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Clients&FriendsMemo

The Banking Act 2009: Counterparty Rights and Insolvent Banks

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Historically, the United Kingdom has not had a specialised bankruptcy regime for dealing with the failures of financial institutions. Rather, these were handled under the same rules that applied to ordinary corporations. By contrast, the United States has had a number of different specialised bankruptcy regimes, including (i) the Federal Deposit Insurance Act of 1950 ("FDIA")[1] provisions that apply to banking organisations; (ii) the Securities Investor Protection Act provisions that apply to broker-dealers; and (iii) the Commodities Exchange Act provisions that apply to futures commission merchants. As a general matter, the specialised United States insolvency regimes have worked fairly well, as witness the reasonably smooth transfer of the futures business of Refco and Lehman Brothers Inc., and the recent forced transfer or liquidation of a number of US banking institutions. By contrast, the lack of a specialised regime in the UK has seemed problematic, as recent events have demonstrated in the case of Northern Rock and others. As a result, the UK has moved to adopt a specialised regime that would deal with the failure of banking institutions.

The UK Banking Act 2009 (the "Act") received Royal assent on 12 February 2009 and came into force on 21 February 2009. The Act formalises and refines the temporary provisions of the Banking (Special Provisions) Act 2008, which was used to bring Northern Rock into temporary public ownership in February 2008, as well as to address the possible collapse of Bradford & Bingley in September 2008 and the UK subsidiaries of two Icelandic banks in October 2008.

The new Act has potentially great significance not only for depositors and other creditors of institutions, but also as to derivative and financing counterparty contractual rights of set-off and netting, counterparty security interests and structured finance transactions.

The main purposes of the Act are:

- to establish a permanent "special resolution regime" that enables the Tripartite Authorities of the Financial Services Authority ("FSA"), Bank of England ("BoE") and the UK Treasury ("HMT") to deal with a failing bank in order to keep part or all of the failing bank in business

[1] Pub. L. No. 81-779, 64 Stat. 873 (1950) (codified as amended at 12 U.S.C. §§ 1811-35a).

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using three options: (i) transfer to a private sector purchaser; (ii) transfer to a "bridge bank"[2] (a bank organised to assume the assets and liabilities of an insolvent bank); and (iii) transfer to temporary public sector ownership;[3]

- to put in place a new bank insolvency procedure to deal with the termination of a failing bank; and
- to put in place a new bank administration procedure for use where there has been a partial transfer of business from a failing bank.

1. Special Resolution Regime ("SRR")

As stated above, until the adoption of the Act, the UK had not had a permanent statutory regime specifically tailored to dealing with bank failures, but rather has dealt with any bank or financial institution failures under the general corporate insolvency regime. The Act puts in place a statutory regime: the SRR.

The SRR gives each of the FSA, the BoE and HMT "stabilisation powers" to transfer shares, other securities, property, rights and liabilities of a bank deemed to be failing (according to statutory criteria) but which is potentially worth rescue, in whole or in part, as a going concern. The transfer takes place by operation of law through the exercise of one of three "stabilisation options".[4]

The options apply to banks as defined in Part I of the Act, *i.e.*, banks that have permission from the FSA to take in deposits. That means that the SRR would **not** have been available to the Tripartite Authorities as a tool for intervention in the administration of Lehman Brothers International (Europe)

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[2] In the United States, the Competitive Equality in Banking Act of 1987 authorized the Federal Deposit Insurance Corporation ("FDIC") to establish bridge banks. 12 U.S.C. §1821(n).

[3] Any of the three options can be implemented by way of a partial property transfer or by a transfer of the entirety of the failing bank. A partial property transfer will leave behind a residual "bad bank", which could theoretically also be transferred to a bridge bank or temporary public ownership (or, improbably, sold into the private sector) or more likely put into administration and subsequently liquidated under the bank insolvency and administration regime (see below).

[4] The Act requires HMT to issue a code of practice covering the use of the stabilisation powers, the bank insolvency procedure and the bank administration procedure. That code can be viewed at http://www.hm-treasury.gov.uk/d/bankingact2009_codeofpractice.pdf.

In the United States, the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") mandated that the FDIC select the "least cost resolution" method – i.e., a resolution method that has as little impact on the federal deposit insurance fund as possible. 12 C.F.R. 360.1.

