangements are undermined, to allow them to close out their own hedges and other positions as they see fit in order to determine that loss, and to claim for immediate payment from the Government.

6 Clause 65

6.1 Clause 65 contains an extremely widely drafted power allowing the Executive to modify legislation (both primary and secondary) by order. The power is subject to the affirmative procedure. This is of particular concern for the following reasons:

(i) amending primary legislation by order is not generally considered good practice by constitutional experts;

(ii) the order may make provision which has retrospective effect[7]-an objective which has often been criticised from a Rule of Law perspective;

(iii) the only limit on the exercise of the power to make an order with retrospective effect is that the Treasury has to "consider it necessary or desirable"[8]-by giving the Treasury what is effectively an unfettered discretion, this in practice removes any objective criteria against which the Treasury's decision could be judged e.g. by way of judicial review. This gives rise to the impression that the Clause seeks to prevent proper judicial control.

6.2 Whilst it is recognised that the Authorities need to be able to act quickly in certain circumstances, this in itself does not obviate the desirability of their operating within the checks and balances inherent in the parliamentary scrutiny process and, where necessary, the scrutiny of the courts. Bearing in mind the fact that the Bill already gives the Authorities the power to intervene as they deem appropriate, it should not be necessary to have this clause.

6.3 If the Clause is not redrafted so as exclude the possibility of its being used to amend the Banking Act itself and secondary legislation thereunder, it will undermine the protections afforded to creditors by creating very significant legal uncertainty. With Clause 65 incorporated, the practical construction of the Banking Act and related secondary legislation would be that they have unlimited powers in relation to a UK-incorporated bank with a deteriorating credit rating, despite the safeguards discussed above. If it is not in fact intended that Clause 65 should be used self-referentially to amend the Banking legislation, it would be helpful if this restriction were made explicit so as to avoid giving undue concern to the financial markets.

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[1] The three papers are available on the FMLC website at www.fmlc.org.

[2] There are other types of arrangements having a similar effect on limiting credit risk, and which are recognised by the Basel II regime and the European and national legislation implementing that regime. These include financial and other guarantees, and credit derivatives. Whilst outside the scope of this paper, these will need to be appropriately addressed in the final form of the legislation.

[3] Although see footnote 2 above on other types of arrangement.

[4] *National Westminster Bank plc plc v Spectrum Plus Ltd* [2005] UKHL 41.

[5] No doubt the Government will wish to be able to sell on the bridge bank, and to know the value of its assets in order to do so. To achieve this, the bill should provide that the close-out/termination provisions, while not being able to be triggered so as to block a transfer to a bridge bank, could be invoked immediately after transfer. This would leave the bridge bank with a quantified closed out position, allowing a sale. This would be consistent with the partial transfers regime of Part VII of the Financial Services and Markets Act 2000.

[6] For example, there has been widespread criticism of the absence of a definition of "control" in both the Directive and the Regulations. See "Using Intermediated Securities As Collateral: equitable interests with inequitable results" (2007) 2 JIBFL 70, by Geoffrey Davies, which refers to the fact that the City of London Law Society Financial Law Committee raised this point in its response to the European Commission's questionnaire evaluating the directive.

[7] See clause 65 (3).

[8] See clause 65 (3).