Banking Liaison Panel (BLP)

Subgroup on the Code of Practice

Advice to HM Treasury

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Sub-group chair	Guy Sears (Investment Management Association)
Sub-group members	Charlotte Kelly, BNP Paribas; Dorothy Livingston, City of London Law Society (CLLS); Ed Murray, International Swaps and Derivatives Association (ISDA); Jeremy Palmer, Building Societies Association (BSA); Peter Beales, Association for Financial Markets in Europe (AFME); Roger Brown, British Bankers Association (BSA); Richard Heis, Insolvency Practitioners Association (R3)
Observers	Stephen Leinster, Insolvency Service (InsS); Alex Kuczynski, Financial Services Compensation Scheme (FSCS); Peter Brierley, Bank of England ; Geoff Davies, Bank of England ; Matt Lucas, Financial Services Authority (FSA); Jake Pidcock (FSA)

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Introduction

1. The Banking Liaison Panel (BLP) agreed with the authorities to consider the Code of Practice issued under section 5 of the Banking Act 2009 ("the Act") and if appropriate to provide advice concerning it. This advice has been prepared from work carried out in a subgroup of the BLP and has been assisted by the provision of information and briefings by the authorities. In several of the areas, the authorities have already indicated to us that they proposed changes and have sought our advice on that basis; we have sought to identify such areas.

The Code itself

2. This is the first occasion upon which we have provided advice concerning the content of the Code. Proposals for changes to the Code whether by way of amendment, clarification or addition have come from members of the BLP, from the authorities themselves and from a number of other parties with whom we have had contact in preparing this advice. This first issue, that of explaining the role of Code, was something that the authorities thought would be worthwhile, as did we and several of those to whom we spoke.

3. Some of the issues raised with us relate not to technical matters as such, but arise from a desire better to understand the purpose of the Code; the extent to which it may be relied upon as identifying the expected practice of the authorities and the types of circumstance in which a particular power may be exercised. Shareholders, creditors and counterparties of banks, as well as persons prospectively in any of these categories will always desire a very high level of predictability of how events will unfold in any bank resolution. It is clear to us that the authorities acknowledge such concerns and would aim to meet them wherever practicable. However, the variety of different factual circumstances which may face the authorities in any particular resolution, as well as thankfully a paucity of practical experience in

using these powers, understandably causes the authorities to be cautious in limiting their options by ex-ante expressions of expected behaviour within what are often very widely drawn statutory provisions. In framing our advice the need for the Code to strike the right balance between these two considerations has been a key point of reference.

4. The Code provides information as to how the SRR powers may be used in practice. The Code of Practice does two things. First, it describes the legal powers under the Act, including the legal constraints on the authorities. This element of the Code expands on the Explanatory Notes that were published with the Act and the explanatory memoranda that are published with the relevant statutory instruments made under Parts 1-3: it describes the legally binding provisions of Parts 1-3.

5. Second, the Code sets out the authorities' policy approaches to using the powers. In so doing, the Code draws on comments in Parliament about the use of the powers, and much of the current text setting out the policy intention is taken directly from Hansard. The authorities must 'have regard' to these statements of policy intention (under s.5(4) of the Act) when exercising the SRR powers. The statements of policy intention in the Code should therefore provide a greater insight into how the authorities would expect to act in order to achieve the special resolution objectives.

6. The Code should be viewed as a guide to the most likely use of the powers. The resolution tools may be exercised in a range of ways, provided these are consistent with the special resolution objectives. So while the authorities must have regard to it, they are not necessarily bound to adopt an approach set out in the Code where circumstances arise which mean that the alternative approach is consistent with the Act and better meets these SRR objectives.

7. Subject to commercial and regulatory confidentiality, where an alternative approach is in fact used, the BLP would hope that the

authorities would subsequently take the opportunity to update the Code to explain or describe the circumstances underpinning the choice of the alternative approach.

8. We agree with the authorities' proposal that it may be useful to clarify the status and purpose of the Code and recommend that they do so within the Code itself in a manner consistent with the statements in this section.

Entering the SRR (section 7)

9. The two conditions for entry into the SRR are set out in section 7 of the Act. Other than in the case of an unforeseen or very rapid failure, the authorities have explained to the BLP that they will, in practice, have undertaken contingency planning and sought commercial solutions to address the problems of a failing institution, such as a commercial sale, prior to the FSA reaching a decision that the conditions for use of the SRR powers have been satisfied. The FSA Handbook in COND 3.1[1] contains further guidance on the factors it will take into account when determining whether or not actions can be taken to avoid use of the SRR. The authorities believe that it would be useful to clarify in the Code that section 7 requires that a bank could only enter the SRR at a point where it is clear that it will not be able to continue as an authorised deposit-taker.

10. It is clear to us from discussions we have had, including with bondholder representatives, that creditors and funding providers to banks may feel that authorities have not always been guided by such a view of section 7. This is not helped by the fact that examples cited to us occurred under earlier legislation; for example, the action taken in relation to Bradford & Bingley plc. There is a risk that commercial decisions on assuming exposures to a bank will be informed by a fear

[1] If the changes proposed in CP10/11 by the FSA are made, then this will be re-numbered COND 3.2 at the 22 July 2010 FSA Board meeting.

that the SRR may be used precipitously. It is also the case that the compensation and creditor protection provisions, described later in this advice, assume that the SRR will be used at a point where it is clear that a bank will not be able to continue as an authorised deposit-taker. Their fairness could be questioned if the SRR was used at some earlier point. We recognise that alone the formulation "will not be able to continue as an authorised deposit-taker" will not address every fear of precipitate action but we consider that for the purposes of the Code, it strikes an appropriate balance, given that FSA describes its own process in greater detail in COND 3.1.

11. We agree with the authorities that it would be useful to clarify in the Code that section 7 requires that a bank could only enter the SRR at a point where it is clear that it will not be able to continue as an authorised deposit-taker.

12. We are aware that the Dunfermline SRR identified the importance of timing the commencement moment in relation to the RTGS and clearing cycles used in the UK. The Code may wish to make clear that the authorities will liaise with Euroclear UK&I and other relevant parties to seek to minimise operational disruptions to critical market infrastructure. Such liaison will no doubt occur independently of any specific resolution, but would allow the authorities to understand the different risks and stresses associated with selecting different moments of the day ahead even of market openings.

Conversion and delisting (section 19)

13. The Code of Practice does not currently cover conversion and delisting (section 19).

14. Section 19 can be used when the Bank of England makes a share transfer instrument to a private sector purchaser, or the Treasury makes a share transfer order to exercise temporary public ownership. Section 19 allows the instrument or order to convert securities into

another form or class of security of another type.

15. The Financial Services Secretary sent a letter on 25 February 2009[2] to the Association of British Insurers (ABI) in relation to the modification of the terms of subordinated debt in Bradford & Bingley; but it also contrasted the power under the Banking Act with those under which the action was taken.

16. Although that letter was published to the wider market, the authorities propose to amend the Code, to explain their view that

    a. in contrast to the Banking (Special Provisions) Act, section 19 does not allow the authorities to alter a class of securities by simply modifying specific terms of securities;

    b. they may convert securities into another form or class of security of another type as appropriate in the particular circumstances of the case in order to achieve the special resolution objectives; and

    c. where the property rights of third parties are affected by provisions of a transfer instrument or order, to the extent that it appears to the Treasury that those parties have suffered compensatable interferences in their property rights, the Treasury must make provision in a third party compensation order for compensation to be assessed.

17. **We agree that these would be useful clarifications.** We had been minded to ask for examples as to how section 19(1) might be used. Given the clarifications at a. and c. above, we accept that there may not be any more helpful statement that could be made than at b in this regard.

