



Amendments recommended by the City of London Law Society to clause 48(1) of the Banking Bill 2008

[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 and including, in relation to Scotland, a heritable security,
- (b) “set-off or netting arrangement” is an agreement or arrangement between two or more parties under which Obligation 1 can be set off or netted against Obligation 2 to discharge or reduce the amount of Obligation 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 and whether through the interposition of a clearing house, central counterparty, settlement agent or otherwise,
- (c) “set-off” includes, in relation to Scotland, compensation, retention and/or balancing of accounts, as the case may require,
- (d) “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;
 - (e) "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 the same or 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, title transfer collateral arrangements 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, title transfer collateral arrangements 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, title transfer collateral arrangements 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, title transfer collateral arrangements 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, or by the exercise of rights arising, 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.

NOTES ON THE PROPOSED AMENDMENTS

The proposed amendments are technical, but deal with two fundamentally important distinctions in the financial law of the United Kingdom, namely:

1. between a security interest and a title transfer arrangement; and
2. between set-off and netting.

It is important that the Banking Bill not undermine these distinctions, first to protect the integrity of the Banking Bill itself and of the safeguards under clause 48 and to protect the integrity of these concepts more generally under English financial law.

The proposed amendments to the definitions in clause 48(i) are designed to achieve this and also to ensure consistency with the definitions used in the Financial Collateral Arrangements (No. 2) Regulations 2003. The redraft of "security interest" and the new definitions of "close-out netting provision" and "title transfer collateral arrangement" are based on similar definitions used in those Regulations.

Security interests and title transfer

A security interest gives A an interest in the property of B. A title transfer arrangement does not. Instead, B transfer title to property to A and, if B defaults, A is able to set off or net the debt due to A against the value of the transferred property. So a title transfer arrangement is a type of set-off or netting arrangement.

Both approaches are widely used in the financial markets, and each has its advantages and disadvantages. There are important differences between the legal consequences of each approach, even though they have a similar economic effect.

Security interests are more commonly used in traditional banking, including residential lending. Title transfer arrangements are the basis of the securities lending and repo markets and also most financial collateral arrangements used in the derivatives markets.

The Financial Collateral Arrangements Directive (2002/47/EC) recognises the distinction between the two approaches and this distinction is preserved in the UK implementation of that Directive under the Financial Collateral Arrangements (No. 2) Regulations 2003.

The bracketed language in the current definition of "security interests" in sub-clause (a) of clause 48(1) is therefore incorrect. But because every title transfer financial collateral arrangement is a form of set-off or netting arrangement, a version of the bracketed language may be included instead in sub-clause (b) of clause 48(1). We note that this same language appears in clause 242(2)(c) of the Banking Bill, which should also be corrected.

We suggest that a "title transfer collateral arrangement" should be eligible, for the purposes of clause 48, to the same protection as a "security interest" and that clause 28(2) be amended appropriately.

Set-off and netting

Set-off is a fundamental concept of English law, the origin of which may be traced back to medieval law and possibly earlier. English law provides for contractual, equitable, procedural (in court proceedings) and statutory insolvency set-off, and includes specialised forms of set-off, such as a banker's right to combine accounts. Scottish and Northern Irish law also provide for various forms of set-off in commercial and financial transactions.

Netting is a much more recent concept, but it is of fundamental importance in reducing risk in the financial system, as the tripartite Authorities have recognised in their consultation documents on the proposed special resolution regime and bank insolvency and administration procedures. Netting is now widely recognised and protected by various statutory provisions at European level and in various UK statutes and regulations, including section 163 of the Companies Act 1989 and the UK regulations implementing the Collateral Directive and the Winding Up Directives for credit institutions and insurance undertakings. Those Regulations deal in separate clauses with set-off and netting, acknowledging the distinction between these concepts.

A netting arrangement is a contractual arrangement (so, in that sense, it is a narrower concept than set-off, which may also be equitable, procedural or statutory) that reduces a group of related claims between A and B to a single net claim owed by A to B or B to A. A netting arrangement may use contractual set-off to determine the net claim, but there are other legal techniques that may be used instead of contractual set-off (so, in that sense, netting is a broader concept than contractual set-off). Most financial market master agreements are not based on contractual set-off but involve the use of conditional clauses to achieve netting.

It is important to preserve the distinction between set-off and netting by appropriately amending sub-clauses (b) and (c) of clause 48(1) as proposed in our suggested amendments.

We suggest that, in the definition of "set-off or netting agreement", the terms "Debt 1" and "Debt 2" be changed to "Obligation 1" and "Obligation 2" as it would be restrictive to protect the set-off or netting of debts when debts are a sub-category of obligations.

Netting in clearing houses, investment exchanges and designated systems

It is important that the set-off or netting rights to be protected under Clause 48 of the Bill include close out netting exercisable under "default rules" and in "default proceedings" (within the meaning of section 188(1)&(3) of the Companies Act 1989) of a recognised clearing house or recognised investment exchange or in the "default arrangements" (within the meaning of regulation 2(1) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999) of a designated system. Similarly, pre-default netting within a clearing house, exchange or system should also be protected. For this reason we have amended the definition of "set-off or netting agreement" and, at the end, added the words "and whether on a bilateral or multilateral basis and whether through the interposition of a clearing house, central counterparty, settlement agent or otherwise". This wording is taken from the end of the definition of "netting" in regulation 2.1 of the above Regulations.

Scots law

In order to ensure that the relevant but different concepts of Scots law are covered by Clause 48, we suggest that "security interest" be defined to include, in relation to Scotland, a heritable security and that "set-off" be defined to include, in relation to Scotland, compensation, retention and/or the balancing of accounts, as the case may require. Although the Law Society of Scotland's Banking Law Committee has not yet had an opportunity to review Clause 48 of the Bill, our suggested amendments reflect the personal comments and suggestions received from a member of that Committee.

Trusts

We also suggest that trust interests be added to the interests protected under Clause 48(2). We understand that, as there are no equitable interests in Scots law, trusts are often used in commercial situations in Scotland where equitable transfers or interests are used in England, such as in debt factoring, securitisation and even repos. Trusts are also constituted under Regulations 31(4) & (7) and 42(11)(d) of the Uncertificated Securities Regulations 2001 to provide protection when Scottish shares move out of CREST (and pursuant to certain other legislation). We should be glad to provide suggested language for this purpose, in liaison with the Law Society of Scotland's Banking Law Committee, if this would be helpful.

The City of London Law Society (CLLS) represents over 13,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. These recommended amendments to clause 48(1) of the Banking Bill 2008 have been prepared by the Financial Law Committee. The Committee is made up of a number of solicitors from City of London firms who specialise in financial law. The Committee's purpose is to represent the interests of those members of the CLLS involved in this area.