Financial Stability and Depositor Protection: Further Consultation and Special Resolution Regime

Introduction

We are grateful for the opportunity to respond to the July consultations of the tripartite authorities (the **Authorities**) on financial stability and depositor protection.

As a law firm, our principal concerns with the regime are issues raised by the proposals which go to legal and regulatory certainty. Accordingly, this response primarily focuses on legal and regulatory issues raised by the proposals of the Authorities, and in particular addresses the special resolution regime (**SRR**). Other market participants are better placed to address commercial and economic consequences of the proposals.

This response includes a discussion of the wider issues that the SRR raises, together with an Appendix responding to individual consultation questions. We would be delighted to meet with the Authorities to discuss any aspects of this response, whether alone or with other law firms or market participants. Please refer any questions or comments to Bob Penn (bob.penn@allenovery.com) in the first instance.

About Allen & Overy LLP

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Background

English law (and English courts) is one of the great UK exports. It supports a thriving legal community in the City and elsewhere. It is also a significant factor in the desirability of London as an international financial centre.

London, and indeed English law, have competitors – both within and outside Europe. Key to a successful legal system is respect for property rights, certainty and the rule of law. We believe that these are key to the continuing success of the City. Any erosion of these risks undermining that success and the competitive position of London.

The financial industry is global, highly competitive and mobile. (An example of that mobility is the movement of equity derivatives business to London, following the regulatory turf-wars between the US regulators in the early 1990s.) We are concerned that the SRR, by upsetting legal certainty, will be a significant disincentive to investment in the UK banking industry, and to contracting with UK banks under English law. This will adversely affect the position of UK banks relative to their competitors; the position of London relative to other European financial centres as the best European headquarters for non-European financial institutions; and the success of the English legal system (and hence legal industry).

The proposals therefore present risks not just to banks, but to the legal industry and indeed the wider economy. Given the mobility of the financial markets, the Authorities must be careful not to give market participants incentives to relocate.

Why certainty matters

Certainty matters. Implicit in a decision to buy a bond from, or enter into a swap or repo with, a UK bank is an assumption as to the enforceability of the rights in the bond or agreement; and an assessment of the impact of failure of the bank on the rights of the bondholder or counterparty. Commercially, stakeholders need certainty as to what they are buying into when they buy securities in, make a deposit with, or enter into a swap with, a UK bank. This certainty extends to knowledge of their position on a default of the bank - in

particular that swaps and similar agreements can be closed out and collateral realised, and that the stakeholder will be in the queue of creditors waiting to receive the proceeds of the insolvency. The law gives them that certainty.

Uncertainty carries a cost. For example:

(a) A shareholder who is unsatisfied with the compensation he may receive for a bank nationalised or sold under the SRR will be less willing to invest in bank stocks.

(b) A bondholder who discovers that the rules of the game have changed and he may not form part of the orderly queue of creditors, or that fewer assets are left for creditors than would otherwise have been the case, will demand a larger risk premium - or simply be unwilling to invest. Increased risk premiums mean increased credit spreads.

(c) A lender who realises that he may not be able to pull his credit lines on a counterparty entering the SRR may think twice about making a commitment to lend: in addition, a lender with existing outstanding debt due from a borrower, who discovers his ranking on an insolvency of the borrower may be impaired, will suffer greater risk as a result – and will be likely to find out that the secondary market for such debt exposures is impaired.

(d) A party to a contract who finds that his contract is not enforceable with its terms against his counterparty is likely to reconsider his position before entering further contracts with that counterparty.

(e) An investor in a covered bond who discovers that the covered bond pool may not be ringfenced against the issuer's default will want a higher risk premium to reflect the fact that he is possibly unsecured – or not invest at all. Increased risk premiums mean increased credit spreads.

(f) A swap counterparty whose legal opinions change to indicate that he may no longer manage his risk on a net basis as the close-out netting and/or collateral arrangements he has in place are not enforceable on the occurrence of the SRR may reduce his credit lines to the bank, or change his arrangements to take them outside the scope of the regime (for example by moving to non-UK governing law and collateralising the relationship offshore), or simply take his swaps business elsewhere.

(g) A rating agency rating a securitisation in relation to which there are doubts as to the true sale of assets from the originator bank to the SPV may refuse to give a AAA rating to the deal – resulting in the securitisation paper becoming unattractive to investors and ineligible for certain Bank of England liquidity schemes.

All of these situations would carry a cost to the relevant UK bank. Some of them also have immediate wider repercussions (e.g. on regulatory capital); some of them do not. Together they show how the loss of certainty would have a damaging effect on the UK banking industry.

The case for an SRR

The case for an SRR in the form proposed has not been made, in our view. Neither the initial consultation nor the subsequent consultations have addressed the need for further powers for the Authorities in light of their existing powers. The issues arising from Northern Rock were more about the failure of regulators than the failure of regulation. For so long as regulators are incentivised to exercise forbearance the risk of regulatory failure will persist. No amount of additional powers will address the risk – but they may do further damage to the standing of UK regulated financial institutions.

In our view the right target for the Authorities is therefore improved regulation, not further powers to deal with failing institutions.

However, we understand the perceived need for something to be done to address the potential risk associated with a bank failure – and progress for the purpose of this paper on the basis that an SRR may be a useful tool for the Authorities, if drawn up correctly, with appropriate powers and limits on those powers.

Concerns

Our primary substantive concerns are as follows:

- legal and regulatory certainty;
- predictability;
- ensuring so far as possible, equality of treatment of stakeholders in a failing bank; and
- avoiding preferential treatment of the Authorities and/or depositors (other than to the extent provided for by the FSCS).

The balances between Authorities' powers and private law rights

The SRR has to strike a number of balances. These include the balance between the importance of prevention of (i) systemic failure and (ii) depositor loss[1] on the one hand with the adverse consequences that taking powers to deal with those events could have (i) on private law rights and (ii) as a result, on the wider markets and investor confidence. In particular, a solvent rescue may necessarily involve infringing rights of stakeholders in a failing bank.

The question of what is the right balance between these competing interests has been raised, but not discussed in any detail, in the consultation process to date. The January consultation (question 4.5) asked whether the potential abridgement of property rights in the special resolution regime can, in principle, be justified with a suitable public interest test. The abridgement of property rights is an area of critical concern and the answer is dependent on the form that this would take. However, respondents have not been given sufficient information – even at this late stage – to formulate a meaningful answer to this fundamental question.

In addition, comments of respondents to the first consultation on these areas appear not to have been taken into account in the further consultations. Further, neither of the subsequent consultation papers has included a discussion as to the balance to be struck between the maintenance of financial stability and the protection of depositors on the one hand, and the erosion of the rights of stakeholders on the other, and no cost-benefit analysis has been conducted to demonstrate the benefits of the proposed regime.

Cost-benefit: acknowledging the costs

We note above that no cost-benefit analysis has been conducted as yet into the proposals. It is in our view essential that this analysis be undertaken in respect of each arm of the SRR, as we believe that the economic costs associated with loss of legal or commercial certainty are likely to substantially outweigh any incremental benefits for financial stability. Quantification of this is easy in relation to some areas, and difficult in others: but as recent events show, market confidence is an intangible whose absence can have serious effects.

