

ANNEX 17 SPECIAL RESOLUTION REGIME INTRODUCED IN U.K.: Powers and safeguards -

1. Introduction

In the United Kingdom the Government, the Bank of England and the Financial Services Authority conducted an extensive series of consultations on issues relating to financial stability and depositor protection during 2007 and 2008.

Before 2008 the United Kingdom did not have a permanent statutory regime that could deal effectively with failing banks.

The banking Act (Special Provisions) 2008 passed in February 2008 gave the Treasury powers in order to:

- facilitate an orderly resolution to maintain financial stability
- protect the public interest

This Act was temporary and ended on February 2009.

Based on this consultation, the Banking Act 2009 was passed and received Royal Assent on 12 February 2009.

The Banking Act 2009 conferred important powers on the relevant authorities. If all stakeholders agreed that such a policy was necessary in redressing the lack of an effective set of regulations to deal with crises in the financial sector, they also expressed their concerns relating to unrestricted use of powers that could lead to negative consequences for UK banks and financial markets.

Therefore, the Banking Act 2009 makes provision within the UK for the adoption of a statutory instrument providing safeguards against collapse amongst credit institutions.

On this basis, the Banking Act 2009 (Restriction of Partial Transfers) Orders 2009 were presented to Parliament on the 20th February and came into force on the 21st of February.

2. Powers given to the Authorities by the Banking Act 2009

As mentioned above, the United Kingdom did not, until recently, have a permanent statutory regime, which could deal with failing banks.

On October 2008, the Government announced comprehensive measures to address failure in the banking system.

a) Comprehensive measures announced on October 8th, 2008:

On October 2008, the UK government announced comprehensive measures aimed at ensuring stability in the UK financial system:

-access to liquidity: 200 million pounds to banks via expansion of the Bank of England's Special Liquidity Scheme

-strengthening of banks' capital: 37 millions pounds injected into three major banks through the purchase of shares by the government

-confidence in bank funding via a 250 billion Government credit guarantee Scheme on banks' eligible debt issuance

b) The Special Solutions Regime foreseen by the consultations

1. The powers to “split a bank”

The UK Authorities (government, FSA and Treasury) published several consultations, which included the following proposals:

- establishment of a private sector purchaser (PSP) stabilization option, effected through a transfer of shares or property to a PSP;
- establishment of a bridge bank stabilization option, effected through transfer of property from a failing bank to a bridge bank (a new company owned by the Bank of England);
- introduction of a temporary public ownership (TPO) stabilization option; effected through a transfer of shares to the public sector, and;
- establishment of the bank insolvency procedure (BIP), a new initiative designed to facilitate liquidation of a failing bank and fast payouts for protected depositors, or transferral of their accounts.

Within these choices, the Authorities were given the option of splitting a bank in order to take the “healthy” part of the bank to transfer it to a new entity called a “newco”.

This “newco” could be either a PSP or a bridge bank.

In both cases, the entity from which the assets had been transferred would still exist and be called a “residual bank”, a “resco”.

These “property transfer powers” are intended to be used in order to protect financial stability, banking confidence and depositors funds.

2. Supplemental and reverse transfers

Supplemental transfer refers to the possibility of further transferral of property, rights, liabilities (“property”) or securities between a transferor and a transferee.

The term “Reverse transfer” refers to the mechanism available for possible transfers of property back after a partial transfer.

This option for fiscal authorities is considered to be important by the UK Government, since these bodies may have to intervene quickly to resolve a threat to financial stability. It allows for the situation in which authorities charged with powers to act in times of financial crisis may not have the opportunity to collect all relevant information relating to property belonging to or entrusted to a bank.

In consultations the British authorities proposed that supplemental transfers should apply to transfers from a residual bank to a bridge bank, but not from a residual bank to a private purchaser.

During the consultation period, the British Government proposed that the power to transfer property back (reverse transfer) should be limited to exclude liabilities.

