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Dealings with UK Banks – new issues for their creditors

UK Banking Bill: the proposed special resolution regime for UK banks and how it affects the legal position of their creditors.

Executive Summary

The UK's Banking Bill contains proposed new powers for the UK's financial authorities to deal with failing banks in the UK, as well as a more general modernization of the laws surrounding troubled and insolvent banks.

The new powers for the financial authorities are of particular interest to anyone that acquires or has an exposure to UK banks, including other financial institutions, corporations and consumers located in the UK and elsewhere. The Bill confers far-reaching powers for the UK authorities including powers to force a sale, bring banks into public ownership and put banks into insolvency. Rights of creditors are in some cases to be overridden, although safeguards are intended to be introduced to reduce the detrimental impact of such steps on most creditors.

The UK Government's aim is to pass the new law (through securing Parliamentary approval) by 20 February 2009, when key provisions of the emergency Banking (Special Provisions) Act 2008 expire. Such is the expedition with which the Government is trying to pass the Bill that concerns arise as to whether wholesale creditors in particular will be left with sufficient certainty as to the effectiveness of their arrangements with UK banks and whether the market for certain financial dealings with UK banks will need to be re-priced or even face disruption. In particular there may be serious issues for investors who have sold credit protection to UK banks in the form of credit default swaps that include a general set-off provision entitling the investor to set off its indebtedness to the bank under the swap against any indebtedness of the bank to the investor. If the bank's indebtedness to the investor arises from "securities" (e.g. bonds), then, on the current proposals, it may be possible for the authorities to override such set-off provisions to the detriment of the investor.

Background

The global financial turmoil in recent months has seen a number of financial institutions fail or come perilously close to failure, both in the UK and elsewhere. The vicious cycle between loss of liquidity and lack of confidence, and the profound risks that a series of bank insolvencies would pose to the UK economy, have forced the UK government to develop an emergency strategy to tackle the problem. To date this strategy has consisted of implementing *ad hoc* solutions that range from capital injections (e.g. RBS) and government-sponsored mergers (the proposed tie-up between Lloyds TSB and HBOS) to outright nationalization (Northern Rock). These steps were effected under emergency legislation (the Banking (Special Provisions) Act 2008) and other general powers of the relevant authorities. It is now felt that a permanent statutory framework is needed to deal with bank failures.

As a result, the Banking Bill (the "**Bill**") was introduced into Parliament on 7 October 2008 with the aim of establishing a permanent regime, most notably a "special resolution regime" (the "**Regime**"), in order to formalize and enhance the powers available to the government's treasury department (the "**Treasury**"), the Bank of England (the "**BoE**") and the Financial Services Authority (the "**FSA**") (together, the "**Authorities**") in dealing with banks in difficulty and to modernize the law dealing with the position of insolvent or near-insolvent banks. The powers in the special resolution regime are to be used in extreme situations only and are to be exercised by the Authorities acting together. In broad terms the powers will be compartmentalized so that the FSA decides whether a situation is grave, the BoE decides whether intervention is necessary, and the Treasury has final say on decisions that impinge upon public funds—although in most cases the Authorities will consult each other before action is taken.

Despite the safeguards however, the Bill raises serious issues for wholesale creditors, particularly in the context of set-off, netting, security and structured finance arrangements. Having completed an initial round of consultation with the industry, the Government has just published proposals for safeguarding those arrangements, as well as creditors' rights more generally, when partial transfers of failed banks are to be made under the Regime. These safeguarding proposals are welcome. However, concern still remains at the ability of the Authorities to interfere with important commercial arrangements. The Government has made clear it does not wish in most instances to make any such interference. However, despite that, the haste with which the proposals are being rushed through Parliament raises the possibility that the drafting of the legislation may nevertheless permit interference by the Authorities with transactions entered into in the wholesale markets, with unforeseeable (and potentially disruptive) results.

Summary of the Bill

Legislative Intent

The statutory objectives of the Bill are to protect the stability of the financial system, public confidence in the banking system, depositors and public funds whilst avoiding interference with property rights protected by the European Convention on Human Rights.[1]

Many provisions of the Bill will require the Treasury, the BoE and the FSA to consult with each other before reaching final decisions, so that any action taken to address both the systemic impact of bank failures and to protect retail depositors can be more effective and better coordinated than has been the case in the past.

