Banking Liaison Panel (BLP)

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

Advice to HM Treasury

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Background

1. The remit of the BLP subgroup is to identify issues of concern to industry around The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 ("the safeguards order") and to provide advice to HM Treasury on behalf of the Banking Liaison Panel under section 10 of the Banking Act 2009.

Advice to HM Treasury

Small companies carve-out

2. Article 3 of the safeguards order provides protection for rights and liabilities under a particular set-off arrangement, netting arrangement or title transfer financial collateral arrangement. Certain rights and liabilities are excluded from these protections, including retail rights and liabilities as defined in article 1(3), which refers to the definition used by the Financial Services Compensation Scheme (FSCS).[1] That definition of retail rights includes small companies as well as members of the public.

3. There was a rationale for including such small companies in the exclusion from the point of view of existing policy on depositor protection. Small companies are eligible for compensation from the FSCS at the same level as retail depositors. Mechanisms under the SRR to provide continuity of service for protected depositors have been funded on a cashflow basis by the FSCS.

4. For small companies generally therefore some members of the group concur with the policy judgment that on balance, inclusion in the carve-out is in these companies' best interests. Other members take a different view, citing in particular the disincentive for banks to put in place netting agreements and the consequent impact on the service offering for the small companies affected from the outset. All members of the BLP subgroup consider that it will be important to monitor any such unintended consequences. Some members of the BLP subgroup estimate that a minimum of 10,000 small companies have netting agreements with UK banks and under a “gross capital / carve out” scenario these firms could face disturbance to their banking arrangements.[2]

5. It is logical that classes of person who cannot claim from the FSCS are excluded from this group of retail rights and liabilities. But it does not follow that because a class of claimant can be compensated by the FSCS then it must be treated by the SRR identically to a member of the public who has deposited savings at a bank. Instead the answer as to how to treat any class of depositors should always be found in the statutory objectives.

[1] In the safeguards order, “eligible claimant” has the meaning given by rule 4.2.1 of the Compensation Sourcebook made by the Financial Services Authority under the Financial Services and Markets Act 2000.

[2] Some members of the subgroup suggest that the 10,000 figure is a significant underestimate of the number of small companies that would be affected.

6. Accordingly, we have considered whether the achievement of any of the objectives would be put at risk, or alternatively better secured, by altering the current treatment of small companies. As will be seen we think there is a strong case for excluding small companies that are part of larger groups from the class of excluded rights and liabilities and so leave them to be treated with the rest of their group.

Respecting commercial decisions taken by a company's board

7. We do not consider that our proposal would affect depositor confidence. We do however consider that it is artificial to treat small companies that are part of larger groups with aggregated banking facilities as if they are stand-alone small companies or even members of the public for the purposes of the exercise of the SRR. This is because such separate treatment (from the rest of the group to which the company belongs) is at odds with the decision of the small company's Board as to what were the interests of the company in the usual course of business. Those interests were to participate in banking arrangements on a group basis. If that was the decision of the company, we start from having an expectation that it would have the same treatment where the SRR tools are used; that is to say, it would stay with the group arrangements. That starting position can be displaced if we consider that such an approach would weaken the likelihood of the statutory objective of the SRR being met. This might be due to depositor confidence, operational issues, impacts on enterprise value or any other relevant factor.

8. Small companies that are part of a larger group will typically be party to more sophisticated treasury management arrangements. Banks generally have systems in place enabling them to manage group borrowing limits on a net basis – but if some of the companies in a group were within the retail carve out and had to be excluded from the netting agreement the efficacy of the arrangement would be prejudiced. Exclusion of certain group companies from a group facility could be a material impediment to the group's treasury management operation.

9. We would expect as well that by aligning the Order with the existing business arrangements determined by a group of companies it will bring benefits under other objectives. The likelihood of preserving enterprise value from a failing bank ought to be improved. This would arise from a better auction of a part of the bank's business that contained such group arrangements. In the time available it ought to facilitate the valuation process by prospective bidders.

