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Financial Law Committee response to the Working Document of the European Commission on Technical Details of a Possible EU Framework for Bank Recovery and Resolution (the "Working Document")

Information about the respondent

1. The City of London Law Society (CLLS) represents approximately 14,000 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.

2. The CLLS responds to consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS Financial Law Committee, made up of solicitors who are experts in their field, has prepared the comments below on the Working Document, from the perspective of English law. Details about the membership of the working party are set out on page 17 below.

3. The CLLS is registered in the Interest Representative Register of the European Commission under **registration number 24418535037-82**. If the Commission wishes to make available on its website the responses received to the Working Document, the CLLS authorises the inclusion of this paper amongst those responses.

4. Unless otherwise stated, references in this response to Sections are to Sections of the Working Document.

Preliminarily comments

5. We welcome the broad objectives of the proposed legislation and in particular support the aim of ensuring that authorities in Member States have the necessary resolution tools to take fast and effective action to ensure the minimum of disruption to financial markets, the continuity of essential financial services and the avoidance of legal uncertainty. We also welcome the adoption of resolution tools and safeguards similar to those introduced in the UK by the Banking Act 2009. There are, however, a number of points on which the proposals are unclear or require further consideration. In particular we consider that:

   (a) The potential adverse consequences and complications of a temporary suspension of delivery or payment obligations, and of the exercise of close-out netting, proposed in Sections G12 and G13 are likely to outweigh any potential benefit of providing a short "breathing space".

   (b) We welcome the safeguards in Section H for counterparties and market arrangements that may otherwise be affected by a partial property transfer but consider that further safeguards are required (in addition to that based on the Settlement Finality Directive) to protect trading, settlement and payment systems and to preserve certainty, efficiency and stability on financial markets. We also consider that the safeguard for structured finance arrangements requires more detailed consideration and fuller consultation.

(c) If the proposals in Annex 1 to the Working Document for write down of the debt of a failing institution or conversion of debt into equity (referred to in the Working Document as "bail-in") are to be taken forward, they will need to be developed in much greater detail and address the issues summarised by us. Given the complexity of these issues, we have serious concerns whether they can be addressed in the timeframe contemplated by the Working Document.

Response to general approach

6. We note that any proposed resolution regime necessarily involves trade-offs between the private law rights of stakeholders in banks and the perceived need to take action in the interests of financial stability. The proposed framework therefore raises important questions of legal certainty and how best to uphold the legitimate expectations of market participants. We take the view that any interference with private law rights should be kept to the minimum necessary to achieve the aims of the regime. In particular, detailed consideration is needed to assess whether the additional powers, such as the power to write down debt, are workable and a proportionate means of upholding financial stability.

7. The preparatory and preventative powers, and early intervention powers, contemplated in the proposals are excessively broad and would probably be unworkable in practice. In our view, the threshold that must be reached before a preventative power could be exercised by a resolution authority is too low and would create significant uncertainty - resolution authorities needing only to be satisfied that impediments to resolution exist in any "conceivable situation". We note also that certain "preventative" powers - such as the power to prevent firms from developing or selling new business products or services - may have the unintended consequence of paradoxically making bank failure more likely.

8. In terms of the early intervention powers, we are especially concerned that a firm which is still very much a going concern could nonetheless be subject to substantial interference by a resolution authority. Furthermore, if exercised, it might prove impossible to keep the exercise of certain of the early intervention powers confidential from the market, such as the replacement of a board member, or the restricting of a firm's business activities. If the exercise of such powers became known, it is likely to excite market attention, which would be counterproductive. For this reason we are not convinced that supervisors should be given the power to appoint a special manager as an early intervention measure. We suggest that, if a firm is resolvable, and subject to a resolution framework being established, then there appears to be little or no justification for the exercise of these further powers.

9. In considering the possibility of a cross border resolution regime, the Commission needs to bear in mind that its current proposals, like those in the UK, seem to contain two elements:

(a) plans for recovery from financial difficulties without formal resolution processes, preserving the prospect of value recovery for equity investors;

(b) formal resolution processes, which, although they may restore the core businesses or some of them to financial health and safeguard those which are not individually failing, will almost inevitably lead to the winding up of one or more companies in the group and usually involve the loss of substantially all value for shareholder investors in the top company of the affected group (which may well be a quoted company).

