

# THE BANKING ACT: THE NEW “SPECIAL RESOLUTION REGIME” FOR DEALING WITH FAILING BANKS AND ITS LEGAL CONSEQUENCES

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*In this article, the authors focus on the Banking Act as it relates to the “Special Resolution Regime” for failing banks, and the “Safeguards” and “No Creditor Worse Off” orders. The Banking Act has created a flexible regime for resolving problems associated with failing banks, although it has introduced a degree of legal uncertainty. However, according to the authors, the key set-off and netting concerns have been addressed and as such the regulatory capital impact, and the impact on structured finance transactions, will not be as great as was initially feared.*

On 21 February 2009 the Banking Act (the “Act”) became effective as law. Also on 21 February, the statutory instruments dealing with safeguards for partial property transfers (the “Safeguards Order”) and “no creditor worse off” provisions (the “NCWO Order,” together with the Safeguards Order, the “Orders”) came into effect.<sup>1</sup> Together, these replace the temporary special resolution regime set up in the wake of the Northern Rock rescue.

The initial draft bill and delegated legislation caused major concern in the

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City — as originally drafted, they would have undermined legal certainty for set-off, netting and repo arrangements, and secured and structured finance. The Act and Orders go some way to allaying those initial fears. However, the Act gives to the Treasury, Bank of England and the FSA sweeping powers to transfer securities and bank property, rights and liabilities and to amend the law.

This article concentrates on the Act as it relates to the “Special Resolution Regime” (“SRR”) for failing banks, and the Orders. The Act also introduces, or permits statutory instruments to be put in place to introduce, new administration and insolvency regimes for banks, insolvencies of investment institutions holding client assets, the Financial Services Compensation Scheme, financial collateral arrangements, Bank of England oversight of inter-bank payments systems and various other areas.

## MAIN PROVISIONS OF THE SRR

The SRR exists “to address the situation where all or part of the business of a bank has encountered, or is likely to encounter, financial difficulties.”<sup>2</sup> The Act defines a “bank” as a UK institution i.e. one incorporated or formed in any part of the UK, which has permission under Part 4 of the Financial Services and Markets Act (“FSMA”) to accept deposits. The SRR also, with necessary modifications, applies to building societies (for ease, in this article, the reference will be to “banks”).

The SRR provides for three pre-insolvency “stabilisation options” to be applied to such a bank:

- Transfer of all or part of a bank’s business to a private sector purchaser;
- Transfer of all or part of a bank’s business to a bridge bank; and
- Transfer of a bank into temporary public ownership.

These can be achieved through certain specified means, such as the transfer of some or all shares in the bank (i.e. transferring ownership interests in the bank), or in some cases its holding company, and the transfer of some or all of the bank’s property, rights and liabilities to a relevant transferee.

These tools are designed to give the “Tripartite Authorities” (the Trea-

surey, the FSA and the Bank of England) the power to intervene in the business of a failing bank at a pre-insolvency stage and attempting to achieve an orderly resolution to its problems.

## WHEN DO THEY APPLY?

The Act provides that the stabilisation options may be exercised only when various preconditions or circumstances are met. These are, that the FSA is satisfied (a) that the bank is failing, or is likely to fail, to satisfy the threshold conditions set out by the FSA to permit it to carry on regulated activities; and (b) that it is not reasonably likely that other action will be taken to enable it to satisfy those threshold conditions.

Attempts were made by interested parties in their submissions to the Public Bill Committee and by members of the House of Lords to tighten the trigger thresholds (e.g. to "highly likely" to fail rather than just "likely"). The Act did not adopt those proposals.

## THE TOOLS OF THE SRR

### Share Transfer Instruments

Share transfer instruments or orders can have extremely sweeping effects. They can cover not only shares but also a wide range of other securities including bonds, loan stock, warrants and hybrid instruments.

A share transfer *instrument* may be made by the Bank of England for the purposes of selling all or part of the business of a bank to a private sector purchaser.