10. The proposed distinction between small companies in larger groups and standalone small companies (and the small groups of which they form a part) is consistent with the distinctions in accounting treatment laid down in the Companies Act 2006 (and its predecessor legislation) which require small companies that are part of larger groups to have to have their accounts audited to the standard of the groups to which they belong, denying them the derogations in accounting requirements

available to small companies. This recognises that for most practical purposes companies are judged by the status of the groups to which they belong. The existence of the Companies Act provisions facilitates the drafting of provisions in the revised order drawing a clear distinction between small companies that are members of larger groups and those that are not. It also reflects a policy that has a longstanding practical basis in legislation and accounting practice.

11. The proposal put forward by the BLP subgroup would mean that in future a partial transfer would have to respect all relevant aspects of the group netting arrangement, in line with the commercial decision taken by the group. This would also reduce the risk of adverse impacts in the normal running of such arrangements on a day to day basis, few of which arrangements we suspect will ever need to be considered in an SRR context.

Banks' regulatory capital and administrative burden on banks

12. Part of our concern was that the current approach of carving out all FSCS-eligible small companies could have implications for banks' regulatory capital. On the basis of the FSA's interpretation of the Banking Consolidation Directive, banks may have to account on a gross basis for their exposure to small companies with whom they cannot net. While it does not fall within the remit of the BLP to advise on regulatory judgments, we are concerned that the result of the small companies carve-out may be that banks will have to account for their exposure to all FSCS-eligible companies on a gross basis, including for example their exposure to certain FSCS-eligible special purpose vehicles and other small companies that are part of groups of companies.[3]

13. The Treasury has recognised the desirability of avoiding creating legal uncertainty for industry, and made a commitment that the Safeguards Order should preserve the effectiveness of set-off and netting in the UK.[4]

14. Apart from the concern that any imposition of gross capital treatment would increase banks' regulatory costs in doing business with the small companies in question, discussion with the industry suggests that the main impact on the banks would be the administrative burden arising. To begin with each bank would need to identify which of its customers where a netting agreement was in place fell within the Companies Act

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[3] Discussions between BLP subgroup members and the Financial Services Authority lead us to believe that this may be the case.

[4] HM Treasury, *Special resolution regime: Safeguards for partial property transfers* (November 2008), paragraph 2.16

definition of a "small company".[5] For a large bank this could be a significant task. Moreover there would be a continuing burden on a bank, if it were expected to try to monitor when firms entered or exited the "small companies" definition. We have noted however the proposals for a single customer view in relation to FSCS operations. If introduced, we understand these systems would address the monitoring or record-keeping issue in relation to the current approach of the carve-out.

15. However if gross regulatory capital treatment were to be required it seems far from clear that the balance of advantage for the small company constituency affected would lie in their agreements being covered by the retail carve out.

Conclusion and recommendations

16. The BLP subgroup notes the comments from the Authorities that in practice the resolution of a failing institution needs to be done over a very short period of time. We note in particular the concerns expressed around creating a requirement for the Bank to assess whether larger groups contain small companies and (if so) which they are. This is especially difficult because banks dealing with the group as a whole (e.g. for netting arrangements) look at the consolidated group accounts. In some cases there are tens or hundreds of members in a group. There may be also difficulties with small groups, especially if they choose not to use the simplified accounting options available to them, but this issue seems likely to be relatively small in compass. In the case of solo small companies, banks will be using accounts from which their status should be apparent.

17. For the reasons set out, the BLP subgroup believes that the case for excluding from the carve-out small companies that are part of a larger group is compelling. Extending protection to the small companies in question would reflect the commercial decisions taken by the companies themselves in the best interests of their company. We do not think that extending the protection to these small companies would weaken the attainment of any SRR objective.

18. In particular, special purpose vehicles (SPVs) should be provided with protection for their set off and netting arrangements. SPVs are specialised financing vehicles, and are not the type of entity contemplated when the FSCS protection was given to small companies; nor does it accord with most people's concept of a retail

[5] Under FSA rules, set out in the Comp Sourcebook, a depositor is protected unless they are excluded. A "large company", defined as a company that does not qualify as a "small company" under section 247 Companies Act 1985 or section 382 Companies Act 2006, is excluded.

depositor. It seems unreasonable that they should be carved out purely on the basis that they fall within the FSCS definition.