[2] www.hm-treasury.gov.uk/d/letter_myners_haddrill_260209.pdf

‘Trusts’ (Section 34)

18. The Code of Practice does not currently refer to the provisions of the Banking Act, section 34(7) of the Act (‘Trusts’). The BLP has already recommended that a clear statement should be included in the 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. .

19. The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 (SI 2009/322) (“the Safeguards Order”) includes an amendment that makes express in respect of section 34(7) the qualification that a partial transfer under the Act can only be used to the extent necessary or expedient to transfer (a) the legal or beneficial interest of the banking institution in the trust property and (b) any powers, rights or obligations of the banking institution in respect of the property held on trust, to the transferee. This however only addresses partial transfers and we consider it is important to pay regard to equivalent protections in whole business transfers as well.

20. Additionally, as also noted in the BLP’s advice on the Safeguards Order, 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 particular trust passes together.

21. In this sense the section 34(7) power should be used to make legally effective a wider business transfer that has itself been implemented by the use of other powers. This situation can be distinguished from that in which a bank or building society holds structured bonds or corporate bonds that involve a trustee. What may be the happenchance of a bank's involvement in the trust structure should not give rise to

concerns that the Authorities might choose to use section 34(7) to alter the terms of such a trust, so altering, for example, priorities of claims or the timing of payments.

22. **We recommend that the Code of Practice should include a clear statement that the powers under section 34(7) will not be used except to the extent necessary 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, and that all property held subject to any particular trust will be transferred together.**

Client money

23. In similar fashion to the discussions concerning trusts, it has been suggested that where deposits are transferred to a purchaser, client money held for beneficiaries should be moved there too. **We make no specific recommendation in this area at this time.** Some transferees may not act as custodians or safekeepers of the relevant assets. The transfer of a deposit is a very much simpler action than transferring an asset title to which is dependant upon registration elsewhere. We are aware of the work going on elsewhere at Treasury and the FSA in relation to client money and client assets more generally; we also recall concerns during some bank failures of issues such as client money held by solicitors with the failing bank. This therefore may be a subject for the BLP to revisit in due course.

Termination rights and default events (sections 22 and 38)

24. Sections 22 and 38 provide for events of default to be turned off in respect of share transfers and property transfers. The Code of Practice does not currently refer to termination rights or events of default.

25. We address the issues under the following four sub-sections:

a. the nature of the legislative provisions themselves

b. their application to ensure operational continuity

c. their application to financing arrangements

d. an issue relating to credit default swaps

26. *The nature of the legislative provisions:* Sections 22 and 38 provide that share transfer instruments or orders or property transfer instruments are to be disregarded in determining whether a default event provision applies (unless it states they shall not be).

27. It is important to note that the provisions do not prevent the operation of default clauses generally, for example related to assets or solvency. They merely prevent the making of the order or instrument and its operation[3] from being the cause of a default. It is entirely possible that the underlying factual matrix which caused the authorities to exercise SRR powers, also evidences and can be relied upon by a counterparty to exercise a default right.

28. The powers are designed to be able to be tailored to the particular circumstances in question. Thus, where practicable, an event of default might be affected for limited purposes rather than entirely disapplied.

29. The provisions of sections 22 and 38 do address the need at times to prevent reliance upon default event provisions where their activation might endanger disproportionately the effectiveness of operational components of the transfer (as opposed to its cost effectiveness). On the other hand, the provisions at sections 22 and 38 could not be used to override financial collateral agreements, which are protected by the Financial Collateral Arrangements Directive, and which, in broad terms, must be allowed to take effect in accordance with their terms. Between these two, lie a series of contracts and arrangements where the

[3] More accurately, the matters in sub-section 8 of each said section.

immunisation or modification of a termination or default event provision might be operationally convenient or fiscally attractive to a transferor.

30. In the BLP's view, it is not an objective of the Act that powers under sections 22 and 38 should be used in order to provide a more financially advantageous deal for a transferee as opposed to providing greater certainty about what the transferee may be purchasing so as to secure that a better price might be paid within the very short timescale in which the authorities and prospective purchasers must act. Issues concerning financial assistance or benefits are to be considered in relation to the overall objectives and, for example, the power to permit a contribution to costs by the FSCS. As an example, sections 22 and 38 would not be used to effect changes as were made by Article 6 of the Bradford & Bingley plc Transfer of Securities and Property etc. Order 2008 which was made under the now superseded, in this respect, Banking (Special Provisions) Act 2008.

31. Operationally the provisions ought to provide greater certainty for a prospective transferee and increase the likelihood that the authorities will be able to achieve a better outcome, both in terms of price and speed. Immediately after transfer a counterparty may decide to declare a default. It should not be forgotten however that the SRR powers include a power to transfer back under section 44 from a bridge bank; and that this can be exercised consistently with the Safeguards Order. If it were felt that the exercise of a default event provision immediately after transfer itself jeopardised the effectiveness, including financial viability, of the new arrangements then the Bank of England could move the property back to the failed bank. This does therefore provide for power to interfere in termination rights that may not be immediately apparent; though the practical circumstances in which a counterparty would wish to terminate a contract that has been transferred to good bank in circumstances where the Bank of England would then need to re-transfer must be limited. In addition, section 34(5) of the Act also allows for a property transfer instrument to provide for a transfer of

property to be conditional upon a specified event occurring or not occurring. Consequently, one possible means of addressing the authorities' concerns that counterparties will exercise rights to close-out immediately following (but not on the ground of) a transfer could be to specify in the transfer instrument that the transfer of a particular contract under the Act is conditional upon the counterparty waiving this right to close-out.

32. *Ensuring operational continuity.* We understand that one policy rationale for the powers relates specifically to IT and other service contracts - in that termination of such contracts could make it very difficult for the transferee to take on and manage effectively other business transferred from the residual bank. It could necessitate having to renegotiate contracts, potentially with new counterparties, with no guarantee that similar terms could be arranged. Where this involved access to pre-existing data, replacing a supplier may be impracticable or ineffective. In extreme circumstances, for example if the majority of a bank's suppliers sought to rely on termination rights, the bank would be unable to continue its operations. This would give rise to risks that suppliers could hold the authorities hostage and seek recovery of substantial hostage sums as a term of continued supply, related perhaps to the net present value of the remainder of a 5 year contract, or by pricing in a recovery of some part of the lost forward payments into a supply limited only to (say) a 3-month period needed by the administrator. In this context, the NCWO compensation approach would not require such payment.[4] The use of such powers should be conditioned by a need to seek to leave parties in a position in which they are no worse off as regards their position immediately prior to the transfer or partial transfer (save for the loss of hostage rights)!

[4] There is precedent in other areas for overriding termination rights or events of default, for example suppliers of gas and electricity to bankrupts cannot extract special terms for continuance of service where there are outstanding bills (i.e. termination rights).

33. *Financing Arrangements.* It is also recognised that in order to facilitate a transfer to a private sector purchaser it might be desirable to keep financing contracts current so the purchaser could be certain as to which assets and liabilities are being transferred. However, this needs to be balanced against the rights of the finance provider, not to be trapped into facilities to a new counterparty to whom they may not wish to lend, for example, because of risk concentration concerns.

34. The Act does not prevent reliance upon events of default against the failing bank that are triggered otherwise than by reason of the transfer instrument or order itself[5] nor does it prevent the finance provider from enforcing events of default against the transferee should the transferee be in breach going forward. However, there are situations where the transfer itself and/or the consequent change of counterparty would be the only trigger events allowing the finance provider to terminate. For example, in the case of term loans; where the conditions precedent and repeating representations at each rollover may be more limited than those required at drawdown, and may thereby limit the likelihood that the finance provider will be able to terminate. This may leave a finance provider with no option but to continue providing funding for a significant period of time to a new borrower that has been imposed upon it.