10. In legislating it will be very important to distinguish provisions that should only apply to one or the other of the two cases. Where a financial institution can raise capital in the markets itself so as to prevent its situation being a threat to financial stability, this is the best outcome for the business, its shareholders, employees and customers and for the economy as a whole. Care should therefore be taken not to trigger the formal resolution process without having fully explored the possibility of recovery.

11. It is questionable whether solutions which are most effective pre-formal resolution – which would include the raising of additional equity capital, the conversion of contingent convertible capital instruments and/or a "bail-in" debt instruments or a scheme of arrangement with creditors – should be addressed in the context of resolution or dealt with in the context of pre-resolution prudential regulation. In any event, such measures need to be treated separately in the legislation, so that measures which could result in a full recovery could be utilised without the stigma of a formal resolution process, which in itself can be expected usually to lead to total loss of value for equity providers and substantial losses for most creditors. It is important that the "bail-in" process could not be triggered too early. The trigger would need to be based on serious events such as a threat to financial stability.

12. The proposals also need to acknowledge the jurisdictional limits of European Union law. Many EEA banks operate globally and have extensive operations outside the European Union. Absent broader international agreement on bank recovery and resolution, the efficacy of the proposed framework would be limited in relation to banking arrangements involving foreign property (in respect of which resolution authorities of Member States would not have jurisdiction to apply resolution tools) and any systemic risks brought to bear on EEA banks as a result of their counterparty exposure to foreign banks subject to "light touch" regulatory regimes. In order to be able to act decisively to prevent bank failure, it is essential that tools used in the European Union and the rest of the world are deployed in a coherent manner and are mutually recognised.

13. We also take the view that neither broad resolution powers nor broad resolution tools alone will be sufficient to uphold financial stability in the European Union. Diligent supervision by well-resourced and competent authorities in each Member State is critically important.

Response to recovery plan proposal

14. Recovery plans for individual institutions would vary enormously according the circumstances in which recovery is necessary. For instance, a financial institution that was a victim of fraud in a buoyant market is differently placed in relation to available tools and responses, than a company which, like many others, is suffering from a market wide lack of confidence and liquidity affecting many institutions (as in the recent crisis). While at an individual level the "living will" (which gives an in depth view of the business) would be useful for both efficient recovery and resolution, there would be no value in trying to anticipate what tools might best be used, such as sale of part of business, capital raising, or business wind-down.

Reponses to specific questions raised in the Working Document

15. We set out below our comments on a number of the questions raised in the Working Document. We have concentrated primarily on the proposals set out in Sections G12, G13 and H and Annex 1. The fact that we have not commented on other aspects does not necessarily mean that we will not have comments on these aspects when legislative proposals are put forward.

Question 18b: If adopted, should either be subject to a time limit (for example, the priority claim or claw back right would apply only if the relevant insolvency is commenced within a specified period - such as 12 months - after the transfer)?

16. A transaction may be challenged under a number of provisions of English law, including section 238 (*Transactions at an undervalue*), section 239 (*Preferences*) and section 245 (*Avoidance of certain floating charges*) of the Insolvency Act 1986. Such a challenge must be brought within a specified period after the onset of insolvency. This period is extended where the parties to the transaction are "connected". There may be a case for disapplying the "connected persons" rule where the financial support provided by another group company has been approved by the regulator.

Question 30b: In particular, is it necessary to include a general principle that creditors of the same class should be treated equally or should resolution authorities be able to derogate from this principle in specific circumstances?

17. We consider that this general principle should be adhered to as closely as possible. Where an exception is made to the principle, the exception should be clear and predictable so as to avoid legal uncertainty.

18. We note that the first limb of principle (d) in Section F4 is not necessarily consistent with the practical effect of resolution (as unsecured senior creditors generally may not be treated pari passu). This will need to be reflected in the legislation to avoid creating rights of action on the part of disenfranchised creditors.

Question 39a: Should all Member States be required to make provision in national law for all three mechanisms by which resolution can be carried out that are suggested above? If the same mechanisms are not available in all Member States, could this pose an obstacle to co-ordinated cross-border resolution?

19. Yes, we believe that all three mechanisms should be adopted by each Member State in order to ensure that it has an adequate choice of options.

Question 39b: Should receivership - which allows resolution authorities to take full control of the failing institution - be the primary framework for resolution?