Nevertheless, following this consultation the government expressed its will to extend the scope such of transfers to include private sector property (PSP). The same justification as the one applicable to supplemental transfer (transfers can take place very quickly and Authorities may not have all relevant information) has been used in order to support this extension of interventionist powers.

The British Government also proposed that the option to make reverse transfers should be extended to reverse transfers of property and shares in other situations than reverse transferral for the purpose of excluding liabilities. Nevertheless, those powers were not intended for use in reverse transfers in cases of transfers to a private sector purchaser.

The Government proposed that secondary legislation made under the Banking Act (restriction of partial transfer, see below), should define what kind of property, rights and liabilities should be protected from being transferred back.

c) Stakeholders' views expressed during the consultation

The Special Resolution Regime was submitted to shareholders for their reaction within the framework of the consultation.

Stakeholder reaction has focused on the risks and costs relating to partial transfers. Even when they understood and supported the policy, some stakeholders expressed the opinion that unrestricted partial transfer partial transfers could have adverse effects on UK banks and financial markets.

Therefore, several safeguards were proposed to protect stakeholders by address potentially negative effects of the solutions.

The Authorities agreed that several interests would suffer negative effects from the solution, and that those interests should be protected.

They proposed safeguards and adapted them, taking into account the stakeholders' reactions.

The interests to be protected by the safeguards were as follows:

- set-off and netting arrangements
- structured finance arrangements
- security interests

With regards to supplemental and reverse transfers, stakeholders did not express strong dissenting opinions provided that this kind of transfer would be submitted to the same safeguards as partial transfers.

The Banking Act, which received Royal assent on the 12th February 2009, established that these safeguards were to be implemented by statutory instruments.

d) The special resolution regime (SRR) adopted by the Banking Act 2009

3. Stabilisation options

The Banking Act 2009 provides for three stabilisation options available to the SRR:

- transfer to a private sector purchaser
- transfer to a bridge bank
- transfer to temporary public sector ownership

The British fiscal authorities therefore have power to transfer shares and other property, rights and liabilities.

4. Conditions for the exercise of powers

- General conditions

The Banking Act 2009 sets general conditions applying to all kinds of stabilisation options.

Stabilisation powers shall be exercised only when the conditions 1 and 2 set in section 7 of the Act are met.

Condition 1: “the bank is failing, or is likely to fail, to satisfy the threshold conditions (within the meaning of section 41(1) of the Financial Services and Markets Act 2000 (permission to carry regulated activities))”

Condition 2: having regard to timing and other relevant circumstances it is not reasonably likely that (ignoring the stabilisation powers) actions will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions”.

Before determining that conditions 1 and 2 are met, the FSA shall discount the financial assistance provided by the Treasury or the Bank of England other than the ordinary market assistance offered on its usual terms. FSA shall also consult the Treasury and the Bank of England.

-Specific Conditions

The Banking Act sets specific conditions for each type of stabilisation option, private sector purchaser and bridge bank, and for temporary public ownership.

Where transfers to a bridge bank or to a private sector purchaser are concerned, the Bank of England may exercise stabilisation powers only if Condition A or B set in Section 8 is met.

Those conditions both refer to the public interest and to general financial stability. They both require critical circumstances in order to be exercised

but are based on broad terms. In some instances this could lead to a lack of legal certainty.

Condition A is required in general circumstances, whereas Conditions B is required when the Treasury notifies the Bank of England that they have provided financial assistance in order to reduce a "serious threat to the stability of the financial system of the United Kingdom".

"**Condition A** is that the exercise of a stabilizing power is necessary, having regard to the public interest in:

- maintenance of stability in the financial systems of the United Kingdom,
- the maintenance of public confidence in the stability of the banking systems of the United Kingdom, or
- the protection of depositors"

Before determining whether condition A is met, the Bank of England is required to consult the FSA and the Treasury.