A share transfer *order* is the means by which the Treasury takes a bank into temporary public ownership (i.e. the transferee is a nominee of the Treasury, or a company that is wholly-owned by the Treasury).<sup>3</sup>

Share transfer instruments or orders can provide that any such securities be transferred by the holder to the person the Bank of England or the Treasury designates as transferee, "*despite any restriction arising by virtue of contract or legislation or in any other way,*" including any consents or lack of capacity, and "*free from any trust, liability or other encumbrance.*"<sup>4</sup> The securities can

also, or alternatively, be converted from one class to another (e.g. the Bank of England could provide for bonds to be converted into shares).<sup>5</sup>

Moreover, a share transfer instrument or order can include a “Contractual Disregard” provision under which any or all “events of default” in any contract (or other contractual consequences) that would arise on such a share transfer be disregarded.<sup>6</sup> For example, if a bank is a borrower and the loan agreement has a “change of control” event of default, this could — and most likely will — be disappplied by a share transfer instrument or order. The rationale for this is that a share transfer which triggered a series of events of default (either in its own right or through the operation of cross-defaults) could cause serious drainage of a bank’s assets at exactly the time when the SRR is trying to create stability in respect of that bank.

Such Contractual Disregard does not just relate to provisions in contracts to which the bank is a party, but also to contracts *between third parties*. So, for instance, if a credit default swap has a bank’s bonds as reference obligations, and an event of default occurs under those bonds, the Bank of England or the Treasury (as applicable) can provide that it be disregarded as a “credit event” under the credit default swap, notwithstanding what the CDS documentation may provide. This concern was raised explicitly by ISDA in its response to the Treasury’s consultation<sup>7</sup> and by Baroness Noakes in the House of Lords.<sup>8</sup> Lord Myners’ response for the government in that debate did not answer her question on this precise point. As a result we have to assume that credit events triggered by a default in respect of a reference obligation may be overridden by a share transfer instrument or order under the terms of the Act.

## Property Transfer Instruments

Property transfer instruments<sup>9</sup> provide that some or all of the property, rights, and liabilities of a bank be transferred to a private sector purchaser or to a bridge bank.

“Partial property transfers” arise where a property transfer instrument is made in respect of *some but not all* of a bank’s property, rights or liabilities. The prospect of partial property transfers initially caused major concern in the market for the viability of secured financing, set-off and netting arrangements, and for bank creditors generally.

For example, people were concerned that a property transfer instrument might transfer only the most valuable assets of the bank to a third party, leaving just poor quality assets and all the liabilities in the residual bank. Alternatively, the mutuality of debts and credits that set-off arrangements rest on could be disrupted if the bank's assets but not its liabilities were transferred to a separate entity.

It is to provide some protection against these outcomes that the NCWO Order and the Safeguards Order have been implemented, as discussed below. Clearly, where the whole of a bank or its business is transferred, all rights and liabilities remain with the one institution, so these concerns do not arise.

Property transfer instruments can include property located outside the UK or rights and liabilities arising under foreign law. In respect of this foreign property, each of the transferor bank and the transferee are required to take whatever steps are necessary to ensure the effectiveness of the transfer under the applicable foreign law, and until such time as the transfer is effective under foreign law, the transferor bank must hold the property to the benefit of the transferee.<sup>10</sup>

As with share transfers, any property transfer or partial property transfer can include Contractual Disregard provisions so that any or all "events of default" (or other contractual consequences) that would arise on such a transfer in any contract may be disregarded.<sup>11</sup> The same concerns in respect of credit default swaps and like instruments as set out above would apply here also, although in relation to partial property transfers the Safeguards Order gives special protection to set-off and netting arrangements, as discussed below.

## **HOW WILL THIS AFFECT SET-OFF, NETTING, SECURED LOANS, AND OTHER STRUCTURED FINANCE ARRANGEMENTS?**

Sections 47 and 48 allow the Treasury to provide for certain bank-counterparty arrangements to be "protected" from the disruption that might otherwise result from partial property transfers.

As the market recognised, partial property transfers could have seriously jeopardised the position of a party lending to a bank on a secured basis (e.g. if a valuable charged asset is transferred to a third party free of the charge, but the liability remains with the transferor), and potentially would have allowed

“cherry picking” of rights and other assets to transfer, undermining netting or set-off arrangements.

## The Safeguards Order

The Safeguards Order represents a considerable step forward in providing safeguards for set-off, netting and repo arrangements, structured finance arrangements and covered bonds, compared to the draft order that was put forward by the Treasury in November 2008. The changes made from the November draft clearly reflect some of the responses from various city institutions (e.g. BBA, LIBA, City of London Law Society, ISDA) during the consultation phase, as well as input from the Expert Liaison Group. However, there are weaknesses in the drafting of parts of the Safeguards Order, which render its scope and effect uncertain.