19. **We therefore recommend that the safeguards order should be modified such that FSCS-eligible companies that are treated as part of a larger group are not excluded from the set-off protection as established by Article 3 of the existing order. We propose that individual banks would need to be able to demonstrate to the authorities that their systems are such that the group arrangements in question could be identified, and that the necessary information could be accessed, to the timescale that the Bank of England would require in a resolution situation. If a bank were unable to meet this condition, the protection would not apply. However it is important that the administrative burden arising from any such requirements is not disproportionate.**

Treatment of publicly traded securities

20. Article 1(3) of the safeguards order excludes rights and liabilities in respect of subordinated debt from set-off and netting protection.

21. In most situations the bank or counterparty will not be relying on the ability to net the rights arising from publicly tradable securities issued by one of them against the rights of the other that are subject to a netting agreement. Generally speaking an issuer will have no way in practice of applying the set-off. For example, it is unlikely that it would be possible to know whether the other party holds its securities at any given time. And even if it did, in the case of most debt securities, it will have to pay the bond trustee the full amount due under the series of bonds and will not be able easily to argue that it need not pay the full amount due to a netting agreement that it also has with one of the bond holders. Nor can it be certain that the bond holder will not simply transfer the bond to another person.

22. Nevertheless, by not carving out publicly traded securities from the safeguard, the decision on where these securities should go in a resolution may result in the other exposures of the counterparty having to stay with these securities if the counterparty has a broad netting or set-off arrangement that purports to cover all rights and liabilities between it and the issuer. This can lead to results that appear unfair or may defeat the Authorities' intentions in a resolution: for example, where swaps that a purchaser wishes to acquire have to be left behind in the administration simply because the failed bank has securities issued by the swap counterparty that the Authorities wish to leave in the administration. Where the failed bank has issued publicly traded securities, it will also be impossible for the Authorities to ascertain whether any of those securities are held by counterparties that have netting agreements that could make it difficult to comply with the

safeguards.

23. However, some parties do acquire the securities of a counterparty in order to mitigate credit risk. This typically requires a legal opinion as to the enforceability of the netting.

24. We therefore recommend that the carve-out should be expanded to cover all publicly tradable securities or types of securities where the relevant securities are not expressly identified in a netting or set-off arrangement, while retaining the protection in respect of securities that parties do expressly rely on for netting purposes.

Relevant financial instruments (RFIs)

25. By virtue of the definition of "excluded rights" in Article 1(3), the range of rights and liabilities covered by the safeguards order is, in part, established by reference to the Markets in Financial Instruments Directive (MiFID). The first problem arises from the extent to which the MiFID definitions of "financial instrument" do not, or arguably do not, cover a range of transaction types that can be or are typically covered in netting arrangements. Particular transactions include spot and forward FX, commodity / bullion forwards and options, and longevity / mortality derivatives. A related issue is the treatment of banking transactions not currently covered by the relevant financial instruments (RFI) definition: a range of transactions, not least in trade finance, is not currently covered.

26. Ministers have stated in Parliament that if amendments are necessary they will be brought forward as soon as the legislative timetable allows.[6]

27. We set out recommendations in paragraphs 28 to 33 below for amendments to the order to cover the full range of transaction types that can be covered in netting arrangements. The proposed language encompasses transaction types that are already covered by the earlier clauses of the definition of RFI and is to that extent a "belt-and-braces"

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[6] Lord Myners told the House of Lords on 16 March 2009: "I am aware that some market participants are concerned that the scope of the safeguards order is not wide enough, in particular with regard to the protections provided for set-off and netting. I understand that these concerns are primarily related to technical drafting, rather than the property that the order clearly excludes as a result of government policy, and that there are varied legal interpretations on whether some relevant financial contracts have been excluded … I can announce that one of the first orders of business for the [Banking Liaison Panel] will be to review the safeguards order. If changes to the order are necessary and are compatible with the authorities' flexibility, the Government will make such changes before the Summer Recess. (Official Record, 16 Mar 2009 : Column GC2-GC3)

approach. The proposed language reflects the range of financial instruments that the BLP subgroup believes should be covered: however we recognise that if the Treasury adopt this recommendation it will wish to satisfy itself as to the suitability of the drafting.