Relating to cases where the Treasury notifies the Bank of England they have provided financial assistance in order to reduce a serious threat to the stability of the financial system of the United Kingdom.

"**Condition B** is that:

- the Treasury have recommended the Bank of England exercise stabilisation powers on the grounds that this step is necessary to protect the public interest, and
- in the Bank's opinion, exercise of the stabilisation power is an appropriate way to provide that protection"

For transfers relating to temporary public ownership, Section 9 of the Banking Act 2009 sets two conditions that must be met.

Conditions A is that "is that the exercise of the power is necessary to resolve or reduce a serious threat to stability of the financial systems of the United Kingdom".

Conditions B is that "exercise of the power is necessary to protect the public interest, where the Treasury have provided financial assistance in respect of the bank for the purpose of resolving or reducing a serious threat to the stability of the financial systems of the United Kingdom".

The Treasury must also consult the FSA and the Bank of England when this option is taken.

5. Supplemental and reverse transfers

The Banking Act 2009 permits supplemental transfers of shares only after a transfer to temporary Public ownership.

Supplemental transfers of property are allowed after any kind of transfer.

The Government's will, expressed after consultation prior to extending the scope of the supplemental transfer, has therefore been embodied in the Banking Act 2009.

Supplemental transfer of property can provide for property, rights and liabilities to be transferred from the original transferor, and for anything that a property transfer instrument may otherwise provide.

Reverse transfers of shares are only allowed after a transfer to a temporary Public ownership.

Reverse transfers of property are only allowed after a transfer to a bridge bank or to a temporary public ownership.

Neither supplemental transfers nor reverse transfers are subject to the conditions set in Section 7 to 9 (conditions that must be met for a SRR to be launched).

In the case of a supplemental or reverse transfer of shares, the Bank of England must consult the Treasury and the FSA.

In the case of a supplemental or reverse transfer of shares, the Treasury must consult the Bank of England and the FSA.

The Banking Act 2009 also allows onward transfer under specific circumstances.

-Scope

Section 47 of the Banking Act provides a basis on which the British Treasury can impose restrictions on the making of partial transfers.

This section declared that those restrictions could be imposed by reference to the nature of property, rights and liabilities, which may or may not form part of the transfer.

In its response to the consultation process, the Government affirmed that it did not intend to exercise this particular option in the short term because the NCWO safeguard (see below) would guarantee counterparties that they would not receive less compensation than might be the case if a transfer had never been ordered.

The Government also underlined the fact that in light of recent events, it had become apparent that flexibility was crucial if effective control of financial crises was to be achieved by fiscal authorities.

3. Safeguards relating to partial transfers: Consultation and adoption of the Banking act 2009 (Restriction of Partial Transfers) Orders 2009

a) Safeguards proposed for set-off and netting arrangements

6. Propositions and stakeholders' and experts' reactions

Stakeholders have indicated that partial transfers could disrupt set-off and netting which are very often used by commercial counterparties.

Another risk could also be present in transferring some, but not all, of a counterparty's financial contracts otherwise subject to set-off and netting arrangements ("cherry picking").

To avoid the negative effects on those arrangements, the Authorities proposed a solution based on the notion of "Qualifying Financial Contracts". Those QFC's would be protected from "cherry picking", whereas non-QFC's would not.

This proposed safeguard did not satisfy the stakeholders and experts who indicated that it would not assuage market concerns, and that a stronger safeguard should be provided.

The government has taken those remarks into account and has proposed that all contracts covered under set-off or netting arrangements should be protected from disruption in a partial transfer.

Nevertheless, the Government limited this protection to carve-outs that should be defined in secondary legislation.

-Draft version of the Banking Act 2009 (Restriction of Partial Transfers) Orders 2009

The draft version provides for a broad protection of the set-off and netting agreements. Nevertheless, this protection is limited by specific carve-outs.

Provided counterparty's property falls within the safeguards, that property must be transferred to a new bank or left in place along with other counterparty property.