20. No, we suggest that each Member State should be able to choose either administration or receivership, depending on the circumstances involved.

Question 42: Please give your views on the suggested temporary suspension of payment or delivery obligations? Is it appropriate to exclude eligible deposits? Should any other obligations be excluded?

21. A temporary suspension of payment or delivery obligations would be a source of considerable uncertainty for market participants for the reasons explained in paragraph 26 below. We do not support this proposal. A temporary suspension was not considered to be necessary when the UK introduced its own bank resolution regimes under the Banking Act 2009.

22. If the aim of the suspension power is to allow a short breathing space, we consider that this could effectively be achieved in the case of the failure of a major international investment bank only by suspending the whole of the markets in which it operates. This would be a very draconian measure and would require co-ordinated action between regulators in the main financial centres.

23. Although the terrorist attacks in New York on 11 September 2001 resulted in the New York Stock Exchange being closed for four days and all other US stock exchanges (including NASDAQ) and US option exchanges being closed, no purely financial crisis of the last twenty years has led to such closures. For instance, this did not occur in the case of the collapse of Barings in 1995, LTCM in 1998 or Lehman in 2008. A useful analysis of how law and market practice would respond to an event of major operational disruption is set out in the Report on this subject published by the Financial Markets Law Committee ("FMLC") in November 2003: see in particular pages 10 to 19, 86 to 88 and 128 to 132.

24. Although the laws of several jurisdictions provide emergency powers for its government or regulatory authority to declare a special bank holiday or non-business day, these powers have been rarely exercised. As explained in the FMLC's Report, such a declaration would not be the most focused response to a major market disruption and, if an attempt was made to use it for this purpose, it could give rise to a number of issues:

(a) First, the power to declare a special bank holiday is typically a broad power and its use could have wider consequences and unintended side effects. Non-financial types of contract might be affected, even though the parties to them would otherwise have been unaffected.[1]

(b) Secondly, the effect on contractual obligations of calling an unscheduled bank holiday could cause significant potential problems, unless these had been addressed satisfactorily in advance by appropriate contractual terms.

(c) Thirdly, the declaration of a special bank holiday under the domestic law of a jurisdiction would not have extra-territorial effect. Many contracts will include obligations performable outside the relevant jurisdiction or may be governed by the laws of other jurisdictions. Even if banks and financial institutions were permitted to close their operations during a major operational disruption if necessary, they should not be compelled to do so. Equally, parties to contracts should continue to be free to perform their obligations (or to agree appropriate variations) if they wished to do so.

(d) Fourthly, the declaration of a special bank holiday could result in the closure of an exchange or settlement system which would also otherwise have remained open. This would conflict with the objective of preserving the ability of market participants to perform obligations if they chose to do so. The preferred course would almost certainly be to keep markets open and, even if a particular market had to be closed, to keep payment and settlement systems in operation wherever possible.

(e) Fifth, it is doubtful whether such a power could be used to declare a special bank holiday retrospectively. It is unclear whether a bank holiday could be declared during business hours so as to take effect for the remainder of the same day and, even if it could be, it might cause more complications than it would avoid.

25. Responses from market practitioners and trade associations to the Working Document "The Financial System and Major Operational Disruption" published by HM Treasury in February 2003 expressed a strong preference for the UK Government not to intervene unless this became unavoidable. Concern was expressed that the mere existence of wide discretionary emergency powers might cause serious uncertainty as to the circumstances in which those powers would be exercised and how they might affect financial markets, particularly where cross-border trading, clearing and settlement were involved. It was recognised as essential to maintain the maximum possible level of legal certainty in the financial markets.

Question 43: Please give your views on the temporary suspension of close out netting rights suggested in section G13, including the appropriate length of the suspension. Should any classes of counterparty be excluded from the scope of such a suspension: for example, Central Banks, central counterparties, payment and securities settlement systems that fall within the scope of the Settlement Finality Directive?

26. The creation of a power for resolution authorities to impose a suspension of even limited duration would be a source of considerable uncertainty for market participants. Again, we do not support this proposal and note that it was not thought necessary to include it in the Banking Act 2009. If the power were created and exercised, it could cause serious complications and difficulties for counterparties who had outstanding contracts (including financial collateral arrangements) with the failing financial institution and for third parties involved in back-to-back or linked transactions with such counterparties. Further, as there would need to be an exception for clearing houses (see paragraph 28 below), a mismatch could arise if there is a close-out by the central counterparty but the non-defaulting member is prevented for a couple of days from closing out vis-à-vis its counterparty.