The legislation will be supported by regulations and a non-binding Code of Practice, a draft of which has now been published for consultation.

The Regime

The proposed Regime will be potentially applicable to any UK bank, which is defined (in summary) as an FSA-regulated deposit-taking institution which is incorporated in, or formed under the law of, any part of the UK. Separate provisions will apply to building societies and credit unions.[2]

Under the Regime, the Treasury, the BoE and the FSA will have three tools to deal with banks that get into financial difficulties: transfer to a private sector purchaser, transfer to a bridge bank and transfer to temporary public sector ownership. In the case of bank failure, the Bill will (when enacted) establish new administration and insolvency procedures.

The trigger for activating the Regime would be a determination by the FSA (after consultation with the Treasury and the BoE) that:

- a bank has failed (or is likely to fail) to satisfy the FSA's threshold conditions for operating;[3]
- it is not reasonably likely that action will be taken enabling it to satisfy such threshold conditions.

Many deposit-taking organizations potentially subject to the Regime carry out a suite of other regulated investment activities in addition to deposit-taking. The Regulators' powers apply in relation to institutions with a deposit-taking license but can be applied to other financial businesses within such an institution that are capable of being saved or sold. However, in many cases, there is likely to be a 'rump' of bad businesses that are capable of being neither sold nor saved. It is in relation to such businesses that more difficult issues

1 Clauses 4(4) to (8) of the Bill.

2 This note only deals with banks.

3 Such conditions are set out in the COND module of the FSA Handbook, and set minimum requirements for the adequacy of a firm's resources, as well as other aspects of a firm's business including legal status, the location of offices, relationships with other firms, and whether the firm is suitable to be authorized.

concerning creditors' rights arise, as is discussed in greater detail below.

New role of the BoE

The Bill will make certain changes to the Bank of England Act 1998 that are designed to improve the accountability and responsibility of the BoE in dealing with financial stability issues. A new Financial Stability Objective will be imposed upon the BoE, namely "to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom". A Financial Stability Committee will also be established, which will give strategic recommendations and advice about how the BoE should act in matters pertaining to the Financial Stability Objective, and it will also perform relevant functions delegated to it by the BoE.

Operation of the Regime to stabilize banks

In cases in which at least part of a failing bank is expected to survive as a solvent entity, the Treasury and the BoE will have the "stabilisation options" of transferring all or part of the bank to a willing private sector purchaser, a bridge bank or public ownership. Such options could be effected by exercising the "stabilisation powers" of transferring shares and other securities and/or transferring property and other rights and liabilities.

Private sector transfer or forced sale[4]

This stabilisation option will have several advantages over the existing provisions of Part VII of the Financial Services and Markets Act 2000 ("**Control of Business Transfers**"). For example:

- the controllers of the failing entity would not need to be willing sellers;
- there would be no need to apply to court (thus avoiding the attendant uncertainty and delay); and
- shares, as well as assets and liabilities, could be transferred.

Under the Regime, the BoE will be able to effect a private sector transfer or forced sale after consultation with the Treasury and the FSA, if:

- it is necessary, having regard to the public interest or the maintenance of public confidence in the stability of the financial or banking systems of the UK or the protection of depositors; or
- the Treasury has provided financial assistance to that bank as a stabilizing measure and recommended that a transfer to the private sector is necessary to protect the public interest, and in the BoE's opinion such transfer is an appropriate way to provide that protection.

Bridge bank transfer[5]

The Regime will, in addition, enable the BoE to transfer all or part of a failing bank's business to a bridge bank, which would be a company established under the Companies Act, limited by shares and wholly owned by the BoE. The BoE would thus be in a position to align the objectives of the management of the bridge bank with the objectives of the Regime.

The criteria for effecting a bridge bank transfer will be the same as for private sector transfers (see above). After the transfer, the BoE would have the power to sell the transferred business to private sector purchasers (having consulted with the Treasury and the FSA).