If the arrangement is not carved-out, it is protected. Carve-outs allow the Authorities to transfer some or all of the property quickly.

Carve outs are provided for:

- Financial Security Compensation Scheme eligible deposits
- transfers that predominantly include FSCS deposits
- self-issued subordinated securities
- foreign property that cannot be transferred

As far as "foreign property" is concerned (defined as property outside the UK or rights and liability under foreign Law), the Draft Order provides the authorities some flexibility.

If the Authorities decide to transfer foreign property and the transfer fails (an example of failure given in consultations is a foreign court refusing to recognize a transfer), the disruption of set-off and netting arrangements caused by this failure is not considered as a breach of the Order.

b) Safeguards relating to security interests

-Solutions proposed within the framework of the consultation

The British authorities made it clear that the SRR should not disrupt security interests. Should disruption occur, counterparties would have no confidence in their ability to enforce the collateral their loans were secured on, which could have serious consequences for the UK's cost of capital.

Therefore the authorities proposed that liabilities would be transferred to the new entity with the collateral or would not be transferred at all.

At this stage, "floating charges" over all or a part of a bank's assets appeared to be another difficulty. Indeed, floating charges could seriously compromise the authorities' power to execute partial transfer. Therefore, a carve-out for floating charges was considered.

Some stakeholders have underlined the fact that if "floating charges" were not carved out, the bank may start to grant more "floating charges" over their assets.

Nevertheless, it has been pointed out that creating a clear carve out for floating charges on "all or substantially all" the assets of the bank was difficult, especially because it was hard to define.

However, it has also been pointed out that commercial and practical realities made it unlikely that banks would start to have such a reaction.

The Government proposed that the secondary legislation should protect all security interests without exception, considering that there was a small chance that the bank would start to grant wide-ranging floating charges to counterparties.

The Financial Collateral Directive implementation in the UK covers more interests than the Directive itself. Nevertheless, the safeguards proposed by the Government were intended to cover the interests covered by the Directive only.

-Draft version of the Banking Act 2009 (Restriction of Partial Transfers) Orders 2009

The draft version of the order provides for broad protection for security interests, as considered in the consultation.

Nevertheless, paragraph 5 sets down that the safeguards will not apply if the arrangements have been entered into by the banking institution in breach of a rule prohibiting such arrangements made by the FSA.

This FSA rule is aimed at preventing a bank from using the protection granted by the Order to overrule the will of the FSA.

Section 5 of the draft Order provides that:

"(1) Subject to paragraph (5), paragraphs (2), (3) and (4) apply where

the banking institution and a person ("P") have entered into an arrangement under which one party owes a liability to the other and that liability is secured against property or rights; and it is immaterial that—

(a) the liability is secured against all or substantially all of the property or rights of a person;

(b) the liability is secured against specified property or rights; or

(c) the property or rights against which the liability is secured are not owned by the person who owes the liability.

(2) A partial property transfer to which this Order applies may not transfer the property or rights against which the liability is secured unless that liability is also transferred.

(3) A partial property transfer to which this Order applies may not transfer the liability unless the property or rights against which the liability is secured are also transferred.

(4) A partial property transfer to which this Order applies may not include provision under the continuity powers which terminates or modifies the arrangement if the effect of that provision is to provide that the liability is no longer secured against the property or right.

(5) Paragraphs (2), (3) and (4) do not apply if the arrangement has been entered into by the banking institution in breach of a rule prohibiting such arrangements made by the Financial Services Authority under the Financial Services and Markets Act 2000 or in breach of the Part 4 permission (within the meaning of that Act) of the banking institution.