35. *Credit Default Swaps.* As explained, sub-sections (5) to (8) of sections 22 and 38 can be used to ensure that the effect of a property transfer instrument is not undermined by activation (automatic or otherwise) of a default event provision. However, use of the sections must be appropriate given the specific conditions that necessitate the use of a stabilisation option and having regard to the balancing of the special resolution objectives (in particular, regard for financial stability and for Convention rights under Objectives 1 and 5); and it must be justifiable in accordance with the principles of administrative law. These criteria

[5] As set out in sub-section 8 of each section

place a material restriction on the use of section 22 or 38 and will require the authority to balance the risks of allowing counterparties to retain the power to terminate contracts against the extent of the potential interference with contractual rights and the stability implications on markets if this power is used in a certain way. It is possible to conceive circumstances in which in it would be reasonable to apply the power to contracts to which the bank is not itself a party, for example a contract between a supplier of IT services and intermediary dealing directly with the bank itself.

36. Equally, it is possible to conceive of contracts where such action would be unlikely to meet this legal test, for example, applying it to the terms of CDSs to which the bank is not a party but is the reference entity. There have been comments in the markets as to whether sections 22 and 38 have any impact where the failed bank is the reference entity. We are clear that the fact that two parties to a CDS have referenced an obligation to a failed bank should not be a circumstance in relation which investors in CDS may fear an alteration in the terms of their insurance. We advise that the authorities make it clear the general balancing of the special resolution objectives described above and that a specific instrument or order made under these powers does not have to provide as a matter of course that subsections (6) and (7) apply in relation to all possible default events and that if appropriate provision could be included to make clear that CDS referenced to the failing bank (or its obligations) were not within the default events.

37. We recommend that the Code should include a clear statement concerning the nature and usages, and the limitations, of the powers in section 22, 34(5) and 38 as described above. We also think it would be helpful if the Authorities provided brief case studies as to how the powers have been used to date.

Power to change the law (section 75)

38. The Code of Practice covers section 75 in paragraphs 6.18 – 6.23.

Concerns had been raised with us about the final sentence in paragraph 6.21, where it is noted that the power can be used in relation to an instrument or order made in the exercise of a stabilisation power, including transfer orders and instruments. We have discussed this with the authorities. The issue is not so much that the power can be used to amend transfer orders or instruments, but why taking such action might be seen as necessary or appropriate.

39. The authorities therefore propose to provide more detail on how section 75 might be used. This detail may include some examples of legislative provisions that may need to be disapplied in a resolution (e.g. provisions on shadow directorship under the Companies Act or on liabilities for connected or associated persons under the Pensions Act). It could also give further explanation of the types of circumstance in which a section 75 order may be used to amend a transfer instrument or order and where retrospective effect may be necessary or desirable: for example, in the event of further information coming to light that results in a transfer instrument incorrectly reflecting the commercial terms of the transfer or where it is necessary to make a change to avoid a transferee inadvertently being in breach of a law or regulation.

40. For example, as the authorities have explained, the Amendments To Law (Resolution Of Dunfermline Building Society) (No. 2) Order 2009 (2009/1805), made under section 75, amended the Property Transfer Instrument to change the definition of “commercial loan”. The definition of “commercial loan” was intended to exclude Dunfermline Building Society’s commercial property portfolio (of approximately £660m) from the transfer of part of Dunfermline’s business to Nationwide Building Society. The legal effect of the definition as originally drafted in the Property Transfer Instrument, however, was to transfer a significant proportion of this commercial property portfolio and a small number of social housing loans to Nationwide. The loans transferred were not included in the transaction agreed between HM Treasury, the Bank of England, and Nationwide and had been managed on the assumption

that they had not been transferred to Nationwide. Therefore, the power under section 75 was exercised to correct the definition of "commercial loan" to reflect the agreement reached by the various parties to the resolution. The correction was made with retrospective effect so that the Property Transfer Instrument is to be treated as having included the correct definition from the time at which it was made.

41. The authorities would want the Code to recognise that there is always a risk that discrepancies may occur in the drafting of transfer documentation. This could arise as a result of a lack of information or due to misinformation about the failing bank's property. Furthermore, unlike a typical commercial merger and acquisition process, the timetable for carrying out due diligence and preparing the legal documentation is likely to be compressed into a few weeks or even days and the direct channels of communication with the management of a failing bank are necessarily limited to ensure confidentiality and avoid premature disclosure. Despite these challenges, the authorities plan that the text on section 75 in the Code will also make clear that every effort is taken by them to ensure that transfer instruments and orders are drafted accurately to reduce the likelihood of recourse being had to the power under section 75 for this purpose and that it is only where there are serious difficulties that consideration will be given to an amendment made in exercise of this power.

42. We support the proposal that the Code should include examples of the use of section 75 orders have been used for, and clarity on why the Authorities might amend a transfer order.

Continuity obligations

43. The Code of Practice covers continuity obligations in paragraphs 6.13 – 6.17. Paragraph 6.14 of the Code states (in relation to sections 63 to 65):

> "6.14 Group companies will be obliged under the continuity

obligations to provide services and facilities that the Bank of England or Treasury considers are required to enable the acquirer of the transferred business to operate it effectively. A general continuity obligation will arise following a transfer automatically, by operation of law."

44. We are concerned that provision of services and facilities could be interpreted so as to include providing funding to the acquirer of the business. We note the Government's assurances that the power to impose an obligation relates to services and facilities that are required to operate the transferred business effectively, and that examples of services and facilities include employees, mortgaging servicing, communications and IT support.

45. We recommend that the Code should make clear that no obligation to continue funding can be imposed by a continuity obligation under sections 63 to 65. Whether or not there is such an obligation must be determined by the funding agreement itself limited only by a consideration of sections 22 or 38 (see the section on Termination Rights and Default Events above). This is the case whether the agreement remains in the residual bank or is transferred.

Building societies and set-off

46. The FMLC has raised an issue relating to building society set-off. It relates, as the FMLC states, to an apparently inadvertent, but potentially serious, lacuna in the law of insolvency set-off in England & Wales as it relates to building societies in that the rule on mutual set-off in bank and other company liquidations is not present. The issue also arises in Northern Ireland.

47. However the proposed Building Society Insolvency (England and Wales) Rules do contain the mutual set-off provision (at proposed rule 74) and they are intended to apply in relation to a building society

undergoing the procedure in Part 2 of the Banking Act 2009, as applied and modified by section 90C of the Building Societies Act 1986 and by any order made under section 130 of the Banking Act (the Building Society Insolvency Procedure or "BSIP"). We understand that a similar legislative provision may be introduced in Northern Ireland.

48. Understandably therefore, given the widespread expectation that mutual credit and set-off will apply in a liquidation of a financial entity, we have been asked if the Code might make it clear that the procedure in Part 2 of the Banking Act 2009, as applied and modified, will always be used by the authorities to wind-up building societies (and notwithstanding that the regime of building society liquidation which pre-existed the Banking Act still exists and could be used). Technically making a statement in the Code may add little beyond a factual statement since the authorities only have regard to the Code in situations in which the SRR powers are being considered and also the BSIP can only be used as part of the SRR. **Nevertheless on the assumption that Building Society Insolvency (England and Wales) Rules are made as proposed, we recommend that the Code records their role at least in introducing mutual credit and set-off to building society insolvency under the BSIP and that the BSIP will always be used by the authorities to wind-up building societies (where the conditions for entry to the BSIP are satisfied).**

Bridge banks

49. Bridge banks are covered in paragraphs 8.31 – 8.35 of the Code. Paragraph 8.31 of the Code states:

> "In addition to bridge bank reports and specific reports, and the reporting requirements imposed on the bridge bank pursuant to the Companies Act 2006, the Bank of England shall consider, in each case, whether the bridge bank should have regard to any additional reporting requirements to which similar commercial banks may be subject. In addition, the Bank of England shall

make arrangements to provide for regulatory reporting appropriate to the activities undertaken by the bridge bank."