Negative affects on legal enforceability have a direct economic cost. The simplest example is netting and collateral, where economic capital and regulatory capital requirements will increase if market participants

[1] We believe that of the two concerns – systemic failure and depositor protection – the second is of considerably less importance: improvements to the FSCS should be capable of dealing with concerns around depositor protection.

can no longer achieve certainty as to the enforceability of their contractual and proprietary rights. This will have knock-on effects for the availability of credit and the wider economy at the very point in the economic cycle where such effects are least desirable. Other examples also exist – in particular the impact of uncertainty on creditors to a bank where the partial transfer tool is used.

They also have indirect economic costs. The effect of decreased market confidence is one. Allowing unfettered rights for the Authorities to disenfranchise stakeholders in failing banks (and possibly their group companies) would damage market confidence in the UK system, which we believe will carry significant costs for the industry when seeking to raise funds – particularly in the capital and inter-bank markets.

Increased financial instability is another. The SRR actually risks decreasing interbank liquidity and increasing financial instability. If the SRR proposals ultimately discourage other banks from lending to a UK bank facing financial difficulties (because of uncertainties as to the rights and position of such lending banks in the event of the SRR being utilised), this could seriously jeopardise the rescue of that bank. This in turn could exacerbate the financial instability which the SRR is intended to prevent. Contractual overrides (in relation to lending or other commitments) could also have exactly this effect, for example.

Timing

From a procedural perspective we remain of the view that given the complexity of the regime and the scale of its impact on the UK banking industry, it remains overambitious to suggest implementation until there is a full consultation on the terms of the SRR. The remaining uncertainty about the fundamental points of principle discussed above illustrate that we are far from a fully thought out regime.

Until we have a fully thought out regime, it is impossible to assess the consequences of the regime – and hence quantify the costs. It seems disproportionate, and fundamentally rash, to implement a regime whose impact on the UK banking market could be so substantial without having given market participants sufficient information to rationalise its effects. It hence risks doing for the UK banking industry what Sarbanes-Oxley did for the US equity market.

Principles underlying the SRR

In light of the ramifications of the SRR we believe that the following principles must underlie its structure, as well as its practical operation:

(a) The SRR should have predictable outcomes: a stakeholder in a bank (whether as shareholder, creditor, collateral holder, employee or pension trustee) should be able to assess the effect each SRR option will have on its stake.

(b) The SRR should not prejudice legal and regulatory certainty as to contractual and property rights. In particular it should not prejudice close-out netting or the existence or enforceability of property rights (including in collateral).

(c) The SRR should not disturb the rights and *pari passu* treatment of creditors arising on an insolvency, including preferring (in practice) the Authorities or depositors.

(d) The SRR should operate on the basis of procedural fairness, making the Authorities accountable for their actions and giving adequate rights to stakeholders to be heard and obtain recourse through an appropriate forum.

All of these principles are, we believe, sufficiently fundamental to require enshrinement in law. Putting them into a code will not be sufficient to provide legal and commercial certainty – particularly in the absence of precedent. We are also concerned at the proposals that any primary legislation could be amended in the future by secondary legislation as this will lead to even greater legal uncertainty in respect of stakeholder rights.

In addition, the SRR should not result in any loss of competitive advantage for the UK banking system within the EEA - in particular by encouraging investors to invest in non-UK banks rather than UK banks or by encouraging non-EEA banks to establish EEA banking subsidiaries outside the UK.

We believe that these principles can be respected with respect to stakeholders other than shareholders in relation to the majority of the SRR options, subject to the removal of some of the more unworkable overrides on private law rights. However, partial transfers (whether to a bridge bank or a private sector purchaser) raise very serious difficulties. This arises because an option to undertake partial transfer (leaving a "good", solvent, transferee and a "bad", and almost certainly insolvent, residual company) is fundamentally incompatible with several of the principles above. At a cost to the authorities' flexibility, it can be made to provide legal certainty, and in particular to respect close-out netting and property rights in collateral (we would regard these as necessary conditions to the regime). But it is incompatible with commercial certainty and destroys creditor rights on insolvency. We would also question whether partial transfer would be likely to be practicable.

We therefore strongly believe that the partial transfer route should not be included in the final legislation. All of the detailed responses below should be read subject to this overriding point. If the authorities choose to include partial transfer, then there must be appropriate limits and safeguards (in addition to compensation) to ensure clarity of the authorities' powers over private law rights: these must be set out clearly, consulted on, and have been the subject of cost-benefit analysis prior to implementation.

Illustration

By way of illustration of the potential impact of the SRR: market participant A has bonds in, and OTC derivatives collateralised under a credit support annex with, UK bank B. It is considering buying further bonds in B.

Bond

A's credit committee must be able to assess the additional credit risk associated with holding bonds issued by B as a commercial matter. If the SRR is to affect that credit risk assessment, then any uncertainty about how the SRR will affect the credit position will be reflected in a more pessimistic assessment. Legal certainty (including as to the terms of the debt securities, and ranking on insolvency) as part of certainty as to creditor rights will be a key input to that assessment. If that assessment becomes more pessimistic, then the risk premium associated with the relationship will increase, thereby increasing the costs of borrowing and derivatives business for B. The ability of the Authorities to vary or nullify contracts where contractual or other provisions present a barrier to taking action under an SRR (e.g. negative pledges) will also be a cause for concern.

There is a very real risk that the Authorities' powers and objectives will be read as statutory subordination. A conservative bondholder would in our view regard the objectives requiring protection of depositors and public funds as a mandate to prefer depositors and the Authorities – with a consequential increase to risk premium. A sophisticated bondholder would be likely to regard the financial stability objectives as indicating likely preference of interbank debts as well – with a further increase to risk premium.

From a regulatory perspective, A will need to be able to assess loss given default (**LGD**) for its own regulatory capital purposes. The greater the uncertainty as to LGD, the greater the capital charge to A, which will in turn be reflected in an increased cost of credit to B (and other UK banks). We are concerned that given the potential concentration of creditor loss under a partial transfer scenario, the SRR will directly affect this assessment as well.

The loss of creditor rights on an SRR will also impact marketability given uncertainty around the value of the insolvent estate of a residual bank. This too may also be expected to affect investment decisions.

Swap

In relation to the swap relationships, in addition to the points raised above, any restriction on the recognition of close-out netting or right to enforce against collateral will have material consequences for regulatory capital requirements for A. If A is a bank, it is required to be satisfied as to enforceability of collateral rights under applicable bank regulation. It is also required to be satisfied to an opinion standard as to enforceability of close-out netting[2]. If either of these conditions is not met then it will be required to hold collateral on a gross basis (i.e. on the basis that the collateral right and/or netting right is not effective in mitigating credit risk, as the case may be).

A move to calculating capital based on gross exposure requirements will render the regulatory capital cost of the swap relationship prohibitive. Legal doubt on the enforceability of collateral rights or of close-out netting would affect enforceability opinions and could ultimately cause collateral and close-out netting to be derecognised for regulatory purposes, with adverse consequences for B's ability to engage in derivatives transactions.

We note that the Financial Markets Law Committee response to the SRR consultation paper includes a worked example of the potential impact of the SRR on netting and collateral relationships: we endorse this.

Other concerns

We believe that there are other areas and concerns that have not yet been adequately addressed by the Authorities. These include the following.