(6) For the purposes of paragraphs (2) and (3), a property transfer instrument or order which purports to transfer the property or rights of the banking institution shall be treated as having effectively done so, notwithstanding the possibility that any of those property, rights or liabilities are foreign property (within the meaning of section 39(2) of the Act) and may not have been effectively transferred by the property

transfer instrument or order or by virtue of steps taken under section 39 of the Act.”

c) Safeguards proposed for structured finance

7. Lack of solutions proposed by the consultation on this question

“Structured finance” relates to a set of financial arrangements and is an important type of financing in the UK. This notion includes, for example, securitization products and covered bonds.

Partial transfer could disrupt interconnecting parts of structured finance arrangements, which in turn could inflict serious damage on concerned parties.

The Authorities recognized that structured finance should not be disrupted by partial transfers.

Therefore, the Government proposed an explicit safeguard that would be set by regulations made under Clause 42 of the Bill.

The ELG proposed that this safeguard should be included in the Order protecting set-off, netting and security interests (Banking Act 2009- Restriction of partial transfers- Orders-part 2).

Nevertheless, at the stage of the consultation, no draft provision had been adopted on this question.

8. Protection of market arrangements and financial markets by the Banking Act 2009 (restriction of Partial Transfers), Order 2009.

The Banking Act 2009 (restriction of Partial Transfers) Order 2009 provides for protection for capital market arrangements and financial markets.

The Draft Order 2009 provides for protection for "Capital market arrangements".

Section 6 of the Draft Order determines that Capital market arrangements cannot be disrupted by a partial transfer. Therefore, rights and liabilities covered by this arrangement shall be wholly transferred or not transferred at all.

Section 6 provides that:

"6.—(1) Subject to paragraph (3), a partial property transfer to which this Order applies may not provide for the transfer of some, but not all, of the rights and liabilities between a particular person ("P") and a banking institution which are or form part of a capital market arrangement to which the banking institution is a party.

(2) Subject to paragraph (3), a partial property transfer to which this Order applies may not include provision under the continuity powers which terminates or modifies rights and liabilities between P and a banking institution which are or form part of a capital market arrangement to which the banking institution is a party."

Nevertheless, paragraph 3 of this section provides for a limit to this protection when all rights and liabilities transferred are rights and liabilities that relate to deposits.

Paragraph 4 guarantees that in case of the transfer of all the rights and liabilities between a person and the bank, the limit set for capital market arrangements shall not be applied if a part of the transfer fails because some of those rights and liabilities are foreign property.

Paragraphs 3 and 4 of the Section provides that:

"(3) Paragraphs (1) and (2) do not apply where the only rights and liabilities transferred or not transferred, or terminated or modified (as the case may be) are rights and liabilities which relate to deposits.

(4) For the purposes of paragraph (1), a property transfer instrument or order which purports to transfer all of the rights and liabilities between P and a banking institution which are or form part of a capital market arrangement shall be treated as having effectively done so, notwithstanding the possibility that any of those rights or liabilities are foreign property (within the meaning of section 39(2) of the Act) and may not have been effectively transferred by the property transfer instrument or order or by virtue of steps taken under section 39 of the Act."

Article 7 of the Banking Act 2009 (restriction of Partial Transfers) Order 2009 also provides protection for financial markets. Under this provision, a property transfer cannot have the effect of rendering invalid at law:

-a market contract;

-the default rules of a recognized investment exchange or recognized clearing house (in each case);

-the rules of a recognized investment exchange or recognized clearing house as to the settlement of market contracts not dealt with under its default rules.

d) Safeguards for third-party compensation

When assets are taken from the 'resco' in order to be transferred to the 'newco', the creditors remaining in the 'resco' may, as a result, be worse off than if the transfer had never taken place.

9. Consultation's responses and safeguard foreseen in the consultation

Stakeholders have underlined the risk of a worse situation for the creditors of the resco arising from the solution as proposed.

The government has taken into account this remark and compensation was provided for by the draft Clause 53 of the Bill. This Clause set down that surplus proceeds of a sale of some or all of a bridge bank's property shall return to a resco and its creditors (less the costs of the resolution).