50. As can be seen, little is said in the current Code about bridge banks. There are no doubt a range of factors to which the Authorities must have regard in determining the appropriate arrangements. For the purposes of transparency, and to alleviate fears of unfair competition, the Code should at least identify those factors. We envisage the size and nature of the bridge bank's activities, the risk of competitive distortions, the length of time since creation, the foreseeable life of the bridge bank, and the need for information for financial stability purposes would at least be considered.

51. We recommend that the Code make clear that the default position should be that the bridge bank should be subject to the same requirements as another bank of that type and size and that a case should have to be made to lift any requirements. Such a case would be easily made where disapplication is expected for a matter of weeks only. The Code should make it clear that any disapplication would be kept under review, and that such might be periodic in nature or event-driven. The Code might also commit the authorities to ensure that any significant disapplication should be identified in any annual reporting.

Competition and management of banks in temporary public ownership

52. The impact of banks in temporary public ownership is covered explicitly in paragraph 9.14 of the Code. Paragraph 9.13 – 9.14 of the Code states:

"9.13 In circumstances where an institution is likely to remain in public ownership for longer than a short period, the Treasury may seek to put in place arrangements to operate the bank at arm's length, for example through UK Financial Investments

Limited (UKFI), which is an arm's length company wholly owned by the Government.

"9.14 In such circumstances, the Treasury may set out objectives for the directors as to how the bank should be operated. It is likely that these objectives would include protecting and creating value with due regard to the special resolution objectives, and maintaining and promoting competition in the banking sector."

53. The previous draft of the Code read included stronger language on competition, stating that "the Treasury shall also take steps to ensure that the bank is operated in a manner that does not distort competition in the UK banking system…"

54. We recommend that the previous, stronger wording should be reinstated in the Code, and that the Code should explicitly recognise that a bank in temporary public ownership has an advantage in that it will be perceived as risk-free. We also recommend that the Code should outline the Government's approach to temporary public ownership and should identify where the principles on which UK Financial Investments Ltd manages such institutions are made public.

Objectives and FSCS

55. The special resolution objectives are covered in Chapter 3 of the Code. As currently interpreted in paragraphs 3.11 – 3.13, Objective 3 – protection of depositors - appears to relate only to the depositors of a failed institution. This has always been viewed by members of the banking industry as problematic, in particular because in the context of the use of the FSCS to contribute to the cost of an SRR intervention, depositors in other banks or building societies will also bear the cost of that intervention via the FSCS. The language of "protection" covers only the direct risk to the funds of depositors in the failing entity, not the

indirect risk to other depositors from FSCS levies on their own institutions. On the other hand, paragraph 3.14, interpreting "protection of public funds", talks about the protection of the (indirect) taxpayers' interest in effective expenditure of public funds. Concerns have been raised with us that the interpretation advanced in paragraphs 3.11-3.13 risks creating the impression that, while the taxpayer interest is worthy of protection, the interests of depositors in the rest of the sector – who are, in effect, "taxed" by any FSCS levies – may be disregarded. Against this there is the argument that the Treasury is expected as part of its general approach to seek the cheapest solution for taxpayers. But more specifically, the authorities would point to the provisions that limit the total cost that can be imposed on the FSCS by reference to the maximum amount of money that would have been paid out by way of compensation. This is a welcome safeguard, though it remains a concern that the FSCS should not be treated as a "free good".

56. We recommend that the Code should describe the different types of involvement that the FSCS may have in providing compensation or facilitating a resolution and the protections that are put in place to prevent contributors to the scheme from having to pay more than they would if there were no resolution.

Bank resolution fund

57. As a matter of law, a resolution fund order must be made by the Treasury where there has been a transfer of business to a bridge bank. The resolution fund order may provide for persons to share in the proceeds of the disposal of things transferred. Such persons will be the transferors, so either the residual of the failing bank in the case of a property transfer or the shareholders in the event of a share transfer. These persons will receive a contingent economic interest in the proceeds of resolution in specified circumstances and to a specified extent. So when property of the bank in resolution is first transferred to a bridge bank and then successfully and for value transferred on to a

purchaser, the proceeds will come into the bridge bank and thence pass to the bank resolution fund, which can be expected to be an interest bearing account held at the Bank of England. The fund can bear costs before the proceeds are distributed to the relevant persons.

58. The authorities believe that it would be useful to outline in the Code the costs they would normally expect to be borne by the bank resolution fund. For example, the Dunfermline Building Society Compensation Scheme, Resolution Fund and Third Party Compensation Order 2009 (S.I. 2009/1800) specifies:

- Treasury's right to retain discretion over payments made to the Bank of England and the Treasury from the bank resolution fund;
- that costs which may be deducted from the fund relate only to certain costs incurred in connection with the bridge bank and not to other costs incurred in connection with a resolution; and
- that an independent valuer must be appointed to certify that any costs to be deducted from the fund are certified as having been reasonably and properly incurred by the authorities.

59. The authorities propose that it may be useful to clarify general principles along these lines in the Code. We agree.

Secondary legislation issues

60. The Code does not yet reflect the most recent secondary legislation. The authorities will therefore propose amendments to the Code following this advice to cover:

- Updated safeguards for partial property transfers
- Revised building societies insolvency and special administration
- Revised FSMA (Contribution to Costs of SRR) Regulations

61. In particular, the authorities believe that the Code should include a more full explanation of how set off and netting protection works and clarity about what safeguards do to protect netting arrangements. The safeguards for partial property transfers are set out in The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009, The Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009 and the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009.

62. **We agree with these broad proposals.** In addition below under the headings NCWO: policy and practice, we provide our views, an example from discussions with bondholders and end with a discussion of compensation. We have also made some observations and comments about the safeguards for set-off and netting; secured liabilities and Community law. The authorities themselves propose much greater explanation of the compensation provisions and a case study, their working draft is set out in the Annex to this advice.

NCWO : policy and practice

63. The early partial transfers completed under the Special Provisions Act, in particular those covering the Icelandic banks, raised concerns that such tools would be used to the benefit of retail depositors, and to the detriment of wholesale depositors, who could be left in a disadvantaged position as a result of adverse cherry-picking. These concerns could have damaged confidence in the UK banking sector, because of the uncertainty – a wholesale deposit claim that appeared of high quality, with high rating, could end up bearing disproportionate losses. These concerns have been most acute in the local authority sector.

64. Quite rightly, the Government addressed these concerns through the “no creditor worse off” principle in the Banking Act, and the relevant regulations made under it. However, Panel members have picked up

that the intended protection of NCWO is not well understood among wholesale creditors, if indeed they are aware of it at all. So, although the Government has honoured its commitment to legislate appropriately, the full benefits in terms of creditor confidence are not being realised.

65. It is also noteworthy that chapter 10 of the Code of Practice, which is supposed to cover third party compensation orders, mentions them only in passing with the rest of the chapter devoted mostly to bank resolution fund or (transferor) compensation scheme orders – suggesting that NCWO is of only marginal importance. We accept that to the contrary, it has always been viewed by the authorities as an important part of the protections provided by the SRR.