The state aid and competition issues that arise in relation to partial transfers to bridge banks, public funding and the payment of fees by a bridge bank for the provision of services by the residual company through the special bank administration procedure have not been fully considered in the consultation papers.

The SRR also raises complex conflicts of law questions. As a general matter foreign law will not respect the transfer of contracts other than in a universal succession. This may drive overseas counterparties to seek to contract under foreign law and collateralise relationships offshore to avoid the possibility of contractual override or disenfranchisement by the Authorities – with consequential economic knock-on effects for UK banks.

It is not clear whether partial transfers or provisions nullifying or varying contractual rights would be recognised outside the UK or in respect of contracts governed by laws other than English law. It is also not clear whether the special insolvency procedures would be recognised as "insolvency procedures" for the purposes of the Credit Institutions Winding Up Directive so as to be recognised throughout the EEA – in particular the special administration regime for dealing with a residual company following a partial transfer to a bridge bank.

The interrelationship between the regime and the Financial Collateral Directive remains unclear.

Is the US model a good model for the UK?

The Authorities have looked overseas for regimes for dealing with failing banks when putting together the proposed SRR - and in particular to the US regime under the Federal Deposit Insurance Act (**FDIA**), administered by the Federal Deposit Insurance Corporation (**FDIC**).

We believe that the US model is not a good precedent for the UK for the following reasons.

[2] See, for example, the recast Banking Consolidation Directive Annex VIII, Part 2, Paragraph 3(a) (on balance sheet netting), and Annex III generally (off-balance sheet and cross-product netting).

(a) FDIA is largely designed for small banks. The UK bank market is dominated by a small number of large banks. It is unclear whether the FDIC would be able to handle the failure of a large US bank. The general perception is that such banks are too large to be allowed to fail.

(b) US Banks are not "universal" banks: their activities are limited by US law to engaging in specified powers such as deposit-taking, lending, custody and trust activities. US banks typically do not have substantial secured liabilities: many UK banks do. FDIA's provisions impairing creditor rights therefore do not greatly displace the expectations of bank creditors: equivalent rules applied in the UK would do so.

(c) The FDIA regime has received criticism for impeding innovation and competitiveness within the US market. As FDIA includes a moratorium on most creditor action, the development of new products often requires the consent of the FDIC before a product may be sold. This tension then is often resolved in favour of the FDIC, which inhibits new products finding their way into the market. A recent example of this is the development of covered bonds in the US, where the FDIC's refusal to provide guidance recognising that the rights of bondholders in collateral would be respected on the bank's failure held up the development of the US covered bond market.

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Detailed comments on the consultation questions and draft clauses

First July consultation

Our comments on the first consultation are limited to question 3.1.

Paragraphs 3.28ff of the first July consultation requests views on the possibility of statutory nullification of restrictions on borrowing and provisions having a similar effect to the extent that the same would prevent financial assistance by the Authorities for the purposes of financial stability or are otherwise triggered by steps taken by the Authorities (the statutory override). Regulation restricting the ability of banks to enter into such provisions is suggested as an alternative.

Statutory override

A statutory override along the lines suggested would be a disturbing development. The scope of the provision is not clear (as to which see our further comments below), but the effect of such a provision appears dangerous in effectively negativing counterparty rights and/or subordinating the rights of market participants to those of the Authorities. To do so would be fundamentally prejudicial to counterparties, give rise to legal uncertainty and raise the costs of funding for UK banks.

Purpose

Although the purpose of the provision is not entirely clear from the draft, we make two assumptions as to the purpose of the provision.

We assume it is not the intent of the Authorities to prevent banks from providing security to counterparties for their obligations (which would be unfeasible, given the extent of secured arrangements to which banks are party customarily - eg covered bonds, repos, collateral annexes to derivatives documentation, collateral provided to clearing houses). All of these have the effect of depriving the Authorities of potential collateral, and therefore potentially preventing financial assistance.

We also assume that it is not the intention of the government that the provision should affect established UK insolvency law. Where the effect of an action taken by the Authorities is to render a bank insolvent, it must be clear that any power to nullify provisions does not extend to a counterparty's right to terminate for default or vary any contractual term so that the variation would have effect on the insolvency of the bank. To do otherwise would give the Authorities an effective preference and raise serious questions over the fairness of the UK legal environment.

If either of these fundamental assumptions is incorrect we believe that further consultation would be necessary to give respondents the opportunity to consider the wider implications for legal certainty and credit risk management, and respond appropriately.

Scope

It is not clear from the paper what the scope of contractual provisions intended to be covered is. The example of a negative pledge is given: but potentially a whole variety of legal provisions could prevent financial assistance, including undertakings to take on only pari passu debt, floating charges, account control agreements, other legal provisions securing assets in favour of a counterparty and thereby rendering them unavailable to the Authorities for security purposes, or limits on commitments to lend. A further array of provisions (including termination rights) could be triggered by steps taken by the Authorities.

There is also a significant question as to what "would prevent" financial assistance. It should be made clear that a provision is within scope only if it prohibits borrowing by the bank from, or the provision of unencumbered collateral to, the Authorities.

Similarly, it is unclear what provisions that would be triggered by the Authorities should be captured. While we see some case to make for ousting provisions directly triggered by Authority action, contractual certainty demands that the scope of what provisions will or will not be ousted is clear. The Authorities' actions are likely to have knock-on effects - for example, in the case of liquidity provision, an increase in liquidity of the bank in return for a decrease in its credit profile credit (by reason of provision of collateral); or in the case of an SRR transfer, change of control. While there may be a case for overriding termination events arising from the action of the Authorities itself (for example lending by the Bank of England), extending the statutory override to oust related provisions (such as termination arising by reason of the deterioration of the credit of the bank or change of control) would have undesirable consequences for legal certainty and counterparty rights.

Consequences

Even on the basis that the assumptions above are correct and the suggestions above taken on board, the proposals still raise concerns. While there seems to be a good policy reason for disapplying negative pledges, there would be a potentially considerable cost to the beneficiary of such a provision - who will be likely to have a legitimate commercial interest in avoiding deterioration in the bank's assets arising by virtue of the provision of collateral or security in return for borrowing. Quantifying that cost would be difficult: but a counterparty to a transaction with nullified provisions on inception of the regime could reasonably claim that he is prejudiced as a result of the operation of the provision and should be compensated for the loss.

In relation to the further limb of the provision - provisions triggered by steps taken by the Authorities - there are considerable concerns around certainty, subordination and insolvency. A much wider array of provisions could be triggered by steps taken by the Authorities - including close-out provisions - depending on the actions taken by the Authorities. This would leave considerable uncertainty as to what contractual provisions a counterparty could rely on.

There is also a wider concern that the provision could be used to support an effort by the Authorities to ensure that they are effectively statutorily preferred by overriding the rights of other counterparties and lending as a super-senior creditor. We believe that this is not an appropriate approach, and would have seriously adverse effects on the ability of banks to raise funds in the market.

Regulation prohibiting negative pledges

Regulation prohibiting banks from entering into such provisions would in our view be a more equitable way of dealing with the issue. Such an approach would necessarily have to leave existing negative pledges or similar in place, but would avoid the considerable uncertainty mentioned above. There is also a precedent in the form of the historic prohibition on banks granting floating charges.