For each bridge bank transfer, a mandatory "bank resolution fund" would be established by the Treasury in order to provide the residual transferor bank – and its creditors—with a contingent economic interest in the net proceeds of the resolution. The Authorities recognise that the bank resolution fund may sometimes be too small to provide full compensation for creditors who have lost out through a partial transfer; however,

4 The Authorities have indicated that a transfer of all or part of a failing bank to a private sector purchaser by the BoE is likely to be the preferred option, as this would provide continuity of banking services while achieving desirable outcomes for creditors and counterparties as well as protecting public funds.

5 This would help to preserve stability, franchise value and continuity of banking services, while giving the central bank time to pursue a private sector solution – a strategy that has been used successfully in the United States, for example with the placing of IndyMac Bank into conservatorship in July 2008.

it is felt that this risk will be significant only where external market conditions play a decisive role.

The intervention of authorities using similar powers around the world has tended to result in value subsisting in those of a bank's businesses which are transferred (e.g. deposit-taking businesses) as such businesses retain a 'going-concern' value. Although the assets in the failed bank will as a result decrease in value, the bank resolution fund may in some instances receive significant funds from purchasers.

As a second source of redress, the Treasury would have the power to make "compensation orders" to provide for the assessment of any compensation payable to third parties whose property rights were interfered with in consequence of the transfer. This compensation is, however, likely to be limited where a partial transfer is made; in such an event, pre-transfer creditors' compensation will be limited to the amount they would have obtained had the bank been subjected to an ordinary whole-bank insolvency.

Public ownership[6]

The Treasury will also have the power to transfer all or part of a failing bank into temporary public ownership through the transfer of shares. This could be carried out only after consultation with the BoE and the FSA, and only if it is necessary to:

- resolve or reduce a serious threat to the stability of the financial systems of the United Kingdom; or
- protect the public interest, in cases where the Treasury has provided financial assistance to resolve or reduce such serious threat.

After the transfer, the Treasury would have powers (similar to those relating to bridge bank transfers) to return the transferred business to the private sector after consultation with the BoE and the FSA. The option would exist for a bank resolution fund to be set up, but in most cases former shareholders and third parties would be provided for by means of compensation orders.

6 The Authorities have indicated that this option would be deployed as a last resort.

Administration and Insolvency Cases

Bank administration

In cases involving a partial transfer to a private sector purchaser or bridge bank, a court will be able to make a bank administration order and appoint a bank administrator in respect of the residual bank.

The two objectives of a bank administrator would be:

- to provide support to the transferee bank by ensuring it is supplied with such services and facilities as the BoE thinks it requires to operate effectively; and
- either rescuing the residual bank as a going concern, or achieving a better result for its creditors than an immediate liquidation.

Only the BoE will be able to apply for a bank administration order, and to succeed the BoE will have to show that:

- it has exercised, or intends to exercise, its property transfer power; and
- it is satisfied that the residual bank is unable to pay its debts, or is likely to become unable to pay its debts, as a result.

Where appropriate, action can be taken in the public interest against directors of a failed bank under the provisions of the Company Directors Disqualification Act 1986.

Bank insolvency

Where the closure of a failing bank is considered to be the most appropriate option, a court may make a bank insolvency order and appoint a bank liquidator.

The BoE or the FSA (with the BoE's consent) will be able to apply for a bank insolvency order, on the grounds that:

- the bank is unable to pay its debts, or is likely to become unable to pay its debts; and
- the winding up of the bank would be just and equitable.

The Treasury will also be able to apply for a bank insolvency order, but only on the grounds that the winding up of the bank would be in the public interest notwithstanding that the bank is not technically insolvent.

The two objectives of a bank liquidator would be:

- to work with the Financial Services Compensation Scheme (the "**FSCS**", the powers of which are discussed further below) to ensure that each eligible depositor has his account transferred to another institution, or receives compensation under the FSCS, as soon as is reasonably practicable; and
- to wind up the affairs of the failed bank so as to achieve the best result for the bank's creditors as a whole.

The aim of this procedure is to ensure the swift payout of compensation to depositors, and to cut the time that depositors are denied access to their accounts.

Other reforms

The FSCS

The FSCS is a statutory scheme, to which all UK authorised deposit-takers must contribute. The FSCS provides compensation to retail depositors in the event of a bank failure up to a maximum (currently £50,000 per person) or more at the FSCS's discretion.