66. **We recommend that the Code is amended in three respects** : first, to indicate that the NCWO principle will operate to restrain the adverse impact of any partial transfer on wholesale creditors to the minimum necessary to achieve the other objectives of the SRR; secondly – in chapter 10 – to explain in more detail exactly how a creditor's eventual position is protected through third party compensation orders where some adverse impact is necessary; and thirdly to provide indicative timetables by which compensation will be assessed and paid.

67. As regards the third area of amendment of the Code mentioned above, we recognise that in an independent valuation process the authorities will have no real control over critical parts of the process, but the appointment of the independent valuer is made by HM Treasury. The resolution of Dunfermline Building Society took place on 30 March 2009, but the appointment of the independent valuer only took place on 22 December 2009. The equivalent dates for Bradford & Bingley (under the Banking (Special Provisions) Act 2008) were 29 September 2008 and 24 June 2009. We recognise that the first exercise of any new power may take more time and seeking value for money and open competition in appointments must be welcome, but a period of 9

months to appoint a valuer does mean the compensation process is likely to be overly drawn out from the point of view of those who may be entitled to compensation, including a payment of interim compensation.

An example concerning subordinated debt holders

68. As regards the NCWO, our meeting with the ABI's bond committee was particularly instructive. There is clearly a very different understanding of how resolutions may impact bond holders than the authorities, from our discussions with them, would believe the real impacts to be.

69. Few market participants after the events of the last two years would suggest that every investor, creditor or depositor should or even could be protected from the failure of a bank. It is also the case that the views of some concerning the current regime are highly coloured by their experiences of the operation of the previous regime, and not least with the Bradford & Bingley resolution. It is not the Panel's role to offer some objective assessment of policy decisions nor do any of its recommendations presume there has been a failure to date. On the one hand, there is a legitimate need for as much legislative flexibility (within the bounds set by Parliament) as the authorities may require to secure timely resolutions in the wider interests of financial stability and the economy. On the other hand, wholesale investors need predictability as to outcomes and the factors that may affect such outcomes. This is particularly where statutory interventions are possible since no amount of enquiry (such as by researchers and credit analysts) can reveal how a discretion will be exercised in a particular case by the Bank of England, for example. That is, of course, what lies behind much of this advice; the promotion of clearer statements of expected behaviour by the authorities so as to reduce the weighting any market participant has to give to the potential impact of an exercise of discretion permitted under the legislation but which is unlikely ever to be exercised in the circumstances of a particular bank.

70. Discussions with subordinated bond holders raised three areas of concern. First, a feeling that early (pre-Banking Act) resolutions may have been an over-reaction and that some of the banks concerned could have survived. This will remain a concern especially for subordinated creditors, but the division of responsibilities on determining whether a particular resolution occurs is now set out in the Banking Act and that division requires several parties to be satisfied about different components. The authorities proposal to make a statement about section 7 mentioned earlier should assist.

71. Secondly, the alteration of terms of subordinated notes in Bradford &Bingley is something that the Authorities accept cannot now occur. That message has been given by Ministers in both Houses and any revision of the Code could usefully re-affirm this. This has been addressed above under the heading Conversion and de-listing.

72. Thirdly, there is the question of compensation. This is not well understood. It is also unclear how applications would be made in a trading situation. If Firm A had contracted to sell and Firm B to buy securities issued by Bank Y which is then subject to a resolution, the Code does not help the parties understand who would be expected to apply for compensation. The “pre-transfer creditor” is the party in relation to whom the compensation is assessed and to whom it is paid. More substantively, the markets cannot assess what value of compensation may attach to any holding. Where underlying investors hold units or shares in a fund or life contract that holds such debt, the length of time until assessment of any compensation may disadvantage them if they need to sell or encash their interests in the meantime.

73. As mentioned at the beginning of this section the authorities have a working draft to address the theme of compensation. **We recommend that the Code is amended to include such explanations and descriptions.**

Safeguard for set-off and netting arrangements

74. We agree with the authorities that it would be useful if the Code included comments about the safeguards which provide broad protection for set-off and netting, by ensuring that property included under a counterparty's set-off and netting arrangement with a bank may not be 'split up' through the exercise of a property partial transfer. However, in order to allow the flexibility to carry out partial transfers in the interests of financial stability and depositor protection, the Order features a number of carve outs from this protection ('excluded rights' and 'excluded liabilities'). It is of course, not mandatory to exclude such rights and liabilities and they can be dealt with without them being 'split up'. These include excluded rights and liabilities in connection with:

    a. deposits held in a class or brand of account mainly used or marketed to depositors eligible for compensation under the Financial Services Compensation Scheme ("FSCS"); (this includes most individuals and some small businesses); and

    b. subordinated debt issued by the failing bank or the failing bank's counterparty.

75. In addition, the Order provides that where a transfer order or instrument has purported to respect the safeguard for netting and set-off, the fact that some of the property being transferred is foreign property, and so may not have been effectively transferred, does not give rise to a breach of the safeguard.

Protection for secured liabilities

76. This safeguard protects financial collateral and other secured arrangements to which the bank in SRR is party. It provides that where the bank or its counterparty has a security interest over an asset securing a liability owed to it by the other party, the collateral asset may not be 'split up' from this liability under a partial transfer. In this way,

counterparties can continue to be confident that they will be able to have recourse to collateral assets over which they have taken security. We agree with the authorities that it would be useful to describe this protection; the Code could also note that the exclusions of rights and liabilities that relate to set-off and netting do not apply here.

Protection for structured finance arrangements

77. There is a safeguard for financial arrangements broadly covered by the term 'structured finance'. These arrangements are referred to in the order as "capital markets arrangements" and refer to, for example, covered bonds, and securitisation vehicles. The safeguard provides that partial property transfers may not interfere in the operation of such arrangements to which a bank is party by transferring some, but not all, of the relevant property, rights or liabilities. We agree with the authorities that it would be useful if the Code described this protection.

Community law

78. The safeguards include an express bar on action in contravention of Community law. Despite its apparent simplicity, the issues that arise from the inclusion of this bar can be extremely complex. The authorities consider the legal interpretation is clear - that only actions which would contravene Community law (as opposed to UK law which implements Community law) are prohibited. Under this approach, in light of the wide-ranging powers under the Banking Act and the explicit safeguards introduced in the secondary legislation, the safeguard is a necessary assurance that the safeguards brought in by United Kingdom should not be interpreted or operated in a manner that would mean the UK failed to comply with its treaty obligations to the European Community in this regard. This may be summarised as the "limiting interpretation" approach. Despite the authorities' clear view, a different approach has been proposed to the proper nature and extent of this bar though this approach may be informed by not just what might be considered as

narrow interpretative issues but also by the practicality of determining what is, and what is not, protected. Such an approach understands this safeguard to be a self-standing identification of additional activities or circumstances which are to be protected. This may be summarised as a “protected activities” approach. .

79. Of course, either a purported action is in breach of Community law or it is not. But holders of these viewpoints approach the question as to what one really means by Community law with very different expectations (and they may do so on a mixed basis of law and practicality). In the vast majority of circumstances the provision that is to be considered by a party will likely be contained, at least in the first instance, within national legislation introduced so as to comply with an obligation arising under a community directive. In that regard it will be rare that there is a one-for-one conformation between the wording of the community directive and the precise form of implementation that has been used. Moreover where the directive is itself not maximally harmonising, the United Kingdom consistent with its treaty obligations may have decided to include a wider set of circumstances or activities within the selfsame clause that meets some particular issue addressed in a community directive. A single clause of English legislation may therefore in one sense both be an expression of community law domestically enforceable and on the other an identical protection provided to some other set of circumstances or activities in relation to which the United Kingdom had no treaty obligation to introduce it into domestic law.