We would therefore strongly urge the Authorities not to intervene in the operation of contractual and property rights in relation to this point, but rather regulate. If the Authorities do choose to intervene in contractual and property rights, then there must be clarity of its intervention powers: currently there is none. Given the damaging effects of intervention powers, there must be consultation on a fully thought through set of rules on the topic if a workable result is to be attained.

SRR

Our responses to the questions on the SRR consultation are as follows.

CP Q	***Issue***	***Comment/response***
	Scope	We have a general comment on scope. The current draft clause 2 would capture insurance companies with permission to accept deposits and friendly societies as well as banks. It should be carved back to exclude them.
2.1	Do you agree with the SRR objectives, as set out in draft clause 4?	The SRR objectives, as expressed, are unclear and unhelpful. They conflict in a number of areas (for example, objectives 3 and 4 conflict with 5): there is no guidance as to how those conflicts would be resolved. The absence of any guidance to priority of the application of the objectives in any case renders the objectives effectively of no comfort to banks (or stakeholders in banks). We would query what use they therefore serve. We believe that there may be a case for a least cost resolution objective to be included.
2.1		Presumably the reference in objective 3 to depositor protection should be limited to retail, rather than wholesale, deposits. We are also concerned that the depositor protection objective could give rise to an inference that depositors are (through the SRR) to be preferred over other creditors even if such depositors are not to be given priority in the special bank insolvency procedures. This could tend to point towards a partial transfer solution being used to transfer deposits where depositors could otherwise not receive the full amount of their deposits back (and indeed the consultation paper envisages a transfer of the retail deposit book as a possible example of a partial transfer). We do not believe that this would be the right approach: any suggestion of statutory

		preference will adversely affect creditor certainty and increase the cost of funding. It may also affect UK banks' access to liquidity via the interbank markets. We believe that the objective would be better expressed as "to ensure the continuity of banking services to retail depositors" or similar. A similar point arises in relation to the objective relating to the protection of public finances. We assume that it is not intended to use the regime to provide for preference of sums owed to the Bank of England: it should be made explicit, whether in the Code or elsewhere, that that is the intention of the authorities.
2.2	Do you agree with the role of the FSA in determining the conditions for entering the SRR?	Yes.
2.3	Do you agree with the conditions for entering the SRR as set out in draft clause 7?	It is important to define what constitutes "ordinary market assistance" offered by the Bank of England on its usual terms. Presumably, the post-SLS arrangement currently under discussion will fall within "ordinary market assistance".
2.4	Do you agree with the role of the Bank of England in operating the SRR in the public interest as set out in draft clause 8?	There is an interrelationship between the improvements to depositor protection under the consultations and the operation of the SRR. Assuming that changes to the FSCS payout are to protect depositors, we see no justification to prejudice creditors in the interests of the protection of depositors who are already protected. We therefore believe that the balance between legal and commercial certainty and depositor protection should be drawn such that condition (c) (protection of depositors) is not sufficient to trigger the private sector purchaser or bridge bank tools.
2.5	Do you agree with the roles of the Treasury as set out in draft clauses 8(4), 8(5), 9 and 10?	Yes.
2.6	Do you agree that the SRR objectives should be supplemented by a code of practice?	As a "soft" means to indicate how the Authorities will deal with the run-up to and implementation of the SRR we believe that a code of practice (**Code**) may have considerable value. Given the potential importance of a Code to counterparty confidence, we believe that it should be publicly consulted on in accordance with the better regulation

		principles before implementation. We are also concerned about how the Code may be updated – there is no reference to consultation on amendments. Any amendments should be consulted on.
2.7	Do you agree with the proposed areas to be covered in a code of practice?	As indicated in the introduction to this response, there are a number of concerns with the use and status of a Code. For purposes of legal certainty, however, and in particular to provide safeguards around property or creditor rights that could be disturbed by the operation of the SRR, as guidance it is arguably valueless – particularly absent any precedent – in relation to the exercise of powers. Any additional safeguards, particularly on those areas, must appear in the legislation as limitations on the Authorities' powers.
3.1	What are your views on the breadth of the property transfer powers in clauses 14 to 23? Are there particular powers that are lacking?	See the introduction and our response to question 3.6 below, in relation to partial transfers. We believe that share transfer powers are generally acceptable subject to appropriate compensation provisions for existing shareholders, but believe that share transfer powers should be consulted on along with property transfer powers. We would appreciate information on what further provisions the Authorities would seek to make as suggested in para 3.10 of the CP. There are no powers lacking.
3.1	Effect of transfer	Legal certainty demands that the party to a contract or other legal instrument has certainty as to his rights and obligations. The interaction of section 15(3) with contractual provisions is particularly important here. Any override should not prejudice other provisions of the agreement. So, for example, a contract may include a right of the counterparty to terminate on any of the following events: (i) if the bank is below a specified credit rating (assuming the transferee is unrated); (ii) on the exposures of the bank to the counterparty exceeding a limit. We see no policy reason for an override limiting the ability of the counterparty to exercise its rights to terminate if either of these termination triggers is met following a transfer. It is not clear whether these are

		intended to be capable of override under clause 19 of the proposed legislation. In our view such contractual rights should not be overridden by the statutory provision: the transfer should occur without prejudice to any other lawful right or obligation of the parties. Compensation is likely to be perceived as inadequate recompense by industry for loss of termination rights, and quantification will be difficult. Another example is loan agreements, where a counterparty's commitment to lend may terminate on the occurrence of certain events. Lenders would be surprised, and no doubt consider themselves seriously prejudiced, to find that they could not pull lines of credit on the occurrence on the SRR. Lending commitments should not be subject to a contractual override from the authorities. As noted in the introduction, netting must be protected on a transfer. This must be codified in the legislation to enable netting opinions to continue to be given.
3.2	What are your views on the nature of these powers? (Share transfer powers)	The share transfer powers of themselves are not of concern, provided that appropriate compensation rights are provided. The scope of the Banking (Special Provisions) Act to securities other than shares gives rise to wider concerns, however. The Authorities should bear in mind that powers taken with respect to securities other than shares give uncertainty with respect to holders of those securities. While we believe that equity interests, and rights in or to equity interests, are appropriate subject matter for transfer and consequential powers, the case for hybrid capital instruments to be so affected has not been made. We believe that the rights of the Authorities with respect to shares should not extend to other securities.
3.3	Do you consider that a company limited by shares, with the Bank of England as the sole or controlling shareholder, would be the most appropriate governance structure?	We agree that a company limited by shares is the most appropriate legal form of a bridge bank. There are questions as to capitalisation: particularly as to what (if any) return on capital the Bank of England would anticipate if it were to capitalise a bridge bank, and how this would (i) rank relative to the interests of disenfranchised stakeholders in the failing bank and (ii) interrelate with payment for the SRR by the FSCS. More detail is needed on these points. Operationally, we would query how it is proposed that a bridge bank will be capable of compliance with the detailed requirements of the FSA Handbook. In

