

Banking Reform consultation responses
Banking Reform Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ
(By e-mail to banking.reform@hm-treasury.gov.uk)

15 September 2008

Dear Sirs,

Financial stability and depositor protection: special resolution regime

The International Capital Market Association (“**ICMA**”) is pleased to respond to the consultation paper *Financial stability and depositor protection: special resolution regime* (Cm 7459) (the “**Consultation**”) issued by the Treasury, the Bank of England and the Financial Services Authority (together, the “**Authorities**”) in relation to a proposed special resolution regime (“**SRR**”) for UK banks and building societies (“**Banks**”).

ICMA is the self-regulatory organisation and trade association representing the financial institutions active in the international capital markets worldwide. ICMA's members are located in some 50 countries across the globe, including all the world's main financial centres, and currently number almost 400 firms in total.

We set out our response in the Annex to this letter and would be pleased to discuss it with you at your convenience.

Yours faithfully,



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Annex

General comments

This response is drafted from the perspective of the efficient functioning of the international debt securities markets (and in particular bondholder rights as creditors) and does not focus on the overall proposal to establish the SSR but rather on some of the detail of its proposed implementation.

An overall concern (arising primarily in the context of partial transfers) is that the ability of Banks to originate debt securities may be adversely affected by the SRR and so consequently will be the overall liquidity and resilience of the international debt securities markets, especially given current volatile conditions. In the absence of clear safeguards, granting sweeping powers to the Authorities in such cases to vary or suspend creditor rights creating substantial commercial and legal uncertainty, which in turn may result in reduced investor exposure appetite, increased regulatory capital charges for lenders and increased cost of capital for borrowers.

Specific comments

1. Priority of creditor rankings (Question 2.1)

The Consultation is not entirely clear as to a possible precedence of Bank depositors over other Bank creditors (including bondholders) in the context of partial transfers.

The SRR provisions for partial transfers are effectively stated to be likely to result in a separation of a Bank's 'stronger' and 'weaker' balance sheet items – with the retail deposit book (and more than equivalent parallel assets) being likely to follow the 'stronger' pool and remaining creditors' claims being left with the 'weaker' (and probably insolvent) residual company.

Compensation for residual creditors is intended to accrue from the bank resolution fund or (in the case of a third party disposal) the sale proceeds (less resolution costs). However, there is no guarantee that the sums available would be sufficient to compensate fully for any losses consequent to the partial transfer – leaving such creditors worse off than they would have been on insolvency. The position of creditors of the residual company may be compounded where the residual company continues to operate with the objective of supporting the bridge bank.

Application of the above provisions would be subject to the general objectives of the SSR, which include the protection of depositors but not clearly the protection of creditor's rights generally. On insolvency, a Bank liquidator's objective to assist the Financial Services Compensation Scheme ("FSCS") in relation to depositors is generally¹ stated to take precedence over the other objective winding up the affairs of the Bank to achieve the best results for the Bank's creditors as a whole.

This would not seem to be entirely consistent with the Authorities' stated aim of maintaining the priority ranking and equitable treatment of classes of creditors under existing insolvency law (leaving depositors with the benefit of protection under the FSCS in respect of shortfalls).

2. Disassociation of collateral rights (Questions 3.21-3.22)

The Consultation acknowledges that secured liabilities should be safeguarded from separation from the collateral which secures them (which would effectively leave counterparties unsecured). Any exceptions to this principle should be explicitly and narrowly stipulated in legislation consequent to detailed consideration of specific cases where this is found to be warranted. No evident cases appear likely to arise and we consider that the safeguard should apply without exception.

¹ Draft section 42(4) and the bracketed wording in draft section 42(6) seem to provide some, not entirely clear, mitigation.

3. Structured finance arrangements (Questions 3.19-3.20)

We agree that structured finance transactions, such as securitisations and CDOs – where originating banks retain servicing or other roles and/or retain legal title to securitised assets – should be safeguarded. Any exceptions to the application of property rights in this respect could have a direct impact on true sale and/or enforceability legal opinions.

4. Set-off and netting arrangements (Questions 3.15-3.17)

As most debt securities are backed by OTC instruments, we share the concerns of other market constituencies in relation to safeguarding the integrity of netting agreements. Derogating from such integrity, such as in the proposed context of 'non-qualifying financial contracts', would effectively leave counterparties exposed on a gross basis to Banks in SRR. Again this should only be explicitly and narrowly stipulated in legislation consequent to detailed consideration of specific cases where this is found to be warranted.

5. Legal uncertainty (Questions 3.7-3.10)

Many of the above challenges to operating the tools of the SRR are acknowledged in the Consultation. The Consultation proposes to address most of these issues in a statutory code of practice, but in the form of non-binding 'comply or explain' guidelines. However, such a code would not seem to be a suitable vehicle for the provision of such fundamental safeguards as it would not mitigate any legal uncertainty created by the entrenchment of the Authorities' proposed SRR powers in primary legislation. All principles governing creditor rights – including safeguards – should be enshrined in the SRR legislation itself.

Recommendation

Effective implementation of the SRR, that achieves an appropriate balance between operational flexibility and the legal certainty that only legislation can provide, is a challenge that needs to be addressed in further detail. The proposed sweeping statutory powers over property rights cannot be properly evaluated without the simultaneous presentation of detailed safeguards in their entirety.

The formulation of such detailed safeguards is itself a challenging task that needs to be explored further. This will likely require more time for input by the Authorities and market participants – time that should be allowed given the potential consequences described above that may arise from interfering with private property rights.

We therefore recommend that the SRR legislation (or at least the part dealing with partial transfers) be deferred pending the publication and consideration of more detailed proposals.