80. So, for example, financial collateral arrangements involving the shares of private companies, are said not have needed to have been introduced into domestic legislation in order to comply with the United Kingdom's obligations in relation to the Financial Collateral Directive. Article 2(1)(e) of the FCD states that "financial instruments" means shares in companies and other securities equivalent to shares in companies [……] if these are negotiable on the capital market, [….].

The italicised qualification is not included in the definition of financial instruments in Regulation 3 of the Financial Collateral Arrangements (No 2) Regulations 2003. Nevertheless within the same clause that ensures the United Kingdom meets its treaty obligations for other asset classes, is a protection for this further asset class[6]. Those favouring the protected activities approach do not consider the express bar requires an individual clause to be looked behind since it exists so as to meet the UK's community obligations, even if there is a second purpose to the clause. In practice there is a real risk that parties will need to determine not only what domestic legislation states but also the precise terms of the directive and whether or not any implementation of that directive necessitated the very terms of the domestic legislation. This need to look beyond domestic law is very unattractive to those using the protected activities approach; and is essential to those addressing the issue from a limiting interpretation approach.

81. This is an issue which is being debated in relation to work on the substantive parts of the safeguards order. It is unlikely that any statement in the Code could itself resolve the practical issues and concerns that some market participants have expressed. Nevertheless it is worth recording both that there are complexities to this otherwise simple statement and also that the authorities maintain a willingness to have identified any particular circumstance in relation to which there may be an issue. The point of that is that even if the authorities consider certain arrangements are safeguarded generally by Community law, it is always open for the authorities to address a particular issue explicitly in the safeguards order. Accordingly there are provisions in the order which relate to netting and set-off. These are

[6] This document is advice on the Code and not on the example from the FCD or the particular UK provision that is used. What constitutes negotiability on the capital market is assumed for the example not to extend to some private shares; analogous language is used in MiFID where the European Commission and FSA takes a broad view of the meaning of capital market and considers private equity may commonly be caught.

self-standing safeguards and do not require a consideration of the extent of community law.

82. We recommend that the Code makes clear that the safeguard order is one of the provisions that is kept under review by the authorities, in particular where specific concerns may arise that an activity analogous to those otherwise protected by explicit safeguards itself falls outside the safeguard order; including where the determination as to whether some analogous activity is protected depends solely on the application of the bar on action in contravention of Community law.

Remedies

83. Part 3 of the Safeguards Order deals with the remedies that are available where partial property transfers occur in contravention of its provisions. There are three articles in Part 3 which provide for different outcomes for contraventions of what can be described, broadly, as the eight types of safeguards and the continuity powers.

84. Article 10 provides that contraventions of the financial markets (Art 7) and termination rights (Art 9) provisions or the continuity powers are void.

85. Article 11 provides that contraventions of the set-off and netting provision (Art 3) and related Community law (Art 4) are of no effect (unless void for being a contravention of the continuity powers).

86. In contrast Article 12 provides for a notice and counter-notice regime to identify and potentially resolve disputes with a relevant authority over the legal effect of a partial property transfer. Such disputes may arise in relation to the safeguards concerning secured liabilities (Art 5); capital market arrangements (Art 6); trusts (Art 7A); and reverse transfers (Art 8); along with the Community law safeguard (Art 4) if not covered by Art 11.

87. This arrangement gives rise to several concerns which have been voiced by market participants:

88. The notice to be given under Article 12(3) could be considered invalid if the information the authority reasonably requires is not provided or is not within the 60 day time limit for giving a notice.

89. We recommend that the Code should explain what information the authorities will expect to receive, and how and against what timetable, they would commonly seek to request further details or otherwise treat a notice (notwithstanding that Article 12 provides 60 days for a response and longer if complexity makes a decision impracticable in that time.

90. The remedy will be by use of a further transfer instrument or order under sections 43 to 46 and does not extend to monetary compensation if such a remedy is not available (article 12(9) does provide that other property or rights could be transferred).

91. Those involved in clearing and settlement, whether as custodians or clearing houses and payment and settlement systems, will invariably rely on security interests protected by Article 5. Securities lending businesses need to provide effective collateral arrangements to the relevant underlying lenders of securities. Both could be severely impacted by any uncertainty as to the impact of a partial property transfer.

92. This advice is concerned however with the text of the Code, not the provisions of the Safeguards Order. Paragraph 7.13 of the Code contains the statement that "The Authorities are under a statutory duty to comply with the safeguards, and this duty is unaffected by the existence of such remedies. The remedy provisions exist to provide certainty to the market as to the outcome should the safeguards be inadvertently contravened".

93. We think that in light of the one resolution operated since the

Safeguards Order came into effect, more helpful statements could be made concerning the authorities' approaches. The Dunfermline Building Society Property Transfer Instrument 2009 contained a formulation to exclude certain property and rights from a transfer at several points including at Article 3(3)(k) as follows:

> "any property, rights and liabilities the transfer of which would constitute a contravention of articles 3 to 7 of the Partial Property Transfers Order".

94. On the assumption that future references would be to articles 3 to 7A, it would be helpful if the Code explained whether this would be the likely formulation for any future transfers or otherwise if the authorities consider that this resolution (or the building society in question) has certain characteristics which meant such a formulation could be used. Our understanding is that the authorities would always want to describe what is transferred with complete certainty, in a positive sense, without relying on formulations to exclude what might otherwise appear to be transferred. The precise formulation will depend upon the nature and complexity of the resolution and the time available to the authorities to carry out any due diligence. In this regard, the supervisory tools commonly referred to as 'living wills' may change the level of information available to those carrying out the resolution. **We recommend that the Code does provide some explanation of this type.**

95. In circumstances where it is in dispute whether Articles 10 and 11 apply, for example that a transfer contravenes Community law related to title transfer arrangements, the dispute procedure in Article 12 will not assist.

Annex A

Compensation

1. Sections 49-62 of the Act make provision for the compensation measures that must or may be put in place by the Treasury following an exercise of the stabilisation powers. Provision is made for three types of orders: compensation scheme orders, resolution fund orders and third party compensation orders.

2. These measures are designed to ensure that appropriate provision for compensation is made to secure the compatibility of the actions of the Authorities under the SRR with Article 1 Protocol 1 of the European Convention on Human Rights ("A1P1"). A1P1 provides that the right of a person (such as a bank or a shareholder) to the peaceful enjoyment of his own property should only be interfered with where that interference is proportionate and a balance is struck between wider public interests and the protection of a person's interests in his property. In order to strike a balance between public and private interests where property has been transferred compulsorily (for example, as a result of an exercise of the share transfer powers) it is appropriate to make provision for compensation to be paid which is normally required to be an amount reasonably related to the market value of the property in question.

3. In addition, in the case of partial property transfers, further measures have been put in place to ensure that pre-transfer creditors of a bank are left in no worse position as a result of the exercise of the transfer powers than they would have been in had the powers not been exercised and the bank had gone into insolvency. The safeguards for creditors and counterparties have been put in place in response to the concerns of industry that partial property transfers may prejudice their rights and interests.

Nature of the compensation measures to be put in place following an

exercise of the stabilisation options

4. Where the Bank of England has effected a transfer of shares or business to a private sector purchaser in accordance with section 11(2) of the Act, the Treasury must make a compensation scheme order (section 50(2)). In the case of a transfer of business to a bridge bank the Treasury must make a resolution fund order (section 52(2)).

5. Where the Treasury has transferred a failing bank into temporary public ownership, the Treasury may make either a compensation scheme order or a resolution fund order (section 51(2)).