		particular, a bridge bank, at inception, would need to comply with: - the regulatory capital requirements applicable to banks. How will capitalisation occur? Given that typically a failing bank will be likely to be failing, or on the verge of failing, the financial resources requirements (in respect of capital against credit and market risk, and/or (more likely) liquidity risk), how will credit or liquidity enhancement be given to the bridge bank? Will this be provided by the Bank of England through additional capitalisation and/or liquidity? - systems and controls requirements: a bridge bank will also need off the shelf systems and controls to comply with the requirements of SYSC. Again, we would be interested in exploring how these requirements would be satisfied.
Para 3.27	Bank resolution fund	We endorse the clarification that the bank resolution fund would be established where the bridge bank tool is used. See further our comments below.
3.4	Do you agree that the lifespan of a bridge bank should be limited? What do you think is an appropriate length of time?	No comment.
3.5	Do you think that the extension of a bridge bank's lifetime should be subject to certain conditions? If so, what?	No comment.
3.6	Do you think that partial transfers increase the chances of the successful operation and sale of a bridge bank and the chances of a private sector purchase?	Partial transfer undoubtedly increases the chances of a successful operation and sale of a bridge bank and/or private sector purchase. However, as indicated in the introduction the real question is one of the cost-benefit analysis – whether the ongoing costs to the industry in allowing partial transfer (in particular in the commercial ramifications for legal and contractual certainty) outweigh the benefits. We believe that the costs substantially outweigh the benefits. Partial transfers in practice will almost inevitably be a form of **statutory preference**: counterparties to transferred assets (which will be performed) will effectively receive a preference relative to creditors to untransferred assets (which will not). (This will occur not least because of the overcollateralisation of assets relative to liabilities on transfer to ensure continued compliance with capital adequacy requirements – this is indicated in paragraph 3.50 of the consultation.)

		Partial transfers will also affect **commercial certainty – not just at the point when a bank is put into the SRR, but in relation to all commitments of UK banks**: a creditor of a bank does not know whether, in the event the bank is put into an SRR, his entitlement will be transferred, or left in the residual bank. Because the powers place no limit on the Authorities' ability to effect partial transfer, his possible loss given default following SRR implementation may be nothing (if the debt is transferred to the bridge bank or private sector purchaser), everything (if all the assets are transferred out of the residual bank, the debt is left within it, and the bank resolution fund does not generate a return) or anything between those extremes. This may potentially have a damaging effect on the capital cost for the regulated sector of doing business with UK banks, as LGDs will become more difficult to calculate (and therefore possibly may be presumed to be zero). Partial transfer also creates legal uncertainty, including (i) as to counterparty, (ii) as to the effect of transfer on rights and obligations (see in particular our comment on question 3.1 above), and (iii) as to rights in collateral and close-out netting. Of these, we believe that (ii) and (iii) can be adequately mitigated through legislation, but not through guidance. Legislation will be necessary for purposes of Basel II as well as legal certainty. However, this will inevitably restrict the powers of the Bank of England (for example from splitting or 'cherry picking' contractual positions subject to netting or collateral). We therefore remain of the view that the partial transfer power is so fundamentally inimical to the certainty which the markets require to operate efficiently as to be unjustifiable. All our other responses to the questions should be read subject to this overriding principle. We are also concerned with the comments made in paragraph 3.43 as to the transfer of the deposit book. While we see the attraction of the transfer of the deposit book as a means of retail depositor protection, and as a relatively easy liability to transfer, we would query whether, given the adverse consequences of such transfer, partial transfer on grounds of retail depositor protection can ever be justified in light of the costs associated with power to undertake partial transfer: we would also query whether such a power would be necessary, given the improvements to the FSCS and other measures to be taken to ensure depositors are

		'rebanked' promptly.
3.7	Do you agree that guidelines, setting out when partial transfers might be used, should be provided in the code of practice?	As indicated in the introduction, guidelines on "soft" procedural matters such as the process of decision-making on implementation to the SRR would be useful to market participants. But the necessary safeguards to mitigate the concerns raised in the introduction, and preserve market integrity, must be enshrined in law, not guidance.
3.8	Would these guidelines provide reassurances about how the Authorities might use partial transfers?	The guidelines might provide reassurance: they will not provide legal certainty.
3.9	Do you agree with the situations in which it is proposed that the partial transfer powers could be exercised?	See introductory comments and 3.6 above: we can see that there might be circumstances in which a partial transfer could be more attractive than other SRR tools, but the costs of having that tool will outweigh the benefits.
3.10	What is the appropriate level of flexibility for the situations in which these powers can be used?	See 3.6 above.
3.11	Do you think the Bank of England should have the flexibility to make subsequent transfers between a bridge bank and a residual company?	See 3.6 above. Subsequent transfers give rise to the same issues, and would need to be subject to the same statutory protections, as initial transfer.
3.12	Do you think the Bank of England should have the power to make subsequent transfers using the stabilisation powers?	See 3.6 and 3.11 above.
3.13	Do you agree with the restrictions the Authorities propose for subsequent transfers (that they should only occur between a bridge bank and a residual company and not involve moving liabilities from the bridge bank to the residual company)? Should there be additional restrictions?	See 3.6 above. The additional restriction proposed appears to be necessary.
3.14/ Para 3.63-5	Do you think that the bank resolution fund is an appropriate means for compensating creditors left in the residual company?	We agree that a bank resolution fund is an appropriate means for compensating creditors in the residual company. But it is important that it should not be the only avenue of compensation. As the paper acknowledges in paragraph 3.65, it will not always be the case that the fund is sufficient to compensate creditors. In addition, in the interim it is likely that both the residual company and bridge bank will be

	"The effect is that creditors who remain in the residual company may be worse off than creditors who would have had the same insolvency priority in a whole-bank insolvency but are transferred to the bridge bank."	run for the benefit of the bridge bank and not the residual company. This statement cited left appears to miss a very fundamental point. The assertion that creditors of the residual company "may" be worse off than creditors of the bridge bank is misleading. In practice, as the paper acknowledges, the residual company will be made insolvent by the transfer. Creditors of the residual company therefore will be highly likely not to receive full value for their debt, and will lose liquidity as realisations will be delayed pending winding up. Creditors of the bridge bank will receive performance and will not lose liquidity: they will not be prejudiced at all. Barring exceptional situations (a solvent residual company), creditors of the residual bank will **always** be worse off than creditors of the bridge bank (or indeed public sector purchaser). The bank resolution fund **partially** mitigates this issue by ensuring that the proceeds of the bridge bank go back to the insolvent estate of the residual company. But this does not equalise the position as between creditors of the two sides of the structure. Put another way, in practice a partial transfer will **always** be prejudicial to the creditors of the residual company. The suggestion that it is only in "some circumstances" that creditors to the residual bank will not be compensated is tendentious, and appears to be untested. We believe that the Authorities may have too much confidence in their ability to manage the continuing asset base of the bank. We would expect management of the continuing asset base to be challenging: existing management is likely to have failed and new management is unlikely to have familiarity with the business; such management as can be found will be primarily occupied with the splitting of assets between the residual entity and bridge bank, and markets will be likely to move against the failing bank. We therefore do not share the Authorities' confidence. While the point as to the advantages of a going concern value rather than a break-up value in para 3.65 is valid, we do not believe that the outcome of what will be a highly invasive process, transforming a single going concern into a smaller going concern and a residual insolvent estate, will necessarily generate value. Where it does not, the affect of partial transfer is to concentrate losses in the hands of creditors left in the residual bank.
3.15	Do you agree that an explicit safeguard to protect set-off and netting arrangements is required?	As indicated in the introduction, we believe that statutory safeguards for set-off