27. The better approach would be to provide that a transfer to a bridge bank or third party purchaser of a failing financial institution's property or shares would be disregarded in

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1 The proclamation of a special bank holiday might relieve employees of their obligations to work even if they were urgently required to cope with an emergency and, for others, would entitle them to be paid overtime rates.

determining whether an event had occurred enabling the counterparty to exercise close out netting or other rights, as provided for in section 22 of the Banking Act 2009.

28. If a power of suspension were introduced, exceptions would be required to safeguard recognised clearing houses, recognised investment exchanges, securities settlement or payment systems and settlement banks etc. It is essential, for instance, that a clearing house should be able, immediately a member defaults or is likely to default, to take immediate steps (if it chooses) to enforce its default rules, including exercising close out netting, realising collateral and applying this against any resulting net single amount then due. Otherwise, the clearing house could have a major liquidity problem in ensuring overall settlement on the business day affected, unless it called on other members of the clearing house to provide additional collateral or guarantee fund contributions and these calls were promptly met in full or unless emergency funding was provided by a central bank or another source.

29. As stated above, if a suspension applies to some counterparties but not others, this could potentially have unexpected and arbitrary results on those with direct or indirect contractual relationships with the failing financial institution, particularly in a falling market. A suspension of rights could result in greater losses for a counterparty or result in a counterparty being required to fulfil its obligations to a central counterparty but being unable to take action against the failing financial institution.

30. It should be borne in mind that the length of any moratorium will be factored into the cost of collateral and credit for firms within the scope of the regime, as counterparties will have to take more collateral and charge more for unsecured credit exposures if they become subject to delays in their enforcement rights – raising the cost of doing business.

31. We understand that in the USA the Dodd-Frank Act provides protections for specified classes of financial contracts and for specified classes of counterparties.[2]

Question 46a: Do you agree that the classes of arrangement suggested in this section should be subject to the suggested safeguards in the case of partial property transfers? Should any other market arrangements be included?

32. We agree that the proposed safeguards are essential in the case of partial property transfers. It is also essential that the remedy for a breach of a safeguard be clearly spelt out and that this be capable of being consistently applied across the EU.[3]

33. We note that, as a general matter, the safeguards proposed in respect of the proposed resolution framework are modelled on the UK Banking Act 2009 safeguards. We broadly support the inclusion of these safeguards, which largely protect the position of counterparties whom we consider have a legitimate interest in not being "cherry-picked". However, the UK regime is not perfect: it includes elements of uncertainty (particularly in relation to structured finance), and some safeguards which arguably do not go far enough in protecting the legitimate interests of creditors and other stakeholders. We draw attention to these where relevant below.

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2 We understand that the Dodd-Frank Act provides protections for "qualified financial contracts" such as repurchase agreements, securities contracts, forward contracts, commodity contracts and swap agreements and, in each instance, for specifically defined classes of counterparties such as clearing organisations. Consistent with special protections afforded under other U.S. insolvency regimes (e.g. FDIC receivership of a bank), certain non-defaulting counterparties to such agreements are free to exercise their contractual rights to terminate, close-out and liquidate their positions upon the insolvency of their counterparties. However, the Act does have a one-business-day stay on netting by prohibiting a protected party from terminating, liquidating or netting out its position solely by reason of the appointment of the FDIC as receiver or the financial condition of the financial company in receivership until 5:00 p.m. Eastern Time on the business day following the date of appointment of the FDIC. A protected party is also precluded from exercising any such contractual rights after it has received notice that its qualified financial contract has been transferred to another financial institution, including a bridge financial company. The Act requires that the FDIC notify a protected party of any such transfer by 5:00 p.m. Eastern Time on the business day following the date of appointment of the FDIC. The Act provides that no "walkaway clause" shall be enforceable in a qualified financial contract of a covered financial company in default. See also footnote 11.

3 See, for instance, article 11 of The Banking Act 2009 (Restriction on Partial Property Transfers) Order 2009 which provides that, if the safeguard for set-off and netting is breached, the partial property transfer does not affect the exercise of the right to set off or net.