The Safeguards Order provides the following protections against disruption under partial property transfers:

***Where a person and a bank have entered into a set-off, netting or “title transfer financial collateral arrangement,” all rights and liabilities under that arrangement have to be transferred, or none at all***<sup>12</sup>

This is, in other words, an anti-cherry-picking provision, consistent with the requirements of an ISDA Master Agreement. In addition, the Contractual Disregard provisions cannot be applied to set-off, netting or title transfer financial collateral arrangements relating to “relevant financial instruments” (meaning deposits, loans, bonds, debentures, transferable securities and, basically, the majority of derivatives contracts).<sup>13</sup>

However, there are a series of rights and liabilities which are excluded from this protection. These are:

- Retail deposits and retail liabilities;
- Rights which relate to the person or the bank’s subordinated debt; and
- Rights which relate to a contract which was entered into by or on behalf of the banking institution otherwise than in the course of carrying on of an activity which relates solely to relevant financial instruments.

Retail deposits and liabilities are excluded on the basis that the flexibility to include them in a partial property transfer in the interests of preserving banking continuity must be maintained.<sup>14</sup>

The second carve-out, related to bank subordinated debt, is aimed at preventing subordinated debt from being available for set-off in circumstances which could in effect make it "senior" to other debt of the bank.

The third carve-out, like the first, is intended to ensure that the protection intended to be given by the Safeguards Order to the financial markets does not inadvertently prevent the partial property transfer from including rights and liabilities incurred in the ordinary course of the bank's business outside the financial instruments, deposits and loans areas — the view being, that the transfer of these ordinary course rights and liabilities may be essential to banking continuity.

There is considerable uncertainty and concern in the marketplace due to the drafting of the definition of "excluded rights" in the Safeguards Order. As drafted, netting arrangements are protected where they relate to a contract, "entered into...in the course of carrying on an activity which relates solely to relevant financial instruments."<sup>15</sup>

The use of the word "solely" is problematic, as it suggests that a single transaction which fell outside of this safeguard would invalidate an entire netting agreement covering possibly hundreds of other protected transactions: a problem characterized by ISDA as, "one bad apple spoils the whole barrel."<sup>16</sup>

The use of the phrase "carrying on an activity" is uncertain in its scope and potentially could be interpreted very widely, such that even if the contract related solely to relevant financial instruments, if the related "activity" of the bank included entering contracts which were not protected, all contracts would fall outside the protection. This extreme outcome cannot have been the government's intention, thus, we suggest that an amendment to the Safeguards Order to clarify the scope of this exemption and removing — or restricting — the "one bad apple" risk would be a welcome response.

### ***Secured lending to banks and by banks is also protected from disruption***

No partial property transfer can transfer assets over which a bank has granted, or has the benefit of, security without transferring the relevant li-

ability (and vice versa). This includes floating charges over all or substantially all of a bank's assets.<sup>17</sup> The only carve-out to this is if the secured lending arrangement has been entered into by the bank in breach of any rules promulgated by the FSA under FSMA.

***Capital markets arrangements to which the bank is a party are also safeguarded***

As with secured financing, no partial property transfer can transfer some but not all of the rights and liabilities which are or form part of such a capital market arrangement. This specific safeguard arose as a result of respondent requests in the Treasury consultation. The definition of a "capital markets arrangement" is that used in the context of the capital markets exemption from the bar on appointing administrative receivers (Schedule 2A Insolvency Act 1986). However, arrangements relating to the rights and liabilities in respect of deposits (not just retail deposits) are excluded from this protection.

***"Clearing house" contracts***

"Clearing house" contracts (that is, contracts connected with recognised investment exchanges or clearing house or default rules in respect of the same<sup>18</sup>) are also protected from any partial property transfers which might otherwise render them invalid.

**OTHER PROVISIONS OF THE ACT**

**"No Creditor Worse Off"**

Section 60 permits the Treasury to make regulations to provide compensation for creditors of a residual bank, the assets of which have been transferred to a bridge bank or other entity. In doing so the Treasury has to have regard to the desirability of ensuring that those creditors are not in a worse position than they would have been had the original bank been wound up, rather than any of the stabilisation measures put in place. The challenge of course lies in valuing what these creditors would have recovered in a hypo-



thetical liquidation. The NCWO Order sets out the process for appointment of the independent valuer and a series of mandatory and optional principles he must apply when making the valuation. Nevertheless, any such valuation is going to be an inexact process.