		and netting arrangements are essential. These are essential tools in managing credit risk, that are of enormous importance to market participants.
3.16	Do you agree with the risks of adopting a complete master netting arrangement safeguard?	We do not share the view of the Authorities that the risks associated with master netting arrangements stifling the abilities of the Authorities to cherrypick assets are sufficient to exclude master netting arrangements. Master netting arrangements are a valid means of managing risk. Any effort to override some, but not all, netting arrangements would be an unacceptable limitation on freedom of contract. It would also have very significant consequences for market participants. The limits of any netting regime would necessarily be arbitrary in scope. Limits will create doubt as to the enforceability of existing and new netting arrangements which may not fall directly within scope. Given the importance of netting arrangements, doubt will be as bad a result as unenforceability. This in turn will stifle innovation. We also believe that those parts of the financial services industry that rely on non-standard netting arrangements would risk being squeezed out of UK banks. A good example is prime brokerage. UK hedge fund prime brokerage is a substantial industry. Its documentation is typically bespoke, rather than standardised in the way that OTC derivatives are. Both parties to master netting arrangements manage credit risk arising under a wide variety of transactions. For a hedge fund manager, any suggestion that netting under a prime brokerage agreement will not be enforceable in accordance with its terms will be unacceptable (particularly in the current environment, given rumours around the solvency of some of the investment banks). Contracting with prime brokers in other jurisdictions, or with non-banks, is likely not to be subject to this problem. The relationship will simply be moved to a jurisdiction, or entity type, which respects freedom of contract. This will necessitate those financial services participants which operate such arrangements to house those activities outside UK banks, and could result in an indirectly imposed segregation of activities between banks and investment firms in UK financial services groups. If this occurred, then financial stability concerns would simply be moved from the banking to the non-banking sector, at considerable cost to the industry (in terms of restructuring and the loss of netting benefits) and with no corresponding benefit.

		Similarly, a number of banks operate master netting arrangements in order perfectly legitimately to manage risk and mitigate regulatory capital requirements. These are subject to requirements on enforceability as a result of Basel II: Annex III of the Capital Requirements Directive sets out a requirement that cross product netting agreements should be recognised by competent authorities only if there is "a written and reasoned legal opinion to the effect that, in the event of a legal challenge the relevant courts and administrative authorities would find that the credit institution's claims and obligations would be limited to the net sum of their transactions and rights under: - the law of the jurisdiction in which the counterparty is incorporated…. - the law that governs the individual transactions included, and - the law that governs any contract or agreement necessary to effect the contractual netting" (paragraph (b) (ii) of Part 7, and BIPRU rule 13.7.6 of the FSA Handbook). We believe that there would be a high likelihood that limiting the scope of netting so as to put the scope of any currently enforceable netting arrangement in doubt would have adverse consequences for the UK financial markets, by driving business offshore and increasing the costs of funding for UK financial institutions.
3.17	Should the qualifying financial contracts approach be adopted, what do you think should be defined as qualifying financial contracts?	See above. We do not believe that the qualifying financial contracts approach should be adopted.
3.18	Can you suggest any alternative options for how the safeguard might be framed in a sufficiently wide but workable way?	We do not believe that a qualifying financial contract definition is needed. Instead the regime should explicitly protect any contractually enforceable netting arrangement.
3.19	Do you agree that an explicit safeguard to protect structured finance arrangements is required?	Yes. However, as a starting point, in principle, partial transfer powers are problematic from a securitisation/structured finance perspective because such powers create legal uncertainty which is likely to impact on the legal opinions upon which such transactions depend. Asset-backed products require certainty of cash-flows, which in turn requires certainty of the enforceability of the rights and obligations contemplated by the transaction documents Any legal uncertainty in

		this area could impact on the (already struggling) ABS markets. We note that the Bank of England's Special Liquidity Scheme (**SLS**) requires collateral positioned under it to be triple-A rated. We are concerned that the legal uncertainty created by the proposals (in particular, the provision for partial transfers and modification of contractual obligations) will impact on the legal opinions required in respect of securitisations and other structured finance transactions which, in turn, may impact on the ratings in respect of such transactions. Given that the Bank of England introduced the SLS with a view to "improving the liquidity position of the banking system and to increasing confidence in financial markets", it seems to us that certain of the SRR proposals are potentially inherently inconsistent with other recent financial stability related initiatives. Similarly, we note that earlier this year the much-anticipated UK covered bond regime was implemented. This regime is intended to assist in the development of long-term fixed rate mortgage lending in the UK and to support the UK covered bond market in general by ensuring relevant products are able to compete on a level playing field within the EU open market. The significance of covered bonds to UK credit institutions in the current funding markets cannot be underestimated. We are concerned that the legal uncertainty created by the proposals may impact on various aspects of UK covered bond programmes. In particular, it is not clear that the powers contemplated under the proposals could not be used in a manner which would affect the transfer arrangements in respect of the underlying mortgage loans (e.g. by impairing or delaying the transfer of legal title, which typically remains with the originator/issuer on closing) (a concern which is equally relevant in an ABS context) and/or the enforceability of the contractual arrangements in respect of existing programmes. As noted in the introduction, the US regime (which we understand has been used as a model for certain of the SRR proposals) has received some criticism due to the obstacles it presents with respect to the development of a US covered bond market - an issue of some significance given recent comments by the US Treasury Secretary that "covered bonds have the potential to increase mortgage financing, improve underwriting standards and strengthen US financial institutions". It is difficult to comment on the proposed carve-out in the absence of any details

		as to how it may be shaped. As noted in the consultation paper, such a carve-out will be difficult to draft given the competing principles behind it (i.e. necessary flexibility to reflect a complex and dynamic market and sufficient limitations to allow meaningful partial transfer powers). If provision for partial transfer is included, then a carve-out will be necessary but the parameters of such a provision would require further discussion and should be subject to full consultation with sufficient time for consideration by market participants.
3.20	Do you have any suggestions for how the safeguard might be framed in a sufficiently wide but workable way?	In our view a quick fix response is unlikely to address the wide range of potential market participant concerns with respect to the application of the partial transfer power to a UK bank involved in a securitisation/structured finance transaction (whether involved as originator, issuer and/or service provider etc). To ensure that any carve-out provides the necessary protections, full consultation on more specific proposals is necessary. We would be happy to meet with the authorities to discuss the proposed carve-out.
3.21	Do you agree that a safeguard to protect all security interests could make a partial transfer practically difficult?	We agree that a safeguard to protect security interests could make a partial transfer move difficult. However, we do not believe that, of itself, that fact justifies an override of the legitimate interests of holders of security. The same issues, and principles, apply to the linkage between secured obligations and security as apply to netting arrangements discussed at 3.16 above. Holders of security interests have a legitimate interest in the realisation of security. A loss of certainty as to their rights in security will have damaging effects on confidence in secured financing arrangements, and on the regulatory treatment of secured interbank lending. This is highly significant, as banks engage in significant secured credit relationships (particularly through repos, covered bonds and collateral under OTC derivatives). Limits on the recognition of security arrangements will cause uncertainty around the margins. It will also adversely affect regulatory capital requirements of secured lenders to UK banks. Under the Capital Requirements Directive recognition of collateral as a credit risk mitigant is subject to a high level requirement that the bank have confirmed the enforceability of the collateral arrangements (Annex VIII, Part 2, paragraph 6(b) (financial collateral), paragraph 8(a) (real estate), paragraph 9(a)