6. In addition, where any of the stabilisation options have been effected the Treasury may make a third party compensation order which establishes a scheme for paying compensation to third parties (persons who are not transferors). Where a partial property transfer has been effected the Treasury must make a third party compensation order in accordance with the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 (S.I. 2009/319).

Compensation scheme orders

7. A compensation scheme order may either:

    a. deem an amount of compensation to be payable to the transferors (i.e. the persons whose shares have been transferred, or in the case of a property transfer, the failing bank), or

    b. establish a scheme for assessing the compensation, if any, payable to the transferors.

8. Where the Treasury consider that the process for the disposal of the shares or business of a failing bank has established the market value of the shares or business (for example an auction process prior to the transfer), the Treasury is likely to deem any amount paid by the

purchaser to be the compensation payable. In these circumstances it would be inappropriate for an independent valuer to be appointed under a compensation scheme order to establish the value of the business or shares because a market process had already done so.

9. Alternatively, the Treasury may provide for the appointment of an independent valuer to assess the value of the shares or business immediately before the transfer was effected (see further paragraph 28). Examples of this arrangement exist in relation to Northern Rock plc and Bradford & Bingley plc, the shares of which were transferred into temporary public ownership by the Treasury in exercise of powers conferred on the Treasury by the Act's predecessor, the Banking (Special Provisions) Act 2008 (see the Northern Rock plc Compensation Scheme Order 2008 (S.I. 2008/718) and the Bradford & Bingley plc Compensation Scheme Order 2008 (S.I. 2008/3249)).

Resolution fund orders

10. Rather than providing for the appointment of an independent valuer to assess any compensation payable following an exercise of the stabilisation powers, a resolution fund order provides for the transferors (the residual of the failing bank in the case of property transfers or the shareholders in the event of a share transfer) to receive a contingent economic interest in the proceeds of resolution in specified circumstances and to a specified extent.

11. As a matter of policy, the authorities do not intend to profit from a resolution of a failing firm, and the authorities will outline in broad terms in the Code of practice the types of costs incurred by authorities in carrying out a resolution that may be borne by the bank resolution fund.

Bridge banks

12. Where some or all of the business of a failing bank has been transferred to a bridge bank the resolution fund arrangements provide that the residual of the failing bank is to receive the proceeds achieved

from the sale or disposal of that business. As the residual bank is likely to be in an insolvency procedure, the net proceeds of the resolution will constitute an asset of the insolvency estate to be applied for the benefit of creditors in accordance with normal insolvency priorities.

13. A resolution fund order has been made following the transfer of some of Dunfermline Building Society's business to a bridge bank discussed in the case study below.

Temporary public ownership

14. Where a failing bank has been transferred into temporary public ownership, a bank resolution fund order will provide for the former shareholders to receive any proceeds of the resolution of the bank in temporary public ownership, for example, any consideration paid by a private sector purchaser to acquire the shares from the Treasury.

15. However, it may not be appropriate for the Treasury to put in place a bank resolution fund order in relation to a failing bank that has received a significant amount of public financial assistance or where it is anticipated that the Treasury will be unable to make disposals for some time following the initial transfer. In such circumstances, the Treasury would make a compensation scheme order.

Costs of resolution

16. The proceeds of resolution may be calculated net of any resolution costs. For example, such costs could include the costs of financial assistance – including loans or guarantees provided from or backed by public funds during the course of the resolution. This is to ensure that the taxpayer receives a suitable return for public funds that have been invested or put at risk in the bank during the course of the resolution. "Costs" may also include administrative costs such as advisers fees incurred in relation to, or in consequence of, the transfer of the shares or business and the incorporation or authorisation of a bridge bank.

17. It is likely that the Treasury will adopt the approach taken in the case of the resolution fund arrangements established for Dunfermline Building Society (discussed in the case study below) where the Treasury has discretion to determine what, if any, costs of the Authorities are to be deducted from the resolution fund. Where the Treasury determines that costs may be deducted from the fund, an independent person will be required to certify that the costs have been reasonably incurred by the Authorities.

Management duties

18. The Treasury may specify in a resolution fund order that the resolution authority, the Bank of England or the Treasury, is required to maximise the proceeds available for distribution (a "management duty"). However, the management duty must be complied with only in so far as compatible with the pursuit of the special resolution objectives (section 4), and compliance with the Code of Practice under section 5.

19. It is likely that a duty will be imposed in cases where it is anticipated that a bridge bank or a bank in temporary public ownership will be under the control of the relevant authority for a period of time in which longer-term operational management decisions will need to be taken.

Third party compensation orders

20. The Treasury has the discretion to provide for a third party compensation order in a compensation scheme order or a resolution fund order (sections 51(3) and (4)) to make provision for the assessment of any compensation payable to persons other than transferors, such a commercial counterparts of a bank.

21. Generally the order will provide for the appointment of an independent valuer to assess the compensation, if any, payable to certain parties whose property rights have been affected by virtue of provision made in a transfer instrument or order, for example, those parties whose termination rights are modified by virtue of the application of sections

22 or 38 of the Act (see the case study below for a brief discussion of the way an independent valuer may approach this task).

Third party compensation scheme orders in the case of partial property transfers- the "No creditor worse off safeguard"

22. Where a partial property transfer is effected the Treasury must make provision for a third party compensation order in accordance with the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 (S.I. 2009/319), which establish the "no creditor worse off" safeguard to compensate pre-transfer creditors of a bank (defined in section 60(3)(b) of the Act). This measure is intended to reassure commercial counterparties of a bank who are creditors that their position (as compared to that on the insolvency of the whole bank had the Authorities not effected a transfer) will not be seriously prejudiced as a result of the transfers of property from the residual bank. This measure applies to all pre-transfer creditors whether or not left behind in a residual bank.

23. The safeguard provides that, in the event of a partial transfer, the Treasury must make provision for an independent valuer to be appointed to assess the treatment the pre-transfer creditors would have received had the bank entered into insolvency immediately before the transfer was effected ("the insolvency treatment") and to compare this with the treatment the creditors have received as a result of the transfer ("the actual treatment"). The insolvency treatment is calculated on a counter-factual basis, with an independent valuer modeling what would have happened had the transfer not been made in accordance with any principles specified by the Treasury in the third party compensation order. Compensation must then be paid to pre-transfer creditors (or to persons to whom these claims have been assigned) to the extent that the actual treatment is worse than the insolvency treatment.

24. The independent valuer may also require the Treasury to pay interim

compensation before the actual treatment has been finally established (for example the winding up of a residual company may take a long period of time so it may not be possible for the actual treatment of a creditors to be established for several years after a transfer is effected) where appropriate having regard to the merits of ensuring that the creditor receives compensation in a timely manner. A more detailed discussion of the third party compensation arrangements is set out in the case study below.

Onward and reverse transfers

25. Where the Treasury or the Bank of England exercise onward and reverse transfer powers, the Treasury may make compensation scheme or resolution fund orders (section 53(2)).

Independent valuer

26. A compensation scheme, resolution fund or third party compensation order may provide for an independent valuer to be appointed to perform certain functions. Sections 54 to 56 make provision for safeguarding the independence of the valuer. For example:

    a. The valuer must be appointed by a person appointed by the Treasury. This person may be an individual or a panel of persons selected by the Treasury. In previous resolutions, a panel has been appointed to select the independent valuer from any applications received following the publication of an invitation for applicants on the Treasury's website. A number of criteria will be relevant for an applicant to be considered for appointment as valuer, including the ability to demonstrate independence from Government and interested parties, freedom from conflicts of interest, professional skills and experience, particularly in relation to the valuation of complex companies, ability to carry out a high profile public process and also value for money.

b. A monitor must be appointed to oversee the operation of the arrangements from remuneration and payment of allowances for independent valuers.

c. The valuer may only be removed from office by a person appointed by the Treasury on the grounds of incapacity or serious misconduct.