The Treasury will have certain new powers in relation to the FSCS, including powers to:

- make regulations permitting the FSCS to (i) impose levies on regulated financial institutions for contingency funds from which possible expenses may be paid and (ii) contribute to the costs of exercising the stabilisation powers;
- invest any sums received from FSCS contingency funds as part of the National Loans Fund (in order to reimburse the FSCS when it has paid out compensation);[7] and
- make loans to the FSCS (such loans to be funded from the National Loans Fund) in order to assist the FSCS in making payments to claimants.

[7] The National Loans Fund is the UK government's main borrowing and lending account.

Interbank payment systems ("IPSs")

An IPS is defined in the Bill as, broadly, an arrangement designed to facilitate or control the transfer of money between participating financial institutions. IPSs are currently not subject to formal regulation, but only to the informal oversight of the BoE. (On the other hand, payment systems embedded into recognized clearing houses are regulated by the FSA and the BoE has some insolvency law-related designation and consultation powers over such systems[8].)

Under the Bill, the Treasury will have the power to make "recognition orders" in respect of IPSs where it is satisfied that any deficiencies in their design or any disruption of their operation would threaten the stability of, or confidence in, the UK financial system, or otherwise have serious consequences for businesses or other interests throughout the UK. Such recognised IPSs will come within formal oversight by the BoE, which will include being required to have regard to principles and codes of practice published by the BoE, and to comply with orders and directions given by the BoE to operators. The BoE will have enforcement powers in the case of non-compliance.

What does the Bill mean for bank creditors?

The Authorities' powers under the Regime to transfer retail investors' deposits from a failing bank (the "**Bad Bank**") to a sounder private institution or bridge bank (the "**Good Bank**") could potentially give preferential treatment to retail depositors at the expense of the non-retail creditors of the bank.[9]

Concern arises in particular at the possibility that set-off and netting might not be protected, thereby disrupting the lending market and reducing the UK banks' ability to raise capital; that security might be moved to the Good Bank leaving wholesale creditors unsecured; that charges, particularly floating charges, might be overridden; and that structured

[8] Under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979).

[9] Retail depositors currently enjoy protection through the FSCS, but claims under this scheme are against the scheme itself, not preferential claims against the bank's assets.

finance transactions could be interfered with adversely.

The UK Government has now set out its proposals in the form of draft regulations for dealing with these concerns. The draft regulations are generally to be welcomed. It is proposed that all contracts covered by set-off or netting arrangements (including bespoke agreements as well as those made under industry standard forms) be protected from disruption in a partial transfer. The draft regulations seek to achieve this objective by expressly providing that a partial transfer of a bank must keep together so-called "protected rights and liabilities" that exist between a particular person and a bank, i.e. rights and liabilities of a person which that person is entitled to set off or net under an agreement.

There are four principal carve-outs to this protection, although the Government may add more. The first carve-out relates to rights and liabilities that are foreign property. This is to enable a transfer of contracts even where non-transferable foreign law contracts are covered by a netting agreement. The second carve-out covers claims arising from debt securities issued by the failed bank on the ground that counterparties 'generally do not tend to expect these claims to be included in set-off and netting calculations'. The proposals do not address how narrowly 'securities' will be defined. If a protection seller's indebtedness to a bank under a credit default swap could be set off under the provisions of the swap against any indebtedness of the bank to the protection seller, however arising, and if the bank's indebtedness arises under bonds held by the protection seller, it seems that the protection seller's rights under the bonds would be excluded from protection with the result that no set-off is possible under the swap after a partial transfer that leaves the swap with the Good Bank but the bonds with the Bad Bank. Furthermore, would collateralised debt obligations or collateralised loan obligations which contain set-off provisions constitute securities and hence fall outside the scope of protection? The third carve-out relates to claims that are, in the Government's view, critical to the preservation of banking continuity such as retail deposits, mortgages and other loans, as well as liabilities other than financial contracts in the ordinary course of business, e.g. trade debts and litigation claims. The fourth carve-out would enable the authorities to transfer any liabilities that constitute some or all of a counterparty's claims against the bank so that the counterparty can enforce the claims against the solvent Good Bank.