		(receivables) paragraph 10 (a) (other physical collateral)). If a lending bank cannot achieve the requisite certainty, it cannot recognise the collateral. We believe that the presence of an override of security interests would cause some banks to regard the enforceability test not to be met in respect of loans to UK banks. If correct this would have significant consequences for the costs of secured funding for UK banks. We believe that specific concerns as to floating charges would be better dealt with by regulation restricting banks from giving such charges than by an override.
3.22	Which security interests should not be covered by this safeguard?	See 3.21 above.
3.23	Do you consider that where part of a failing bank's business is transferred to a bridge bank, a special bank administration procedure may be required to deal with the residual company?	For the reasons given above we do not believe that the partial transfer route should be allowed and therefore, in our view, there is no need for the special bank administration regime. We have therefore not considered in detail questions 3.23 to 3.37. However, we would make the following general points in relation to the proposed regime: • As the residual bank would almost certainly be insolvent, it would be necessary for the directors to commence the special bank administration regime immediately to protect them against wrongful trading liabilities. • We cannot see why the special procedure would be needed in the case of a partial transfer to a bridge bank but not in the case of a partial transfer to a private sector purchaser. • It is not clear whether the special bank administration regime would be recognised as an "insolvency proceeding" for the purposes of the Credit Institutions Winding-Up Directive so as to be recognised throughout the EEA. As the primary purpose of the procedure is to support the bridge bank (rather than its being a collective procedure for the creditors), it is doubtful that the proceeding would be recognised. • The concern for creditors in relation to the proposed purposes of the special bank administration regime is that they suffer a double hit. First they are left

		behind with the under-performing assets rather than being transferred to the bridge bank. Secondly, any (limited) resources or assets that the residual bank may still have are then to be utilised in order to support the bridge bank (rather than being realised in order to make a distribution to those creditors). Furthermore, the creditors will have little say in what are "non-essential" services and assets that the special bank administrator is able to realise in the interests of the remaining creditors. • The role of the residual bank is primarily one of support to the new bridge bank. It is unclear how this support role would work in practice. Presumably there will need to be agreements between the two banks. This assumes that the residual bank has the ability to enter into any such agreements and to make such promises of continued support and service provision. What if, for example, the essential service relates to IT that is licensed to the residual bank or intellectual property that is not owned by the residual bank – can the Authorities force a third party that is outside the residual bank's group party to continue to provide services? The matter becomes more complicated if the third party is not subject to the jurisdiction of the UK court. • We consider that the special administrator should be an officer of the court and the procedure should be commenced by order of the court in order to give creditors an opportunity to make representations as to who is appointed or to bring disputes before the court. • As a general comment, we do not consider that the usual rights and powers of creditors should be transferred to the Bank of England. In circumstances where those creditors have already been prejudiced by being left behind with the residual bank, we consider that it is even more important that they have some say in how the residual bank is managed. However, if partial transfer is to be provided for then it is clear that if there is to be a partial transfer to a bridge bank there will need to be power to deal with the ongoing relationship between the residual company and the bridge bank. This will be particularly true where the residual company is party to foreign law contracts, whose transfer under the SRR tools may not be recognised.

3.24	Do you think that this special bank administration procedure should be confined to the residual company where a partial transfer is effected to a bridge bank or should it also apply, with any necessary modifications, where a partial transfer is effected to a private sector institution?	See above.
3.25	Do you agree that the special bank administration procedure should have specific objectives?	See above.
3.26	Do you agree with the objectives and their priorities as proposed above? In particular, do you agree that the objective of supporting the bridge bank should take priority?	See above.
3.27	Should the grounds for commencing or applying for special bank administration be linked to the partial transfer of assets and liabilities to a bridge bank?	See above.
3.28	Should any other grounds be included in the legislation?	See above.
3.29	Should the special bank administration procedure be commenced by an order of the court or initiated automatically by the direct appointment of a special bank administrator by the Bank of England?	See above.
3.30	Should the special bank administrator be an officer of the court, or in the interest of promoting the objectives of the SRR should he or she be subject to overall direction by the Bank of England, with the court ruling on any disputes arising in the resolution?	See above.
3.31	Are the moratorium provisions outlined above sufficient for the purposes of a special bank administration procedure? If not, what additional measures would be required?	See above.
3.32	Do you think that the existing powers of an administrator would be sufficient for the purposes of special bank administration?	See above.
3.33	Should the special bank administrator be given any additional powers, including some or all of the powers of a liquidator outlined above? If so, what extra powers	See above.

	do you consider would be appropriate?	
3.34	Do you agree that the Bank of England should have a key role to play in the special bank administration procedure to facilitate the successful resolution of a bridge bank and to assist in the winding up of the residual company in the interests of its creditors generally?	See above.
3.35	Should the Bank of England rather than an initial meeting of creditors be responsible for considering and agreeing to, with or without modification, the special bank administrator's proposals?	See above.
3.36	Should the Bank of England rather than creditors fulfil the functions of a creditors' committee?	See above.
3.37	Should the rights of creditors to challenge the conduct of the procedure be subject to restrictions to ensure that the principal objectives are not jeopardised?	See above.
3.39	Should any special provisions relating to statutory set-off be introduced within a special bank administration procedure?	See above.
3.38	Do you agree that there should not be any substantial change to the ordinary statutory order of priority of creditors in the special bank administration procedure?	Yes. In this regard we refer to our response to question 2.1 above. There must be a level playing field as between the Bank of England and other creditors.
3.40	Do you agree that the procedure should only be terminated where the Bank of England provides consent?	Yes.
3.41	Do you think that provisions should be made for a variety of ways to bring the procedure to a close, including conversion to ordinary insolvency procedures?	Yes.
3.42	Do you agree that temporary public ownership should be subject to similar public interest tests as the Banking (Special Provisions) Act 2008?	Yes, we agree that it should. We note that nationalisation effectively involves state expropriation of shareholder rights. Share sales to a private sector purchaser have the same effect. The European Convention on Human Rights allows infringement of private law rights in this way only if appropriate compensation is provided. As discussed below, the quantification of compensation is a complex and