28. First, the definition of "relevant financial instruments" does not currently cover all regulated derivatives products. This is likely to mean that it is not possible to give satisfactory netting opinions in relation to some derivatives transactions even if they involve regulated transactions under the Financial Services and Markets Act 2000 (FSMA). This issue arises because the RAO covers a wider range of derivatives than MiFID. For example, the current text would have the effect of excluding from protection:

- over-the-counter (OTC) bullion options falling within article 83(1)(c) RAO, which in many cases would not be financial instruments under MiFID (because the restrictive requirements of Commission Regulation 1287/2006/EC would not be met);

- OTC physically settled commodity transactions falling within article article 84 RAO, which in many cases would not be financial instruments under MiFID because of the restrictive requirements of the Commission Regulation;

- contracts for differences which are regulated investments under article 85 RAO but which are not financial instruments under MiFID because they relate to an underlying subject matter which is not specified in MiFID or the Commission Regulation (e.g. longevity and mortality derivatives).

We therefore recommend that the definition of "relevant financial instruments" should be extended to include

(e) any investment falling within articles 83 to 85 of the Regulated Activities Order;

29. Second, the definition of "relevant financial instruments" does not include spot and forward commercial foreign exchange transactions and transactions in gold and bullion. These transactions do not constitute "financial instruments" under MiFID and are not regulated investments under the RAO (although they are covered by the Bank of England's Non-investment Products Code). These transactions commonly rely on netting arrangements to manage counterparty risk.

30. We therefore recommend that the definition of "relevant financial instruments" should be amended to include:

(f) any contract for the sale, purchase or delivery of currency of the United Kingdom or any other country, territory or monetary union or palladium, platinum, gold or silver;

31. Third, the definition of "relevant financial instruments" does not cover

other spot and forward commodities transactions that fall outside MiFID and the RAO because they are for commercial purposes, but may be hedges for derivatives transactions entered into in relation to them. Including these would also (partially) address some of the issues addressed around the "relating solely to" language, which are set out in detail below.

32. **We therefore recommend that the definition of "relevant financial instruments" should be amended to include:**

> **(g) any other spot, forward, future, option, swap, contract for differences, derivative or other agreement, contract or transaction, whether cash-settled or physically-settled, with respect to one or more reference items or indices relating to (without limitation) interest rates, foreign exchange rates, currencies, equities, bonds and other debt instruments, commodities, energy products, electricity, climatic variables, inflation rates and other economic statistics, emissions allowances, actuarial statistics and other insurance risk measures, precious metals, quantitative measures associated with an occurrence or extent of an occurrence or contingency associated with a financial, commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value; or**
>
> **(h) any forward, future, option, swap, contract for differences or other derivative in respect of, or combination of, one or more of the foregoing."**

33. Finally, we recommend that the definition of excluded rights should be expanded to including banking activities as set out in the Banking Consolidation Directive Annex 1. In particular, this will incorporate trade finance activities. At the end of clauses (c) and (d) of the definition of "excluded rights" insert the words

> **"or an activity referred to in Annex I to Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions".**

34. These amendments are summarised in Annex 1.

The "relating solely to" language

35. Paragraph (c) of the definition of excluded rights in article 1(3) has the effect of excluding rights (and liabilities):

> "which relate to a contract which was entered into by or on behalf of the banking institution otherwise than in the course of carrying on of an activity which relates solely to relevant financial instruments;"

36. Ministers have given assurances in Parliament that the term “relates solely to” is intended to prevent market participants from “wrapping up” service contracts with financial contracts thereby gaining the protection of the Order for their service contracts.[7] However, we believe that the unintended legal effect of the term “relates solely to” is that the existence of any excluded right / liability existing under a set-off and netting arrangement excludes the entire arrangement from the Order’s protection – in other words that “one bad apple spoils the barrel”.