(which entered into administration in September 2008), as that was not a deposit-taking institution.[5]

The stabilisation options are:

(i) The BoE sells all or part of the business of the failing bank to a private sector purchaser either by a transfer of the shares and other securities issued by the bank, or by transfer of its property, rights and liabilities;

(ii) The BoE transfers all or part of the bank's business to a bridge bank, which may only be done through a transfer of the bank's property, rights and liabilities;

(iii) HMT takes the bank into temporary public ownership. The transferee may be either a nominee of HMT or a company wholly owned by HMT and the transfer may only be made through a transfer of shares and securities.

In all cases, the definition of "securities" issued by the bank is very broad, and includes shares and stock, debentures and warrants, as well as any other instruments that give their holders an entitlement to acquire securities and rights granted by the bank that form part of its own funds for the purposes of the Banking Consolidation Directive.[6]

2. Bank Insolvency and Administration Procedures

The Act's bank insolvency and administration procedures are based in the main on the existing compulsory liquidation procedures set out in the Insolvency Act 1986, *i.e.,* the entirety of the failing bank is to be put into liquidation, or an administrator is to be appointed to run the residual "bad bank" to assist the private sector or bridge bank purchaser of the "good bank". Bank insolvency and administration are therefore still to be undertaken at the instigation of the Court and subject to its supervision.

Once appointed by the Court, the bank liquidator or administrator must work to statutory objectives. In the case of liquidation, when the decision has been taken that the entirety of the bank has failed, these objectives are: (i) to work with the Financial Services Compensation Scheme to ensure that either depositors' accounts are transferred to another bank or compensation payments are quickly

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[5] That is not to say that the SRR and associated powers, including the power to make partial property transfers, apply to banks that only do deposit-taking business. UK banks may conduct, for example, broker-dealer business alongside banking business.

[6] See Section 1 of Chapter 2 of Title V of the Banking Consolidation Directive (2006/48/EC).

made to those eligible; and (ii) to wind up the failed bank in the interests of its creditors as a whole.[7] In the case of the administration of a residual "bad bank", the administrator must: (i) provide support to the bridge bank or private sector purchaser of the "good bank"; and (ii) once the first objective has been achieved, either resuscitate the bank as a going concern or achieve a better result for its creditors than an immediate liquidation.

The new feature of the regime is the ostensible rapidity of compensation payments by the Financial Services Compensation Scheme to eligible depositors, though this has of course yet to be tested.[8] Because of this, the new insolvency and administration procedures only apply to UK banks with eligible (retail) depositors.[9]

3. Partial Property Transfers and Set-Off, Netting, Security Interests and Structured Finance

The facility within the Act that gives the Tripartite Authorities powers to split a bank, effectively hiving off any healthy elements from the failing body, has raised fundamental concerns for counterparties (and potential creditors) of UK banks, to the extent that the British Bankers Association commented that:

> "We are aware of a number of large international banks that have raised with the tripartite authorities their belief that unless concerns expressed by the banking industry and the legal profession are taken on board then they would need to unwind current positions with UK banks to the tune of £hundreds of billions which would have an immediate disruptive effect on key UK financial markets."[10]

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[7] In the United States, the National Depositor Preference Amendment (Pub. L. No. 103-66, § 3001 (1993)) ("NDPA") established a standard creditor priority scheme for all FDIC receiverships. Under NDPA, claims against failed banks are paid in the following order: (i) administrative expenses of the receiver; (ii) deposits; (iii) other general or senior liabilities of the failed institution; (iv) subordinated obligations; and (v) shareholder claims.

[8] In the United States, the FDIC serves the role that the Act establishes for the Tripartite Authorities. The FDIC recently adopted a Final Rule requiring expedited processing of payments to depositors in the event of a large bank failure. *See Processing of Deposit Accounts in the Event of an Insured Depository Institution Failure*, 74 Fed. Reg. 5797 (Feb. 2, 2009). The new rule requires every bank with more than $2 billion in assets to establish systems able to place provisional holds on various classes of deposits in varying amounts and percentages as directed by the FDIC by 9:00 a.m. the day after failure. Banks must promptly provide the FDIC data about individual deposits in a standard format to enable the FDIC quickly to determine the amount of deposit insurance coverage to which each depositor is entitled.

[9] In the United States, no such distinction is made. The FDIC resolution regime applies to institutions that receive any of five categories of obligations deemed a "deposit" under the FDIA. 12 U.S.C. § 1813(l).