### **Power to Amend Law**

Section 75 contains a sweeping permission for the Treasury to “by order, amend the law for the purpose of enabling the [stabilisation] powers to be used effectively, having regard to the special resolution objectives.” It excludes the power to make any amendment to the Act itself or subordinated legislation passed under it (a qualification which was not included in the first drafts of the bill). In Parliamentary debates, the government made it clear that this power was simply to override legislative provisions which prevent the SRR operating effectively in a timely fashion. Considerable debating time was also taken up by the fact that the Act permits the Treasury to make such orders without Parliament approving them first, and also that such orders can apply retrospectively if the Treasury considers it “necessary or desirable.” Notwithstanding spirited opposition in the House of Lords to the principle of retrospective lawmaking and the exercise of such power where it is merely “*desirable*” (i.e. not just “necessary”), the government maintained that the flexibility that these provisions would provide was required given the potentially fast-moving emergency situations in which the SRR powers could be used.

### **Treasury Support for Banks**

The Act makes specific provision for the Treasury to provide urgent financial support for banks out of the Consolidated Fund; and that although the Treasury must disclose this in a report to Parliament, “if the Treasury think it necessary on public interest grounds, they may delay or dispense with a report [to Parliament].”<sup>19</sup> The logic of this is to prevent the kind of public panic seen in respect of Northern Rock once it emerged that the government was seeking to provide financial support. By retaining the right to keep such support private, the government hopes that it can in the future be provided in a more orderly way. Clearly that could be so in respect of unlisted institutions

or ones wholly nationalised, but for publicly-quoted companies this would not obviate any stock exchange disclosure requirements so may well prove to be of limited value at points where it is needed most.

## Registration of Certain Charges by Banks

Section 252 disapples the Companies Act requirement to register charges at Companies House in respect of charges granted by banks to the Bank of England, the ECB or central banks. The rationale for this is that such security may be granted by a bank to support central bank/ECB liquidity advances to it, potentially including advances of an emergency nature. Disclosure of this through a Companies House registration may be prejudicial to the bank borrower and so discourage take-up of such liquidity.

## CONCLUSION

The Act has created a flexible regime for resolving problems associated with failing banks, although it has introduced a degree of legal uncertainty. However, it is broadly felt that, through the Orders, the City's key set-off and netting concerns have been addressed and as such the regulatory capital impact, and the impact on structured finance transactions, will not be as great as was initially feared.<sup>20</sup>

## NOTES

<sup>1</sup> The Banking Act 2009, The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 and The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009, respectively.

<sup>2</sup> Section 1(1). All section references are to sections of the Act.

<sup>3</sup> For share transfer instruments, *see* Sections 11(2)(b) and 15; for share transfer orders, *see* Sections 13(2) and 16.

<sup>4</sup> Sections 17(3) and (5).

<sup>5</sup> Section 19.

<sup>6</sup> Section 22.

<sup>7</sup> Letter from ISDA to the Treasury Banking Reform Team, 9 January 2009.

<sup>8</sup> HL Debates, 9 February 2009, Column 963 ff.

<sup>9</sup> Sections 33 ff.

<sup>10</sup> Sections 39(2), (3) and (4).

<sup>11</sup> Section 38.

<sup>12</sup> Safeguards Order, Article 3.

<sup>13</sup> Safeguards Order, Article 9. ISDA, in a letter to the Treasury dated 27 February 2009 drew urgent attention to the fact that — because the Safeguards Order definition of “financial instruments” is based on the definition used in European Directive 2004/39/EC (“MIFID”) — certain types of derivative transactions might fall outside of the safeguard (such as spot and forward foreign exchange contracts, OTC bullion contracts, certain OTC physically-settled commodity transactions, and certain contracts for differences referencing non-MIFID instruments).

<sup>14</sup> See the Treasury consultation paper “Special Resolution Regime: Safeguards for Partial Property Transfers,” November 2008, at paragraph 2.13.

<sup>15</sup> Safeguards Order, Article 1 (3).

<sup>16</sup> Letter from ISDA to the Treasury, 27 February 2009.

<sup>17</sup> Safeguards Order, Article 5.

<sup>18</sup> Safeguards Order, Article 7. The applicable definitions are: “default rules”: per Section 188 Companies Act 1989; “market contract”: per Section 155 Companies Act 1989; “recognised clearing house” and “recognised investment exchange”; per Section 285 FSMA.

<sup>19</sup> Section 228.

<sup>20</sup> In this regard one should note Fitch Ratings’ comment of 19 February 2009, “Impact of the UK Banking Act 2009 on Structured Finance and Covered Bond Ratings.”