37. Industry perceives that the limitations on the scope of the protection granted by the order by reference to the nature of the business carried on by the bank will mean that in many cases it will be difficult for counterparties to determine whether their rights and liabilities are protected rights and liabilities even if those rights and liabilities relate to RFIs.

38. For example, if the bank enters into a series of cash settled commodity derivatives transactions (i.e. RFIs) with a counterparty as a hedge for a purchase of physical commodities, it would appear that the transactions will not constitute protected rights and liabilities as they will have been entered into in the course of an activity which does not relate *solely* to relevant financial instruments (since physical commodities are not RFIs). This will be the case even if the counterparty did not know and had no means of knowing the nature of the bank's business. As already noted, similar issues will arise with respect to derivatives entered into by a bank to hedge its loan or mortgage book.

39. However, even if the definition of RFI is expanded as suggested above, there will still be many other cases where a bank enters into transactions in RFIs in relation to a business that also concerns other types of assets, liabilities or services. For example, it might enter into derivatives in connection with corporate finance services, leasing business or trade finance services (letters of credit, guarantees, etc.) or to hedge credit card exposures or other retail activities.

40. In addition, there will be issues where a netting arrangement includes contracts that are not themselves RFIs, such as forward contracts on commodities.

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[7] Lord Myners told the House of Lords on 16 March 2009: “it is not the Government's policy intention that the presence of excluded rights or liabilities under a wider set-off and netting arrangement should render that entire arrangement unprotected by the order. I would like to make it clear that, in the Government's view, the drafting of the safeguards order does not yield this legal effect… If changes to the order are necessary and are compatible with the authorities' flexibility, the Government will make such changes before the Summer Recess.” (*Official Record,* 16 Mar 2009 : Column GC2-GC3)

41. Counterparties are likely to require representations from banks that their transactions do not involve excluded rights or liabilities and it may be difficult to give those representations on the basis of the current wording of the draft order.

42. As noted in paragraph 36, we recognise that Ministers have given assurances that in the Government's view the current wording does not give rise to this "bad apple" risk. However the legal members of the sub-group and other lawyers consulted by members of the sub-group all consider that bad apple risk is real and needs to be addressed urgently to avoid lack of confidence in netting arrangements in the UK markets or under the law of any UK jurisdiction arising from this.

43. We therefore recommend that in addition to the modifications suggested in paragraphs 28-33, the definition of excluded rights should be clarified by deleting the word "solely" from each of clauses (c) and (d) of the definition of "excluded rights", and inserting new paragraph (7):

> **The inclusion of any excluded rights or excluded liabilities under a particular set-off arrangement, netting arrangement or title transfer financial collateral arrangement will not affect the protection of that arrangement under paragraph (3) in relation to any other rights or liabilities subject to the arrangement.**

44. New paragraph (7) reinforces the point that the inclusion of an unprotected right or liability under a particular set-off, netting or title transfer collateral arrangement will not cause the arrangement to lose the protection of the Safeguards Order. It carries a clear negative implication that the inclusion of an unprotected right or liability under such an arrangement does not in any way confer protection where protection should not apply: it therefore deals with the concern that the word "solely" in clauses (c) and (d) of the definition of "excluded rights" was intended to address.

45. As with the proposed drafting covering RFIs, the BLP subgroup recognises that if the Treasury adopt new paragraph (7) it will wish to satisfy itself as to the suitability of the drafting.

Section 34(7) "Trusts"

46. Section 34 describes the effect of the transfer of a failing bank's property, rights and liabilities. The purpose of the section is to ensure that a transfer of property is able to provide certainty of outcome and speed of execution, in spite of any restrictions that might otherwise exist.