For those holding security interests over a bank's assets, the Government proposes an explicit safeguard in secondary legislation for such security holders. These protections apply to floating charges as well as to fixed charges and other types of security. Thus, a partial property transfer may not transfer the property or rights of a bank against which its liability to a person is secured unless the bank's liability to the person is also transferred. This raises potential issues of preferential treatment. For example, if some creditors have security over the Bad Bank's assets and such assets (and the corresponding liability of the Bad Bank) are transferred to the Good Bank, they will be able to enforce their security after the transfer. However, those secured creditors whose security is not transferred to the Good Bank may find themselves unable to enforce such security in full if the Bad Bank is placed into administration and there is a shortfall of assets subject to the security arrangements.

Although protection is extended to floating charges, the Government notes in the proposals that it is unlikely that banks would start granting "whole business" floating charges to their creditors. It expects the FSA to use its powers to ensure that banks do not generally grant such floating charges.

The proposals would additionally confer protection on rights and liabilities which are the subject of financial collateral arrangements under the Financial Collateral Directive.[10]

Furthermore, there will be a safeguard protecting structured finance obligations from disruption due to partial transfers.

If there is any breach of the safeguards by the BoE, the affected person may give notice in writing to the

[10] Directive 2002/47/EC.

BoE specifying the breach that has occurred. The BoE is then required, within 30 days of receiving notice, to remedy the breach if it agrees one has occurred or, if it does not agree a breach has occurred, to give reasons for its views.[11] An absolute prohibition on breaching the safeguards would have been a much more welcome option than the proposed notice procedure, given the certainty it would engender amongst financial institutions and their advisers about the inviolability of set-off arrangements, security interests, financial collateral arrangements and structured finance transactions.

To deal with issues of preferential treatment that might arise once a bank's retail deposit book (together with healthy assets) is transferred to the Good Bank, the Government proposes a new protection that aims to ensure that creditors remaining in the residual bank (i.e. the Bad Bank) will be no worse off after a partial transfer than they would have been had the bank been subjected to an ordinary insolvency (as opposed to the partial transfer regime). The proposals envisage the calculation by an independent valuer of the dividend, if any, that creditors of the Bad Bank would have received from an ordinary whole-bank winding up of the failed bank. This is then compared to the actual dividend payable to the creditors of the residual bank on its winding up. Any shortfall would then be paid under a third party compensation order.

Comparison with Bank Insolvency regime in the United States

Banks in the United States are not subject to the U.S. bankruptcy code but to a tailored bank insolvency regime under the National Bank Act, the Federal Deposit Insurance Act and the Federal Deposit Insurance Corporation Improvement Act which confer a wide range of powers upon the regulatory agencies responsible for administering such insolvency proceedings, primarily the Federal Deposit Insurance Corporation ("FDIC").[12] Under the U.S. regime, administrators of insolvency proceedings may:

- take such action as may be necessary to restore or strengthen the bank's operations, preserve its assets and carry on its business so that the bank may re-commence operations as a going concern or be sold to another bank; or
- appoint a receiver whose mission is principally to liquidate the banks' assets and wind up its affairs by realising on the bank's assets and repaying its creditors.

The FDIC may auction off a failing bank's assets to other chartered banks or it may otherwise arrange for a sale of all or part of such bank. The FDIC may also promote the merger of one bank with another, transfer any asset or liability of the failing bank to healthy bank (without shareholder or other consent), or establish a transition bridge bank, which may be owned in whole or in part by the FDIC, to assume the weakened bank's deposits and other liabilities while acquiring its assets. Historically, such transitions have worked seamlessly from the retail depositor's point of view.

[11] The BoE can also state that it agrees a breach of the safeguards has occurred, but not the one identified by the affected person. The BoE is then required to take such steps as it thinks fit to remedy the breach it has identified.

[12] An independent agency of the federal government, the FDIC, was created in 1933 in response to the thousands of bank failures that occurred in the 1920s and early 1930s. Since the start of FDIC insurance on 1 January 1934, no depositor has ever lost a single dollar of insured funds as a result of a failure. The FDIC directly examines and supervises approximately 5,250 banks and savings banks, more than half of the institutions in the banking system. Generally, in the United States, banks can be chartered by the states or by the federal government. Banks chartered by states also have the choice of whether to join the Federal Reserve System.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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