Nevertheless, stakeholders' response to this proposition was that creditors could not be certain they would be no worse off than in the event of a whole-bank winding-up.

10. Compensation set by the Banking Act 2009

The Banking Act 2009 provides three methods of protecting the financial interests of transferors and third parties in case of a transfer:

- A 'compensation scheme order', relating to transferors' compensation.
- A 'resolution fund order', relating to the right for transferors to become entitled to the proceeds of any disposal of assets transferred in specified circumstances and to a specific extent;
- A 'third party compensation order' for compensation to be paid to persons other than transferors.

Section 50 provides that in case of a sale to PSP, the treasury must make a compensation scheme order. This Order may include a third party compensation order.

Section 51 requires that in the case of a transfer to temporary public ownership the Treasury must make a resolution fund order (which may include a compensation scheme order) or a compensation scheme order. In both cases, the order can include a third party compensation order.

Section 52 requires the Treasury to make a resolution fund order (which may include a third party compensation order and a compensation scheme order) in the case of the Bank of England exercising the bridge bank stabilization option.

In case of a partial transfer of property, section 60 of the Bill provides that

a third party compensation order shall ensure that if the 'resco' enters an insolvency procedure following such a transfer, the objective of "no creditor worse off" (TPCO) is respected. Under this principle, pre-transfer creditors shall not receive less favourable treatment than would be the case in an insolvency procedure prior to a partial transfer.

This process consists of calculating the result of a whole-bank insolvency for the creditor, and comparing it with the actual dividend payable to the creditor after the partial transfer.

The calculation can be determined by an independent accountant. His independence and powers are granted by the Bill conditions set in Clause 54-56.

On the basis of the Banking Act, the Banking act 2009 (Third party Compensation Arrangements for Partial Transfers) Regulations 2009 was presented to Parliament on the 20th February 2009.

11.Sources of compensation set by the Banking Act 2009

Section 61 of the Act confers power on the Treasury to make a provision as to who should pay compensation under a compensation scheme order, resolution fund order or third party compensation order.

Provision can be made for the FSCS, the treasury or another person (a purchaser for example) to pay compensation.

12. Procedure

The procedure for a compensation scheme order, a resolution fund order

and a third party compensation order is that they must be made by statutory instrument subject to the draft affirmative procedure.

e) Code of practice

Section 6 of the Banking Act 2009 requires the Treasury to consult with the FSA, the Bank of England and the FSCS in order to issue a Code of practice that was to be laid before Parliament as soon as possible following issue.

The Code was laid before the Parliament on the 23th of February.

It provides guidance as to when and how British fiscal authorities shall use the tools they were given by the Banking Act 2009.

During the consultation, stakeholders had expressed the opinion that a non-statutory instrument was not sufficient in order to address their concerns about loss of certainty.

The Government responded that their concerns on this point were already addressed by the safeguards for netting, security and structured finance, and by the fact that the Banking Act would allow scope restrictions to be made by secondary legislation.

The Code laid before the Parliament on the 23th February declares how:

"In accordance with section 5 of the Act, this Code sets out:

"-how the special resolution objectives are to be understood and achieved;

-the choice between different resolution options;

-the information to be provided in the course of a consultation under this Part (i.e. information to be provided as part of any consultation between the Authorities and the giving of advice between one authority and another);

-the giving of advice by one relevant Authority to another about whether, when and how the stabilization powers are to be used;

-how to determine whether Condition 2 in section 7 is met (this condition stipulates that, before a banking institution can be placed in the SRR, the FSA must have determined that it is not reasonably likely that action will be taken by or in respect of the institution that will enable it to satisfy its threshold conditions);

-how to determine whether the test for the use of stabilization powers in section 8 is satisfied (i.e. how the Bank of England will determine the public interest test for the use of the bridge bank and private sector purchaser stabilization options will be satisfied);

-sections 63 and 66 (general continuity obligations); and

-compensation."