47. However, the terms of section 34(7) seem to extend to trusts where a bank or building society is either the trustee or beneficiary, and this potentially means that trust arrangements for any bond held by a failing

bank or building society could, on the face of the legislation, be modified or terminated irrespective of the consequences for the transaction, bond holders or any other interested parties. So, for example, the position where a bank or building society holds structured bonds or corporate bonds involving a trustee is now uncertain.

48. We are concerned that this may lead to trust business and financial and corporate transactions with a trust element being lost to UK banks (for example safe custody arrangements for trust assets, acting as agent bank or paying agent holding collateral subject to a trust).

49. It would be particularly important to beneficiaries that if any interest in trust property held by a bank on trust is transferred it is transferred subject to the terms of the trust with the transferee taking as a trustee with the same obligations and powers as the transferor bank. It is also desirable that all property held subject to a trust passes together.

50. We therefore recommend that the order be amended to reduce the scope of the problem in relation to partial transfers. We suggest the following amendment to the order:

> **7A A partial property transfer to which this Order applies which makes provision under section 34(7)(a) of the Act may remove or alter the terms of the trust only to the extent necessary or expedient for the purpose of transferring:**
>
> **(a) where the transferor is a trustee of the trust, all the property interests which the transferor holds on trust and the powers and obligations which it has as trustee to a transferee which will become trustee of those interests in place of the transferor; and**
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> **(b) where the transferor is the beneficiary of the trust, such property interests as it has as beneficiary.**

51. As with the other suggested drafting in this advice, the BLP subgroup recognises that if the Treasury adopt this recommendation it will wish to satisfy itself as to the suitability of the drafting.

52. We also recommend that there is a clear statement included in a revised Code of Practice, indicating that the powers given would not be used except to facilitate the transfer of the trustee role from one bank to another and the movement of any trust property held by the bank to the custody of the new trustee. We note that another BLP subgroup of the Panel is considering advice on revisions and has been made aware of this recommendation.

Annex 1: Summary of specific amendments to The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009

Relevant financial instruments (RFIs)

Amend the definition of “relevant financial instrument” to add the following additional clauses:

“(e) any investment falling within articles 83 to 85 of the Regulated Activities Order;

(f) any contract for the sale, purchase or delivery of currency of the United Kingdom or any other country, territory or monetary union or palladium, platinum, gold or silver;

(g) any other spot, forward, future, option, swap, contract for differences, derivative or other agreement, contract or transaction, whether cash-settled or physically-settled, with respect to one or more reference items or indices relating to (without limitation) interest rates, foreign exchange rates, currencies, equities, bonds and other debt instruments, commodities, energy products, electricity, climatic variables, inflation rates and other economic statistics, emissions allowances, actuarial statistics and other insurance risk measures, precious metals, quantitative measures associated with an occurrence or extent of an occurrence or contingency associated with a financial, commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value; or

(h) any forward, future, option, swap, contract for differences or other derivative in respect of, or combination of, one or more of the foregoing.”

At the end of clauses (c) and (d) of the definition of “excluded rights" insert the words

> “or an activity referred to in Annex I to Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions”.

“Relating solely to” language

Delete the word “solely” from each of clauses (c) and (d) of the definition of “excluded rights”.

Add an additional paragraph (7) to article 3 reading as follows:

> "(7) The inclusion of any excluded rights or excluded liabilities under a particular set-off arrangement, netting arrangement or title transfer financial collateral arrangement will not affect the protection of that arrangement under paragraph (3) in relation to any other rights or liabilities subject to the arrangement."

Section 34(7) "Trusts"

Amend the safeguards order as follows:

> "7A A partial property transfer to which this Order applies which makes provision under section 34(7)(a) of the Act may remove or alter the terms of the trust only to the extent necessary or expedient for the purpose of transferring:
>
> (a) where the transferor is a trustee of the trust, all the property interests which the transferor holds on trust and the powers and obligations which it has as trustee to a transferee which will become trustee of those interests in place of the transferor; and
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> (b) where the transferor is the beneficiary of the trust, such property interests as it has as beneficiary."