27. To ensure that independent valuers have the power necessary to obtain all information reasonably required to conduct his or her functions, the Treasury can confer a power on valuer to apply to the court for an order requesting any information reasonably required for those purposes to be supplied to the independent valuer.

Appeals against determinations of the independent valuer

28. An independent valuer will be required to set out his or her determinations as to the compensation, if any, payable in assessment notices.

29. Consistent with provision made for the independent valuers appointed for the purposes of the Northern Rock plc, Bradford and Bingley plc and Dunfermline Building Society compensation arrangements, we envisage the following provisions would be made in exercise of the power conferred by section 55(6):

a. The Treasury or any person affected by a determination of the independent valuer set out in an assessment notice would be able to require the independent valuer to reconsider his or her determination and must set out his or her revised determination in an a revised assessment notice.

b. If the Treasury or any person affected by a determination set out in a revised assessment notice are dissatisfies the determination, they may refer the matter to the Tribunal and the Tribunal may remit the matter to the independent valuer for

further consideration.

Valuation principles

30. Where the Treasury provide for an independent valuer to be appointed, they may specify the valuation principles to be applied by the valuer in determining the amount of compensation payable (section 57). These may require, for example, the valuer to apply or not to apply specified methods of valuation, assess values or average values, take specified matters into account. Valuation principles may also require or permit the valuer to make certain assumptions, for example, that the banks has had a permission under Part 4 of the Financial Services and Markets Act 2000 varied or cancelled and that it is unable to continue as a going concern, is in administration or is being wound up. The Treasury will consider whether to specify these assumptions on a case-by-case basis.

31. However, in determining any amount of compensation payable an independent valuer must disregard financial assistance that was, or could have been, provided by the Bank of England or the Treasury (disregarding ordinary market operations offered by the Bank on its usual terms) (section 57(3)). The authorities consider that there are extremely strong public interest justifications for each of these assumptions. For example, it would be entirely inappropriate for the assessment of any compensation payable to former shareholders of a bank that has been transferred into temporary public ownership, to include the value in the distressed bank created by public financial assistance.

Case Study: Dunfermline Building Society

32. On 30 March 2009, the Bank of England exercised its powers under the Act to transfer some of the property, rights and liabilities ("business") of Dunfermline Building Society ("Dunfermline") to:

a. Nationwide Building Society; and

b. a bridge bank (wholly owned and controlled by the Bank of England).

33. This action was taken to protect depositors and to safeguard financial stability and the transfers were effected by virtue of the Dunfermline Building Society Property Transfer Instrument ("the Transfer Instrument").[7] Following these transfers Dunfermline was placed into building society special administration.

34. The Act required the Treasury to make:

a. a compensation scheme order because the Bank of England effected a transfer of Dunfermline's business to a private sector purchaser (in this case Nationwide) (section 50(2) of the Act);

b. a resolution fund order because the Bank of England transferred some of this business to a bridge bank (section 52(2)); and

c. a third party compensation as the Bank of England effected two partial property transfers (sections 50(4) and 52(4)).

35. In accordance with these obligations the Treasury made the Dunfermline Building Society Compensation Scheme, Resolution Fund and Third Party Compensation Order 2009 (S.I. 2009/1800) ("the Compensation Order"), which combined these orders into one instrument, which provides for the appointment of an independent valuer to perform the functions referred to in article 4 of that Order. Detailed provision for the independent valuer is made in the Dunfermline Building Society Independent Valuer Order 2009 (S.I. 2009/1810) ("the Independent Valuer Order").[8] The Explanatory

[7] The Bank of England's press release is available at the following address: http://www.bankofengland.co.uk/publications/news/2009/030.htm

[8] S.I. 2009/1810

Memoranda to the Orders provide a detailed explanation of the various provisions of the Orders. However, a general overview is provided below:

Compensation scheme

36. It was determined that no compensation was payable to Dunfermline in respect of the business assets and liabilities transferred to Nationwide as the Treasury was satisfied that the auction process put in place by the Bank of England effectively established the market price.

Resolution fund

37. As the powers under Part 1 of the Act were exercised for the first time to effect the resolution of Dunfermline, the arrangements put in place in relation to this resolution (see Part 4 of, and Schedule 2 to, the Compensation Order) may be taken as something of a precedent for the way in which the resolution fund arrangements work (although of course the Treasury could exercise their powers under the Act to make such provision as they consider to be appropriate in any subsequent resolutions).

38. The Treasury is required to establish an account at the Bank of England to be known as the Dunfermline Resolution Account ("the Account"), which is the resolution fund. Although the Authorities may have an interest in the monies in the Account for the purposes of recovering any cost incurred in connection with bridge bank aspect of the resolution, it would be inappropriate for the monies in the Account to be treated as public funds as the principal beneficiary is Dunfermline. As such, the Account must be held in the name of an independent person ("the Account Holder") appointed by the Treasury (paragraph 1(2) of Schedule 1 to the Order).

39. The Bank of England (as the owner of the bridge bank and lead resolution authority) must pay monies into the Account in specified circumstance (see paragraph 3 of Schedule 1 to the Order), for

example any consideration received following the sale of the shares of the bridge bank or following the sale of the business transferred to the bridge bank.

40. Payments out of the Account may only be made by the Account Holder on the direction of the Treasury (paragraph 4 of Schedule 1 to the Order) and the Treasury may only direct payments to be made to specified persons. In the case of the Dunfermline resolution, payments to the Bank of England or the Treasury may only be made for the purpose of reimbursing the Authorities for certain costs and following certification by an independent valuer that the costs have been reasonably and properly incurred (see paragraphs 5 and 7 of the Schedule).

Third party compensation

41. Article 9 of the Compensation Order specifies the arrangements to be put in place for the assessment of compensation payable to third parties. The detailed arrangements are set out in Schedule 2 to the Order.

Third parties affected by provisions of the transfer instrument

42. An independent valuer is required assess the amount of any compensation payable to third parties whose default event provisions were affected by the application of section 38(6) of the Act. The independent valuer may put in place whatever procedure he or she considers appropriate for the purposes of identifying those parties and for the purposes of assessing the compensation, if any, payable. However, the independent valuer must take into account any diminution in the value of a person's property or right or any increase in liability on that person.

"No creditor worse off" provisions

43. Part 3 of the Schedule makes provision for the "no creditor worse off

safeguard". Under these arrangements an independent valuer is required to determine the compensation, if any, payable to the pre-transfer creditors of Dunfermline (defined in section 60(3)(b) of the Act) (article 9(3) of, and Part 3 of Schedule 2 to, the Compensation Order) as discussed in §§23ff. This requires the independent valuer to assess the treatment the pre-transfer creditors would have received had Dunfermline entered into insolvency immediately before the Transfer Instrument was made ("the insolvency treatment") and to compare this with the treatment the creditors have received (e.g. on being transferred to Nationwide or to the bridge bank, or in special administration of Dunfermline) ("the actual treatment").

44. The independent valuer has a discretion to determine that the Treasury must make interim payments to pre-transfer creditors before the determination of the actual treatment of the pre-transfer creditors has been made (paragraph 11 of Schedule 2 to the Compensation Order).

45. Where the independent valuer has determined that the Treasury must make interim payments, the independent valuer must determine what, if any, balancing payments are required to be paid to ensure that the pre-transfer creditors receive the relevant amount of compensation, if any, assessed to be payable under the "no creditor worse off" arrangements (paragraph 12 of Schedule 2 to the Compensation Order).