[10] "Banking Bill: Lords' Briefing" British Bankers Association 12 December 2008.

The fundamental question for counterparties is whether creditors of a bank which is subject to a partial transfer will be worse off than if the entire bank was liquidated? Tangentially, but equally importantly, under an SSR that allows the Tripartite Authorities to override contractual and other legal rights, there are a number of fundamental questions for counterparties of UK banks:

(i) Can the administrator or liquidator of a failing UK bank set aside contractual rights of set-off and netting, properly perfected security interests and rights over associated collateral?[11]

(ii) Can the administrator or liquidator cherry-pick the good contracts to push into the new, healthy bank?[12]

(iii) What happens to commercial and legal certainty? Will counterparties be able to obtain the definitive legal opinions they need in order to be able to enter into transactions?

(iv) Will counterparties be subject to prohibitive regulatory capital requirements – will they be required to account for the exposures to UK banks on a gross rather than a net basis? Will capital costs increase because counterparties require higher risk premiums from UK banks?

In an attempt to address these issues, two pieces of delegated legislation also came into force on 21 February 2009:[13] (i)the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the "Restriction Order") and (ii) the Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009 (the "No Creditor Worse Off Order").[14]

Set-Off and Netting The Restriction Order prohibits the transfer of some but not all protected rights and liabilities under particular set-off, netting and title transfer financial collateral arrangements. Partial property transfers may not modify or terminate these protected rights. This is subject *inter alia* to carve outs for retail contracts, rights relating to a claim for damages or under an

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[11] In the United States, while the FDIC has the authority to repudiate contracts selectively, that right does not extend to prohibiting the exercise of any right to offset or net out any termination value, payment amount, or other transfer obligation arising under any "qualified financial contract", including any master agreement. 12 U.S.C. 1821(e)(8)(A)(iii).

[12] In the United States, the FDIC must transfer to a single substitute institution all "qualified financial contracts" of each counterparty (or its affiliate) of the failed bank, as well as all claims under such contracts and all property securing or other credit enhancements for such contracts or claims. 12 U.S.C. 1821(e)(9)(A).

[13] For a discussion of the options for safeguards for partial property transfers, see also "Special resolution regime: safeguards for partial property transfers" HM Treasury, November 2008.

[14] SI 2009 No. 322 and SI 2009 No. 319.

indemnity and subordinated debt. The Restriction Order is a compromise from earlier proposals for carve outs, which had included own-issued securities.[15]

Secured Liabilities: Partial property transfers may not transfer the liability without also transferring the benefit of the security. This protection covers all security interests, including floating charges.

Structured Finance: The Restriction Order prohibits the transfer of some but not all of the property, rights and liabilities that form or are part of a "capital market arrangement". The definition of "capital market arrangement" used in the Order is that of the Insolvency Act 1986,[16] which is a broad definition that captures securitisations and covered bond issuances. It is not yet clear whether this definition is sufficient to cover all that can be called "structured finance". In addition, the carve out is silent as to any trustee or servicing functions performed by the failing bank in relation to capital market arrangements.

No Creditor Worse Off Order: This requires a calculation to be made by an independent valuer of the outcome of a whole-bank insolvency and the resulting creditor dividend to be paid out at the end of the insolvency process. This dividend would then be compared to the actual dividend payable to creditors of the residual, failed part of the bank, and any shortfall made good under a Third Party Compensation Scheme Order. Issues of fair value are inevitable, even when calculated independently, notwithstanding the recent defeat at first instance of Northern Rock shareholders disputing the value attached to their shares in the nationalisation of that bank.

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[15] In a letter to HM Treasury of 27 February 2009, the International Swaps and Derivatives Association, Inc. ("**ISDA**") raised two concerns over the scope of the protections for set-off and netting arrangements: (1) because of the use of particular definitions, arrangements involving spot and forward foreign exchange, certain OTC bullion options, certain OTC physically-settled commodity transactions and certain contracts for differences are not covered; and (2) ISDA is concerned that the drafting of the carve-outs from these protections (see part (c) the definition of "excluded rights" at Article 1 of the Restriction Order) operates to deprive any master netting agreement of the safeguards if it includes a single transaction that is not covered by that Order, including those mentioned above.

[16] See Schedule 2A of the Insolvency Act 1986.

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