		controversial issue.
3.43	Do you agree that the Authorities should have the power to put in place a bank resolution fund for a bridge bank and temporary public sector ownership?	Yes.
3.44	Do you agree that the bank resolution fund should be mandatory in the case of the bridge bank tool, but optional in the case of temporary public ownership?	Yes.
3.45	Do you agree that the bank resolution fund should comprise only the net proceeds of resolution (that is, less the costs of resolution)?	Yes.
3.46	Do you agree with the mechanisms for compensation and appointing an independent valuer in the circumstances set out above?	The proposed legislation does not appear to provide for an obligation on HMT to make third party compensation orders where third party rights are affected. It should do so. Similarly, appeal of valuation should be safeguarded – a discretion to enable appeal (clause 28(6)) is not sufficient. There should be adequate compensation for the infringement and erosion of private law rights but the quantification of such compensation is complex and gives rise to the following practical and legal difficulties: • How should one quantify the value of shares in a failing bank which is supported by the State (typically a failing bank will have had recourse to the Bank of England as lender of last resort, without which it would have become insolvent earlier)? • If there is shareholder value, how should one quantify loss to shareholders as a result of the operation of the relevant SRR tool? • What rights of recourse should be available to shareholders for mismanagement by the Bank of England and should this Authority have statutory immunity for its role? The concern with substituting shareholdings for unquantifiable compensation rights is that the consequent uncertainty could affect the ability of banks to raise capital in the markets – at a time when the banking industry is capital constrained. It is imperative that stakeholders have a right to challenge the valuation (and the valuation process) after the event. A purchaser, however, will want certainty that

		the consideration paid by it will not be subject to subsequent query or challenge. At the very least, it will be necessary to ensure that, even if the value of the consideration is called in to question, this would not unwind the transfer nor affect the purchaser's title to the assets. It is arguable that, if it is the Authorities that have procured the transfer, then they should be the ones compensating stakeholders for any loss resulting from a flawed valuation.
3.47	Do you agree with the proposals to confer specific powers on an independent valuer, and the nature of the powers described above and provided for in draft clause 28?	See above.
3.48	Do you agree with the principles of valuation set out in draft clause 30?	Clause 30 sets out a spectrum of possible assumptions on which valuation is to be based. It is unclear which of them will be used in any particular case. This will be likely to give considerable uncertainty to stakeholders as to the basis of compensation. Further clarity is needed to give stakeholders certainty.
3.49	Do you agree that the Treasury should have power to provide for the reconsideration of the independent valuer's determination and appeals from the valuer to a court or tribunal?	See 3.46 above.
3.50	Do you agree that alternative compensation arrangements are needed for a private sector purchaser tool, that would not involve an independent valuer?	See 3.46 above.
3.51	Should any of the costs described above not be covered by the FSCS, under the Authorities proposals? Please explain why.	There is a policy issue here as to whether the banking industry should subsidise shareholders in failing banks and on which others (e.g. the BBA) will be more qualified to comment. We note, however, that requiring the FSCS to bear the cost of the SRR is expanding the responsibilities of the FSCS significantly. We believe that the costs of resolution should fall initially to shareholders. It is only if shareholder funds are insufficient to bear the costs of resolution that the FSCS should bear those costs.
3.52	Are there any additional costs of resolution which could be borne by the FSCS?	See above.
		As a general comment, we note that the Authorities have taken on board the comments of a number of respondents to the January Consultation Paper and have

		sought to avoid making wholesale changes to existing winding up provisions. We welcome this approach. On this basis, we consider that the modified liquidation procedure is likely to be recognised as a collective insolvency proceeding for the purposes of the Credit Institutions Winding-up Directive although we would welcome the views of the Authorities in this regard.
4.1	Do you agree with the provisions for entry into the bank insolvency procedure, as set out in draft clauses 38-41, 60 and 62?	These do not appear to be contentious.
4.2	Do you agree with the provisions for the appointment and objectives of the bank liquidator, as set out in draft clauses 37, 42, 46 and 47?	The difficulty here for a liquidator will be in balancing the first objective (i.e. to engage with and assist the FSCS to ensure that depositors are paid out on a timely basis) with the second objective (i.e. winding up the affairs of the bank to achieve the best result for the bank's creditors as a whole). For example, it may be in the interests of the creditors as a whole to reduce costs by closing down the bank's operations and making the employees redundant, particularly in cases where there is no business to be saved. However, in order to assist the FSCS, the liquidator may be obliged to keep certain branches open and to retain certain staff for this purpose. As the first objective is to take precedence, it would appear that, in such circumstances, the liquidator would be obliged to keep the operations going even if this was not in the interests of the creditors as a whole. It is not clear why, from a public policy perspective, the rights of depositors should be more important in this respect than the rights of other creditors (including potentially employees and pensioners).
4.3	Do you agree with the provisions for the powers and responsibilities of the bank liquidator, as set out in draft clauses 47, 48, 61, 63 and 66?	No comment.
4.4	Do you agree with the provisions for the liquidation committee, as set out in draft clauses 44 and 45?	As one of the main purposes of being on the liquidation committee is to be kept informed of the progress of the liquidation, we can see no reason why creditors other than (and in addition to) the FSA, the Bank of England and the FSCS should not be entitled to be appointed to the liquidation committee from day one. Such creditors have an interest in knowing what actions the liquidator is proposing to take to realise the first objective and what the costs of these actions are likely to be, particularly as such costs could have a direct impact of such creditors'

		recoveries (subject to the proposals that the FSCS would cover the costs of protecting eligible claimants[3]).
4.5	Do you agree with the provisions for the end of the bank insolvency procedure, as set out in draft clauses 50-58?	No comment.
5.1	Do you agree that the objectives, roles of the Authorities and governance of the SRR should not differ for building societies and banks?	We think that it is right that the SRR should be applied to building societies as well as to banks. However, we would query what happens to the members of the failed building society. We presume that de-mutualisation would occur on the transfer of the undertakings to a bridge bank if such entity is a private company limited by shares but, in the case of a transfer to an existing building society, we think it would be useful if the legislation allowed a transfer of the memberships of the failing building society to the purchaser (as is the case pursuant to Building Society Act 1986).
5.2	Do you agree that the Authorities should have powers to disapply statutory requirements including the principal purpose and lending and funding limits, for the residual element of a building society following a partial transfer?	See above.
5.3	Do you agree that there should be a special building society administration procedure for building societies in the event that part of a building society's business is transferred to a bridge bank?	See above.
5.4	Would temporary public ownership be a useful tool for resolving a failing building society in some circumstances?	See above.
5.5	How would this tool best be implemented in the case of a building society, given the lack of applicability of share transfer powers?	See above.
5.6	Should a set of principles be established to determine how compensation is distributed between members of building societies? If so, what would be the most appropriate fair and equitable principles?	See above.

[3] We find these proposals problematic as we are not convinced that a liquidator's costs will always be divisible between actions taken to protect depositors and actions taken to protect creditors more generally.

5.7	What are the risks in creating a pre-determined set of principles for distributing compensation?	See above.
5.8	Should the former members have a say in how compensation is distributed?	See above.
5.9	Do you agree that the Government should legislate to enable the Treasury to create, alter or nullify contracts between group companies, and introduce duties for group companies (where necessary) to cooperate with the use of those powers?	The possibility of statutory creation, alteration or nullification of group contracts (a **group statutory override**) is very worrying from a legal standpoint. Our comments made in relation to question 3.1 of the first July consultation apply equally here (*mutatis mutandis*). The scope of the provision is not clear (as to which see our further comments on the first consultation paper), but the effect of a group statutory override appears dangerous in effectively negativing counterparty rights and/or subordinating the rights of market participants to those of the Authorities. To do so would be fundamentally prejudicial to counterparties, give rise to legal uncertainty and raise the costs of funding for UK banks. It is unclear from the paper what the overrides might be. This needs to be clarified, and clear proposals consulted on, if it is to be taken forward. Otherwise group companies of UK banks will be contaminated by the risks discussed above.